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INFLATION AND THE POLICY OPTIONS

Remarks by

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

at the

1980 Business Outlook Conference

Sponsored by

The Conference Board

New York City

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Summary and Conclusions

(1) We are underestimating the damage that inflation is doing to our economy. Inflation reduces and may ultimately destroy productivity gains. The losses from that source can far exceed losses from temporary unemployment and underuse of resources, and they can never be made up.

(2) All government programs that increase prices and costs must be reoriented toward the objective of restraining inflation.

(3) A new form of incomes policy is desirable. It would take the form of a two-stage approach to wage setting that would allow labor to share in any increase in business profits resulting from initial acceptance by labor of a low wage guideline.

(4) It is too early for a tax cut, although one will be needed eventually to offset the move of taxpayers into higher brackets owing to inflation. At that time, the best cut would be one that avoids appearing

to give gifts to business but instead restores normal depreciation based on replacement instead of original cost.

(5) Monetary policy should take more account of the expansion of money substitutes such as money market mutual funds and should aim at maintaining positive real interest rates over broader periods of time.

I am honored to be asked to speak before the 1980 Business Outlook Conference of The Conference Board on the subject "Inflation and the Policy Options." Speaking for myself, I do not feel that we have many options against inflation, certainly not good ones. Most conceivable measures have already been tried at some time and in some degree or other or at least proposed legislatively. We will have to try again and try to do better mainly with the means already at hand.

Inflation Tends to Accelerate

I do not consider "benign neglect" of inflation as an option. Experience shows that if inflation is not attended to vigorously, it accelerates. I would like to begin by examining the recent evidence on this a little more closely. During the 1973-74 burst of inflation, the rise in consumer prices reached a rate of over 12 percent for several quarters, somewhat less than during the first half of 1979. Over the next year or two, the rate dropped by more than one-half, indicating significant progress. But the anti-inflationary measures taken, at considerable cost in unemployment and widely criticized for that reason, had little long-term impact. In 1977 and after, inflation began to accelerate once more as capacity limitations made themselves felt. Thus, we went into that new round of price increases from a base level of less than 6 percent.

At the present time, under circumstances in some respects similar, but with much less inflationary steam in the economy than in 1973-74, we have reached rates of inflation somewhat higher than the peaks of 1973-74. But, and here is the essential difference, none of the forecasts that I have seen anticipates a reduction of the rate of inflation in 1980 to anything like one-half. The administration expects inflation in 1980 to be only fractionally below 1978, as measured by the GNP deflator. The Federal Reserve expects inflation in 1980 to be higher than in 1978. Thus, even if the projections are realized, we seem likely to go into the next expansion from an inflation level considerably higher than at the start of the previous round. Inflation has clearly accelerated.

Inflation is Destroying Productivity

Meanwhile the costs of inflation are being increasingly borne in on us. Productivity, as you all know, has slowed alarmingly. I do not believe that it is altogether an accident that the slowdown of productivity which began in the late 1960's coincided with the emergence of inflation.

That slowdown, from a rate of over 3 percent during the early 1960's to something like one percent over the last five years -- I ignore the abysmal productivity numbers for the last two quarters -- has, of course, many roots. Some among them, such as the changing age composition of the population and government price raising regulations, are not caused by inflation. On the other hand, inflation has something to do with the slow growth of investment, the slowing of associated research and development expenditures, the reduction in savings, the higher tax burden, the entrance into the labor force of untrained persons motivated by pressures on household budgets, and the associated shift to less productive service occupations. These can all be traced in greater or lesser degree to the pervasive influence of inflation.

In particular, inflation has reduced corporate funds available for investment. Profits have been overstated through underdepreciation and failure to account properly for inventory profits. The burden of taxes, therefore, has increased and, in the case of inventory profits at least, cash flow has been less than it appeared to be. Inflation has reduced the feasibility of investment projects both by reducing their after-tax return and by raising the risk premium. It has reduced investment also by raising the cost of capital. Although the cost of debt capital has been low, after taxes indeed clearly negative, the cost of equity and the implicit cost of internal funds has been very high owing to the low price/earnings ratio to which inflation has driven equities in the stock market. Inflation has penalized savers, helped to drive down the saving ratio to abnormal levels, and pushed the use of savings into relatively unproductive channels.

In addition, lasting damage to our capacity to innovate is done by inflation through the havoc it has wreaked on institutions of higher learning and through the damage it has done to the dollar which increasingly inhibits foreign travel and enhances our national provincialism.

Inflation has done damage also by provoking ill-conceived government policies such as wage and price controls. These tend to squeeze profit margins, hurt investment, and generally cause misallocation of resources. The unfortunate fiscal and monetary policy mix which has caused us to fight inflation by tight money and then to offset its effects by easy budgets has also been adverse to investment and productivity. Fighting inflation is bound to have costs just as inflation itself has, but it is possible to minimize those costs by appropriate policy mixes.

It has sometimes been said that the cost of fighting inflation, especially by the traditional means of fiscal and monetary policy, is so high that we cannot afford it. Examples and studies cited suggest that a reduction of inflation by one percentage point costs five million jobs and $250 billion of GNP over five years. I regard such calculations as invalid for two reasons. First, the studies assume that the economy can continuously operate at "potential," whereas if operating at this level means inflation that is not a realistic possibility. Second, and even more important, the calculation accepts potential as a predetermined magnitude whereas it is determined very importantly by the functioning of the economy. The recent slowdown in productivity gains has greatly reduced the potential of our economy contrasted with what it would have been had productivity gains continued at their old rate of 2-1/2 - 3 percent a year. Inflation bears part of the ultimate responsibility for the slowdown. It has obviously caused permanent damage by holding down the growth of potential. In this way, inflation causes a loss of output that is almost sure to be much larger than any loss from temporarily operating below capacity.

The gradual shift from about 3 percent productivity gains during the early 1960's to about one percent during the second half of the 1970's implies a loss of 15 percent of the average GNP of that period. Projected into the distant future, a 1-2 percent annual loss of GNP growth from lowered productivity quickly mounts to astronomical levels: the permanent costs of inflation promise far to exceed the temporary costs of unemployment.

Inflation poses threats beyond loss of output. Uncurbed, it will almost certainly lead to further experiments with wage and price controls. Over time, imposing and removing controls will scarcely change the speed of inflation unless something is done about its causes. But the distortions and conflicts inherent in controls will work their own brand of damage. The survival capabilities of a free enterprise economy under such conditions strike me as low.

Measures to Restrain Inflation

I would now like to turn to measures that, if we chose, could be employed to deal with inflation. They can be divided into three kinds: (1) abatement of the numerous cost and price raising actions of the government, (2) incomes policy, and (3) monetary and fiscal policy.

I do not see any real options among available techniques. We shall need all the techniques that are available. Sole reliance on fiscal and monetary restraint, especially in the face of what has been referred to as "self-inflicted wounds" through government price raising actions, will not be adequate.

On these "self-inflicted wounds," ranging from farm price supports through minimum wage, health and safety, and environmental regulations, and protectionism, to inadequate antitrust action, I have nothing new to contribute. I would only say that national security considerations must have priority even over inflation fighting and for that reason I would still welcome it if the government were to change its mind on immediate oil price deregulation. If progress is to be made in dismantling government-mandated price increases, defenders of many good causes will have to make painful sacrifices. Willingness to accept these becomes, in a way, a measure of one's concern about inflation.

Incomes policy is as yet a largely unexplored terrain for the war against inflation. The wage and price standards seem to me to have had some beneficial effects.

My personal preference is for a tax-oriented incomes policy. The administration's proposal for real-wage insurance is a particular genus of this species, embodying what is known as the "carrot" approach. My own preference would be for a "stick" approach, involving an increase in the corporate income tax for firms giving excessive wage increases. Of course, I am aware that the approach lacks political appeal, both for business and for labor. For that reason perhaps one could claim that it is evenhanded. I expect that, once the inflation-curbing effects of the present economic slowdown have worn off, and the full struggle to contain inflation resumes, we shall hear more of tax-oriented incomes policies.

A New Version of TIP

Many versions of this technique have been proposed. I would like to suggest an additional one, in the hope that it may be politically more acceptable, although without backing away from my original preference.

The most serious obstacle to acceptability of TIP, in the light of recent experience, seems to be labor's concern that acceptance of a wage guideline might lead to excessive profits for business. In the light of historical experience, this concern may seem unnecessary. Prices have tended to follow unit labor costs closely except when events like bad crops or oil price increases have broken the relationship. Ordinarily, fixed mark-up pricing ties prices to unit labor costs with profit margins fairly constant over the long run. Nevertheless, labor's concern needs to be met.

My new version of TIP proposes to do this by means of a two-stage approach to wage setting. In the first stage, wage increases are to be restrained by a guideline. In the second stage, if, contrary to expectations, profits have increased abnormally following wage restraint, there is a secondary wage increase or equivalent that, in economic terms, amounts to a form of profit sharing. This could be accomplished either at the micro level, by renegotiation of individual wage contracts, or at the macro level, through an excess profits tax and a cut in lower bracket tax rates.

If the scheme is carried out at the micro level, a guideline would have to be set for a "normal" increase in profits. Firms that had profit increases in excess of the guideline would renegotiate wages so as to share the "excess" with their employees according to some formula. If that formula were set during the initial wage negotiation, it would save negotiating effort later and perhaps create incentives for greater productivity. Some nationwide formula for the sharing of the excess is also conceivable. The share of profit being distributed to the employees would, of course, have to be tax deductible to the company.

The advantage of this micro approach is that it adapts itself easily to individual company circumstances. A disadvantage is that some companies may have no above-normal profits while others do. The employees of both types of companies, on the other hand, would be affected equally by rising living costs. In that case, protection against rising living costs would be unequal.

A macro approach, as an alternative, would proceed by levying an "excess profits tax" on above-normal profits. The proceeds of the tax would be used to reduce income taxes in the lower brackets, or alternatively to compensate the employees of the tax-paying companies in proportion to their wage shortfall with respect to profits.

The excess profits tax would take the form of an increase in the regular corporate income tax for all corporations, whether they had abnormal profits or not. The increase would be aimed at keeping constant the share of corporate profits in GNP, or bringing that share closer to some benchmark. This would involve a rise in the corporate rate probably of only a few points, without major disincentive consequences. A benchmark for the appropriate share of corporate profits in GNP would be required.

These alternative versions of TIP have some similarity with the principle of real wage insurance that has been before the Congress. They differ, broadly, in avoiding its budgetary burden, by limiting the compensation paid to employees to a share in abnormal profits or the proceeds of a tax thereon. The proposals also resemble present wage guideline principles and the guaranteed real wage proposal in recognizing that, in order to break into the wage-price spiral, somebody has to move first, but that there will be no loss to the first mover, provided this move is not followed by a redistribution of income.

A Tax Cut Is Premature

Finally, I come to fiscal and monetary policy. They have to be the wheelhorses of any effort to contain inflation. They should not have to carry the full burden, but the other approaches can in no way be substitutes for the orthodox techniques.

At the present time, there is growing discussion of a tax cut. In my view, that is entirely premature. At some point in the future, assuming continued inflation, a tax cut will be needed simply to reduce fiscal drag. Taxpayers are being pushed into higher tax brackets by rapid inflation. That is why the so-called high employment budget is moving into higher and higher surplus. But the reality is that we are at full employment, and we have an effective deficit of around $40 billion. The chimerical surplus, of course, is simply due to the manner of its computation. It does convey a meaningful signal through its rate of change. But that we still base our calculations on unrealistic benchmarks of this sort shows how much progress we still have to make in bringing our thinking up to date. If we want to arrive at a structurally sound budget, it is too early for a tax cut.

Replacement Cost Depreciation

Neither do I find particularly attractive the specifics for a tax cut that are sometimes being proposed. As much of a hypothetical cut as is politically possible, I agree, should be designed to stimulate business investment. But why, instead of seeming to make gifts to business through investment tax credits or accelerated depreciation, would it not be better to allow business to have no more than ordinary depreciation, but base it on realistic bookkeeping? Depreciation based on original cost makes very little sense in 10 percent inflation, when the half-life of a dollar is about seven years. Underdepreciation, according to the Department of Commerce, amounted to $45 billion last year. The tax paid on this overstatement of profits, at 48 percent, amounted to $22 billion. Replacement cost depreciation would remedy this. It seems simpler, and less vulnerable to criticism, to eliminate taxes that should not have been paid in the first place rather than collect these taxes and try to offset them with what looks like special favors to business.

The much discussed cut in payroll taxes also seems less desirable than a cut in personal income taxes. If we start to hold down the consumer price index by reducing payroll taxes, we may eventually find ourselves doing so by subsidizing the cost of food or other items that could be used to manipulate the CPI. Moreover, shifting part of social security to the general fund, as would be implied in a cut in the payroll tax, destroys the insurance character of the social security system and opens it up to limitless financing through the income tax. In any event, I must not allow my interest in discussing the specifics of a future tax cut to create the misleading impression that I meant to argue for it at this time. I do not.

Monetary Policy, Quasi-Money, and Real Interest Rates

In conclusion, a word about monetary policy. I have great sympathy with the proposal to bring down the growth rate of the monetary aggregates gradually but steadily. Gradualism is essential. A policy of sudden drastic restraint would almost certainly be counterproductive economically and politically. But gradual reduction of the monetary aggregates is no easy task even if one is fully prepared to face the consequences. The monetary aggregates have ceased to be a reliable guide to monetary policy, because they have ceased to sustain a stable relation to economic activity. At 10 percent inflation the losses on demand deposits are so horrific that their holders will exert enormous ingenuity to discover alternative means of managing their liquidity. How the various quasi-monies that are exploding on all sides -- RPs, Eurodollars, ATS and NOW accounts, money market mutual funds -- should fit into the liquidity spectrum running from M-1 to M-7 is debatable. If, with appropriate avoidance of duplication, they were included in M-1, they would drastically accelerate its growth rate. Included in higher aggregates, which are much larger than M-1, the impact on growth rates would be less, but still significant. Thus, the recorded growth particularly of M-1 may lead us into seriously underestimating recent monetary expansion.

To guard against such errors, it is helpful to focus on the behavior of real interest rates. It can reasonably be argued that interest rates that are negative in real terms are excessively expansionary. We should not, I believe, be deterred from using real interest rates by the scruples of theoretical economists who point out, correctly, that they depend upon expectations. Short-term real rates, in any event, are clearly observable. Anyone who held short-term assets during the first half of this year can readily, albeit roughly, compute with the help of the CPI whether the real rate was positive or negative. Complications arise, to be sure, in computing real rates after taxes, but after taxes most interest rates today are heavily negative.

In advocating real interest rates as a guide to monetary policy, and in proposing that we should aim at keeping them positive, I am not suggesting that interest rates should follow every wiggle of the CPI. Monthly and even quarterly aberrations seem unavoidable. But monetary policy that allows real interest rates to be negative for prolonged periods strikes me as much more likely to stimulate rather than to restrain inflation. That is the lesson that a real interest rate guide can have for monetary policy.

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