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GOVERNMENT AND INFLATION -- PART OF THE PROBLEM OR OF THE SOLUTION ?

Remarks by

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

at the session

"In Honor of Arthur Okun"

at the annual meeting of the

American Economic Association

Washington, D.C.

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Is government wholly responsible for all inflation, as we are often told? And, coming closer to my home, is the Federal Reserve responsible for all government-caused inflation? Richard Lipsey has given us a systematic and thoughtful analytical framework in which I have little difficulty placing myself. What he describes as the Keynesian view is what I would regard as the common-sense view. I must confess to considerable uneasiness, however, in the face of this affinity, because I believe it is the Keynesian thinking of our times that, permeating most of the older generation of economists and through them government and the public, that is fundamentally responsible for much of our inflation. It is not how one analyzes inflation that counts, but how strongly one believes in the need to fight it.

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As regards the role of the Federal Reserve, I find particularly meaningful Lipsey's distinction between the role of an active leader and that of a passive validator. Of all the arms of the government, surely it is the Federal Reserve that has stood most consistently and forcefully against inflation. Without claiming that the Fed ever had "the only game in town," I do not feel that it is exaggerated to say that in any ranking of the arms of government according to their inflationary propensities the Fed comes at the bottom.

Let me examine some aspects of Lipsey's distinction between active leadership and passive validation. Some might argue that contributing to inflation in the latter role nevertheless implies causation. This raises philosophical questions. Am I the cause of everything that happens if I could have prevented it? Somebody goes hungry in town tonight. I could have helped him. Am I guilty?

The Fed, to be sure, is not just another citizen. It has a responsibility for preventing inflation, in a sense other than that in which a citizen might have a responsibility for preventing hunger in his neighborhood. But does the Fed's responsibility with respect to inflation override everything else? If the Fed receives little help from other parts of the government and must indeed fight against the inflationary impulses coming from the rest of government, how far is it the cause of any inflation that develops?

Today we face the prospect of very high budget deficits. It is argued that these are not in themselves inflationary. It is only the Fed's monetization of deficits, i.e., their financing through money creation, that

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makes them so, we are told, and the Fed need not monetize. To monetize or not to monetize is indeed the critical decision. But even without monetization, deficits are inflationary. Nonmonetized deficits compete for savings and raise interest rates. At higher interest rates, the velocity of money rises. A given money supply then produces a higher price level, even though not a sustained higher rate of inflation, a difference noted by Lipsey. Any temporary price shock, moreover, whether from this source or from supply factors such as oil or food, tends to move into wages. Once lodged there, the inertial effect is difficult to unwind. Continuance of inertial inflation, to be sure, implies validation by monetary policy. Is it the responsibility of the Fed to avoid all validation at any cost?

Unmonetized budget deficits promote inflation in still other ways. High interest rates impede investment. Productivity remains depressed. One or two percentage points of productivity, in the face of present relatively modest demands for real wage increases, can make the difference between upward and downward spiraling nominal unit labor costs.

High interest rates increase the resistance to restraining monetary policy. They also greatly increase its costs. Not only unemployment but damage to institutions and critical situations in markets are among the risks. The argument that deficits are not inflationary when they are not monetized is not even a half-truth.

I said before that I found Lipsey's Keynesian version of inflation analysis commonsensical, but its proponents not very firm allies in the struggle against inflation. The opposite relation prevails with respect to

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Lipsey's two other analytical categories -- the monetarists and the rational expectationalists. I have difficulty with their analysis. But their proponents usually are staunch anti-inflationists. I find it regrettable that their analysis causes them to concentrate their criticism on the Fed. Allies fighting for a common cause ought not to fight among themselves. I abstain from employing some of the easy retorts that come to mind, because I believe that monetarists and rational expectationalists have the right policy goals, whatever they may think and say of the Fed.

About their principal policy tool -- the money supply -- however, I need to express a warning. Even during the mid-1970's, this tool showed significant weaknesses. Following the first episode of exceptionally high interest rates in 1974, numerous innovations in economizing cash balances occurred which produced a massive downward shift in the demand function for money. The Fed's M1 target of 5 - 7-1/2 percent or less seemed pretty restrictive at a time when nominal income was rising at rates of 11 or 12 percent from year to year. The demand shift made these targets turn out quite loose and tripped up the Fed. A similar demand shift occurred in 1981, as indicated by a nominal GNP rise of about 9 percent (81.4/80.4) in the face of a rise in M1-B (adjusted for NOW account shifts) of only about 2 percent. Innovations in economizing cash balances are now coming fast. Money-market mutual funds, retail repo's, the prospect of "sweeps," of household deposits into money-market mutual funds, are examples. M2 suffers from other ailments, one now looming ahead being the much wider availability of IRA and Keogh accounts under the new tax law.

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In the face of all this, the monetary base often is recommended as a target. But the base is three-quarters currency, a sluggish mass of whose whereabouts we know little and which in any event the Fed cannot control other than through its own influence on GNP. Controlling bank reserves as a means of controlling the base implies accepting wide fluctuations in reserves and in the deposits which they support. Controlling bank reserves alone, without regard to the base, runs into the objection that they are not closely related to GNP. I am confident of the continuing validity of the ancient wisdom that less money of all sorts is less inflationary than more. But the relationship between any particular definition of money and the real economy is becoming very loose. No doubt it will always be possible, by vigorous massage of the data, to produce new relationships that look stable. But while one can win arguments that way, the war against inflation may not be won.

Lipsey examines the prospect in this war and its costs. He hopes that those who believe the cost will be moderate will prove right, but he does not believe it. I would rather stress the very high cost of not winning this war. Inflation, I believe, is costing us a large part of our potential growth, through its impact on investment, on other aspects of resource allocation, on productivity, and incentives. Projected over the long run, the cumulative costs of a lower growth path seem likely to exceed even very substantial costs of bringing the inflation down. In this regard, as well as with respect to the analysis of inflation and its causes, one can side with the Keynesian analysis and nevertheless be a strong opponent of inflation.

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Even so, however, every effort obviously must be made to bring down that cost. In my view, this means to diminish the burden now resting on monetary policy. More support from the fiscal side is urgently needed. Beyond that, as Lipsey has noted, there is the possibility of innovative anti-inflation techniques. My friends will not be surprised that I applaud his reference to TIPs (tax-oriented incomes policies). The enactment of large tax cuts without tying some kind of conditions for wage and perhaps price restraint to them seems to me a great loss.

We are now looking ahead to the outcome of wage bargaining between a few large unions and a few large corporations or industries. The inflation outlook for all the rest of the economy, vastly larger in the aggregate than these contenders, seems to hang on the outcome of those isolated struggles. We are reenacting a scene from the Middle Ages, when wars between armies were decided by the single combat of their champions. There must be a better way of dealing with inflation, and we had better find it.

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