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WHAT INFLATION HAS DONE TO US

Remarks by

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

at a meeting sponsored by

Westminster College
and
The Chamber of Commerce

Ogden, Utah

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It is a pleasure to address this dinner gathering of the Chamber of Commerce of Ogden on the subject of inflation. I had been told that there would be an audience with ladies and inflation is a topic that is of special concern to them. Certainly, today there is no reason for an economist to try to explain what inflation means.

This small coin that I hold in my hand symbolizes what has happened to our dollar. It is a Susan B. Anthony dollar, which will be put into circulation the first week in July and may eventually replace the one-dollar bill. The Susan B. Anthony dollar is very handy, a little bigger than a quarter. It will buy for you more or less what a quarter used to buy during the early 1940's. I am speaking, of course, in terms of averages. Some things have gone up much more. When I started to work in New York City in 1935, a subway ride cost a nickel. Recently I paid 50 cents. A copy of The New York Times then cost two cents. It costs 20 cents today.

The Susan B. Anthony dollar is a good way of reminding ourselves what has happened to our money. In practical terms, replacing the depreciated dollar bill by a small coin is a very good idea. It will save the Government money, because even if it circulates rapidly it will wear out much more slowly than a dollar bill. It costs 3.3 cents to coin a Susan B. Anthony dollar, and 1.9 cents to print a dollar bill. But the dollar bill, on average, lasts only 18 months, and the less it buys, the more carelessly people treat it, stuffing it into their pockets instead of carefully placing it in their wallets.

In introducing this coin, the United States will be following the example of many other countries, including Switzerland and Germany, whose money has preserved its value better than ours. Swiss francs and German marks circulate in the form of coins and over there they also have two- and five-franc and D-mark pieces. A five-franc piece is worth about $3.00. They are easy to handle and give you an agreeable sensation of having a pocket full of solid money.

But the Susan B. Anthony dollar's main virtue, I hope, will be to teach us a lesson. The lesson is that we must do something to preserve the value of our money, or it will shrink. The dollar is now what a quarter was at one time. The nickel buys little more than what a penny used to buy, and there is a real question whether the Government is well advised in continuing the expense of minting billions of pennies instead of allowing the nickel to become our smallest unit. We would all save a lot of time making change and unfortunately a price difference of a penny hardly is any difference anymore. The main objection to such procedure is the surge of inflation that would result if vendors were to round prices up instead of down to the nearest nickel

The new dollar will serve its purpose if it reminds all of us of inflation. Perhaps such a reminder is not needed, but what is needed is a strong resolve to deal with the problem. This problem affects everybody, although it takes a somewhat different form for people in different situations.

Let me examine for a moment a few familiar cases. First, there is the family that is trying to make ends meet. In an average family, they probably more or less keep up with inflation, with pay checks generally rising with prices. But that is not always the case, and in any event they can never be sure. What if one year there should be no pay raise? Or what if the main breadwinner should lose his job? Ordinary household decisions, moreover, become gnawing problems. Should the family buy new furniture, or a new car, before the price goes up? If they do not, they will probably have to pay more later. But if householders try to buy ahead, and something then goes wrong with a pay raise or job, can their payments be met? Inflation creates insecurity and tension.

If the family is young, and has small children, there may be the question of how to prepare for college. With the price of college education going up 10 per cent per year, as it has been doing, there is no way of setting aside, from today's pay, an annual sum that will be of much use 18 years from now. At today's rate of inflation, the half-time life of money is only 7.2 years. Many people seem to think that the best way to save for college expenses is to buy a house and hope that its value will have risen enough when the time comes so that they can put a second mortgage on it. Few parents will be happy to have to gamble in this way for the future of their children.

That gets us to the role of the homeowner in inflation. On the surface, he is the big beneficiary. The price of the average home has risen from $27,383 in 1971 to $55,058 in 1978. Those who bought their home with a mortgage have seen the value of their equity in the house rise proportionately much more. Nevertheless, most homeowners do not seem to be happy. They find taxes and utility costs rising, and many do not like the idea of trying to cash in on their capital gains by refinancing. As a result, people take drastic political action, such as the passage of Proposition 13 in California. That helps to hold down real estate taxes. But for people who want to buy a house even this is only a partial help, because the effect of Proposition 13 in the opinion of many seems to have been to drive up further the price of California real estate and to put it further out of reach of new buyers.

Worst off probably are people who have retired, or are planning to do so soon. Private pensions cannot be reliably indexed to inflation, because the payor may not be able to perform. Putting money in a savings bank means putting it under a Government-mandated interest rate ceiling which for years now has not allowed the saver to keep up with inflation. The great popularity of money market certificates, of which over $100 billion have been issued since June 1, 1978, by banks and thrift institutions, attests to the savers' deep concern over this situation. But a saver who can put up $10,000 for such a certificate may not always be what is frequently called a "small saver." Consequently, he probably pays a substantial income tax. If so, the yield to him after tax and inflation is still negative. If he puts his money into bonds, the same applies. He may get a good interest rate, but inflation and taxes makes his yield negative. He loses money on every dollar he invests. In addition, if inflation should accelerate, he runs a risk with respect to the market value of his investment.

Finally, if the saver invests in common stock, he comes up against one of the great puzzles confronting present-day investment strategy. In abstract logic, common stocks over time should keep up with inflation, unless some drastic changes have befallen American corporations and their profits. But the fact is that stocks have not been a good inflation hedge. As inflation has progressed, stock prices, on average, have remained roughly constant. That means that stocks have become cheaper each year in real terms. If one adjusts the Dow-Jones index for inflation, he finds that, in real terms, the stock market is now where it was in 1954. Foreign investors seem to think that American industry is for sale cheaply and are moving in. American investors and their advisers seem to believe that 9 per cent interest is better than 5 per cent in dividends, even though stocks by and large are backed by real assets while bonds are fully exposed to inflation.

Faced with these unattractive alternatives, the saver who hopes to retire on his or her savings is in a losing game. Such persons might ask what depreciates faster -- people or money. Our senior citizens deserve better than that.

But it is not only the consumer who suffers from inflation. The businessman, the farmer, the worker, also are victimized. The businessman probably finds the uncertainty with which inflation confronts him to be its most damaging consequence. Future costs, future selling prices, future taxes, all become a gamble. Everything becomes more risky. To make an investment, the margins must be much more attractive than they would need to be if prices were stable and predictable. The tax system, moreover, makes nonsense of normal business calculations. The businessman is now allowed to charge off what it would cost to replace the wear and tear on his machinery and equipment. Rather, he can charge only at the price at which he bought the equipment, perhaps many years ago. When the time comes to replace it, he must go out to borrow new money because the money the tax law allowed him to set aside via depreciation has become inadequate. The tax law treats as profits money that should be set aside for future replacements. As a result, profits are overstated. The stock market recognizes this by putting a very low value, in terms of price/earnings ratios, on the profits of most corporations. That, in turn, makes it difficult to sell new stock for financing of new investment. Inadequate investment leads to inadequate productivity, and inadequate productivity, as I said earlier, leads to more inflation.

The farmer, too, is hit by inflation. A few weeks ago, a group of farmers came to Washington to ask the Government for relief from their financial pressures. It was pointed out to them, in the press and elsewhere, that farmers for many years have benefited from the great rise in the price of farmland. That, in fact, has been one of the principal returns to farming. But, in this regard, farmers are in the same position as homeowners. Rising land prices do not mean cash in the bank to pay bills or interest, and so the farmer faces a liquidity squeeze. The problem of the young farmer who wants to buy a farm is even more serious.

The worker, too, and -- if he is organized, his union leader -- faces difficulties from inflation. A powerful union may be able to take care of its members by making wage demands sufficiently larger than the rate of inflation. But if they do this, they expose themselves to public criticism and governmental pressure. A responsible union leader is bound to be seriously concerned about what he would be doing to the trade-union movement and to the entire country by enforcing a settlement that would break the President's guidelines. On the other hand, a labor leader who does not do all that he can for his people may find himself voted out of office. Wherever we look, inflation breeds insecurity and conflict.

If inflation is so universally damaging, why is it that we have made so little headway against it? In particular, why is it that in the year in which the Government made the fight against inflation its number-one priority, inflation has once more accelerated into the double-digit range? The basic reason, I believe, is that in fighting inflation we are still violating the first rule of economics that there is no such thing as a free lunch. We delude ourselves if we believe that a cure will not be painful and costly. But the ultimate pain and cost of letting inflation go on is far greater. There is no way of "living with inflation." Unattended, it will accelerate in the future as it has done in the past, contrary to many predictions, and will end up by destroying our market economy.

What we shall have to do, in broadest terms, is this:

(1) Allow for somewhat greater slack in the economy in the form of more excess capacity and unemployment than we would ordinarily want to accept. We must reject speculative calculations of the amount of output that we would be sacrificing by such a policy. That additional output would never be available in an economy wracked by inflation as ours is. At the same time, we must continue to compensate decently those who, for shorter or longer periods, suffer unemployment. We can immediately reduce the worst part of our

unemployment, that of teen-agers, by lifting temporarily or, better, permanently the minimum wage restrictions that militate against employment of teen-agers.

(2) We must end the many activities of the Federal Government that spawn inflation, including numerous forms of regulation.

(3) We must bring Government expenditures under better control. While I do not believe that a Constitutional amendment for an ever-balanced budget is a practical answer, we can and should set firm limits on Government expenditures.

(4) We should pursue a strong anti-inflationary monetary policy, taking advantage of the fact that while monetary policy works only with a lag on employment and output, its effect on prices, which works by affecting peoples expectations, can be much quicker.

(5) We should implement guidelines of the kind established by the President and support them, together with a real wage guarantee or some other use of the tax system to restrain the wage-price spiral.

(6) We should reform the tax system to strengthen our productive forces and eliminate the existing bias against productive activities.

The execution of such a policy would have to take many forms. It will encounter resistance and will require courage and steadfastness. I have no doubt that the solution to the problem of inflation is in our hands. The cost of victory in this struggle may be high, but the cost of losing would be incalculable.