The Threat of Inflation

Remarks by

David M. Lilly
Member, Board of Governors of the Federal Reserve System

before the

Virginia Council on Economic Education
Richmond, Virginia

September 23, 1977
It is a pleasure to appear before you today, especially since the Virginia Council on Economic Education has long been a leader in promoting improvement in economic education and understanding, an improvement that is sorely needed in our society.

I would like to discuss with you an issue that is perhaps the greatest threat to our economic society as we know it today. That threat is inflation. It's a disease that could change the entire fabric of our life unless it is brought under control. And I must say to you in all frankness that we at the Federal Reserve feel very lonely when the Government institutions that worry about inflation are asked to stand up and be counted. We live in almost virtual isolation, a condition that I hope will change, and change dramatically, as time goes on.

The seriousness of inflation cannot be overestimated. Except for a brief period after World War II, prices in this country in recent years have been rising faster than in any other peacetime period in our history. Most recently, there has been some respite from double-digit inflation, but a resurgence of inflation could jeopardize the future of our
country, if past experience is any guide. No country in history has been able to maintain widespread economic prosperity once inflation got out of hand. And the unhappy consequences are not just of an economic nature. Inflation inevitably causes disillusionment and discontent. It robs millions of people who have set aside funds for education or retirement, and it hits the poor and the elderly especially hard.

Inflation has also been a contributing factor to the fall of governments. Even in this country, the distortions and injustices created by inflation have contributed to a distrust of government officials and governmental policies. History teaches us that the discontent bred by inflation can provoke disturbing social and political change. The ultimate consequences of inflation could well be a significant decline of economic and political freedom.

To appreciate the threat of inflation fully, one must understand how it has infected our economy. There is in our society a built-in inflationary bias that has grown more intense over the last decade. Our long-range problem
of inflation has its roots in the structure of our economic institutions and in the financial policies of our Government. This basic fact is all too frequently obscured by outside events that increase the rate of inflation noticeably, such as a crop failure or action to raise oil prices. The plain truth is, however, that the United States -- and many other countries throughout the world -- has developed an underlying bias toward inflation that has only been magnified by these special influences.

Where does this leave our traditional tools of policy? Fiscal and monetary policy still have important roles to play in our fight against inflation, but they can no longer do the entire job. Removal -- or even a reduction -- of structural barriers will help us squeeze the inflationary bias from the economy and remove the distortions that we, ourselves, have made a part of our system.

One indication of these distortions is the constant penchant of our society to run budget deficits. There are times when a Federal budget deficit can be helpful. But must we run deficits all the time? Since 1950, deficits
have outrun surplus by 23 to 5. That is a runaway score in anybody's language.

Throughout the postwar period, there has been heavy emphasis by governments on rapid economic growth. This, of course, is commendable. But while we have tended to move promptly to check recessions, we have been hesitant to move just as promptly to check inflation. Many governments, including our own, have attempted to relieve the adversity facing their citizens and in the process they have moved in varying degrees toward an economy that places more and more emphasis on welfare.

Welfare programs have been established for a large portion of our population and they now include food stamps, school lunches, medicare and medicaid, public housing, and many other forms of assistance. Many of these programs are commendable, and they help segments of our population face an otherwise burdensome life. But they also add to the inflationary bias in our economy when they produce budget deficits.

Let me give you some additional examples of what I mean by the inflationary bias in our economy.
For many years, the Federal Government has regulated various forms of transportation -- trucks, railroads, airlines, water. A certain amount of regulation is undoubtedly good, but analysts estimate that regulation of transportation in this country has raised costs anywhere from 10 to 30 per cent.

Tariffs, together with import barriers, are another factor in this bias. Granted, tariffs and import barriers have benefited certain industries and groups of Americans. But they have also served to increase prices in some commodities, or to prevent a drop in others.

The list of examples is legion -- restrictive building codes, agricultural price supports, the market power of business and unions, pollution controls, safety regulations, pension costs, mandatory retirement, the minimum wage laws. Taken together or individually, they increase the economy's bias for inflation.

Let me take a moment to explain one bias that is particularly troublesome to me. That is the innovation that has crept into our economic thinking in recent years of indexing price increases. Since the economy experienced
double-digit inflation several years ago, there has been more and more emphasis on indexing. The "cost-of-living adjustment" was once called an engine of inflation by government economists. Recently it has lost that title. More and more labor contracts now include a cost-of-living escalator and business contracts frequently include the same type of provisions.

There are some economists who believe a cost-of-living escalator -- or indexing -- is a perfectly rationale approach to the nagging problem of inflation. As costs go up, incomes also go up by the same amount and the effects of inflation are nullified, or so the argument goes. But indexing also has one destructive feature that makes it an unacceptable approach to inflation. It serves to take away the incentive of people to fight the inflation itself. It is an admission of defeat. It is, literally, throwing in the towel, and that is one thing I and my colleagues at the Federal Reserve will never do.

What we as a people have done, therefore, has been to subject our available resources to increasingly intense
demands. At the same time, we have sought to insure that incomes do not get eroded when excessive pressures generate inflation. This amounts to creating upward pressures on costs and prices, and then arranging to perpetuate them. It is an awesome combination and one which we at the Federal Reserve must cope with.

I become very disappointed when I see the Federal Reserve alone in its struggle against inflation. Inflation, or rather the control of inflation, is a primary objective of the Federal Reserve. But we Americans cannot afford to assign that job only to the "Fed." Inflation is everybody's business, and it is up to everybody to lend a helping hand to control it.

But you ask: Won't the unemployment picture worsen if we try to reduce inflation? The answer to that is an emphatic NO. There is no longer a meaningful trade-off between unemployment and inflation. Inflation is one of the major causes of unemployment in the current environment. It leads to hesitation and sluggish buying. Today's high unemployment rate is, fundamentally, the legacy of an inflation that surely could have been avoided if proper steps had been taken in time.
It is true that stimulative policies have merit when unemployment is extensive and inflation weak or nonexistent. But such policies do not work well once inflation has come to dominate the thinking of the nation's consumers and businessmen as it does today. Expansionary monetary and fiscal policies might provide some additional thrust to the economy for a short time. But inflation would inevitably accelerate and even more difficult economic problems would be encountered.

I hope you have not become discouraged by my remarks thus far. Now that I have painted a rather gloomy picture of inflation, let me offer some measures designed to bring it under control. And I must emphasize that inflation can be brought under control if we work together. Only a few years ago, we had double-digit inflation. The present rate of inflation is half what it once was but we must do better and we can.

Conventional thinking about the economy, however, is out of date. Ways must be found to reduce unemployment while at the same time avoiding a new wave of inflation. The areas
that must be explored are many and difficult, but we must open our minds if we are to have any chance of ridding our economy of its inflationary bias.

The first step in an anti-inflationary program is prudent monetary and fiscal policy. That is essential. Any heightening of inflationary expectations will erode business and consumer confidence and impair the economic expansion now underway. Thus, any attempt to make a "quick fix" of our major economic problems by a heavy dose of economic stimulation may be counter-productive. Only a steady, moderate policy will provide the foundation for both a lessening of inflation and a return to full use of our labor force and productive capacity.

A prudent policy requires a balance between monetary and fiscal measures. Huge increases in government spending place a heavy burden on monetary policy. Large deficits can create strains on our financial markets, raise interest rates, and make the financing of business capital and housing outlays more costly. As a result, monetary and fiscal policy must complement each other and work in tandem.
But that is not all that must be done. Inflation is more than an evil of the business cycle. It is a structural phenomenon as well. We must improve the efficiency and flexibility of our markets. Structural changes in our economy will be hard to come by. But we must make the effort if we are to have any success in our struggle.

For example, steps must be taken to improve competition among businesses through increased emphasis on anti-trust policy, changes in regulatory procedures, and an easing of barriers to international trade. Job training programs should be strengthened to increase productiveness of workers, particularly minorities and teenagers. Minimum wage laws need to be altered to encourage the employment of the less skilled and disadvantaged workers. Local building codes which do not reflect modern construction techniques, should be re-examined and changed where necessary.

As a former business executive, I have a special interest in our labor market policies. As I mentioned, the Federal minimum wage law is pricing many teenagers out of the job market. When the minimum is raised, employers tend to ignore
the less skilled worker and seek the more productive employee. Employers may also attempt to get along with fewer employees. Some Federal laws -- such as the Davis Bacon Act which requires the payment of "prevailing wages" on all government construction contracts -- continue to escalate costs. There is also a belief that the unemployment compensation laws provide such generous benefits that incentives to work are reduced. I could go on, but I think you get the picture.

A restructuring of our economic system -- along the lines I have outlined -- would improve the efficiency and effectiveness of our conventional tools. During periods of excessive demand, for example, less restraint would be required to bring inflation under control. Consequently, I am convinced that structural reforms deserve more attention from Congress and, yes, from the general public, than they have been receiving. Too many people have tended to concentrate on overall fiscal and monetary policies. These traditional tools are, of course, useful and essential; but once inflationary expectations have become widespread, they must be used with great care and moderation. We must work to remove the inflationary bias of our economy.
On our part, we at the Federal Reserve will continue to provide money and credit sufficient to accommodate a continuation of the orderly economic expansion. We will strive to avoid excessive growth in money and credit that would stimulate further inflationary pressures. The Federal Reserve System, moreover, is committed to a gradual reduction over the longer run as one of the conditions that must be achieved in order to bring about an end to the inflation. As I have tried to emphasize, however, other conditions are also necessary to reach this happy end, including progress in reducing the structural distortions that have added to our economy's inflationary bias.

But these policies require public support and understanding. People must understand that this problem of inflation is a serious long-term threat to our social and economic system. People must understand that government programs, no matter how worthy, are likely to have inflationary consequences unless they are accompanied by an appropriate means of financing. Even programs that are superficially costless, still may impede the efficient workings of markets and the
flexible adjustment of prices. Such programs may impose very heavy burdens of their own.

The Federal Reserve, in this struggle against inflation, has a unique role to play. Congress has enabled the Federal Reserve System to operate independently of day-to-day political pressures. Considerable scope for independent judgment has been permitted by providing for the appointment of Members of the Federal Reserve Board for long, staggered terms. Moreover, Congress has placed the Federal Reserve System outside of the usual appropriations process.

This provides us with a unique environment especially conducive to adopting a longer-run point of view. And it is this longer-run perspective that leads us to our great concern about the problem of inflation. We hope to convince others, including people like yourselves, that this concern is warranted and that this struggle against inflation is worthy of your support.

Let me offer one idea that might have appeal for Americans who are worried about inflation. Many people who have been worried about the destruction of our environment succeeded in
pushing through requirements for "environmental impact statements" for many types of development. Although many businesses have complained about the "red tape" produced by these statements, they have served a purpose in helping to protect our environment. In some cases, projects have been cancelled or modified because of their impact on the environment. We should, perhaps, borrow a page from this book and require "inflation impact statements" to be filed by the Government in connection with changes in such programs as the minimum wage, import restrictions, and the other provisions that give our economy an inflationary bias. True, this would add another layer of red tape to already cumbersome procedures, but it would awaken the public to the cost that must be borne when new legislation is adopted and new procedures are instituted.

I would hope that you on the Council would continue to place yourselves in the forefront of economic education by encouraging people in your community to understand inflation and do something about it. In this way, the Council, in pursuing its purpose of improving economic education, can confer even greater benefits on us all.
Somehow, inflationary pressures have to be uprooted. But that cannot be done without changing a number of ideas and attitudes that have been popular for a generation or more. Consequently, we should have no illusions about finding a quick and easy solution. It will take years of prudent and vigorous public policies and restraint on the part of consumers, workers, and business firms alike. Even so, I am confident that with the imagination and leadership you and other citizens across the country are displaying, we can work to put an end to inflation and restore the conditions essential to a stable prosperity.

Remember, control of inflation is not just the job of the Federal Reserve, it is everybody's job.

I would be happy to answer any questions that you may have.

o0o