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The Inflation Outlook in the United States

It is a pleasure for me to be with you today to participate in this look at two of the world's largest economies. Japanese trade is particularly important to the midwest. Over one-third of all Japan purchases from the U.S. are agricultural products--more than $4.4 billion last year. Much of that, in turn, came from the farms of the midwest.

So while I am happy to be here with you today, I am not so sure I am happy with my assigned task--to discuss the inflation outlook. There are times when looking into the future can be a pleasant task. When the forecaster can talk about a growing economy, stable prices, and similar good news, he can approach the podium with a smile on his face. I am personally an optimist and would prefer to be the bearer of good news. Unfortunately, my message today has to be a more somber one than I would prefer to bring. The present state of the economy does not permit me to bring the happy message I would have liked to present to you today.

Today we are at or near the end of one of the longest peacetime periods of economic expansion in our history. Real economic growth turned down in the second quarter of this year after expanding steadily since the spring of 1975. The growth in the first quarter was so small as to be virtually negligible. Preliminary estimates from the Department of Commerce indicate that there was some recovery in the past three months, but nothing suggesting a revival of activity to a level comparable with the last three years.

Many economists are currently saying we are already in a recession that began in March or April. Whether this period we are in gets the official designation as a recession or not doesn't really matter. What is important is that economic activity has slowed substantially.

Most of this slowing in growth has been caused by the American consumer pulling in his horns. He has bought fewer cars. He has stopped buying refrigerators and furniture and other things where the purchase can be postponed. He has slowed up on his buying because he feels less well off financially than he did six months or a year ago. And he is right. For the average consumer, income has not kept up with the rise in prices, particularly since the beginning of 1979.

We are going through a painful re-evaluation of the means available to the federal government for influencing the economy. It has become increasingly clear that the continued use of federal deficit spending to push economic growth has been a major factor in our steadily worsening inflation.

We are now in the fifteenth year of an inflationary cycle. That cycle had its roots in our attempt to simultaneously finance the Viet Nam War and a whole new array of Great Society programs by borrowing rather than by taxation. Now I know that there is a strong tendency to blame inflation--particularly the high rates of the past few years--on OPEC, or the oil companies, or the utilities, or labor, or whoever is the most popular or convenient scapegoat at the moment. But the real culprit has been federal government economic policy. During the last fifteen years we have tried to solve all of the nation's problems by a fiscal policy relying heavily on deficit financing. Indeed, the decade of the '70s can be looked on as the decade of the deficit. During every single year of the decade the federal budget operations have resulted in added borrowing. And borrowings for federally-sponsored programs not counted in the budget have added significant amounts to the total debt. This string of deficits, together with those accumulated in the late 1960s, has been the primary source of the inflation which now plagues us.

In the final analysis inflation is a monetary phenomenon. When money growth outruns physical output, prices rise. If it's that simple, then the solution ought to be easy: just slow down the growth of the money supply and all will be well. But it is not that simple. To shut off the growth of money abruptly would produce a rerun of the depression of the 1930s--and 25 percent unemployment. We are not starting with a clean slate. Monetary policy is tied to fiscal policy. There is no way that the long sequence of deficits of the 1960s and 1970s could have occurred without placing severe constraints on the conduct of monetary policy. The Federal Reserve System had to permit more rapid monetary expansion than it felt desirable. Otherwise the increased public debt could not be successfully financed in a free market without squeezing private credit mercilessly.

This linkage between monetary policy and fiscal policy is a direct consequence of the political structure of our country. The Federal Reserve System is a creation of the Congress. But the body Congress created the Fed is not independent <u>of</u> the government--it is independent <u>with</u>in the government. Thus while monetary policy has a range of independence, it cannot ignore the economic targets the government wishes to achieve. As independent monetary authority which regularly acted to frustrate fiscal policy over any extended time period would fast lose its independence.

So, as a result of a long chain of federal deficts and the financing of those deficits by monetary expansion, we have reached our present rough situation. Today's inflation is the last link in a long chain of well-meant actions. The benefits of tax cuts, of increased public spending, of a faster rate of money growth, may be felt within a few weeks or quarters. The penalty in terms of inflation comes later, perhaps a couple of years later, perhaps even later. Today's inflation is the long-run consequence of the short-run policies of the past.

Now we have finally arrived at a time when there is widespread public recognition that our primary economic problem is inflation. This recognition has produced a new attitude toward the economy, both in the administration in Washington and in the Congress, not to mention the tax revolt now sweeping the country at the state and local government level. The problem confronting us has become so severe that we seem to be ready to take a longer-term view in seeking a solution. With negative real economic growth in prospect for this year, and perhaps much of next year, and with inflationary pressures intense, I hope that this can be a watershed year for economic policymaking. The traditional national response to a widely expected recession would be to reverse the economic policy gears. Thus we would be backing off from immediate deep concern about inflation and starting to pump up the economy again. But there is hope that our economic policy will be significantly different this time. President Carter has pledged his support to this principle of fiscal conservatism. Let's hope he can still stick with it during his entire term.

Opposition to "knee-jerk" policies--switching to stimulative government policies whenever slower economic growth seemed likely--has, of course, existed among some economic thinkers--and many politicians--for a long time. But it has taken the pressure of persistent inflation to bring the majority of our people to the point of making a significant and necessary change in their thinking about economic policy. I think that change has occurred. It was evident in the Economic Report of the President issued early this year. It was evident in the budget that the administration proposed for fiscal 1980. Even more important, despite the OPEC oil price increase this spring and increasingly negative expectations for economic growth for the next few quarters, Congress has adopted the President's basic program of progressively reducing the Federal deficit and the size of total federal spending relative to the economy. In line with this less stimulative fiscal policy, monetary policy is aimed at a very gradual reduction in the rate of growth of the money supply.

With this policy framework in place, I expect negative growth for the rest of this year, and probably into the early part of next year, followed by a relatively slow recovery. However, I confess I do not expect to see any sweeping strides in winding down inflation during the next year or so, although I am expecting some decline from the double digit rates of the first half of 1979. Much as I would like to see major gains on the inflation front I am convinced we cannot undo fifteen years of excesses with one year of restraint. The President's wage and price standards program continues to be tested. Action has already started to relax those standards somewhat in the light of the higher than expected inflation since they were first introduced. Labor demands will continually try to make up for the price increases that have already occurred. Businesses will have to pass through the added costs, and real profits are still low historically.

Undoubtedly, only modest improvement in reducing the rate of inflation arising from slower economic growth can weaken the resolve of the Administration and the Congress and test its patience. The public wants quick solutions. There are none. It will be difficult for the less courageous to continue to accept slower growth and some attendant unemployment increases--in the absence of dramatic price effects. Nevertheless, such a course is necessary.

Is there any hope for a more optimistic view? Might we get better results in slowing down inflation than I have suggested? Well I can offer you one possible basis for a more favorable outcome than I have described. There is a possibility that reductions in the rate of inflation will come somewhat more rapidly as consumers and business firms begin to lose some of their cynicism and accept the view that inflation will, indeed, be constrained over the longer run. The present high rate of inflation has generated responses by individuals and institutions that perpetuate a rising spiral even in periods of economic slack. If expectations change about the future course of prices--even slightly--behavior will also be modified. The name of the game is expectations. The sooner we have confidence that a lower inflation rate is in prospect, the shorter the period will be to bring us closer to reasonable stability. It is therefore particularly important that both monetary policy and fiscal policy remain firm. The public must be convinced that policy will remain aimed at reducing the inflation level.

It is equally important that the public support holding the line--starting now. If we can maintain reasonable fiscal and monetary restraint now, we should be able to make substantial progress toward a more stable, less inflationary economy for the years that follow. We must not be deterred because one year of stringency fails to bring little immediate relief from inflation. The government policymakers react quickly to the demands of a mobilized public opinion. As long as inflation remains public enemy number one, it will also have first priority in Washington.

But there is also still a chance that we could just give up the battle. The danger is, of course, that our political resolve will weaken as the unemployment rate rises and the public becomes restive in the doldrums of a temporarily sluggish economy. Even worse, the chances for retaining a neutral-to-restrictive policy stance could evaporate if the mild turndown now foreseen turns into a really severe contraction. A deep, sharp recession would bring swift Congressional action to stimulate the economy. Such action would carry the risk, even the probability, of still higher inflation a year or two down the road. We are walking an economic tightrope. The policy actions and the economy's response to those actions are going to make our future much clearer six months from now than they are now.

I said earlier that I am an optimist. I think we are on the right path--modest restraint in both monetary and fiscal policy. We must perservere in that policy direction even though it is going to take several years to attain our goals of stable growth and stable price. The path is clear, Now we have to demonstrate the will.