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WHAT SHOULD WE DO ABOUT WORLDWIDE AND DOMESTIC INFLATION

Remarks of

Philip E. Coldwell

Member

Board of Governors

of the

Federal Reserve System

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What Should We Do About
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In the time available, the topic assigned cannot possibly be covered with the care and caveats necessary for thoughtful presentation. Therefore, only the highlights will be developed along with some of the basic reasoning for the recommendations. A fuller treatment might detail the rationale behind certain assumptions which seem important to the future course of events. Of course, these comments and recommendations are mine alone and should not be attributed to the Board of Governors or any of my associates in the System.

First let me place before you a fundamental tenet that the domestic and worldwide inflations are inseparably interlinked under today's conditions. In my opinion, almost half of the domestic inflation is due to international factors such as the coincident cyclical positions of the major industrialized nations, food shortages, the massive price increases for oil and other energy-related products and the uncertain and volatile international exchange rates. Beyond doubt the oil price increases coming on top of the sharp run up of food prices have brought truly remarkable deficit pressures on the balance of payments accounts of some countries and have led to the increasing reserve accumulations in others. In my view, the adjustments necessary to accommodate these tremendous shifts have been a major cause of inflation, certainly for the industrial nations, where economic growth has been so closely tied to abundant supplies of cheap energy. The adjustments have been quite painful as we experienced an upward ratcheting of prices for all products where energy is an important cost in either production or distribution. This process has been underway since late 1973 in its primary impact stage and is now filtering into other product prices in a secondary wave. The impact on consumer income of the rising cost of living sets up its own pressures for wage increases to compensate for the loss of purchasing power. These in turn create a further cost-push toward higher prices in a broadening if not fully encompassing range of products and services.

What I am saying is that we have been, and are now, embroiled in a massive cost-push inflation. For this segment of the inflation, the cause is partly self-destructive because inflation dampens demand by reducing consumer discretionary incomes and creating burdensome inventory accumulations which then encourage competitive price reductions or at least a lessened ability to raise prices. The same process is evident with regard to food prices and their impact on discretionary income. While product substitution and reduced consumption can moderate the impact of food price increases, there are limits to these responses and if personal income fails to keep pace with inflation, then consumers must use a steadily higher proportion of income for food. So long as we, as individuals and as a Nation, demand energy and food at near present consumption levels, the cost-push pressures will ramify into related products and services, while demands for non-essential goods will decline and inventories of discretionary products will rise.

Another very troublesome aspect of the international inflationary pressure of high cost energy is the self-generating feature of the impact on some other raw materials. Thus the producers of bauxite, iron ore, nickel, manganese, and other similarly isolated materials, have attempted to raise their prices in order to meet the high cost of imported energy or to emulate the cartel pricing policies of the OPEC countries. Such price increases constituted a second wave of inflation in selected raw materials which again hit primarily on the major industrialized nations. But this secondary wave was of only temporary duration and limited impact because in most cases the new price levels were not sustained in the market place. In fact, prices of raw materials in general declined about a third over the past year.

If the over-all rationale of cost-push from the international sources is correct, then this phase of the inflationary pressure is slowly losing its influence. To further reduce the secondary impact and cut back the resulting cost pressures, demand would have to be dampened to the point where price and wage increases are no longer sustainable, but this point could be sharply lower than either past or present levels of production and employment. Rather than put the economy through such a wringer, it would be far preferable to reduce oil prices or substitute new energy sources in order to re-establish a stable and hopefully moderate cost energy base. In my opinion, this is not likely to happen except through active pursuit of the goals of project Independence. Such a program would have important economic, social, and political ramifications, but it may be the most palatable solution and for the long run growth of our Nation, I recommend its prompt implementation. It seems to me that a moderate cost energy base is a requirement for our industrial economy and that if we fail to ensure that base, we may see a considerable erosion in our real standard of living. Project Independence could encompass a program including elements such as Government action and financing of enlarged non-oil energy production, protection against excess profits, and at least partial public ownership and competition in the energy field. It would also require restrictions on energy use in the interim period as well as close control over distribution to assure priority for public uses.

Even these rather drastic steps would not, in my opinion, alleviate all the inflationary pressures from international sources. The shifting exchange rates under a floating environment has worked to absorb some of the heavy shocks the international financial system has had to face. But this same volatility has been a destabilizing force to the exchange traders, the exporters and importers and to the central banks of the free world.

However, international monetary reform may be delayed and compromised by the truly massive payments being made to the primary oil-producing nations. If 1974 is representative of the payments imbalances created by the oil price increases, the oil-consuming nations face a payments deficit of more than $60 billion and the oil-producing countries face the job of reinvesting this amount. With interest payments and new oil revenues, the monthly investable total may exceed $6 billion. Fund transfers of this magnitude will indeed create more strains on market mechanisms, to say nothing of the fundamental problem of liability assumption, if recycling to the deficit nations is to be accomplished. In my opinion, we should be working toward lower costs at every policy juncture, while determining our best posture for handling the large transfers until they can be reduced. Some of the policy problems in the interim are how to encourage longer maturity deposits or investments, how to limit liabilities of financial institutions or the U.S. Government in the recycling process, how much equity or debt investment to tolerate and in what industries, and how to screen our economic and financial power from external decision making. These and other problems associated with the oil payments lend great urgency to U.S. action on project Independence.

But if international forces are largely responsible for only half of our inflation, the other half must be of a domestic origin. In my opinion, the primary factors causing the domestic inflationary pressures stem from the basically inflationary policies and attitudes of government, business, unions, and the consumer. It takes only a little effort to recall the upward ratcheting of wages and prices caused by (1) steadily higher minimum wage levels, (2) the inflationary budget deficits of our Federal Government in meeting the demands at home and abroad, and (3) the inflationary bias of business, land, and securities speculation. These have been aided and abetted by a too generous monetary policy over too many years and the subsequent debt creation has built a base of interest service requirements, which can be met only if inflation continues to accelerate. Even a small downturn leaves a trail of illiquid, insolvent, or bankrupt companies and individuals and the trail is now encompassing some over-extended financial institutions. The Nation's policy response to each such interruption in growth has been reflation but we are now trending toward the logical end of such policies, as hyper-inflation looms on the horizon. To break this chain of events and reduce our reliance upon perpetually higher rates of inflation at each cyclical swing, will require a painful but absolutely necessary long-run policy change.

It is theoretically possible for the necessary policy posture to come voluntarily if the population recognizes the risks inherent in past policy and reduces its demands for steadily more Government protection and largesse. But the chances of an effective voluntary move are not high in my opinion and thus I believe we need a long range policy, combining moderate availability of credit, tax reform, reduced Government deficits, and more limited opportunities for speculation. Simultaneously we should consider a public posture of priority preferences in credit and tax reform to insure (1) business capital expenditures for greater productive capacity, (2) enlarged basic consumer expenditures for food, clothing and housing, and (3) reduced preferences for non-productive efforts.

In summary, I believe our inflation is a multifaceted problem with elements of long-term bias domestically and a number of long-run and short-run international pressures. In other words, demand-pull inflation from the domestic side has been accentuated by cost-push and structural inflation stemming from international sources. I believe we are beginning to see a lessening of the inflationary pressures from the original excess demand and from the initial oil price boost and the secondary wave of resultant price pressures. This is happening in my opinion partly because of the adjustments already made and partly because consumer discretionary income has been reduced and thus demand for non-essential items has declined creating a burdensome inventory position. Business raw material inventories also have become burdensome and new orders cutback or cancelled. These developments have impaired the ability of business to raise prices and have encouraged price cutting and output limitations to reduce final product inventories. Such actions have curtailed the demand for labor, increased unemployment, and dampened inflation somewhat. However, the pressure for sustaining real wages is so strong that the remaining employed persons are seeking large wage boosts even in the face of rising unemployment. This phase is likely to persist in coming months but should slow in 1975.

Similarly, demand-pull inflation has weakened sharply in the past year with the reduced real income, higher unemployment, and credit restraint all playing some causative roles.

Thus both demand-pull and cost-push pressures are showing signs of weakening as demand slackens and the secondary cost-push wave recedes. But the basic problems are still with us and must be corrected or a resurgence of inflation could develop.

Unfortunately one of the principal reasons why inflationary pressures have begun to ease is the deepening recession both at home and abroad. As demand weakens, new orders and production decline and unemployment increases with consequent pressures for Government action to restimulate the economy. To some extent the built-in stabilizers have begun to reduce tax revenues, increase unemployment compensation benefits and thus shift the Federal budget toward a large deficit. At the same time, monetary restraint has been eased somewhat. These policies must move cautiously however so as not to rebuild a credit base for another round of demand-pull inflation when recovery develops.

Thus we again face the critical juncture of policy determination but this time with the added dimension of international complications from the monetary and price adjustments to the high cost energy problem and the unstable exchange rate patterns. If we domestically follow the past practices of reflation we should expect an even more vigorous demand-pull inflation the next time. On the other hand, if we limit our efforts to reflate, we might achieve a longer lasting equilibrium for sound growth, but only a courageous long range policy position by Congress and the Administration would validate this decision of moderation, since such a position runs the risk that the recession might accelerate as expectations of reduced production, higher unemployment, and lower incomes permeate the economy.

Even though a long range policy of moderation seem attractive, I feel we must recognize the prevailing intolerance for policies which appear to foster higher unemployment, slow recovery, and considerable underutilization of human and material resources. Moreover, there is a potential for panic when unemployment rises and human suffering increases. Thus our dilemma is that a policy prescription which fails to come to grips with the unemployment problem is one likely to fail while a policy of excessive reflation is a proven policy for future inflation. Between these must be a policy compromise or modification of the traditional responses. It seems to me that rather than return to full reflation by monetary ease, we should be using other tools to handle the unemployment problem, leaving monetary policies of moderation as a long-run hope for basic equilibrium.

Government policies have several important jobs to accomplish over coming months which will influence our pattern of life over years ahead. For the short-run, some measures should seek restimulation to foster recovery and redevelop a feeling of confidence in our economic future. Such stimulation should provide for maximum short-run impact but small long-term effect. Other measures could be aimed at longer-term encouragement of business capital and residential housing expenditures. Still other actions should be aimed at the long-range containment of inflationary pressures. In essence then the program to meet our current economic instabilities must include efforts to provide short-run relief to unemployed workers and failing businesses and foster an atmosphere of recovery, provide a stronger base for fundamental growth of our economic capacity, and create an environment conducive to non-inflationary progress.

I am convinced that the unusual character of our current inflation with such a heavy causation from international sources requires an equally unusual group of remedies. It is my hope that with a prompt National effort toward project Independence, a new push for international monetary reform, some tax reforms, Government subsidies for new jobs and business capital outlays, and a moderate monetary stimulus we can weather this storm and recover our economic vitality in an environment of non-inflationary growth and prosperity.

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