LIVING WITH INFLATION

An Address

Presented by

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LIVING WITH INFLATION

You have already been told that my talk is entitled "Living With Inflation." But before getting to this topic I should like to say a few words about some of our broader economic problems.

Some persons would have us believe we are in the midst of an economic recession. Now if this were a Midwestern auto assembly center, you might think this was so, no matter what I told you. But, of course, Chattanooga is not Detroit. In any case, it seems to me that to attach the tag of recession to current economic conditions is a slight exaggeration.

Many business analysts define a recession as a period during which the Gross National Product, when adjusted for rising prices, falls for two quarters in a row. So defined, it is still too early to tell whether we are in a recession. The first drop in constant dollar GNP just occurred in the first quarter of 1974. Therefore, it will take a decline in the second quarter before those who so define recessions can be sure we are in one; and they will not be sure until the second quarter GNP figures come out this summer. Personally, I think the times we live in, right now at least, are not recessionary. They seem more like a period of stagnation, where some sectors are going up while others are going down. What is really happening is that the economy has been more or less holding its own.

Recession or not, nobody will dispute that we are beset with serious inflation. It was not too many years ago when some of us shuddered about talk that a 1- or 2-percent annual rise in prices was inevitable and harmless to boot. Last year, consumer prices in this country rose 9 percent in the worst inflation since 1951.

This problem, furthermore, is becoming, if anything, more disturbing rather than less. Inflation has accelerated to a 13.6-percent annual rate in the first quarter of 1974. Thus, it has become abundantly clear that the problem is not going away.

There are several aspects about this situation that I find particularly disturbing. It used to be that only after wars did prices rise rapidly. Only then was inflation at its fiercest. But with the Vietnam conflict ending 15 months ago, we cannot use historical analogy as an excuse. For the first in a long time, inflation is rampant, not during or after a war, but in a period of comparative peace.

Another astonishing thing is that inflation in this country is no longer mild compared with the rest of the world. For years, we rationalized, saying: Most other countries have worse luck than we. A change has taken place in this respect, however. Our inflation rate is now greater than that of some foreign countries. Consequently, we no longer can comfort ourselves with the thought that we are not as bad off as everyone else. This change is important, not just for its own sake, but because a continuation of this trend would make our goods less attractive to foreigners, thus hurting our economy and our balance of payments.

The galloping price trend in which we now find ourselves has its seeds in the Vietnam War, when we tried to have guns without giving up butter. Before Vietnam, this country enjoyed a period of price stability that many of us have long forgotten. Actually, for six years (1958 to 1964) the consumer price index rose only 1 percent per year. Then came our involvement in Vietnam. We stepped up our defense spending while consumers and businessmen, at the same time, increased their spending at rates faster than the economy could sustain. The result was the start of an inflationary climate that except for temporary successes has never been broken.

Instead of dealing directly and forthrightly with this problem, the Federal Government failed to enact permanent tax increases. And it failed to hold down spending. All of this produced horrendous Federal deficits that added to the inflation. In fact, only once since 1964 has the Federal budget been in surplus; and for the last three years, we have had a deficit of $24 billion in fiscal 1971, $23 billion in 1972, and $14 billion in 1973.

To be sure, unwillingness to reduce private spending during the Vietnam War and insufficient fiscal restraint during and after bear some of the responsibility for our inflation. But there are other aspects that also deserve mentioning. For example, some people might say that prices would have increased less had the Federal Reserve followed greater restraint.

Who else is to blame? One can cite wages going up well in excess of productivity gains as an important factor. The devaluation of the dollar was still another. Although this was a necessary step, it had the effect of making U.S. products too attractive in world markets. Acting as a stimulant to U.S. exports, it cut into domestic supplies, especially food, and in this way propelled prices upwards.

I think the many shortages that all of us have been experiencing are yet another force behind the inflation. For years, we could all feel that whatever we wanted we could buy as long as we could pay for it. But, as we all know, this has not been so recently. A lot of products, in addition to gasoline, either have been or are still in short supply. Booming worldwide demand for many commodities and the embargo, in the case of gasoline, bear much of the blame. Price and profit margin controls that discouraged investment in some basic industries probably also made these shortages even more severe.

Environmental controls have further complicated the situation. All of these factors seem to have generated shortages; and, as we know, shortages lead to higher prices.

The point of this recitation is to suggest that there has been no one villain, but many. Therefore, those who blame the high prices on a single factor oversimplify a problem that reminds one of the many-headed Hydra.

Nor has the problem been mostly one of soaring food and fuel prices, even lately. True, higher fuel and food prices were responsible for 60 percent of last year's consumer price rise. It is clear, however, that many other products have also shown large increases. In fact, food and fuel are now contributing much less to the general price trend than last year. Those who believe we have seen the end of soaring food and gasoline prices have, therefore, shifted their attention to the possibility of an explosive situation in wages.

While rising wages have long put upward pressure on costs and, thus, on prices, it would seem that wages have not been an important reason for the inflation in 1973. Wage rates rose on average about 6 percent last year or much less than prices did. Consequently, it is quite understandable that workers should seek greater pay raises this year. They, of course, have done just that. The collective bargaining calendar being heavy, I am worried about the effect of large wage increases on price trends, just when the end of the oil embargo and the prospects for greater food supplies support the belief that price increases from these sources might moderate.

I express this concern not because I am oblivious to the fact that taking account of the rise in prices and taxes, the take-home pay of a production worker has declined by 4.7 percent this past year. That is a dramatic drop in purchasing power and economic well-being and underscores the tragedy of inflation. The saver, retiree, and others have all paid dearly for it. Check with them what they have lost, not only in terms of income, but in savings, financial assets, and not the least, in peace of mind.

The consequences of inflation do not stop there. In the past majority opinion has accepted it as a transitory misfortune. When prices rose rapidly, most Americans would cut down on their spending, trim their sail, and try riding it out. But when people think inflation has become a permanent way of life, they begin to react differently. Expecting prices to go ever upward, they throw caution to the wind and rush to buy products before prices go up even further. Such a rush to buy can compound an inflation, while the expectations of still more inflation will eventually discourage people from saving. Home construction would not find financing in such an environment. State and local governments, corporations, and other borrowers would not be able to finance their needs. Economic growth would be severely curtailed.

The impact of rapidly rising prices would fall inevitably on the low and middle income groups. The cost of everything we buy would go up faster than our income. Everyone, for that matter, would lose if things deteriorated to what Germany, for example, experienced during the hyperinflation of the mid-1920's.

In citing these dangers, I do not wish to leave you with the impression that this country is about to experience a superinflation, or even a Latin-American type where prices increase in double digits each year. I simply wish to reiterate the dangers. These are especially relevant to us today, not only because prices in this country have recently been increasing at a faster than 10-percent rate, but because the longer an inflation is allowed to exist, the more it becomes entrenched. And the more entrenched it becomes, the harder it is to eradicate. In fact, even in recessions, when one might expect reduced demand to bring about lower prices, prices rarely fall because our economy is not highly competitive as it once was. The record shows that only in those sectors where competition is strong are price reductions during recessions commonplace. Have you found much evidence of lower prices lately, under current near-recessionary conditions?

This brings me to an issue that has received increasing discussion. This is the view that inflation is inevitable and the further view, sometimes given in the same breath, that we should begin to live with it. Professor Milton Friedman, for example, recently advanced the opinion that we ought to start a process by which we regularly compensate for inflation. What he has been advocating is a broad system of indexing. Under indexing, the value of assets (wages, rents, and so forth) are adjusted for price changes. You can find an example of indexing in recent aluminum, steel, and can workers' contracts, where wages are adjusted automatically to allow for increases in the consumer price index.

Brazil uses this device extensively. Not only are workers compensated for their loss of purchasing power, but as I understand it, Brazilian banks and savings institutions will all correct accounts with an amount equal to the rate of inflation. Loans, securities, mortgages, personal tax exemptions and tax brackets are similarly adjusted for higher prices.

Hailing the success Brazilians have had in trimming their price increases, which incidentally are still much greater than ours, Professor Friedman and others believe the United States' economy should copy Brazil and have indexes for wages, interest rates, taxes, legal obligations, and other contracts as a form of coping with inflation.

Now, one need not belittle the contribution of the distinguished Dr. Friedman to conclude that when it comes to his view on indexing he is absolutely wrong--wrong, indeed, on several counts. First, on a strictly technical level, there is nothing magical about indexing. Right now, for example, there is a heated dispute going on over the way the official price indexes in this country are constructed. Secondly, no matter how perfect price indexes are, some groups are bound to come off second best in the correction process. And, as Henry Wallich (the most recent Federal Reserve Board appointee) reportedly remarked: Two major components of economic activity are impossible to index. These are money and profits. Can you imagine anyone wanting to hold money in an economy where most everything is indexed? I cannot. Nor can I imagine that profits would not be squeezed where most everything else is indexed.

Indexing, to my way of thinking, is not what it is cracked up to be. On the contrary, it has serious shortcomings. Indexing could give momentum to a still faster price spiral as people become convinced there is no longer a need to fight inflation.

To suggest that indexing is a way of living with inflation means throwing in the towel, and to some of us old-fashioned people it is almost unthinkable that our country would be part of any such process of solving our problems. It seems to me that there should be enough statesmanship and common sense to deal with it directly and forthrightly.

How then can the inflation be countered? From what I have said before, it should be clear that the economy has been on an inflationary bent for too long for a variety of reasons. And it's going to take many different actions, ranging from more production to greater statesmanship, to do what has to be done.

Such an attack must certainly include fiscal and monetary restraint. In this connection, I would hope that the Congress, the Administration, and the Federal Reserve will exercise the necessary statesmanship and will have the fortitude to act in ways they know will restrain price pressures.

Restraint--whether fiscal, monetary, or any other kind--unfortunately, is never painless. Can it be achieved without some adverse effect on jobs, on housing, or other economic programs? The answer most experts would give to this question is, of course, "No." Fiscal and monetary restraint is, therefore, often unpopular and requires support from key business leaders and opinion molders such as you.

On the other hand, what choice is there? After all, battling inflation is never easy. There will be rough days ahead. But if we continue to accept inflation at this past year's rate, we will pay in the long-run a far greater price than if we accept some dislocations temporarily. The way to deal with inflation is to fight it, not to live with it.