

LIVING WITH INFLATION

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by

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You heard that the title of my talk is "Living with Inflation." But before I get into that topic, I want to say just a few words about the broader economic climate in which we find ourselves today.

People in Washington and elsewhere are still debating whether we are in a recession. Those who say, "Yes," allude to back-to-back declines in GNP adjusted for price changes; those who say we are not in a recession feel the declines are too small to be significant.

As important as that question is, I believe the more important question is whether the economy will slide off further, head upward, or just keep rocking along on a plateau. From what I can tell, the economy is more or less holding its own, and there is little evidence that anything will replace this economic sluggishness very soon.

Many people are concerned about the economy's performance, and rightly so. But the public's main economic concern, according to a Gallup poll, is still inflation. It was not too many years ago when some of us shuddered when we heard mention that a 1- or 2-percent rise in prices was inevitable and harmless to boot. Contrast this with last year's 9-percent increase in consumer prices in this country, the worst inflation since 1951.

Particularly distressing is that prices keep climbing at an alarming rate. The inflation rate hit a double-digit 14-percent figure in this year's first quarter and was still a thumping 9 percent in the second one. What some of us have long suspected has become abundantly clear: No matter how much we fret, the problem of inflation simply is not going away.

I find several aspects about this problem especially disturbing. It used to be that prices would rise rapidly only after wars. But we cannot

say that any more. The tragic war in Southeast Asia ended a year and a half ago. Our country is at comparative peace; yet inflation remains rampant.

For years, we used to say: "Sure, we have inflation but look how much milder ours is compared to the rest of the world." But now we cannot take comfort in the thought we are not as bad off as everybody else. The inflation in this country is as serious, or almost as serious, as that of most major industrial countries. This change is important, not just for our own sake but, because if it continues, foreigners will buy less American products. That would hurt our economy as well as our balance of payments.

The galloping price trend in this country has its seeds in the Vietnam War, when we tried to have guns without giving up butter. Before the Vietnam buildup, this country actually enjoyed a period of price stability that many of us have forgotten. For six years--from 1958 to 1964--the Consumer Price Index rose only 1 percent per year. Then came our involvement in Vietnam. The Government stepped up its spending on defense, while consumers and businessmen continued to spend 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 mounting an attack when this problem surfaced, the Federal government delayed and vacillated. It failed to increase taxes except on a temporary basis. And, perhaps even more significantly, it failed to hold down spending. All of this produced horrendous Federal deficits that added to our inflation. In fact, only once since 1964 has the Federal budget been in surplus; and for the last four years, it has been in the red to the tune of \$65 billion.

I believe that the unwillingness of businessmen and consumers to reduce their spending during the Vietnam conflict and insufficient fiscal restraint during and after bear much of the blame. But these are by no means the only causes of inflation. For example, some persons say that prices would have increased less if the Federal Reserve had followed greater restraint. In retrospect, this is probably true, though in the main the inflation resulted from a series of distressing developments.

Who else is to blame? That wages went up faster than productivity was an important factor. Another was the devaluation of the dollar. While a necessary step, it had the effect of making American products too attractive in world markets. Acting as a stimulant to U. S. exports, it cut into domestic supplies, notably food, and in this way propelled U. S. prices upward.

Along with these developments, we have experienced shortages. It used to be that you could buy almost anything you wanted as long as you could pay for it. But this has not been the case for some time now. It is true that gasoline is no longer scarce; but steel, coal, certain kinds of paper, and many other products are still in short supply. Booming worldwide demand for many commodities and the embargo, in the case of gasoline, are to blame in part. To these events can be added the controls on prices and profit margins that discouraged investment in some basic industries. Environmental controls further complicated the situation. All of these factors generated shortages; and, of course, shortages give rise to higher prices.

The point of this recitation of reasons for the inflation is to suggest that there has been no one villain, but a great many. Indeed, I believe

that 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. True, higher energy and food prices were responsible for 60 percent of last year's consumer price rise. However, the major impact is now coming from other commodities and from services which have racked up very rapid price increases this year.

There is certainly no sign yet of any marked slowing in inflation. On the contrary, the record-breaking August rise in wholesale prices and the big jump in farm prices that followed earlier declines could make liars of those predicting the worst on the inflation front is over. And as I look more deeply at the prospects, I am particularly disturbed at the emerging pattern of wage increases. Wage gains for contracts that include cost of living adjustments have averaged out a bit more than 10 percent thus far this year.

Rising wages have long put upward pressures on costs and, hence, on prices. Quite fortunately, 1973 proved to be an exception. In fact, wage rates last year rose much less than prices. It is, therefore, understandable that workers are demanding greater pay raises this year. What concerns me about these raises is that, unless profit margins get pinched, the increase in labor costs is passed along in higher prices.

I express this concern about soaring wage hikes not because I am oblivious to the fact that, taking account of the rise in prices and taxes, the take-home pay of factory workers has declined by about 5 percent this past year. That is a dramatic drop in purchasing power and in economic well-being and underscores the tragedy of inflation.

Workers, of course, have not been the only group feeling the pinch. Savers, retirees, and others have all paid dearly. Check with them about what they have lost, not only in terms of income, but in savings, financial assets, and--not the least--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 heavily on the low and middle income groups. The cost of everything we buy would go up faster than our income. Everyone, for example, would lose if things deteriorated to what Germany, for example, experienced during the hyperinflation of the mid-1920s.

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 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 as competitive as it once was. The record shows that price reductions during recessions are commonplace only in those sectors where competition is still strong.

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, has stated that we ought to start a process by which we regularly compensate for inflation. What he has advocated is a broad system of indexing. Under indexing, the value of assets (wages, rents, and so forth) are adjusted for price increases. You can find examples of indexing or escalator clauses in recent aluminum, steel, and can workers' contracts, where wages are adjusted automatically for increases in the Consumer Price Index.

Brazil uses this device extensively. Not only are workers compensated for their loss of purchasing power, but Brazilian banks and savings institutions will all correct accounts with an amount equal to the rate of inflation. Loans, mortgages, bonds, 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 U. S. economy should copy Brazil and have indexes for wages, interest payments, financial assets, business accounting practices, taxes, legal obligations, and other contracts as a form of coping with inflation.

Now, one need not belittle Dr. Friedman's many contributions to conclude that when it comes to his view on across-the-board 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. The technical difficulties of indexing are enormous. Secondly, even if perfect price indexes could be developed, some groups are bound to come off second best in the correction process. Thirdly, some things are impossible to index. That is especially true for money. Can you imagine anyone wanting to hold money in an economy where most everything is indexed? I cannot.

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. The more people learn to live with inflation, the less reason they have to take actions correcting it.

To suggest that indexing is a way of living with inflation means throwing the towel, and to some of us old-fashioned people it is almost unthinkable that our country would be part of accepting inflation as a permanent way of life. 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 a long time and for a great many reasons. Therefore, I believe it will take not one but many different actions, ranging from greater production to greater leadership.

Such an attack must certainly include fiscal and monetary restraint. This, in turn, requires statesmanship not only by the Federal Reserve but also by the Administration and the Congress and the necessary fortitude to act in ways they know will restrain price pressures.

Restraint--whether fiscal, monetary, or any other kind--is unfortunately never painless. Can it be achieved without some adverse effect on jobs, on housing, or on 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 recent rates, we will pay a far greater price in the long run than if we accept some dislocations temporarily. I believe the way to deal with inflation is to fight it, not to live with it.