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Remarks by

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

to the

New York Chapter
of the
American Statistical Association

New York City

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It is an honor to keynote this meeting of the New York Chapter of the American Statistical Association on the topic "Sustainable and Healthy Growth in the Next Five Years." This topic, assigned to me by the organizers of the conference, is a challenge. To accomplish what the topic proposes is an infinitely greater challenge. To succeed, this endeavor would have to bring about an eight-year expansion, from 1975 to 1983. Ours has always been a cyclical economy. The only time in recent memory when it was widely believed that we were substituting stable growth for a cyclical uptrend was during the 1960's. As we now know, we were then laying the ground work for the worst inflation and the worst recession since World War II. Economics and economists certainly have had much to become modest about since then. Whether we have fully absorbed the lessons of that experience so that we can avoid similar mistakes hereafter, I feel far less certain.

Policies of the Past

Let me recapitulate what seem to me to have been the main errors of that period, not to allocate blame, but because the danger of repeating our mistakes seems so imminent. These mistakes, I believe, were two. First, the demands that we made on the economy, for growth and for maximum utilization of human and material capacity, were excessive. We sailed too close to the wind. Second, as the winds began to blow from alternating directions, we did too much tacking. We shifted our policies -- it was then favorably known as fine-tuning -- from fighting unemployment to fighting inflation and back to fighting unemployment and back again to fighting inflation. We thought we were riding a stable trade-off between inflation and unemployment. But that trade-off was not stable.

What happened was that when we were pushing down unemployment, inflation accelerated strongly. When we then turned to fighting inflation, unemployment accelerated strongly. The trade-off shifted against us no matter which way we shifted our policies. In this zigzag pattern between unemployment and inflation, the economy ratcheted upwards to ever higher levels of both, culminating with 11.0 per cent inflation in 1974 and 8.5 per cent unemployment in 1975. The Phillips curve that we traced out over a period of 12 years turned out to be positively inclined, unemployment and inflation both rising although not at the same time. The lessons from this experience will become clearer when we take a look at the present situation.

Approaching the Full Employment Zone

After three years of expansion, in itself not a bad performance as cyclical expansions go, we now find ourselves at a critical point. Unemployment has come down sharply during the last 15 months. Unless this turns out to have been a statistical fluke, we are about to enter the full employment zone, which I see in the range of 5-6 per cent. But we have done poorly on inflation, which is beginning to accelerate. That, I believe, is the root of the uneasy feeling that prevails, even though it is possible to massage the data in ways that seem to deny acceleration. In an expansion that has gone for three years, this is not at all a surprising development. But it has never been a good omen, and it is not a good omen now.

On the other hand, our three-year-old expansion has not yet developed the kind of imbalances that have characterized many earlier cycles. Most business cycles have ended with a bang, although there are some that have ended with a whimper. The bang, such as occurred in 1973-74, typically has been the result of an excessive boom that was bound to end in a more or less severe correction. Neither consumption, nor inventories, nor even housing, and certainly not plant and equipment spending have shown obvious excesses. The large budget deficit, and the prospect that in the fourth year of the expansion it will be further increased, could be viewed as a serious imbalance. The large current account deficit which is producing a rapid decline of the dollar, definitely deserves to be so classified. As it happens, however, the two imbalances tend to offset each other. The budget deficit is restoring -- and more than restoring -- the purchasing power absorbed by the current account deficit and the surpluses of State and local governments.

The energy situation and our uncontrollably mounting oil imports further complicate our situation. For national security reasons, if none other, it seems essential to raise the price of oil in order to induce conservation and shifts to domestic sources of all forms of energy. The best way of accomplishing this objective, in my opinion, would be to relax domestic price controls on oil and channel incremental receipts into resource development. A second best solution would be enactment of the well-head tax and rebating the proceeds or perhaps substituting them for the social security tax increase that is now in dispute.

But if these two approaches turn out not to be politically feasible, an import fee imposed by the President could accomplish approximately the same objective, although it would run the risk of inviting an OPEC price increase. Any one of these actions, by the nature of its objective, would contribute to the rise in prices. Once prices accelerate, there is the danger that the move will go into wages and so perpetuate itself. National security considerations, however, must have priority, and the prospect of a rise in the price of oil simply becomes another reason for working harder to restrain other price increases.

The declining dollar poses similar problems in that it also contributes to inflation. Unlike higher oil prices, however, a lower dollar is not a desirable remedy for the large current account deficit. The current account deficit is in large part cyclical. Once other countries achieve the same degree of recovery from recession as the United States, much if not all of the deficit should vanish. If the dollar had previously fallen, it might then rise again. Meanwhile, however, the drop in the dollar is doing damage not only to U.S. prices and to the international position of the United States, but also threatens further to slow growth abroad, if not to produce a recession.

Under a fixed rate system, a largely cyclical deficit probably would not have been the occasion of an exchange rate movement. Moreover, the United States does not need such stimulus as might come from a declining dollar. In fact, the damage that this decline is doing to economic growth abroad might nullify or even reverse the usual expansionary effects on domestic demand of exchange rate depreciation. But a fixed rate system is not conceivable under prevailing conditions.

Policy Directions

The various circumstances of our day all point in the same direction. The approach to full employment, the acceleration of inflation, the need to conserve energy, and the weakness of the dollar, all suggest that some tapering off in the rate of expansion is desirable. This has already been happening: from 5.7 per cent real growth during 1977, we are moving to perhaps 4-1/2 per cent growth during 1978. Obviously it is not desirable to curtail drastically the rate of growth. But for a combination of reasons, the time has come to get ready for a soft landing.

Such a soft landing, gradually phasing into the long-term rate of growth, is an essential condition to extending the expansion into the medium run. An attempt to maintain an abnormally high rate of growth would almost certainly lead to a serious acceleration of inflation, guaranteeing us a bad recession a little later.

Monetary Policy

In the face of accelerating inflation, monetary policy has a clear obligation to do whatever is possible to slow down over time the growth of the monetary aggregates. Price-level stability is the least achieved of our objectives. Fighting inflation, therefore, should have priority among these objectives. The use of money supply targets rather than interest rate targets is appropriate at this time. The simple facts that less money means less inflation and that more money means more inflation are intuitively plausible and should have wide acceptance among the public.

A policy focusing on the monetary aggregates must be constrained, of course, by concern about interest rates. But an effort to hold interest rates down by pumping out more money in the face of mounting inflation is bound to be counterproductive. It is a short-run policy that has no future. A credible money supply policy aiming at slowing the aggregates over time, moreover, should by itself engender expectations of declining inflation which would restrain interest rates. If monetary policy cannot instill that kind of expectations, the outlook for continued medium-term expansion is dim.

Restraint of the monetary aggregates is needed also to deal with the weakness of the dollar. The familiar theoretical position, to be sure, that monetary policy should be directed primarily toward balance of payments while fiscal policy is directed toward domestic equilibrium applies less to the United States than to smaller countries. Moreover, it is a proposition that contemplates a monetary policy oriented toward interest rates more than toward the monetary aggregates. In so large a country as the United States, monetary policy must ordinarily be conducted with a view primarily toward the domestic economy. But a severe drop of the dollar damages not only the rest of the world, but injures also the domestic economy through added inflation, threat of higher oil prices, and the danger that a slowdown abroad may hurt U.S. exports. Hence, monetary policy cannot at a time of dollar weakness, ignore this pervasive threat.

Fiscal Policy

The mix of fiscal and monetary policy is important also in considering the domestic objectives of fiscal policy. It has been argued, most recently by the Joint Economic Committee that this mix has been unbalanced, with monetary policy carrying too much and fiscal policy too little of the burden of combating inflation. While one might question whether a monetary policy that has validated an ongoing 6-7 per cent inflation has been overly tight, one would not disagree as regards the inadequate role played by fiscal policy.

Nevertheless, it should be clear that changing the fiscal-monetary mix, by tightening fiscal and easing monetary policy, cannot mean increasing the rate of growth of the money supply to compensate for a reduction in the budget deficit. At most this could be a very temporary and a very limited expedient. A sizable and continuous step-up in money growth would simply lead to higher inflation, preceded by an only temporary decline in short-term rates and perhaps no decline in long-term rates at all.

A variation in the monetary-fiscal mix must come from the change in interest rates that changing demands by the public sector on the financial markets bring about in combination with constant rate of money growth. A tighter budget, in this framework, means lower interest rates. In other words, under a money supply target, interest rates are really mainly governed by fiscal policy. This way of looking at the fiscal-monetary mix makes sense in the light of the well-known fact that the central bank cannot, except very transitorily, influence interest rates. Fundamental economics tells us that interest rates are determined by the supply of and demand for savings, including the demand of the government.

The principal directions in which fiscal policy should go if it is to contribute to inflation restraint now and to sustainable growth in the medium run are clear. First, the Federal deficit should be reduced. It is dangerous to increase it in the fourth year of an expansion. That does not mean that a tax cut should be foregone. It seems appropriate to offset fiscal drag, but unwise to engage in additional stimulation.

Second, the structure of taxes should be shifted decisively in the direction of stimulating investment. The proposed tax cut seems scheduled to be split about two-thirds for consumption and one-third for investment. This is not a good division. It seems to reflect mainly our peculiar habit of referring to an investment-oriented tax change as a change "favoring business." We should not allow political rhetoric to get in the way of economics.

In urging a tighter budget, I want to be clear that I am not urging a move to a balanced budget in the foreseeable future. Depressing as it is, we probably have to give up the idea of achieving a surplus at full employment in the near future if we see full employment as falling somewhere in the 5-6 per cent unemployment range. So much damage has been done to the private sector, through inflation, through the sudden rise in the cost of energy, and through government controls and regulations, that one must doubt the ability of the private sector to sustain itself without some assist from a budget deficit even after a high level of activity is reached.

But, on the other hand, I do not believe that reducing the deficit would be very costly in terms of stimulus foregone. The effect of budgetary stimulus today is smaller than it used to be. Too many negative forces are called up by a rising deficit -- higher interest rates, expectations of higher inflation, fears of a continuing increase in the public sector. Reducing the deficit would help to turn these same variables in a positive direction.

Incomes Policy

So far, I have discussed our immediate and longer run objectives as being pursued with the help of the traditional macroeconomic instruments -- monetary policy and fiscal policy. There is reason to doubt that these tools will prove adequate, particularly to the goal of reducing inflation. The record is not encouraging. Price inflation came down from the double-digit range. Wage inflation, while it did not advance as much, also has not come down much. Price inflation came down primarily because fortunately it was not fully translated into wage inflation. But the underlying rate of price inflation has become stuck at a level equal approximately to wage increases (including fringes) minus productivity gains. Now price inflation threatens to accelerate again, as do wage increases.

A search for new methods of dealing with inflation is needed. We may end up convincing ourselves that none can be found. But that does not absolve us from the need to look. The direction in which I think we should look is, of course, well known -- toward a tax-oriented incomes policy (TIP). None of the forms of TIP that have been suggested has received a rousing welcome from either labor or business. That is understandable. But labor and business ought to ask themselves what the alternatives are. We can aggressively attack inflation by means of the orthodox fiscal and monetary policy techniques. That would probably mean a high level of unemployment for a long time. Alternatively, we could ignore inflation. In that case, it would probably accelerate and thus bring itself to our attention. Wage and price controls, a theoretical third alternative, were discredited by the experience of the early 1970's. As a simple matter of fact, we have run out of attractive options.

TIP is no ready-made panacea. It needs a great deal of exploration and discussion. Nothing is ever enacted as it was first proposed. Indeed, if I could push a button today to put some version of TIP into effect, I would not push that button. But I believe that we should look at TIP in detail, instead of rejecting it wholesale. TIP could take many forms, and I would like to conclude my remarks by leaving with you some of the principal alternatives to think about.

(1) TIP could deal with both prices and wages or with wages only, or with wages and profits. Dealing with wages only seems adequate because prices are closely tied to wages. Moreover, there might be lags in that relationship, and the possibility of a disproportionate increase in profits would have to be considered. That danger would be present particularly if TIP were applied to large firms only, so that the link

between wages and prices might be weakened. Some versions of TIP, such as my own, provide a safeguard against this contingency. As for the price side, anything dealing with measurement of price increases introduces greater complications than measurement of wage increases.

(2) TIP can take the form of a carrot or of a stick. The carrot version naturally is more attractive, or less unattractive, to business and labor. It has the additional advantage that it would be voluntary. But it suffers from the fact that it would cost revenue, as taxes are forgiven to reward wage restraint. It also tends to create "all or nothing" cases, where the reward may be lost owing to a minute infringement of the guideline although this is not the case in all of its variants. The stick approach avoids this by making the penalty proportionate to the magnitude of the infraction. Some versions of TIP combine the carrot and the stick approach. That could make it possible to avoid unintended revenue losses or gains.

(3) If a stick approach were chosen, the peanlty could take the form of an increase in the corporate tax rate, a disallowance of excessive wage increases for corporate tax purposes, or a payroll tax. These approaches would have different implications with respect to shiftability of the tax penalty. They would also affect the relative position of capital-intensive and labor-intensive firms.

(4) TIP in its stick form could be applied selectively, to a group of large firms only, or more broadly to all corporations or even to all businesses. The selective approach would be easier to administer and, given that it is the large firms that principally bargain with unions and make pattern-setting agreements, might be sufficient to determine the trend of wages. There is, however, a question of equity and also of the degree to which wage restraint in large firms would be sufficient to restrain price movements. The carrot version would probably have to be universally available to all firms.

(5) TIP presents administrative difficulties, such as the measurement of wage and price increases. Under an approach that focuses on wages only and employs penalties, an ex post audit could be relied upon to compensate for any ex ante failure to assess the magnitude of a given wage increase correctly. All these versions of TIP are members of a family, and while I have my preferences, I believe that it is too early to be very firm about any of them.

After studying a considerable volume of evidence on the feasibility of TIP, I am inclined to believe that the technical problems can be solved. The benefits should be considerable. First, TIP would help to reduce the rate of inflation, provided it is backstopped by appropriate fiscal and monetary policies and not used as a shield or pretext to engage in excessive expansion. Second, if applied continuously, TIP should lower the noninflationary rate of unemployment and make possible a continuously higher level of employment and output. Finally, TIP would leave largely unobstructed the forces of market. Business and labor could agree on whatever wage increases serve their purposes, subject only to the constraint of the rewards or penalties created by TIP.

These are substantial advantages, and if they can be attained by a carefully designed TIP, I believe that a considerable effort to make TIP work would be justified.

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