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POLICIES FOR 1982 AND BEYOND

Remarks by

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

at

Northern Arizona University's Sixth Annual Economic Outlook Seminar

Flagstaff, Arizona

Friday, October 23, 1981

SUMMARY

1. Some progress has been made in the fight against inflation, but some of the factors causing inflation remain deeply imbedded in our economy.

2. Many past practices need to be changed or modified, including over-generous indexing, three-year wage contracts, and the on-again off-again character of inflation fighting.

3. The tax deductibility of interest, which today implies deductibility of the inflation premium, needs to be reexamined.

4. Saving needs to be increased if investment and productivity are to be raised, and the principal means to that end is a reduction of the federal deficit, preferably through further expenditure cuts, but through action on the revenue side if necessary.

5. Federal Reserve policy must maintain a credible posture of monetary restraint.

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Our country is embarked on a great effort to turn the economy around, away from inflation, low productivity, excessive growth of government, and unemployment, and toward price stability, greater output, less public spending, and higher employment. These are urgent purposes. Our economy has too long gone in the wrong direction. Many parts of the program are already in place, although some are still missing. The Federal Reserve's monetary policy must bear an important part of the burden, but it should not bear it alone. We must be prepared for a long and strenuous job that will test our determination. We must draw strength from the realization that if we turn back, our troubles will multiply and the outlook will be somber.

Where We Stand

Before turning our eyes to the road ahead, let us review where we have been and where we now stand. The economy is in the grip of powerful inflation, which has been mounting for some 15 years. Only recently has inflation shown some signs of responding to the effort to bring it down. Economic growth over the same period has diminished, and productivity gains have become minimal. Unemployment is high, but it has been rising only modestly. In good part, however, this has been associated with the failure of output per hour to increase.

The overall condition of business in recent years has not been stable, but neither has it been exposed to prolonged fluctuations. We had a short and deep dip last year, which many people called a recession, followed by a rapid and strong upsurge lasting into this year. Since early in the year the economy has drifted along, with a slight downward tilt.

Interest rates are extraordinarily high, but are affecting different parts of our economy to very different degrees. Housing, the automobile business, many small businesses and farmers are suffering but some other sectors continue strong. The government has been absorbing an ever-growing share of the nation's income and this trend has only begun to be reversed. The dollar has depreciated against foreign currencies over many years but has had some recovery recently as new policies have taken hold.

Inflation

If we are to deal effectively with these problems, as I believe we are beginning to do, we need to ask ourselves why has this inflation been so intense and so stubborn? One answer, of course, is that we have not fought it with sufficient determination, perhaps because we did not realize fully the damage it was doing to productivity, to our financial institutions, and to our social fabric. Our historical experience, accumulated during the last 15 years, is that efforts to fight inflation are abandoned as soon as they begin to hurt. As a result, inflation has become an addiction. The effort to remove the drug causes withdrawal pains and unfortunately there is no methadone for inflation. Resistance to persistent application of the cure has been understandably great.

We have built inflation into the price system through indexing. The consumer price index, which is usually employed, is itself defective and at times greatly overstates inflation. In any event, however, when a country has suffered a loss in real income as the United States has because it now must pay around 3 percent of GNP for imported oil, it is simply not possible for everybody to be indexed and thereby escape his share in that loss.

In our wage setting, we have introduced the practice of three-year contracts which may be convenient to management and avoid some labor strife but is also very resistant to a slowing of wages and therefore prices. We see that corporations do not have the bargaining power, or the will, to stand up to union demands until profits threaten to disappear. We lack the social consensus that enables countries like Japan, Germany, and The Netherlands to engage in a more cooperative form of wage setting than ours. Low productivity gains have left very little margin for real wage increases.

We also have been confronted by the need to bring energy prices up to a level more conducive to conservation of energy. These are some of the circumstances that make the American brand of inflation particularly resistant to efforts to reduce it, but I believe that these efforts are beginning to bear fruit.

Finally, the government has mandated inflation in so many ways that to single out only a few of them would understate the gravity of the situation.

Productivity

Our low rate of productivity gains and consequently of economic growth have in large part probably been due to inflation itself. In part this has taken the form of low profits and cash flow, low saving, and low investment. Higher risk and severe economic distortions have contributed to inadequate capital spending. Government regulation has channeled investment into nonproductive uses or discouraged it altogether. Our technological lead in the world has diminished and in many cases has been converted into a lag, partly because of diminishing outlays for research and development. The rapid growth of the labor force, desirable, of course, by itself, has been accompanied by a decline in average skill levels as more inexperienced persons entered. Some of these impediments are now being attacked by action to deregulate the economy and free up markets. Some will yield to the maturation of the labor force as its demographic structure changes. Tax law changes have created the conditions for a great increase in business saving and for its translation into investment once the government's need for borrowing has been reduced.

The Government's Share

Why has the government in the past taken so large a share of our income and output? Why does the present effort to reverse this baleful trend encounter such obstacles? It is easy enough to say that a lot of legislated government programs are swollen by fraud and mismanagement. I doubt that this is the principal reason. The trouble is not so much with the fraud as with the law. We have legislated too many benefits that we cannot afford. The one good reason for any "entitlement" that I can see is that somebody has paid for it or performed a service to obtain it. Everything in excess of that or aside from that should be made dependent on whether the budget can stand it. We did not consider ourselves a poor country ten years ago, yet our government expenditures were very much more modest. Why should it be inappropriate or unreasonable to move back in the direction of what was once regarded as adequate, when it is clear that we are not willing to pay for these things except by the destruction of our currency?

Regulation

Why has the United States, the land of the free, become what seems to be the most regulated economy this side of the Iron Curtain? Every regulation has some good purpose, but each one tightens the ropes threatening to strangle the economic giant which is our country. Few businessmen can know all the regulations that they must observe. None can be sure he will not be taken to court for some unintended violation. Large firms survive with the help of armies of attorneys; small ones may be driven out of business because they cannot afford either the risk or the attorney.

Interest Rates

Why, finally, are interest rates so high? There was a time, when prices were stable, when the Federal Reserve could control interest rates, within reasonable limits. That time is gone. Today interest rates are determined mainly by inflation. Wherever efforts have been made to hold down interest rates, through Regulation Q for small savers, through usury limits for small borrowers, inflation has defeated these efforts and raised interest rates to a level that lenders must charge to protect their capital and borrowers can afford because they will repay in depreciated currency.

The Federal Reserve can influence interest rates, at least in the money market, only for short periods. Regarding long-term rates, even such brief influence may no longer be possible. We have just seen short-term rates come down somewhat but long-term rates going up. What the Federal Reserve can do in the short run is to influence economic activity. That will temporarily influence interest rates. But unless the inflation abates, interest rates will not come down durably. Only if the Federal Reserve, hopefully supported by fiscal policy and other government policies, succeeds in reducing inflation will interest rates come down lastingly. Any attempt of the Federal Reserve to bring them down by feeding more reserves into the banks and more money into the economy is bound to rekindle inflation. In the extremely sensitized state of the markets, the consequences would not be slow to appear.

There are other factors, however, that bear on the level of interest rates. I shall mention three of them: the fact that all interest is tax deductible, the low volume of saving in our country, and the large federal deficit.

Reduce Tax Deductibility?

The tax deductibility of interest makes sense when prices are stable and the nominal interest rate equals the real rate, which is nominal interest minus inflation. Even then, one may have legitimate doubts as to whether consumer interest should be deductible. In most other countries, it is not, and usually even mortgage interest is not deductible. But in times of inflation, the interest rate contains an inflation premium which the borrower pays to the lender to compensate him for eventual repayment of the debt in depreciated currency. Since the borrower's debt burden declines with inflation, the inflation premium is the economic equivalent of debt amortization. Nowhere in the tax code is it written that debt amortization payments are tax deductible. Nevertheless, when inflation takes over and converts part of the interest into the economic equivalent of amortization, we continue to call it interest and continue to deduct it. The borrower, therefore, is able to pay a higher interest rate than he could if the inflation premium were separated from the real interest and made nondeductible.

For the lender, the shoe is on the other foot. He has to pay income tax, where applicable, on the inflation premium as well as on the real interest. In other words, he pays tax on the repayment of his loan. No wonder, therefore, that he tries to protect himself, usually without full success, by charging a higher rate. One step, therefore, toward a reduction of interest rates in conditions of inflation would be to end the deductibility and taxability respectively of the inflation premium. While borrowers may not welcome this message, they should bear in mind that interest rates would be lower if such a tax reform were enacted. In any event, a reform of this order could only be introduced gradually.

Low Saving

A second structural factor that affects our level of interest rates is the low saving rate in our country. Consumers and unincorporated businesses save an average 4-6 percent of their disposable income, or recently about $100 billion. Corporations save about $55 billion net after depreciation allowances and dividends. Another $30 billion derives from the state and local and foreign sectors. This adds up to net saving of about $185 billion, equal to about 6 percent of GNP, of which the government borrows at present close to one-half to meet its deficit and its off-budget needs. What is left for net new investment by businesses and consumers is very modest, even making allowance for the over-simplification inherent in these figures. It is not surprising that competition between government and the private sector for this pool of saving tends to keep interest rates high. In other countries, such as Germany and Japan, the scarcity value of savings is much less because they save more.

Dealing with the Deficit

The federal deficit is a third cause of high interest rates. Of the three causes I am mentioning, I believe the deficit is both the most immediate and also the one least difficult to remove. We have already instituted an expenditure cut the likes of which had not been seen before. But so far the benefits of this cut are overwhelmed by the prospective revenue loss from multi-year tax cuts. Even though the incentive effects from personal and particularly business tax cuts may eventually turn out highly constructive, they will take time to materialize. The President has already proposed new expenditure cuts of $13 billion. But the budget deficit for fiscal 1982, as evaluated by the Congressional Budget Office, is likely to be on the order of $80 billion excluding these newly proposed cuts. To this must be added some $20 billion of off-budget borrowing unless the administration succeeds in cutting back this undesirable practice. Thus the markets are looking at total federal financing possibly on the order of

$100 billion. If we add the government's sponsored agencies, total government-related financing may add up to $140 billion. Much of this additional financing, of course, would take place also in the absence of government sponsorship and is recycled into the credit market by loans to private borrowers.

It is not my function to advise the administration on spending and taxing. Various suggestions have been made by others how to deal with the deficit. Among various alternatives, I would much prefer one that brings down the deficit by further expenditure cuts. But a cut of sufficient size would probably require cutting some of the entitlements.

An alternative suggestion has been to postpone the tax cuts. This would probably be the least difficult to implement. It also, however, would delay, for an indefinite period, the incentive benefits from lower marginal personal tax rates.

As a third possibility, a value-added tax has been suggested. This tax, which is widely used abroad, in some ways resembles a sales tax. It has been discussed on and off over the years, usually as a substitute for some part of the corporate income tax or the payroll tax. Substituting it for part of the personal income tax would have a favorable effect with respect to incentives for saving. It would have the drawback of raising prices and thereby escalating indexed payments. But there are examples abroad of countries where increases in the value-added tax have been kept out of the price index legislatively.

All these means of dealing with the deficit have costs and disadvantages. But, given the consequences of a high deficit, any of them seems preferable to a continuation of the deficit.

Federal Reserve Policy

For the Federal Reserve, support from the fiscal side would make it easier to gain credibility for a successful winding down of the inflation. Interest rates could be lower, not through any counterproductive increase in the money supply, but through reduced demands in financial markets. With fiscal and monetary policy complementing each other, inflation would be damped much more quickly and the increased credibility to our anti-inflation efforts would reinforce downward pressures on interest rates.

The Federal Reserve for its part will have to maintain a credible posture of restraint. It will have to maintain this posture even in the face of business fluctuations such as have frequently occurred in the past. Such fluctuations inevitably are associated with ups and downs in interest rates if the money supply is kept approximately on track. With a reasonably stable money-supply growth, business fluctuations, if they occur, should be neither very deep nor very prolonged. Neither should temporary fluctuations in interest rates or short-term deviations of the money supply from its track be regarded as changes in Fed policy. In an economy that does not move at a perfectly stable rate of growth, one or the other of these short-run monetary instabilities is unavoidable. What matters is to bring growth of the money supply down, over time, to a noninflationary rate. If confidence can be established that this will happen, inflation and interest rates will benefit from positive expectations.

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