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DEALING WITH INFLATION

It gives me great pleasure to be with you today and to be able to share with you my thoughts on dealing with inflation.

This subject, I am sure, needs little introduction. Unquestionably, inflation does exist. And, as the President has rightly noted, it is the country's number one economic problem. We all recognize that prices have increased rapidly. Last year, the buying power of the dollar, measured by the consumer price index, dropped almost 5 percent. And this year, the buying power of the dollar has continued to decline. I might point out that there is a wide consensus of agreement that inflation is a major economic problem. But once you get beyond sheer recognition of this fact, you run into sharp differences of opinion.

Therefore, I shall discuss briefly three aspects of the inflation problem, on which different opinions have been expressed. First, how serious is inflation? Secondly, why does inflation exist? What's really behind the rise in prices? And thirdly, what _is_ being done about inflation and what _should be_ done?

My answer to the first question--how serious is inflation--is that the problem _is_ serious. Let there be no question about that. But let us also keep this problem in perspective. Rightly or wrongly, this country is engaged in a war; and, as we all know, wars cost money. No country has ever been able to fight a war without inflation. That last year's rate of inflation was the sharpest since the Korean War, I believe, tells us something. In

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the past, prices have risen rapidly during every war in which we have been involved. And there is no reason why Vietnam should be an exception.

None of this is meant to brand the current inflation solely as a wartime phenomenon. But in many discussions of the current inflation I have found that the wartime nature of the problem gets ignored.

Aside from this aspect, two other points are worth noting. If you look at the longer-run record, say over the last ten years, you'll find that prices in the United States have increased less than in most of the large industrialized countries of the world and, of course, have increased very much less than in the developing nations. This, at least, should give some pause to those who look at everything in the gloomiest light.

Those who go to the trouble of looking past the general pattern of inflation have discovered still another fact: Prices have not gone up equally for every single product or service. Indeed, prices of some things have not increased at all during 1968. For example, there were three major industrial groups--fuel and power, pulp and paper, and chemicals--whose prices were stable last year.

Here again, none of this is to signify lack of concern over the broader problems of inflation. On the contrary, inflation is a most serious matter and one which none of us can ignore for long. Even if we could ignore it, though, I believe inflation is

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something we should very much guard against. We all know that inflation can hurt, especially people on fixed incomes and welfare. Under inflation, everybody whose income rises less than the cost of living is also adversely affected.

But that's not all the damage the increase in prices has brought about. We are all savers in one form or another. Look at what you earned last year as a saver, when you allow for the decline in purchasing power. The answer is "nothing at all," or very close to nothing. This, by the way, reminds me of a pretty good definition of inflation: Those who save for a rainy day get soaked.

But aren't there ways and means of getting around this problem? Certainly! Some individuals put some of their money into diamonds, or coins, or valuable paintings, or jewelry, or whatever other inflationary hedges people put their money in. This may solve their personal problem. But let me point out that once inflation is imbedded, it becomes more than a cruel tax on those least able to pay.

Well-entrenched inflation can become a force that distorts our economy. Suppose people accept the idea that it no longer pays to save, and they act accordingly. Where then will our financial institutions get the money to lend? Suppose investors buy chiefly the hot stock issues instead of the blue chips. How then will our major corporations raise their long-term capital? Suppose investors sink their money into inflationary hedges instead

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of bonds. How then will our hard pressed states and municipalities raise their money? The point is that if continued inflation becomes built into our economic fabric, it will have some very damaging effects on the economy, and all of us, and not merely those on fixed incomes, will lose in the end.

This may be no more than a bit of blue on the horizon, but, as I read what is being written about the current inflation, I am encouraged to find not only a growing recognition of the wider harmful consequences of rising prices but also the further recognition that an inflationary psychology feeds on itself. When people are betting on inflation, such a psychology can become a powerful force in generating even more inflationary pressures. Expectations of more inflation, for example, can prompt people to go on a spending spree. They can cause businessmen to stockpile goods and to build facilities, even when they are not needed. They can encourage labor to demand higher and higher wages and can cause investors to demand higher and higher interest rates. To destroy the expectation of more inflation in many people's minds may be more important in the long run than that prices have gone up.

What I am saying is simply this: We may be unhappy about the dollar buying less and less. But, more importantly, we should recognize the costs to our economy if inflationary expectations are duly accepted as a way of life by investors and consumers.

To carry the argument a step further, let me add that the most important thing, of course, is not just to recognize the

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dangers inherent in an inflationary psychology, but to do something about it. Now, if you are going to fight a disease successfully, you first need to know what is causing it. And before you can decide how to combat the rise in prices, you first need to determine why prices are going up.

Unfortunately, as you might suspect, even the experts don't see eye-to-eye on the causes for the current inflation. Labor has been blamed for pushing up wage demands beyond gains in productivity. Business has been blamed for not absorbing more of the increase in wages and nonlabor costs. Government has been blamed for massive spending and deficit financing. The public at large has been blamed for spending too much, and the Federal Reserve has been blamed for the excessive demand by making money and credit too plentiful.

Going a step beyond, there are some people who try to make you believe that most, if not the entire, responsibility for the current inflation rests on one of these groups: labor, business, government, the public, or the Federal Reserve. Yet, to blame inflation on a single group is to me an oversimplification at best and utter nonsense at worst.

I don't believe there is a single explanation for inflation. Instead, those who offer a simple explanation forget that prices go up or down because of changes in supply or changes in demand, or both. No two prices are affected by the same supply and demand conditions. Therefore, to explain price changes it's important to

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identify the particular supply and demand forces. More specifically, changes in physical supply, related to weather or strikes, may be the main reason for a price change. Sometimes price changes may be related to a change in costs for labor or material. Sometimes they can be traced chiefly to a sharp increase in consumer demand through changes in consumer income, savings, and credit. And sometimes they result chiefly from changes in effective business demand coming from capital spending and inventory building supported by credit.

All of these forces mentioned have recently contributed in some degree or another to the current price inflation, though you should be careful when you try to assess why a specific product has gone up more than another. For example, why has the price of orange juice gone up? Surely not because of anything the Federal Reserve has done or not done, but rather because of the freeze in Florida earlier this year. I could cite other examples. But the essential point is that price increases for different commodities can be explained either by supply forces, by demand forces, or by a combination of the two.

I think the same thing can be said about the general price level. Here again, prices have increased for a variety of reasons. One reason almost everything has gone up is that costs have gone up. Higher costs, however, are only a partial explanation. The other culprit for the current inflation is excessive demand. After all, costs cannot be passed along in higher prices unless

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demand is high. And demand, or spending, has indeed been extremely high.

To be more specific, let me cite what I think have been the real causes of the current inflation. One important reason, certainly, has been that most types of labor have been in short supply. Unemployment has been under the low 4-percent figure throughout 1968. Another cause for the inflation is that workers have received pay increases that exceeded productivity increases. Average hourly compensation last year went up 7.5 percent; productivity went up only 3.3 percent. Furthermore, manufacturers and businesses were able to pass on the higher costs of doing business because total spending was excessive. With costs rising and demands straining against the economy's limited resources, something had to give way. It is not surprising then that prices rose.

The huge increase in demand, in turn, was related to heavy spending by practically every sector in the economy. Moreover, a substantial portion of this increased demand was financed with credit.

This brings me to the role that we in the Federal Reserve have played, especially in the last 15 months. During the first half of last year, we thought Congress would pass a tax increase almost any day. Consequently, we did not clamp down as hard on credit last spring as we might have done if Congress had not been so slow in accepting the need of a tax increase and a hold down

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on spending. Then in mid-year, when Congress finally passed the tax hike, the Federal Reserve thought the fiscal restraint would slow down the economy quickly. Therefore, over the summer and early fall, the Federal Reserve did let up on its efforts to dampen inflation. However, when it became evident that the economy had slowed down much less than expected and we saw that the pace of inflation had quickened, we reversed gears last December and started to tighten our reins on credit once again.

In this connection, let me mention that interest rates were increasing even before the Federal Reserve came to this decision to tighten. Interest rates, of course, have kept rising ever since. I don't know whether this should surprise anybody although, again, the reason for this increase in credit costs cannot rest entirely on what the Federal Reserve has or has not done. Interest rates are a price--a price for borrowing--and any price is influenced by both supply and demand. As long as businessmen, consumers, and government are heavy borrowers, or demanders of credit, and the supply of loanable funds is limited, interest rates have only one way to go and that is up.

I think that the intense demands for credit have pushed up interest rates far more than limits imposed on its supply. In fact, there has been no outright reduction in bank credit so far--only a substantial slowing down in bank credit growth. Consequently, if you are looking for the chief culprit for the highest interest rates in 40 years, you should place most of the blame on the

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insatiable demand for credit.

Let me further emphasize that the Federal Reserve, to my knowledge, has not been seeking an increase in interest rates as such. Instead, what the Federal Reserve actions have been really aimed at are to get the bankers to say "no" more often to their customers. To put it another way, we are trying to encourage the bankers to trim the loan requests of their customers so that the customers postpone some of their spending projects. This is essential because the demand for credit by the business community is still going up too fast. Moreover, as you know, businessmen recently have raised their sights on what already were substantial plans for plant and equipment, and this spending is adding to near-term inflationary strains. In seeking to bring about a slowing in bank lending, monetary restraint is, of course, part of a broader effort to dampen inflation.

We, in the Federal Reserve, have tried to make it perfectly clear to everybody that, in seeking to reduce inflationary pressures in the economy, we mean business. However, much of the business community evidently didn't believe us and the economy has kept booming. Therefore, we felt obliged to take additional restraining action two weeks ago when we raised the discount rate to 6 percent and increased the amount of reserves banks must hold. Under the circumstances, I feel these moves were absolutely necessary.

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But let me also underscore that neither I, nor anyone else in the Reserve System, wants a credit crunch. Our actions are intended to slow down the excessive expansion, not choke it; nor do we want unemployment to become excessive. These are self-imposed restraints that require not only great skill by us in the Federal Reserve, but support everywhere.

I said before that excessive credit is only one of many factors contributing to the current inflation. If your doctor's or dentist's bills are too high, please don't blame the Federal Reserve. We know that less credit is not the way to keep medical charges from going up; the answer is more doctors. However, where we hope to make a contribution is to dispel the idea that prices have only one way to go. We must succeed in dispelling this idea.

But to make inroads against inflation takes more than curbs on credit. There are a lot of things that affect prices besides credit. I have mentioned some of these before: labor supply, productivity, profits, government spending, taxes, and land, wage, and nonlabor costs. These have a far more important effect on the economy and the future buying power of the dollar than credit. This means that the job of dealing with inflation is not one for the Federal Reserve alone. It is a job for government, labor, business, and the consumer. It is a job that will be won or lost not just by what I might help decide, but by your decisions as well. Dealing with inflation is everybody's job.

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