FOR RELEASE ON DELIVERY
FRIDAY, 25, 1975
8:00 P.M. CDT

FULL EMPLOYMENT AND STABLE PRICES IN A DEMOCRACY

Remarks by

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

at the

Institute on "Stagflation: Its Political and Economic Dimensions"
Center for Economic Education
The University of Wisconsin-- Milwaukee

in

Milwaukee, Wisconsin

Friday, April 25, 1975

FOR RELEASE ON DELIVERY
FRIDAY, APRIL 25, 1975
8:00 P.M. CDT

FULL EMPLOYMENT AND STABLE PRICES IN A DEMOCRACY

Remarks by

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

at the

Institute on "Stagflation: Its Political and Economic Dimensions"
Center for Economic Education
The University of Wisconsin-Milwaukee

in

Milwaukee, Wisconsin

Friday, April 25, 1975

I welcome especially the chance to talk with you today about the simultaneous high unemployment and high rate of inflation that we are suffering. I am happy to have this opportunity for two reasons. First, because I am convinced that the time has come to drop the idea that long-run full employment and price stability are not compatible, and to recognize, instead, that they are fully compatible. In fact, I very much doubt that we can have full employment without price stability, or price stability without full employment, and I think the evidence for this is written plainly in the history of the past ten years.

Second, I think the Congress has just taken action, in the form of a concurrent resolution in favor of a non-inflationary monetary policy that should be most helpful to the Federal Reserve Board in executing such a policy. One of the most notable features of this action is that it gives the Board long-needed assistance by giving equal standing to price stability and maximum employment as national policy objectives.

I regard it as a tragedy that our economic problem has so often been defined as either unemployment or inflation. It is only in the very short run that such a choice presents itself. For the long run, there is no choice but that of a policy that can sustain both high employment and stable prices. I want to describe the elements of such a policy applicable at the present time, but first I want to review the effects of aiming policy now at inflation and then at full employment, resulting in an escalation of both over the past decade.

That decade is a record of repeated switches from one of the two objectives to the other, from too exclusive emphasis first on full employment and then on stopping inflation, to be followed by renewed overemphasis on full employment, and so on through three stop-go cycles that have brought us spiraling to rates of inflation and unemployment, almost unprecedented in postwar history.

If we continue to zoom around the curves of this spiral, we shall intensify the experience of the last ten years. To end the agony of unemployment quickly, we would find ourselves reviving and accelerating the inflation. To escape that inflation we might find ourselves driven to measures -- be they tight money, high taxes, wage and price controls -- that will once more create unemployment.

Each time round, the twin scourges of inflation and unemployment reach higher levels, the economy becomes weaker, and investment in the creation of new jobs diminishes. That is what has happened so far, and that is the danger with which we must deal.

The errors of our past policies are rooted in part in a theory that has proved totally misleading: the "Phillips Curve," that is the belief that one can trade off a little more inflation against a little less unemployment in a stable way. If that were true, it would be difficult to argue the case against at least a moderate degree of inflation. Unemployment clearly is the greater evil. But three stop-and-go cycles have demonstrated that one cannot permanently buy more employment by tolerating some limited degree of inflation. Inflation accelerates once it comes to be expected. It then comes to be built in to wage contracts and pricing decisions. To make the Phillips Curve stick people would have to ignore the inflation, that is, they would have to be price blind. But we know that one cannot fool all the people all the time. Inflation probably has by now lost its power to fool even some of the people some of the time.

Let me cite some of the evidence. By early 1965, unemployment had been brought down from a peak of 7.1 in 1961 to below 5 per cent. Had we proceeded with moderation, further gains would have been possible without inflation. But the economy was allowed to overheat, and by August 1966 inflation was moving at a rate of 6 per cent.

The Federal Reserve then briefly stepped on the brakes, temporarily bringing inflation almost to a halt. But the ensuing threat of unemployment quickly led to renewed expansionary policies. By the end of 1969 inflation had reached 7.4 per cent. Tight money and tight budgets then brought inflation down to less than 3 per cent by mid-1971 while unemployment rose close to 6 per cent. Expansionary policies, combined with wage and price controls of rapidly diminishing effectiveness, once more revived inflation while temporarily reducing unemployment. In 1974, inflation hit 13 per cent, in part owing to oil crises as well as food and other shortages. A substantial rise in unemployment would have been inevitable as a result of these events, but the effort once more to restrain inflation added to the effect. By early 1975, that effort has had a measure of success. But unemployment now stands at 8.7 per cent, and the inflation is still high.

It is obvious from this record that a policy of switching from one objective to another, from fighting unemployment to fighting inflation and back to fighting unemployment, provides no answer to our problems. It simply escalates them. Today once more the temptation is great to make such a switch. Our unemployment is very serious, while the inflation, though far from ended, at least has lost some of its virulence. But if such a switch of policy were made, the outcome by now should be clear. We would witness a possibly rapid but insufficient reduction of unemployment which would be followed with some lag by a new outburst of inflation, that to be followed in turn by another policy switch and so on into a dim future.

In our present situation, I frequently hear the argument that a massive policy switch can do no harm because there is so much slack in the economy. This supposedly would give time for a period of strongly expansionary policies which could be cut off in good time to prevent overheating. I would not deny that some months ago this view held certain attractions to me. Meanwhile, however, the probable end of the recession has come into much clearer view and strong budgetary action to expand the economy has been taken. In this changing situation, I believe that a temporary spurt in our money and credit supply would just serve to repeat the pattern of the past.

I want to emphasize that I would not want to tie monetary policy permanently to any fixed rate of monetary growth at all times. Monetary policy must retain its flexibility. There have always been occasions when it was appropriate to use that flexibility, and there will be in the future. But at the present time a massive policy switch would be a mistake. If full employment and stable prices are to be reached together, monetary policy must keep its eye on both objectives.

We must bear in mind that there has been slack in the economy on past occasions as well, although not on the present scale. On those occasions, too, it seemed plausible to say that there was plenty of time first to accelerate the expansion and then to slow it down. We have seen that things do not work that way, and for perfectly understandable reasons.

In the first place, the inflationary pressure in an economy depends not only on the weight of unused resources holding down that pressure. It depends also on the speed with which the economy expands. A very rapid recovery, attractive as it would be in other respects, carries embedded in it the seeds of future overheating.

In the second place, and this is just another way of looking at the same facts, the record seems to show than an increase in money and credit affects output first and prices afterwards. In other words, the lagged effect of monetary expansion is greater for prices than for output. That does not make the ultimate result any less certain. But there might be a period of euphoria, when temporarily everything seemed to be going right. But it would be followed by the same results that we have observed in the past. The euphoria, moreover, could become an obstacle to a timely return to more moderate monetary expansion. Given the long lags, such a tightening of policy would in any event have to come at a moment that many would regard as premature. The same prospect confronts us this time if we do not heed past experience.

Fortunately there is today no need to choose between the objectives to fight unemployment or to fight inflation. As I said in the beginning, in the long run the two objectives do not compete. They can and must be achieved together. The way to resolve the problem is to stop switching. Today the same policy that can lead us back to full employment can also lead us back to price stability. That is a policy of moderation in expansion, of low-pressure rather than high-pressure tactics, and of steadiness in keeping the twin objectives of full employment and price stability equally in mind.

I believe that today there is widespread support for such a policy. Certainly there is very little left of an attitude that may have been more common some years ago, which tended to shrug off inflation, both as a threat and as a fact. The view that inflation will not escalate if left uncombatted, and that in any event whether it escalates or not, inflation is only a minor evil, has lost much of its seductiveness in the face of recent experience.

We have seen how inflation pushes business toward bankruptcy, by destroying its liquidity and profitability, and, on occasion by wage and price controls that tie up business decisions. In Europe, the question has been widely raised how long democratic institutions can survive in an environment in which inflation robs some social groups of as much as 20 per cent of their income or of their assets in a single year.

Nor do I believe that there can be an escape from inflation through indexing. Inflation, painful as it is, does help to cut down irreconcilable demands upon the social product in a manner that minimizes outright confrontation. Indexing would eliminate that cushioning effect. It would push irreconcilable demands into direct confrontation. Social conflict, or else rapid acceleration of inflation might be the consequence.

Controls, too, offer no solution. At the present time, the support for wage and price controls fortunately seems to have fallen away. It could revive if inflation were to move back into higher gear. We have now been through two periods of controls. We know that, after an initial semblance of success, the gains diminish while the damage mounts. If we should fail to defeat inflation, I would not be surprised to see us resort to controls once more. I can see no reason why the outcome should be any different.

I would not argue against forms of incomes policy that stop short of controls. In the past I have written extensively about techniques that would enlist the tax system on the side of price stability. These techniques, I regret to say, have not been explored as fully as I think they deserve. But tax-based incomes policies cannot be a substitute for proper monetary and fiscal policies. They can be a means of reducing the inflation bias in the economy and, in the long run, of reducing the rate of unemployment consistent with price stability. There are many other means that we should examine to accomplish that most important objective, including measures to improve productivity, to improve job markets, to advance labor skills, to raise productivity, and to cut down the inflationary bias inherent in many government policies and related to money and the budget.

These are innovations to be introduced in the course of the years. For the immediate future, I welcome an innovation that has recently been introduced by congressional resolution: an opportunity for the Federal Reserve to explain its policies and plans to the Congress at periodic hearings, combined with a declaration that makes price stability an explicit objective of monetary policy along with maximum employment and lower interest rates, by maintaining a rate of growth of the monetary and credit aggregates commensurate with the long-run growth potential of our economy. This congressional endorsement of a non-inflationary monetary policy is a most hopeful fact. It may not be easy to move quickly to the rate of money growth that the Congress proposes, since it implies a reduction of inflation to a very low level. But there can be no doubt that it is the only way to a lasting reduction in interest rates, and to the attainment of the low levels of unemployment that we all seek.