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IMPACT OF MONETARY POLICY ON BUSINESS

Remarks by

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

at the

Yale School of Organization and Management

New Haven, Connecticut

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It gives me great pleasure to speak at Yale on the relation of monetary policy and business. For 23 years, beginning in 1951, it was part of my job here as professor of money and banking to lecture on this very subject. As is the norm in economics, the questions have remained the same in the course of the years but the answers have changed considerably. Truth in economics is very relative. In 1951, I would have told you that monetary policy was an interesting subject, but not a very major element in managing the economy. Most of the burden of promoting full employment, growth, and price stability, I would have said, rested on fiscal policy. Monetary policy was not altogether impotent, as many of its critics asserted, but theoretical reasoning as well as survey results had clearly established that businessmen paid little attention to interest rates. Moreover, I would have gone on, the economy was extremely liquid owing to the backwash of war finance. Small changes in interest rates could not be expected to have more than marginal effects. I might have noted also that during the 1920's things had been

somewhat different. There had been a time when money seemed to matter, and when a change in the discount rate was front-page news. That kind of remark was always good for a laugh from the better-read students.

Today, things have changed once more. A cut in the discount rate would indeed be front-page news. The prospects of such an event are discussed daily in the financial pages. Wide differences of opinion exist as to the right monetary policy. But there is little difference as to the importance attributed to the subject.

I shall not go into the evolution of thought and events which has brought us to our present condition. That is taught most ably here at Yale (if perhaps not from quite as wide a variety of points of view as it was before Willy Fellner and I left in the early 1970's). The more recent evolution of the role of money is related very importantly, although by no means exclusively, to the inflation that began in the middle 1960's. Monetary policy has had a good deal to do with this inflation, sometimes as an active cause, at others by its insufficiently restraining stance. That the inflation subsequently was brought down from the double-digit range to one-half or even less, on the other hand, can probably be fairly attributed in large part to monetary policy. In talking about the impact of monetary policy on business, therefore, I shall have to say a good deal about the impact of inflation upon business. In the final part of my paper, I shall also have something to say about how the impact of inflation, and indeed inflation itself, could be better controlled than we are doing right now.

Inflation and Business

The interaction of inflation and business has changed in the course of the years. The classical view is represented by Joseph Schumpeter. Schumpeter saw the inflation process driven by the businessman, the entrepreneur, who borrowed from the bank in order to finance a new project. This would increase the money supply, and drive up prices. Consumer purchasing power would lag, consumption would lose share in the national product relative to investment. Once the cycle or succession of cycles had run their course, the process would be reversed. Investment and money creation would slow down, consumption would catch up, prices would fall as new products poured from the factories. The whole episode could be viewed as beneficial not only to the businessman but to all participants in the economy.

The Schumpeterian model suggests that business might view inflation as a positive factor, or at least as an acceptable and probably minor evil. I believe that until not very long ago that was the representative attitude of American business. In the course of the years, to be sure, the positive effects of inflation seemed to diminish. But the actions needed to bring it to a halt, through tighter fiscal and monetary policy, tended to be viewed as too painful to justify a determined attempt at stabilization. On a purely impressionistic basis, however, I believe that this attitude also has changed significantly. Today there seems to be more widespread support on the part of business for an effort to end inflation. Because that effort, which has been going on for several years, impinges with unequal severity upon different industries and different businesses, reactions are bound to cover a wide spectrum.

Costs of Inflation

Inflation, of course, is only in part responsible for the course of the economy over the last 15 or 20 years. But it has been closely connected with many of the difficulties we have had. Few businessmen can be satisfied with developments as this period progressed. Over the years, productivity gains almost disappeared, growth was disappointing, the economy became increasingly stagnant. Unemployment is at postwar record levels. Corporate profits have diminished drastically as a share of GNP. The value of American business as measured by stock-market indexes is low by earlier standards. Even at their recent highs, the levels of the Dow-Jones and the Standard & Poor's averages in real terms, i.e., adjusted for the rise in the general level of prices, today are at the levels of the mid-1950's. At their lows of last year, deflated, these indexes were at the levels of the early 1950's. The market value of total equity in American business, similarly adjusted, now stands at about the level of 1964. Except for the present recovery of the dollar from earlier lows -- itself sharply below the parities of the 1960's -- U.S. per capita income would rank below that of at least a half-dozen other countries. Our share in world trade, even though our economy has become much more open, has shrunk from 18 percent in 1950 to 12-1/2 percent in 1981. Here at Yale, it seems appropriate to note also that Mr. Tobin's "q," according to an estimate of the staff at the Federal Reserve Bank of Boston, dropped below 0.6 in the fourth quarter of 1981 and even now probably is no higher than 0.7. Meanwhile, foreign competition is pressing so hard upon us that American business increasingly seems to be going protectionist.

Accounting Problems

While the results are plain, the channels through which inflation affects business, which in turn relate to the impact on business of monetary policy, seem to have been hard for business to come to grips with. Now, as you know, is the season for corporate annual reports. I have less time to spend on this literature than I would like, and I generally look for only two pages. One is the CEO's opening statement. When I read -- less frequently this time around -- "the year 1982 was another record year for your company ...," and I then go on to be informed that the increase of sales or profits was less than the rate of inflation, my economist's heart sinks. Is money illusion really still that pervasive?

I then search in the back of the book for the inflation-adjusted earnings statements mandated by the Financial Accounting Standards Board since September 1979. I am glad to say that the kind of comment one used to encounter there a couple of years ago -- to the effect that "we are required by FASB to present these numbers. We do not believe that they have any significance for the conduct of our business" -- has yielded to a more temperate although still skeptical tone. Of course, the corporation is right that general price-level as well as current-value accounting are highly imperfect ways of adjusting for inflation. No set of books -- and certainly not one based on original cost -- represents "the truth." But, of all forms of self-deception in business, money illusion must be one of the very worst.

It is understandable, of course, that management does not enjoy seeing a restatement of its accounts that, by revealing the effects of inventory profits and underdepreciation, frequently reduces operating profits by one-half or more, and that often keeps the picture from becoming altogether

appalling only by allowing for gains from depreciation of net debt. But these restated numbers, in effect, are reflected in the profits data in the national-income accounts adjusted for Inventory Valuation and Capital Consumption Allowances, i.e., in Operating Profits. They are reflected also in the shrinking share of corporate profits in GNP, quite aside from the fact that some 10 percent of Corporate Profits before Tax now -- as shown in the national accounts -- are accounted for by the "profits" of the Federal Reserve System.

Fundamentally, however, one must accept the fact that inflation makes business planning more difficult and more risky even when a realistic effort is made to take it into account. An instance of this that bears closely on monetary policy is what happens to interest rates during inflation. Inflation drives a wedge between nominal and real rates. The real rate is reasonably observable for short-term debt since the rate of inflation is not likely to vary greatly over the life of a 90-day loan. For longer term money, however, it is the expected rate that counts, and expectations of inflation can differ. Surveys seem to show, to be sure, a rather remarkable convergence, or at least a strong central tendency for inflation expectations. However, these expectations, in the course of the last few years, have changed substantially and, therefore, must have been subject to a wide margin of error.

The failure of the tax system to recognize the difference between real interest and inflation premium compounds this difficulty. The higher the rate of inflation and, therefore, often with a lag, the nominal rate of interest, the more severe is the distortion that results from tax deductibility of the inflation premium. Real interest rates after tax frequently have been negative for borrowers that have profits and pay a tax. For the lender, if he is taxable, the same is the case.

These concepts have now entered the President's Economic Report and the Congressional testimony of the Council of Economic Advisers. I have been unable to get a sense of how far they have entered into business planning.

Of course, a negative real rate after tax does not mean that it is advisable to finance a project having a negative return. Conceptually, one must assume that a debt that depreciates with inflation implies the acquisition of an equivalent asset that appreciates at the same inflation rate. The appreciation would enter into profits and would be taxed for an amount equal to the tax subsidy received on the debt. But, there are lags and other complications that in any specific case very probably distort the result. Certainly, I find it difficult to believe that the nominal returns on investments -- carried at original cost -- have risen sufficiently with inflation to offset the impact of inflation on nominal borrowing costs, even allowing for the tax deductibility of nominal interest expense.

These distortions now have diminished considerably thanks to the reduced rate of inflation. For instance, the inventory valuation adjustment, which in 1974 amounted to as much as 33 percent of corporate profits before tax and in 1980 was 20.3 percent, has shrunk to about 5.9 percent of (a much diminished) volume of pre-tax profits in 1982. Inflation expectations as measured by surveys have come down, although less than inflation as measured by present price indexes. All this has been accomplished at great cost and with great pain. Business planning should be possible now on a firmer basis although I do not believe that these results are either sufficient or even viewed generally as sufficiently permanent. Considerable compensation for some of the remaining consequences of inflation, to be sure, such as the inadequacy

of original cost depreciation, has in the case of new investments been provided by recent tax changes. None of this, however, is a satisfactory substitute for full price stability, or at least for an inflation rate much closer to zero than we have now.

The Cost of Disinflation

Let me comment briefly on the thorny question of the cost of disinflation. Critics of monetary policy frequently measure it in terms of the shortfall of output and growth from some potential, and in terms of unemployment in excess of some frictional or inflation-neutral level. The cost thus computed is very high, but the premises of the computation are illusory. We do not have a realistic option of ignoring inflation. We cannot measure the cost of disinflation by comparing it with some dreamland. Certainly we cannot compare it with an economy operating satisfactorily and as if inflation did not exist. Neither can we measure the cost on the assumption that inflation, ignored, would stabilize or otherwise become predictable. As I have noted, inflation, at any level, imposes costs because reliable expectations cannot be formed, because the tax system is not adjusted for inflation, and because existing contracts and the consequences of past decisions cannot quickly be adjusted if at all. Inflation ignored by the policy maker, moreover, as a practical matter is bound to accelerate. There is no satisfactory way of living with inflation. Business cannot do it, nor can other institutions, as the financial situation of our universities and the salary and pension problems of present and retired faculty make very clear. The cost of disinflation must, therefore, be measured against the realistic option that

inflation, uncombatted, would impose high costs of its own and, moreover, would almost certainly accelerate. I feel confident that the cost -- in present-value terms -- of letting inflation run is far higher than the temporary pain of bringing it down.

Again as a practical matter, I doubt that private enterprise and the market system, at least in our country, can permanently survive with high and unpredictable inflation. The role of government is bound to increase as more enterprises come in need of public assistance, price controls are tried from time to time, profits erode, and individual saving becomes an unreliable means of providing for the future. The ultimate cost of inflation, in other words, is the loss of the system. Whoever regards this as, indeed, a loss, rather than as an extra dividend on inflationary policies, will have to factor it into his estimates of the probable cost of inflation.

Monetary Policy and the Cost of Disinflation

I now would like to examine some of the reasons for this pain and to suggest some ways in which pain could have been reduced and could still be reduced hereafter to the extent that it subsists.

In economics, it is taken for granted that optimum results are achieved by using all resources up to the point where cost begins to exceed return. That rule applies also to the use of economic policy instruments, all of which have costs of one sort or another. In politics, unfortunately, the rule seems to be to let George do it and then blame him for any inadequacy of the results. Given that inflation had come about, the best way of dealing with it would have been by a combination of monetary policy, fiscal policy, incomes policy, and moderation in the endless activities through which the

government mandates higher prices, which, in turn, get into wages and COLA's, running from protectionism, to price supports, minimum wage, regulation of all kinds, and all the rest. Instead, virtually the entire burden of dealing with inflation was thrown upon the Federal Reserve. This was done on the convenient pretext that monetary restraint technically is sufficient to prevent inflation or to bring it down, provided one is willing to accept the side effects. Therefore, spending and taxing, regulation and all sorts of government-mandated price increases, as well as private sector price and wage setting, could all go their own ways without regard to inflationary implications.

During the late 1940's and the early 1950's, such attitudes would have been very unlikely, given the then prevailing view of the capabilities of monetary policy. It is a token of the change that has occurred in that regard that today monetary policy is widely expected to be able to carry this entire burden. And so it can, but at a cost in terms of output foregone and human pain much higher than would be required if a balanced approach to inflation were taken. As it happens, many sectors of business, along with large numbers of unemployed, are among the primary sufferers from this unbalanced approach.

So far as the impact on business is concerned, monetary and fiscal policies differ in one important point. Monetary policy works principally on investment, fiscal policy principally on consumption. Monetary policy, working principally through interest rates, thereby affects business investment and housing, along with some durable consumer goods. Fiscal policy, working through tax changes and government spending for wages, salaries and transfers, affects primarily consumption, since most income goes for consumption rather than saving, and since tax reductions predominantly have been applied to personal, not business, income.

Therefore, by putting the burden of restraining inflation on monetary rather than fiscal policy, an implicit decision is made to pay for disinflation through relatively less investment rather than relatively less consumption. This has damaging consequences for the capital stock of the economy, for future jobs, and for future growth, which I need not spell out in detail.

On the other hand, when diminishing inflation allows interest rates to come down, it is in the first instance investment that is stimulated. We are now in that situation. However, so long as the budget deficit remains very large and fiscal policy in that sense very stimulative, real interest rates will be higher and investment lower than would be the case with a more balanced policy.

Monetary policy sometimes is said to impact also with particular force on durable consumer goods, especially automobiles. The fact is, of course, that a policy instrument that at times makes it cheaper and at others more expensive to finance a purchase, necessarily affects goods that tend to be financed rather than bought out of income. A more fundamental fact, however, is that durable consumer goods -- and in even higher degree housing -- by their nature cater to wants that are either postponable or at least capable of being satisfied in alternative ways. Thus demands for products that meet these wants are likely to be interest elastic and sensitive to monetary policy.

In order to gear up for its task, monetary policy has had to move toward ever tighter methods of operation. After relying for many years on the relatively mild technique of making small changes in interest rates, in the early 1970's it moved to controlling the money supply, albeit still in a

manner that tended to limit volatility of interest rates. When, in 1979, this method too did not seem to have the necessary muscle, the Federal Reserve moved to control of the money supply through control of reserves. It was realized and stated at that time that the new techniques would lead to wider swings in interest rates.

The expectation of higher interest volatility, unfortunately, was fulfilled in very high degree. In addition, however, the move to a stricter control of the money supply also led, at certain times, to higher levels of interest rates than had prevailed in the past. When the market was given the function of adjusting the demand for money and credit to the supply provided by the Fed, it turned out that at times this balance could not be attained without very high rates. This has had a severe impact on borrowers, especially those not sheltered in some way by the tax system. However, while recognizing the cost, the new technique did the job of bringing down the inflation.

It has been argued by some that even this tighter control of the money supply was not sufficient. Indeed, even under the new technique, there have been considerable fluctuations in the rate of growth of the various monetary aggregates. It does not follow, however, that still tighter control, which might reduce this volatility of money growth, would also reduce volatility of interest rates. It is argued by some that there is some stable rate of money growth that would also stabilize interest rates, some broad highway, as it were, along which money growth and interest rates might gradually and stably move down toward lower levels, with inflation declining in step. In that view, the Federal Reserve has quite unnecessarily taken the

scenic route of jagged peaks and troughs in money growth and interest rates.

In my view, there is no such happy highway. The economy itself is not stable, be it by the week, the month, the quarter, or the year. Neither are the demands for money and credit that arise from the economy. Moreover, there is randomness in the demand for money and credit even after allowing for fluctuations in the economy. That randomness can show up in volatility of interest rates given a stable volume of money and credit, or else in volatility of the volume of money and credit given a stable interest rate. Monetary policy can push the instability, within limits, out of the money supply and into interest rates, or in reverse. It cannot, in a market economy where tens of millions of households and firms borrow, lend, and shift their assets about, eliminate the random element. That poses, of course, the question what distribution of instability between money supply and interest rates is optimal, and whether that distribution has been achieved in practice.

In this regard, it has been alleged that both volatility of interest rates and volatility of money growth have contributed to higher interest rates. To me, it seems intuitively plausible that volatility of interest rates would cause lenders to demand some kind of a risk premium which on average would raise rates. The alternative view is that volatility of money growth makes the market uncertain about the future rate of inflation, and that it is this uncertainty that generates an interest-rate premium. There is some evidence on this question, from a survey of approximately 500 financial decision makers who were asked about the reasons for high long-term rates. Neither factor was

regarded as one of the two most important causes of high long-term rates by more than 3.6 percent of the respondents, and within this small minority those stressing interest-rate volatility considerably outnumbered those stressing money-supply volatility. The two reasons mentioned with overwhelming frequency as most important causes of high rates were fear of resurgence of inflation and the high prospective budget deficit. It would appear, therefore, that instability of interest rates while unquestionably a problem for business, is not regarded by itself as a major cause of high rates.

Interest rates have come down substantially as the rate of inflation has come down. Over the long term the Federal Reserve can control interest rates only by what it can do to control the rate of inflation. The close correlation of the rate of inflation and the rate of interest was discovered, conceptually, here at Yale by Irving Fisher some 80 years ago. Fisher thought, at that time, that there would be lags of many years before investors had formed an opinion about the direction of prices. It is a measure of the extreme inflation consciousness of our day that this lag between inflation and long-term interest rates seems to have almost entirely disappeared. Even during the inflationary spurts of the late 1940's and middle 1950's, those long lags still seem to have discouraged an immediate adjustment of interest rates to inflation. Meanwhile, we have built into the behavioral responses of our markets something that demands a much more disciplined policy from the responsible authorities -- the quick reaction of markets today not only to inflation itself, but also to its expectations. Given the power and the present inflation-oriented nature of expectations, the scope for fine tuning has greatly diminished.

It is partly for these reasons that real interest rates have remained high, particularly at the long end when measured in terms of actual inflation rather than expectations. The survey of financial officers, which I mentioned before, placed expected inflation for the years 1982-87 at slightly over 6 percent, and for the following five years at close to 7 percent. However, in response to a question about the probability of hyper-inflation within the next 10 years, the average response was a one-third probability. It seems that the generation that has lived through double-digit inflation may be scarred for life by that experience. Given such expectations, it is questionable whether the average taxable investor is receiving a positive real interest rate after tax.

Interest Rates and the Budget

The enormous budget deficit contributes in two ways to high real interest rates -- if indeed in the light of what I have just said, they are all that high. First, the deficit nourishes the fear of high inflation. Given the circumstances of political life, there is no way in which the central bank can acquire a degree of credibility to totally calm this fear. Second, the demands of the Treasury on the financial markets and on the very limited net savings of the economy create concern about increased "crowding out" as the economy recovers. In this sense, fiscal policy is much more important for business than is monetary policy. Monetary policy cannot, other than quite temporarily, affect real interest rates. Fiscal policy can.

In comparing the size of the deficit with the saving of the economy, it is sometimes argued that it is gross rather than net saving that counts. Gross saving, which includes business and homeowner depreciation, as well as state and local government saving, was approximately $565 billion or 19 percent of GNP in 1982, while net saving, which excludes depreciation, was $207 billion or about 7 percent of GNP. A deficit of about $200 billion, such as now seems in prospect from 1983 through 1985, would absorb a very large part of net saving, even after allowing for some growth of amounts saved and for some amount financed, in effect, by foreign capital inflows. The absorption of gross savings would, of course, be less. The argument is made that depreciation, after all, is not necessarily reinvested, and often not reinvested in the same kind of asset. Hence, more money would be seen to be available to finance the deficit if we include the proceeds of depreciation. However, this would be at the expense of deterioration in the existing capital stock, which would tend to depress growth of output.

In recent years actual investment may not have been seriously deficient in terms of the resultant capital stock, although higher investment probably would have produced higher productivity gains and growth. Investment from depreciation allowances permitted by the tax system, however, has been insufficient to finance maintenance of the capital stock, owing to original cost depreciation, even though the inadequacy of this form of depreciation has been moderated by accelerated depreciation methods and investment tax credits. Many businesses, therefore, have had to borrow in order to maintain their capital stock, or, if you like, to pay the dividends they had not earned.

At a minimum, they have had far less retained profits to work with than their accountants claimed to think. Tax depreciation, in other words, has been made inadequate by inflation. This inadequacy -- while it has helped to hold down government borrowing -- has nevertheless thrown an added burden on business. Although it has had a zero net impact on the capital market, it has contributed, in effect, to such "crowding out" of new investment as there has been. It is already accounted for in a lower federal deficit and higher business demand for credit. Therefore, it cannot be looked to as a factor helping, on balance, to reduce the pressure of the federal deficit on the supply of saving. This situation has undergone some change very recently, as accelerated depreciation coupled with the decline in inflation has enabled tax depreciation to exceed economic depreciation.

International Effects of Monetary Policy

Returning to the effects of monetary policy, business has been impacted also through the effect of monetary policy on the international value of the dollar. Under a regime of floating exchange rates, some variability has to be expected. A rigorous control of the money supply, however, is likely to widen these fluctuations. Volatility of interest rates leads to volatility of exchange rates, although the relationship of interest rates and exchange rates does not seem to be all that close. Furthermore, as inflation has been brought down relative to inflation abroad, the dollar has tended to appreciate. This has helped in reducing inflation. But when the level of the dollar pushes the balance of payments into a large current-account deficit, it evidently is above its normal past relationship to other currencies. The United States then is becoming a capital importer.

That reflects neither its historical role nor its character as one of the world's richer countries. It reflects merely the capital shortage created by the budget deficit.

As inflation comes down worldwide, there is reason to expect that exchange-rate fluctuations will diminish. Moreover, pursuit of a money-supply target need not inevitably be at odds with efforts to reduce exchange-rate fluctuation. Some central banks, like the German Bundesbank, have been able to pursue a money-supply target successfully while also giving weight in their monetary policy to the foreign-exchange rate. In part, this has been accomplished by allowing for some variability of money growth within the target band. Some compromise between domestic money-supply targeting and foreign-exchange-rate considerations, therefore, seems possible and would, in my view, be desirable. Wide swings in exchange rates that are quickly reversed obviously are of no value other than for the purpose of limiting capital flows and equating them to the surplus or deficit in the current account.

Incomes Policy Against Inflation

In closing, I would like to address myself to one area of policy that I have not dealt with -- incomes policy. The first thing to say about incomes policy is that there seems to be no good one. Leaving aside our disastrous experience with wage and price controls, which I do not consider an incomes policy, we have accumulated a record of at least three partial or total failures -- the Kennedy-Johnson guideposts of the early 1960's, the Carter guideline of 1978, and the legislative proposal for "real wage insurance," submitted by the Carter administration but not enacted. We also

have had considerable debate about tax-oriented incomes policies (TIP) of which the real wage insurance proposal was one version.

Of incomes policies it has often been said that they do not work, and if they did they would not work in the United States. Perhaps that is true, and perhaps it is vain to pursue the topic. But, with 11 million people unemployed, it seems to me that no possibility should be left unexplored. Surely there must be better ways of dealing with inflation than we have pursued so far even though I rule out the alternative of letting the inflation run.

The dictum that an incomes policy holds least promise in the United States is based on the great size and diversity of the economy, the vast number of conflicting interests involved, and the absence of cohesive employer and labor organizations that could negotiate and make responsible commitments. But in one other respect the United States has an advantage for the application of wage-price agreements that other countries lack: wages and prices are very closely tied together. Increases in either variable tend to be followed by increases in the other, making allowance for productivity gains. The same happens on the way down, as we are now observing. Oil shocks and food shortages can disrupt the relationship. So can movements in the dollar. But given the relatively low dependence of the economy on imports -- although it has increased -- the United States does not experience the massive changes in living costs as a result of changes in import prices to which many other countries are exposed.

Wages and prices may part company also when changes occur in the shares of labor and capital in national income. Over many years, however, this distribution has not changed very much in the United States. Labor

over time has been getting about 75 percent of national income, although since 1940 there has been a perceptible trend in the direction of a greater share for labor which in 1982 reached 79 percent. In the absence of such shifts and cyclical swings, any increase in wages that labor can get must eventually equal productivity gains allowing for changes in terms of trade. If prices are stable, wages will tend to rise at the productivity rate, on a national average. If there is inflation, wage increases will tend to run ahead of it by the productivity margin. Labor under these conditions gets its share of the increase in output, and so does capital. That is all there is, and all either can get.

Under these circumstances, it seems plausible that if wage increases were to slow down, price increases would slow likewise. In real terms, labor and capital would both get as much as they would had prices continued to rise. At the present time, this slowing of wages and prices is being brought about gradually and painfully by monetary restraint. If it were done by voluntary cooperation of labor and business, much of the pain would disappear. A possible framework for such cooperation might be the following.

Business firms might give annual wage increases in two steps. The first step would be a moderate increase, only partly allowing for inflation. If this pattern were widely followed, inflation would diminish. The firms in question would then have no incremental profits from wage restraint, and the employees would have no loss in real wages. If, nevertheless, prices continue to rise unchecked, businesses are likely to have incremental profits from the initial wage restraint. There would then come in to play a second pay increase to compensate for the real wage loss, which might take the form of profit sharing. A framework for this, if not the full particulars, might be laid down in the wage contract.

A difficulty in negotiating plausible wage agreements on this basis is that the real wage gain of labor depends on the general movement of prices, while the incremental profits of a firm depend on the movement of its own prices. In other words, what is true of the economy on average, need not be the case for each firm. A firm might have negotiated such an agreement, and might have held down its prices in line with its more moderate wage increase. There would then be no incremental profits from which to pay a second-stage wage increase. Yet that second-stage increase would be needed if the initial pay increase had left the employees with a real wage loss, given subsequent inflation. Spelling out the nature of the difficulty, however, may exaggerate the precision of the procedure, and reasonable wage agreements of this kind may nevertheless be feasible.

A necessary condition for the success of this technique is that it be widely practiced. The more moderate wage increase in the first step will hold down the general price level only if the cost relief affects a large part of private output. In that case, if inflation follows wages down, the second-stage wage increase would be small or zero, with no impairment to real wage gains. If only a small minority of firms were to practice the approach, the price-restraining effect would be small. A second-stage wage increase then would be expected of these firms, nullifying whatever initial favorable effect on prices had occurred. Moreover, these firms might have difficulty financing the second-step wage increase, since they would not have raised prices and would not have incremental profits. The expectation that a firm might find itself in this position might cause the firm to raise prices along with the general rate of inflation even if the first wage step justified a

smaller price increase. This would make the procedure ineffectual and probably unacceptable to the employees.

It is far from clear, therefore, whether such a plan could be instituted without some form of governmental action. Perhaps a broad-based understanding between business and labor would suffice, which unfortunately is harder to negotiate in our country than anywhere else. Perhaps there is an opportunity here for development of an industrial dialogue that we have not had in the past.

A prototype of the two-stage wage increase is the bonus system practiced by many firms in Japan. The bonus, as I understand it, is negotiated as part of the annual agreement, but it may nevertheless be contingent on subsequent profits. It helps to protect Japanese labor against unexpected inflationary developments during the course of the year.

A procedure along these lines might take some of the pressure off monetary policy. It would permit a faster rate of economic growth with a given rate of money growth, as the inflation component of nominal growth diminished and the real component expanded. It would indeed involve a temporary suspension, a kind of truce, in the continuing struggle over income shares. I doubt that in the long run it is either feasible or desirable to seek to minimize this effort, which has been one of the driving forces of productivity gains. But, at our present level of unemployment, it does not seem unreasonable to ask that those who are employed moderate their demands so that those looking for work can find it.

In conclusion, it is obvious that, to deal with today's inflation and recession, we must rely on the tools we have even though we should not give up trying to develop new ones. Monetary policy has been the principal tool, and its impact on business, therefore, is an important consideration in business planning. Monetary restraint, in the nature of things, has had to bear down particularly hard on business investment spending. As the economy recovers at a lower rate of inflation and lower interest rates, the need for a resumption of business investment is urgent. A sustained recovery is possible only if the initial impulses coming from the cessation of inventory reduction are eventually replaced by the stronger business spending. The job of monetary policy will be to promote this development consistent with further declines in inflation and long-term interest rates.

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