REMARKS OF MR. ROBERT P. MAYO
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to the
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INFLATION AND THE FED

Last Thursday, the Labor Department announced that the wholesale prices of finished goods spurted 1.3 percent in April--the largest rise in more than three years. If such an increase were to continue for a year, wholesale prices would be up more than 15 percent. Fortunately, no one expects this to occur. No reasonable forecaster expects a two-digit rate of price increase for the year 1978 as a whole. But the figures did, once again, focus our attention dramatically on the prospect of some further escalation of prices from the recent 6 percent area--which in itself is certainly nothing to brag about.

There has been a large number of economic issues covered in detail by the press, radio, and television in recent months. But none has been so prominent as inflation. Inflation worries have clearly taken center stage. Inflation is the major topic of conversation in the business and financial community and among the general public. The Administration, belatedly, some would argue, has recognized this great public concern. Every major economic advisor has inveighed recently against inflation.

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Secretary of the Treasury Blumenthal, Ambassador Strauss, Council of Economic Advisors Chairman Schultze and Barry Bosworth, Chairman of the Council on Wage and Price Stability, have all appeared on national television to tell us that, yes, there is a problem and that we are working to solve it.

Recognition that there is a problem is a necessary first step. And some steps toward a solution have been taken. I hope that more are forthcoming. Rhetoric can not be a substitute for action!

We all know that inflation is a serious problem--a social "no-no," as it were. But it is not always clear why. One of the traditional reasons that inflation is bad is that it discriminates against individuals on fixed incomes, particularly retirees. Another, that it affects our real incomes--our ability to maintain and to improve our standards of living.

But inflation has other even more insidious effects on the economy. Inflation reduces the real after-tax return on physical capital. This occurs because capital depreciation allowances for tax purposes are based on historic rather than replacement costs. Thus, the real depreciation allowance for IRS purposes declines due to the historical cost basis, as you analysts well know, resulting in an increasing real tax burden and a decreasing real after-tax return. Inflation amounts to a

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tax on physical capital.

Furthermore, uncertainty about future inflation rates often affects the mix of investment projects undertaken. It also produces a bias toward relatively short-lived physical assets when increasing rates of inflation are expected. And inflation also reinforces the consumption bias produced by our progressive income tax structure.

Thus, inflation in conjunction with our current income tax system diminishes the incentive for businesses to invest in physical capital. And, on the other side of the coin, it diminishes the incentives for economic units to save. This proclivity toward lower private real investment means lower future real income.

Inflation is tantamount to taxation without representation. It transfers real economic resources from the private sector to the government sector without passing any new tax legislation. I'm just old fashioned enough to believe that, in most cases, general economic welfare will be maximized if we let the private sector allocate resources rather than the public sector.

In recent years we have learned much more about the costs and consequences of inflation. But we have also learned more about the complexity of the causes of inflation and the complexity of the solutions.

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I don't have any difficulty in identifying the fundamental factors responsible for inflation. These have been Government policies that have produced an excess nominal aggregate demand for goods and services over the real supply of these goods and services. To put it in the usual terms, too much money chasing too few goods.

But other developments, other influences, have been layered on top of these fundamental factors leading to a complex inflationary phenomenon. It is because of this layering that we get price increases even when the economy is not in an excess demand situation; that is, when we still have underutilized resources. It is because of this layering that the time necessary for correction has been extended. It is because of this layering that traditional economic policies seem less effective and solutions become agonizingly more complex.

A number of these layering elements or complexities are easily identified. Such things as the rapid increase in regulatory constraints on private economic activity, the growing awareness of real supply constraints and the enhanced desire for public goods such as clean air and water, whose costs and benefits are not clearly represented, if at all, in our measures of resource costs or the economy's output, have been widely discussed. There are others as well. For every environmental impact study we need

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an inflationary impact study.

One of the sets of complexities that seems to me very important in understanding the inflationary phenomenon of today, and thus important for designing effective solutions, is the fact that there are close, and growing, ties between past inflation and future price increases. These ties exist both in an institutionalized sense--that is, automatic cost of living adjustments--and in an expectational sense.

According to the Bureau of Labor Statistics, 8.5 million union workers are now covered by automatic cost-of-living adjustments. Since the 1960s, Congress has applied the same sort of adjustment to Social Security benefits and other payments. Currently, payments to over 30 million Social Security recipients, 2.5 million Federal civilian and military retirees and their survivors and 20 million food stamp recipients are escalated. And that does not include programs for lunches and breakfasts for 25 million children. For all practical purposes, Federal salaries are also tied to the CPI. Last year, for example, pay increases averaging 7.0 percent went to Government workers, not counting increases for longevity and promotions.

In addition to wage contracts, a growing but undetermined number of rental, royalty, and child support contracts are escalated automatically by the CPI. Federal health, welfare and

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job training programs are affected by the CPI. The "poverty threshold" and "low income" mentioned in legislation are calculated by deflating reported nominal incomes by the CPI. So are the minimum wage increases.

This is what I mean by institutionalizing inflation. We have institutionalized a wage-price spiral--more specifically perhaps, the income-price spiral. The escalation of incomes on the basis of increases in the CPI tends to perpetuate inflation by expanding demand without necessarily increasing the supply of goods and services.

It isn't difficult to see what this means in terms of being able to make sharp improvements quickly in the rate of inflation. It is extremely difficult to do so. With prices locked in from a previous period, even severe economic downturns have limited effects. And supply price increases such as those from food or oil--the result of weather or OPEC decisions rather than excessive demand--feed back into the general price level.

This tie between the past and the future must then result in some modification of our traditional economic policies. But let me stress, I'm talking about modification in timing and force, not abandonment. Unfortunately, the tie between past and future in prices also generates an exaggerated public impression that because results do not appear immediately, the policies are

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ineffective and should be abandoned. They still look for a "quick fix," even though the economic body can no longer respond in that way.

The tie between past and future prices is also reinforced, even outside this institutional structure, by expectations. With each period of accelerated inflation, the expectation that inflation will continue and rise even further has been strengthened. Wage earners have come to expect or anticipate inflation, building these expectations into their wage negotiations. Management, in turn, has accepted higher wage increases because it, too, has come to expect future inflation and, therefore, anticipates being able to pass on these higher wage costs in the form of higher prices. This is the familiar wage-price spiral, or one variant of the so-called cost-push theory of inflation. I do not think that the wage-price spiral in this expectational form is so much a cause of inflation as it is the <u>result</u> of it.

To return to my original point, however, while institutional, regulatory and other developments have made the understanding and the correction of the inflation phenomenon far more complex, the fundamental explanation of inflation can indeed be traced to excess demand. And, in all candor, it is the federal government and the monetary authorities, through albeit well-intentioned

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but over ambitious demand stimulating policies, that must take the responsibility. It would be easy and perhaps even intuitively appealing to point an accusatory finger at labor and management as the major inflation culprits. They contribute to it, of course. But they aren't the major culprit. But it is the economic units of the private sector acting in their self interest that promote economic growth, innovation, research and development, and, in most cases, the efficient allocation of resources. This self interest can result in unbridled price rises only if the Government economic policymakers become accomplices via inappropriate demand management policies.

But what is the Fed's role in this drama called "the fight against inflation?" I feel that we have a two-fold role to play in reducing inflation. First, to follow policies that do not produce excess aggregate demand. Second, to follow policies that will tend to reduce the public's inflationary expectations. And while I identify these as the Fed's roles, they must be even more so the Federal government's economic policy roles. The Fed cannot have the sole responsibility for price stability. It cannot alone attempt to stop inflation dead in its tracks without severe repercussions on the Nation's economy. It cannot alone offset the fiscal policy excesses of yesterday, today, and tomorrow

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without taking on the responsibility for offsetting, in part, the priority decisions of the society's elected representatives--our local officials, our state legislators, and--above all, our Senators and our Congressmen. The Fed cannot alone expect to reduce the public's inflationary expectations.

There are some implicit assumptions in arguments made recently that the inflation confronting us has a large cost-push component and that we have large amounts of unused capacity. Therefore, monetary policy should retain a very accommodative posture. I cannot agree with this position.

First, as I noted earlier, I am not that impressed with the cost-push theory of inflation. But more importantly, it seems to me that we should take a very cautious stance at this juncture about our ability to use stimulative policies to enhance production and employment. Some shortages are already beginning to show up. Productive capacity may not be as great as it was a few years back because of higher energy prices and new work-safety and environmental protection standards. Effective full employment of our labor resources is likely to be in the 5-6 percent unemployment range. And inflationary expectations, as we have already seen, emerge much more quickly today.

Thus the time appears ripe, in terms of both real economic developments and the inflationary prospects, to snug-up a bit.

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I am not suggesting a single-minded policy of eradicating inflation in one fell swoop. That would be suicidal. Our current problems have evolved over a number of years and the social tradeoffs dictate that a long-term perspective be taken in solving them.

In order to bring down the rate of growth in the monetary aggregates, there will be occasions, such as now, when interest rates will increase. But I believe that the extent of these increases will be less if it is believed that government policy-makers are going to honor their inflation deceleration commitments. Speculative inventory building which impacts on short-term credit demands may be tempered. Furthermore, the inflation premium in long-term interest rates could be reduced as market participants come to view temporary increases in short-term rates as a manifestation of efforts to curb excessive growth in the monetary aggregates. I am aware that an anti-inflationary monetary policy will, at times, entail increased credit rationing via market interest rates, but I expect that the severe credit stringencies of 1973-74 variety can be avoided. Corporations seem to have put their balance sheets in much better order by funding a large part of their debt in 1976 and 1977. So I do not anticipate severe liquidity pressures in the corporate sector.

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Due to its institutional arrangement, the mortgage-lending industry always seems to suffer disproportionately when interest rates go up. Part of this has to do with the rapidity at which interest rates rise and where they peak. I believe that a program of gradual money supply deceleration begun now will serve to reduce the extreme volatility of interest rates experienced in previous cycles. Furthermore, due to prudent liability management and financial innovation, it appears that the savings and loan industry, the largest supplier of residential mortgages, is in a better position today to absorb some of the adverse consequences of higher interest rates than it was five years ago. Over the 1974-76 period of declining short-term interest rates, savings and loans were able to attract funds into longer-term time deposits. As a result, although the flow of funds to the savings and loans is slowing, I think there is a good chance that the degree of actual disintermediation will be moderated in comparison with past cycles. The financial innovation referred to is the issuance of mortgage-backed bonds and pass-throughs by individual savings and loans. These new financial instruments are beginning to provide savings and loans an opportunity to tap a new source of funds, the long-term capital markets.

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I am cautiously optimistic that, indeed, we can begin to make progress toward reducing the rate of inflation below what seems to be expected by some observers. I am encouraged that a start is being made on this problem at a time when our own economy and the economies of the rest of the developed free world are not characterized by speculative excesses. A concerted effort on the part of the Administration, the Congress, and the Federal Reserve hopefully will enable us to accomplish our goals much more quickly and in a much more even-handed manner than otherwise would be the case if one of us had to tackle the job alone and were working at cross purposes with each other.

You may have noticed that I didn't mention the public as members of this inflation-fighting team. It's not that the voluntary restraint of wage and price increases on the part of labor and management is not welcomed. It certainly is--enthusiastically so. But realistically I know that we will not be able to enlist the full support of the public until Government policies establish some credibility. This entails setting <u>realistic</u> goals and making sure that we meet them. I stress realistic because I believe that we can do more to enhance credibility by meeting somewhat less ambitious goals than by failing to meet unrealistically over-ambitious ones.

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It is fashionable, currently, to talk about fighting inflation. Even a moderate course of action will, however, entail some sacrifices. I only hope that the political resolve, which must flow from the public's resolve, will not curl up and blow away at the first sign of such sacrifice.

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