FOR RELEASE ON DELIVERY
MONDAY, OCTOBER 22, 1979
3 P.M. MDT (5 P.M. EDT)

ECONOMISTS AND INFLATION

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at a meeting sponsored by

Boise State University

Boise, Idaho

Monday, October 22, 1979

ECONOMISTS AND INFLATION

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at a meeting sponsored by

Boise State University

Boise, Idaho

Monday, October 22, 1979

Few economists, disagree as we may on many issues, today would quarrel with the proposition that our profession has much to be modest about. Many of our forecasts have gone wrong. Some of the laws and rules of economics upon which we used to rely seem to have lost their dependability. Much of our advice has been less than helpful, and we failed to come up with good solutions for urgent problems.

Inflation more than any other problem has been the prize exhibit for the failure of conventional economic wisdom. Inflation today is widely regarded as the nation's number one problem. In this talk, I propose to inquire into the attitude of economists with respect to inflation, and into the remedies that they propose. The short answer, I regret to report, will be that mainstream or "orthodox" economists in the past have only too often been very little concerned about inflation, have contributed much to bringing it about, and have limited their policy advice to finding difficulties for every solution. These attitudes, which, of course, I would not impute to any individual economist, are deeply rooted in the history of economics and in present concepts and values of mainstream doctrine. I shall begin, therefore, with a look at history.

Taking Money for Granted

During much of recorded history, monetary disorder of one form or another has been the common lot of mankind. In the early days, familiar examples included instances of gold, silver and copper coins minted, reminted, debased, and clipped by sovereigns or their subjects. This was followed, later on, by paper currency circulating at varying depreciated values, with occasional major inflations and sometimes total loss of value. Gradually, techniques were discovered to make money a more reliable means of making payment and of storing value. Central banks were created, monetary rules established, and norms developed to control the financial conduct of governments. Gold convertibility and balanced budgets played major roles in securing these arrangements. With the aid of such principles, countries came to have monetary systems much as they came to have transportation systems, which were reasonably reliable and could be expected to keep prices stable.

A new generation of economists forgot, if indeed they ever knew, the difficulties that their predecessors had experienced in arriving at a serviceable monetary system. They began to take the existence and proper functioning of the system for granted. They expected it to be able to take any amount of strain and abuse, through overexpansion, through violation of the built-in safety features, through diversion to purposes for which it had not been designed. The gold standard was cast out as a "barbarous relic." Reserve requirements against central bank liabilities, designed to limit the monetary issue, were dropped. Limitations on government deficits were pooh-poohed. Warning signals flashed by incipient inflation were overriden.

All this could and did happen because mechanically the monetary system continued to function, even though its effects on production, employment, and prices often were very different from what they were expected to be. The need for repairs and maintenance was ignored. As a result, we have today a monetary system that is highly vulnerable and frequently unstable.

Removing the Veil of Money

Taking the monetary system for granted is not the only way in which economists have been trapped by their own past successes. A good part of classical economics was concerned with removing prevailing popular misconceptions, such as that money constitutes wealth. This came to be known as removing "the veil of money." The realization spread that the basic concern of economists had to be with production and employment, that, as Adam Smith put it, the wealth of a country is the product of its labor, and that prices are simply tickets stuck on real objects, whose relationship to each other, but not their absolute level, mattered for welfare. That is the intellectual vantage point from which an economist can say, with sovereign disdain, that it makes no difference whether wages are $10 a day and the price of bread 50 cents, or $100 a day with bread at $5. In an abstract sense, that is right. But the economist is wrong if he or she ignores the problems of the transition from the first price level to the second, popularly known as inflation.

The Supposed Benefits of Inflation

Inflation is something that can be engineered. At one time, it was fashionable to argue that engineered inflation could serve as an engine of economic growth. If businessmen borrowed heavily from banks to build factories, prices would tend to go up and consumption would be restrained. This would free some of the economy's output for investment. But output would grow faster as the new capacity came on stream. In the long run, therefore, everybody would benefit.

More recently, it has been the Phillips Curve which has served to justify the advocacy of inflation. It was argued that unemployment would be less if some inflation were tolerated. Labor would be promised a wage increase in excess of its productivity gains and this would increase the willingness to take jobs. The wage gain in excess of productivity, to be sure, would be eaten up by inflation so that labor would always get less than it had bargained for. But output and employment would increase, benefiting all, and labor was expected not to notice the deceit.

These gimmicks and devices have largely been relegated to the history of doctrines. The proposed techniques to employ inflation for constructive purposes do not work, because wages move quickly in response to changing prices, leaving no margin for the businessman or woman to invest and no reduction in unemployment except of the most transient sort. People have exchanged their money illusion for rational expectations. The result is inflation.

Micro Consequences of Inflation

The preoccupation of many economists with the macro effects of inflation -- employment, output, price level -- was facilitated and encouraged by the difficulty of coming to grips with its micro effects. The principal question here, of course, is who benefits, and who gets hurt. That question does not have an obvious answer. It is easy to say that people on fixed incomes or pensions get hurt, and that creditors are hurt while debtors benefit. But that does not pinpoint any particular individual or firm as a gainer or loser from inflation. How well an income receiver keeps up with inflation may depend on conditions in the industry, or on the forcefulness of the labor union. Whether a pensioner really loses depends on whether the pension is indexed. Moreover, most men and many women are also producers, and what benefits them under one hat may hurt them under the other. Finally, one family may have all its assets in the form of a home while another may have nothing but fixed financial claims.

The most extreme instance of victimization by inflation -- a retired consumer with an unindexed pension and all assets in fixed claims -- may be quite typical. But his opposite number -- a worker in a profitable industry affiliated with a powerful union and owning a home on credit -- does not seem particularly satisfied with his present lot either.

The principal conclusion economists have been able to draw from a study of the micro effects of inflation is that one cannot generalize. A person relatively well positioned may quickly find himself pushed in the opposite direction, through loss of job, retirement, changes in the fortunes of firm or union, or changes in legislation concerning indexing. The abiding fact is a pervasive insecurity as people become increasingly uncertain about their future position in this game.

Neutral Inflation

This difficulty of generalizing about the micro impact of inflation makes it convenient for the economist to focus on overall effects. When we cannot say who will gain and who will be hurt, the easiest conclusion is that on balance gains and losses will wash out. From a sufficiently high level of abstraction, the economist can claim that inflation is neutral with respect to welfare. It is simply a process of random redistribution of income and wealth. It differs in this respect from burglary, which, like inflation, is a form of redistribution not provided for by law but which, in the nature of things, may be presumed to redistribute from the upper to the lower income brackets. If inflation is widely referred to as "the cruelest tax," it is, unlike death and other taxes, a highly uncertain one.

Expected Inflation

Economics, it has been said, is simple but not easy. One perfectly legitimate way of making economic analysis a little easier is to assume that market participants have perfect foresight. Firms and households so endowed will make decisions, given their circumstances and prospects, that economists can predict. The analysis will be free from the confusion that would be introduced by people making mistakes about the future.

A modest subcase of perfect foresight is perfect foresight with respect to inflation only. Firms and households could easily be endowed with such foresight if the government were to announce a given rate of inflation and stick to it.

Some interesting conclusions follow from this assumption. In such an economy, everything could be expected to become indexed. All prices would rise by the general rate of inflation, plus or minus any individual increases or declines that particular products like wheat, steel, television sets might experience. Wages would rise by the rate of inflation plus whatever would be the particular increase in each industry in the absence of inflation. Interest rates would contain an inflation premium, and so forth. In fact, in this fully indexed economy everything would be the same as in a noninflationary economy except that people would hold less money, assuming that the government cannot find a way of indexing currency and demand deposits.

From this hypothetical construct it is only a modest step, at least for an economist, to postulate an economy where inflation has become stabilized <u>de facto</u> without specific government edict, and to argue further that this is the very economy in which we are now living provided the government would just take its hands off the inflation. The economist thus is enabled to conclude that the best thing for government is to ignore inflation. That will spare us the agony of wringing it out of the system.

In some respects, reality is sufficiently close to this construct to give it a superficial plausibility. Many wage contracts have cost-of-living adjustments (COLAs); interest rates contain an inflation premium; many public though few private pensions are indexed; many rent contracts have index clauses. Three things mainly are misleading about this picture:

First, few individual households or firms can be sure that their particular wage, product, price, interest, and so on will move with inflation. To know that this will happen on average is no assurance of survival.

Second, the government cannot really give assurance of a stable rate of inflation. Most of the beneficial effects that are claimed for inflation derive from accelerating rather than stable inflation. Most of the pressures that lead to inflation in the first place make for acceleration as time goes on. If the government did not have the strength to stop inflation when it was mild, how will it be able to hold it to a constant rate once it has become more virulent? Thus the notion of a stable rate of inflation, in the absence of government counteraction, is an illusion.

Finally, the picture of a fully indexed economy at the going rate of inflation is spoiled by the presence of numerous institutional and legal arrangements. Incomes raised by inflation move into higher tax brackets, and the tax system so far is not indexed. Interest received and paid, even though it contains an inflation premium, is fully taxable and tax deductible, respectively. The inflation premium, therefore, has a different value to taxpayers in different brackets. Increases in the price of assets, such as homes or equities that result purely from inflation, are nevertheless taxed as capital gains. Corporate profits are altogether distorted by inflation. In short, we do not have a fully indexed system with a stable rate of inflation. The government probably could not produce a stable rate if it tried, and the risk exposure of individuals and firms would remain high even if some overall inflation rate were stabilized.

The Lesser Evil

It would be unfair to accuse economists of ignoring altogether the evils of inflation. Now that early cries of "wolf" have revealed themselves as not unjustified, inflation is being seen more clearly as a dangerous cancer than in the past when only a few voices were crying about it in the wilderness. But while economists now predominantly regard inflation as an evil, many of them share with politicians the habit of always regarding it as the lesser of any two alternative evils. Bringing it down incurs the risk of a loss of output and of employment. Hence it is better not to fight it too hard. If holding inflation down means to forego some intrinsically desirable budgetary expenditure, it is always tempting to go for the expenditure. If anti-inflationary measures threaten to lose some particular block of votes, it is always cheaper to salvage the votes and hope that the inflation will not materialize.

In particular, inflation very urgently poses the choice between the short run and the long, and I do not see economists generally, as they ought to, coming out unambiguously in favor of the long run. Inflation confronts us with the choice between accepting a moderate amount of pain now or a much larger amount later on. The longer it is allowed to run, the more damaging it becomes, and the harder it will be to get it out of the system. As uncertainty mounts, businesses continue to go slow on investments. Output capacity lags, and so do available jobs. Consumer spending becomes increasingly speculative as people try to buy ahead to beat inflation. Consumer demand thus becomes increasingly unreliable as a basis for business expansion. All this argues for action that will strengthen the economy for the long run, even at some cost in the short run.

The Lure of "Potential"

Fighting inflation energetically may mean that the economy for some time may have to run below potential. This does not mean a permanent recession, but it probably does mean less rapid growth than would be possible if the economy were in good health. The prevailing cult of "potential" makes it very difficult for many economists to accept such a solution. This attitude gives "potential" a much more precise meaning than it deserves. The maximum that the economy can produce is not a well-defined number. If we were all prepared to work 9 hours a day instead of 8, obviously "potential" would rise dramatically. If, on the other hand, we cannot produce even at some seemingly moderate rate without overheating and threatening to destroy the economy, that "potential" obviously is not really within reach. Finally, if by mishandling the economy we reduce the rate of investment and slow the rise of productivity, we are assuring ourselves a future output level well below the potential that a higher rate of investment and productivity could have attained. Lamenting the loss of "potential" output keeps us from effectively acting against inflation.

International Complications

Our permissive attitude toward inflation reaches out into the international field. The old system of fixed exchange rates broke down largely because countries were unable or unwilling to keep their inflation under control. The new system of floating rates was advertised as permitting every country to enjoy the rate of inflation that it preferred. Now we find that a system of widely differing national rates of inflation produces large fluctuations in currencies which threaten to undermine our liberal system of international trade and investment. Freedom to choose one's preferred rate of inflation, an objective once dear to economists, has turned out to be a snare and delusion.

Conclusion

If it is true, as Keynes said, that the world is ruled by little else than the ideas of economists and political philosophers, economists must accept a heavy responsibility for the inflation and all its consequences that we now endure. Economists have downgraded the ancient anti-inflationary safeguards such as a balanced budget. They have greatly overstated their ability to manage the business cycle. The cult of growth and maximum exploitation of potential has undermined stability. The attempt to trade inflation against unemployment, on the theory of the Phillips curve, has been the most disastrous analytical and practical mistake in economics of the last 20 years. If economists had to run for re-election every two years, such policies would be understandable. For tenured academics who see the future stretching endlessly before them, this disregard of the long-run consequences of short-run expediencies is hard to understand.

A new generation of economists is now emerging that seems to see value in stability. It will take time until that value is universally recognized in my profession. Max Planck, the formulator of the quantum theory, once said that physics made progress from funeral to funeral. One would hope that with the evidence of past error so clearly before us, and in the interest of our own survival, we might progress faster in economics.

#