# WHAT DOES INFLATION COST?

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by

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At this time of year, many of us like to look back and measure our accomplishments. I could, therefore, take the easy way and spend my allotted time reminding you of the good things we have gained.

You recognize, I am sure, that we as a nation achieved much in 1968, and the future looks very bright. You also no doubt recognize that the nation's banks shared in this growth, with deposits and earnings up sharply.

I will not, however, enlarge on these points of which you are aware, but should like to discuss the losses we suffered because of the failure to stem the acceleration of inflation during 1968.

Let us consider three developments that, although they

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cover only a part of the loss incurred by inflation, do merit our serious reflection.

1. At the end of 1968, the dollar -- as measured by consumer prices -- was worth almost 5 percent less than it was a year earlier.
2. The United States, partly because of the inflationary trend, lost the major part of its favorable position in world trade.
3. In some instances, planning for inflation was substituted for planning for production by a change of emphasis in making judgments on spending and investing. (In my opinion this is the greatest loss.)

No doubt, some businessmen are happy about their ability to charge higher prices; their financial statements look better as a result. Also, corporations may point to increased earnings per share of stock.

Businessmen may be especially happy if the increase in the prices of goods they sell is more than the increase in the prices of goods and services they buy. This happiness, however, will sour if the prices of the merchandise or services they offer do not continue to rise over the prices of their purchases.

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Not everyone has been so fortunate; and as costs catch up, it is likely that the number retaining this particular type of lead will be greatly diminished. In the long run, the benefits of inflation will inevitably accrue to only a few persons.

One does not have to go far to find many persons who in 1968 lost through inflation. Consumers, as a group, found that, in the end, the major part of 1968's growth in income was an illusion. In 1967, the per capita disposable income, or average income per person after Federal taxes, was $2,744; during the year, the average income increased by $182 to reach a total of $2,926 per capita. Measured in current dollars (that is, without allowance for deterioration in purchasing power), the increase was about 7 percent.

The consumers may not have been acquainted with the statistics, but they learned through hard experience of the attrition in their purchasing power as the year progressed.

Statisticians tell us that, when this $182 gain is deflated for the increase in prices, the per capita gain in personal disposable income during 1968 was only 3 percent.

To refute the belief that the economy gains from inflation, I call your attention to an article in the February 17 issue of the Wall Street Journal reviewing various case studies gathered from throughout the nation. The article concludes, "Inflation is shattering many

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Americans' complacent belief that every year they are living a little better than before."

In the words of the article, many persons report "less bowling, more overtime; no cookies for the kids; retiree stops eating three times a day; and cutting out pork and veal and substituting salads."

The uneven impact of inflation extends beyond those with relatively low incomes. For example, while attending a meeting recently I talked with a businessman who is also the trustee of a preparatory school. He complained that the funds laboriously accumulated over the years for construction of a badly needed building this year fell far short of the present cost because of rising prices.

A city official attending the same meeting was acutely aware of the rising costs of government and capital improvements caused by inflationary conditions. Under inflationary conditions, the economy gets out of joint, and you as bankers, I am sure, have heard many such complaints.

Bankers well know that the price of money, like the prices of goods and services, has increased briskly. Yields on long-term government securities are the highest since the Civil War. Higher rates are charged on loans and investments, and reflect higher earnings

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on bank statements.

But inflated expenses cut net profits and the dollars banks earned from higher interest rates bought less. What is more, every fixed income asset on the bankers' books decreased in market value as interest rates rose -- a recurring development in inflationary periods.

When the general public becomes aware of the decreased purchasing power of its money, many of its members find it more difficult to save and begin to wonder if it is even worthwhile. If curtailed saving becomes widespread, the nation will experience a weakening in one of the chief forces responsible for its economic growth and high productivity. The fact is, the savings of the American people, of consumers as well as businessmen, provide much of the capital investment funds required for economic growth.

The second loss during 1968 because of inflation was a deterioration of the country's competitive position in world trade.

Our total balance of payments for 1968 looks very good on the surface. During 1968, this nation achieved a balance of payments surplus for the first time since 1957. Balance of payments, of course, includes financial transactions and other non-trade factors.

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I shall not go into the details of how this surplus was achieved except to suggest that many of the forces creating last year's surplus may not be as strong this year. The stock market boom, the repatriation of corporate funds, and the success in curtailing lending abroad by U. S. banks all played a part in achieving a substantial increase in financial flows into this country.

The total conceals the serious deterioration in the trade surplus of the United States. In prior years, we have been able to count on selling substantially more goods and services abroad than we imported. This favorable balance of trade helped carry the load of government expenditures abroad and drains through financial transactions.

The United States was competitive in world markets during the early 1960's largely because it was able to keep the prices of its exports relatively stable, whereas many foreign countries suffered internal inflation. We have lost this advantage.

In 1968, the excess of the value of this country's goods and services exported over those imported was more than $3 billion less than in either 1966 or 1967. Rising prices here have made our exports less attractive to foreigners and have attracted more imports. Most experts see little hope for improving this situation very much until we bring our rising prices under control.

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The shifting of emphasis toward inflationary considerations when making decisions to spend or invest may turn out to be the greatest loss during 1968 because of inflation.

Traditionally, the American businessman analyzed economic opportunities on the basis of how they would provide the services or produce the goods to meet the demands of the public. Success or failure, reflected by his profits, has typically depended upon the businessman's astuteness in discovering these opportunities and his efficiency in producing the goods or providing the services the public wants.

In contrast, in many countries of the world decisions to invest or to launch enterprises have been based almost entirely upon inflationary considerations. Investments there are not chosen because they are most productive in meeting the demands of the public, but because it appears they will benefit most or suffer least from inflation.

Under this philosophy, instead of measuring efficiency, profits may reflect only inflation. In the short run, rising prices may conceal mistakes; in the long run, resources are misdirected. Giving rewards to the inflation-minded destroys the very basis for the operations of a free enterprise system.

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One of the things suggested in a recent review of economic history was that economists in 1834 believed the consumer, the investor, is motivated by fear when things are going down or are at the bottom. But when prices rise, as they are now, some people are motivated by greed. And this greed destroys rational judgment.

Could it be said today that a part of the American public is being motivated by greed, as shown for example by those in the stock market who disregard the current price-earnings ratio and the intrinsic value of some of their investments?

Moreover, unfortunately, there are those in the banking business who may have pursued the same misdirected goals. Some of us in the Federal Reserve would like to hear that bankers have begun to say "No" to certain of their loan applicants. We should like to see more consumers with less of this psychological fear of inflation, so that they will base fewer financial decisions on what prices may be tomorrow, next month, or in two months.

It is generally popular to blame rising prices on someone else. Four good targets are:

1. Labor, which is accused of pushing up wages faster than productivity;
2. Business, which is often charged with being over-eager to raise prices in order to maintain profits;

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3. Government spending, which we all think should be reduced except for the things we are interested in; and
4. The Federal Reserve, which some claim has not been tight enough with its monetary policies.

A strong case has been made to support each one of these charges. Labor costs have risen. Employers complain of low productivity. Average hourly earnings of manufacturing workers rose over 6 percent between the end of 1967 and the end of 1968. Some workers experienced greater gains, and some less. There is no question, however, but that inflation itself was a major spur to the push toward high wages, and the average worker can scarcely be blamed for trying to maintain his income in the face of rising prices.

On the other hand, the workers can point to higher corporate profits in 1968 than in 1967. Even after substantially higher taxes, corporate profits rose from $48.1 billion in 1967 to $51 billion in 1968. But would not some businessmen respond that this was only the normal growth required to maintain incentives?

It is, of course, true that government spending has been high. The Federal deficit for fiscal 1968 reached $25.2 billion and in the last half of calendar 1968 was $11 billion. To finance this, the

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U. S. Treasury had to borrow $23.1 billion from the public in fiscal 1968 and $11.3 billion in the last half of 1968. This borrowing on top of heavy demands for funds by the private sector had much influence on the high interest rates. Since a large part of the deficit was financed by additional bank credit, inflationary pressures were increased.

In early 1967, economic and financial experts pointed out that the nation was going to get into trouble if it did not increase taxes or reduce expenditures. There was no lack of warning, but Congress was slow to enact legislation to cope with the problem. Finally, with pressures having been built up for so long, the surtax program that was put into effect in mid-1968 has been slow to take effect. Ultimately, it may help.

Before condemning senators and representatives in Congress for dilatory actions, consider if it might not be true that they were reflecting pretty well the sentiments of their constituents. Is it not possible that the taxpayer hoped taxes could be reduced if the Federal Government would cut expenditures for everything but those projects which had his special approval.

How many of us wrote letters to our Congressman applauding the closing down of a local Federal facility or establishment? On the other hand, how many of us applauded our Congressman during 1967

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and early 1968 if he announced he would have nothing to do with a tax increase?

Another popular whipping boy is the Federal Reserve System. Critics can point out that in the first half of 1968 bank credit rose at what they considered an excessively high seasonally adjusted annual rate of 6.5 percent. After mid-year, the annual rate of growth was even higher -- about 21 percent in July and August and 15 percent in September. By the end of the year, the rate had slowed down a bit. With prices rising so rapidly, critics ask, "Why did the Federal Reserve supply the reserves to the banking system that made this growth in bank credit possible?"

You will find that I am on record as having suggested during 1968 that the bank credit growth was excessive. At the same time, it is only fair to point out that the Federal Reserve was caught in a trap that prevented it from exerting the pressures required to completely offset the effects of deficit Treasury financing. Alone, the Federal Reserve could not have held back the inflationary pressures completely without creating serious side effects.

You will recall that, because of the failure to take timely action in respect to fiscal policy, the Treasury was forced to borrow heavily

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during 1968, especially during the second half. Corporations and state and local governments were strongly competing for funds. Interest rates were high. How much higher they would have gone had not the Federal Reserve supplied some additional credit to the banking system no one knows. An even greater and sudden increase in rates, however, might have been disastrous, possibly including a failure in Treasury financing. Perhaps the Federal Reserve can be criticized for its policy judgments, but those who do so should remember the problem that was faced, who and what created the problem, and what might have been the consequences of a more restrictive policy posture.

In a democracy such as ours, responsibility for keeping our economic and financial affairs in order cannot be shifted to the shoulders of any one group. Neither can a democracy expect any agency it may set up, including a central bank such as the Federal Reserve System, to successfully do the job unless there is widespread public support.

Professor Reuf, the French financial expert, has stated that no democratic society can be expected to run its financial affairs successfully. "Is he right?" you may well ask.

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American economic and financial history has shown that a society such as ours can manage its financial affairs when it wants to. We have made mistakes, sometimes we have refused to face reality, we have refused to accept discipline, and some special interests have at times forgotten the public interest. But the record of our American society is far better than that of most of the nations of the world.

When we have lapsed, we have eventually realized the disastrous consequences that could result unless we changed direction. We have then accepted the collective responsibility and stopped trying to shift responsibility to others. Political leaders, businessmen, and labor have responded by taking or supporting the needed steps to restore financial order.

Who is responsible for our present inflationary problem? Is labor, or business, or government, or the Federal Reserve to shoulder the blame? Perhaps all of them must accept some of the censure, but I am inclined to think we can place most of the blame on our own collective complacency -- the failure of you and me and other Americans to accept the responsibility and to act.

I am confident, therefore, that we can bring inflation under control. More and more persons realize that, if the same inflationary

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conditions prevail in 1969 as in 1968, our losses can be compounded. The realization that these conditions must be controlled is perhaps getting our fiscal affairs in a more manageable state. With better control of our fiscal affairs, monetary policy may have more room to maneuver. Signs here and there attest that the frantic pace of the economy is abating.

Patience and determination can win the battle against inflation. Bowing to the temptation of inflationary greed and disregarding the need for discipline can make the battle much harder to win. If we all support those whose job it is to administer the discipline, victory can be ours.

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