

A NEW POLICYMAKER'S VIEW OF INFLATIONIntroduction

I'm delighted to be here on my first trip to North Dakota, although I will confess that I find the circumstances make me a little nervous. For I realize that I'm really a last-minute stand-in for Bruce MacLaury, who up until a short time ago would have been the one to occupy this spot.

Whenever I think of being a stand-in for someone else, I think of the story I heard in Pennsylvania where I have spent the last ten years, about the Quaker meeting at which the singer was sick, so they asked another man to fill in and sing. He was a little reluctant, but finally agreed. Unfortunately, he did a terrible job. He sang off key, he forgot the words -- it was just awful. One of the men in the congregation could tell he felt very badly about the whole thing, so he went up to him and said:

"Thee should not feel bad.

Thee did thy very best.

Tis he that asked thee should be shot."

I hope for the sake of those who asked me to speak today that I do better than that substitute singer. In fact, I hope that after you have heard what I have to say today, you don't decide that you want to shoot me. Actually, as bankers, I would guess that you would have a better understanding of my remarks today than would many other groups.

As some of you may know, I am not new to the Federal Reserve System. I joined the staff of the Federal Reserve Bank of Philadelphia in 1967. So I am getting on toward being an old System hand. But I have been president of the Federal Reserve Bank of Minneapolis for only a little more than two months. I am therefore new to the responsibilities of a Reserve Bank president, which include serving as a member of the Federal Open Market Committee - or the FOMC. And that committee, as I am sure you are aware, is the most important of all the Federal Reserve committees (of which, let me assure you, there are a great many). It decides the monetary policy of this country, and monetary policy is a very important determinant of economic conditions not only in the United States but in the larger world beyond.

Being a new member of the FOMC has some significant advantages. One of the most important is that it is not possible to blame me for past policy mistakes. And mistakes there have been, even in recent years. Nor do I feel any pressing need to use my time here to explain those mistakes away. And, of course, I cannot tell you in any detail what monetary policy will or should be in the months and years ahead. What I can and would like to do, though, is give you some idea of my view on what is surely one of the great economic issues of this decade -- the issue of unemployment versus inflation. That view will guide me as I participate in the deliberations of the Open Market Committee.

My participation in that committee is my most important responsibility. And while as a member of the FOMC I represent the country at large and not just banking or other groups in the Ninth District, you do have a special right to know how I will approach that assignment. So I have taken this

opportunity in giving my first major speech to explain to you my views on the most difficult challenge and responsibility I will face as president of the Federal Reserve Bank of Minneapolis.

I have been told that there is a grand tradition here in the Ninth Federal Reserve District, a tradition of openness, of people being frank and candid. So you will, I am sure, let me know if you believe that my view on the issue of unemployment versus inflation is in error and that I am therefore likely to serve our country badly. I would, of course, be delighted to hear from you if you think my view makes sense.

Inflation the Number One Problem

I can state my view in a very few words: the over-riding economic problem today is inflation. The Federal Reserve, therefore, must give top priority to restoring price stability.

I do not deny that we have a serious unemployment problem. While the over-all unemployment rate has declined considerably from the peak of 9.0% reached in the last recession, and prospects are good that it will go lower still through the remainder of 1977 and into 1978, even so, we will for some time to come have a serious unemployment problem.

The problem may be, however, a little less serious than it appears. A given unemployment rate does not mean what it meant fifteen or twenty years ago. That is because young people and women make up a larger fraction of the labor force than they did. And although it is regrettable, the young and women experience more unemployment on average than do adult male workers.

On average, they quit their jobs or are laid off more frequently. And thus the larger their share of the labor force, the higher the unemployment rate. Consequently, "full employment" is not what it once was. If 4.0% was a good approximation of full employment in, say, the early 1960's, then today somewhere between 5 and 6% is a good approximation. And that is not as far from the 7.0% rate we had in April as some would have us believe.

Moreover, we have to keep in mind that generally those who are unemployed do not suffer as much economically as they did ten or twenty or thirty years ago. To be sure, being laid off can be a severe trauma, a severe psychological shock. But because a larger proportion of the unemployed are women or teenagers, that often means there is at least one breadwinner in the home who is still working. So many "unemployed families" still have wage or other income to blunt the effects of unemployment. In addition, unemployment compensation is much more generous than it was. Indeed, recent research suggests that for some, unemployment compensation plus other available benefits exceed the take-home pay the individual would get by working. Consequently, for fairly long periods of time, people can be out of work and not suffer a significant decline in their standard of living. This not only means that the economic suffering associated with a given level of unemployment is reduced, but it also means that people are more choosy about the jobs they will accept. So they are likely to stay out of work longer than they otherwise would. To a degree then, our very generosity has aggravated the unemployment problem.

So our definition of full employment has changed. And some unemployment is the result of generous unemployment compensation and other benefits.

Nevertheless, as I said before, a 7.0% unemployment rate is too high. We can (and I hope will) do better than that.

No Tradeoff Between Inflation and Unemployment

The essential point, however, is that tolerating inflation, or letting inflation accelerate again, will not reduce unemployment, except perhaps briefly. More inflation does not mean less unemployment.

A decade ago, many (perhaps most) economists believed that there was a trade-off between inflation and unemployment. A government, if willing to tolerate a high enough inflation rate, could achieve any desired unemployment rate. But the professional consensus has now shifted. Today it is quite widely accepted that at best inflationary monetary and fiscal policies will only fleetingly reduce unemployment. A government that launches on an inflationary course, either deliberately or accidentally, will not achieve a permanent reduction in unemployment. In fact, that very inflation may ultimately cause unemployment to rise.

In his most recent appearance before the Senate Banking Committee, Chairman Burns said:

"My fundamental view is that unless we bring down the rate of inflation, we will not have good times in this country. We will continue to suffer from an excess of unemployment. I think that (restoring price stability) has to be our number one priority because unemployment and inflation are so closely tied together . . . To get unemployment down . . . we will have to get inflation down."

Many people have taken exception to statements like this one of Chairman Burns. I will not today take you through all of the theoretical and empirical studies marshalled on both sides of the issue, and I will readily admit that the evidence is far from conclusive. But as I have studied the sweep of historical events both in this country and abroad, I have reached the judgment that at best, inflation can only buy a temporary reduction in unemployment. And often, it may do so at the expense of even higher unemployment in the long run as accelerating price increases call for stern measures to prevent economic chaos.

But even if inflation could buy some reduction in unemployment, even a temporary reduction, it would be an unacceptably expensive way to do it. Inflation is a capricious tax, which in very arbitrary ways takes from some segments of society and gives to others. We really know very little about who benefits and who gets hurt by inflation, but we do know that it creates uncertainty, and thereby distorts and complicates decisions both of consumers and businessmen. The inevitable result of all of the economic churning that is part of people's attempts to anticipate or respond to inflation is the waste and misallocation of resources. On a national scale, the cost must be horrendous. Surely there must be cheaper and more effective ways, from society's point of view, to reduce unemployment.

We might try a variety of ways to improve the workings or the efficiency of the labor market, by removing artificial barriers and facilitating the flow of job and other information. We might limit future increases in the minimum wage, or indeed even lower it at least for the young and poorly trained job seekers. It seems quite clear that the minimum wage

is in part responsible for the high unemployment rates experienced by the young, and particularly the young of minority groups. And we hardly do the young a favor by promising a nice wage for jobs they will never get.

And other things can be done. The point is that if we would all spend as much time developing creative ways to reduce unemployment directly as we now do figuring out ways to cause and then try to manage inflation, we could most likely solve both problems with much less cost and anguish.

This is particularly true now since we still periodically hear the suggestion that some form of wage and price controls should be used to help manage inflation. Fortunately the current Administration seems persuaded by the large amount of experience in this and other countries that such controls are not only ineffective but costly. They distort the necessary flow of goods and services, cause shortages and bottlenecks, and most important of all they cause a significant reduction in personal freedom. Let's hope that government persists in avoiding application of the wage and price control remedy, which is worse in its effects than the problem it is ineffective in solving.

The Outlook for Inflation

It may seem strange to some of you that I chose this morning to talk about inflation when the inflation rate is now considerably less than it was. In 1974, it was in excess of 12%, and last year it was only 5%. So we have made considerable progress. Yet 5% is still significantly above the average of 2- $\frac{1}{2}$ % that has prevailed for most of the post-war period. And unlike the unemployment rate which is moving down, there are hints in recent economic

reports that inflation may be accelerating again. The Wholesale Price Index and the Consumer Price Index increased at a higher rate in the first quarter of this year than in the second half of last year. And it is no comfort to point to food and fuel prices by way of explanation. Whatever prices increase, inflation is still inflation. Further, labor compensation has lately been increasing at a higher rate than it did last year. While there are still apparently some margins of excess capacity, of capital and of labor, nevertheless the threat of accelerating inflation is very real.

I am, however, cautiously optimistic. I believe there are signs that our government and the Federal Reserve mean to be resolute in containing inflation. I have in mind various of the things President Carter has done since taking office. He has refused to bow to pressures for taxing or restricting imports of shoes and other products. And as we all know, international competition or free trade in goods can make an important contribution to price stability.

Then, too, President Carter's proposed support prices for wheat and corn are lower than the Congress wants to impose, and he has threatened to veto any bill that sets support prices that in his judgment are too high. I perhaps should not have brought that up here in North Dakota. His stand may not be very popular in these parts. That, however, is the point. If we are to restore price stability, we cannot go on as before, acting as if everyone could have more and more. Restoring price stability is likely going to involve disappointing various of our citizens, at least for a while. That is why the task will prove difficult, and why I am somewhat encouraged by what President Carter has said and done.

I should also mention his having withdrawn his proposal for the \$50 rebate -- and what is even more important, his insistence that balancing the federal budget is his top economic priority. I do not know whether he will manage to do that by 1981. I am quite sure, though, that doing so is important. And it is encouraging that he has been so emphatic about his intention to do so. If he manages to curb federal spending and achieves or comes close to achieving a balanced budget, we will be a good deal closer to lasting price stability than presently we are.

The Federal Reserve Response?

And what of the Federal Reserve? Can we be confident that it will do what is required? Again, I am cautiously optimistic.

Being bankers, you are all aware, I am sure, that now the Open Market Committee pays much more attention than it once did to the so-called monetary aggregates, the most important of which are M_1 and M_2 . As you know, M_1 is the narrow money supply, the total of currency and demand deposits owned by the public. And M_2 , the broad money supply, is made up of currency and demand deposits plus consumer-type time and savings deposits.

Now, the Open Market Committee has not become a slave to those aggregates, although some might wish that it were. It attends to other economic indicators as well. But it is important that the Committee has to some extent changed the way it operates, and more particularly that it keeps a closer watch on M_1 and M_2 than it once did. On occasion in the past it has confused an increase in interest rates with a more restrictive monetary policy. But now, with it watching the aggregates, there is less chance that the Committee will fool itself.

The Committee itself chose to put greater emphasis on the aggregates. It was helped along, though, by the Congress. Under Concurrent Resolution 133, the Chairman of the Board of Governors is required to report four times a year, at quarterly intervals, on the target growth ranges for the aggregates that have been adopted by the Open Market Committee. Earlier this month, Chairman Burns went before the Senate Banking Committee to inform it (and thereby the general public) what rate of growth for M_1 the FOMC was hoping to achieve over the year ending in mid-1978. He said, as some of you may recall, that the FOMC was hoping for growth in the range of 4 1/2 to 6 1/2%.

But Chairman Burns also said, as he has on every occasion, that the target growth ranges set by the FOMC are too high, that over time the ranges had to be reduced. And over the past two years the Committee has reduced its ranges, if ever so gradually. I believe we can take some comfort from the fact that the Committee has been changing its target ranges in the direction of moderating inflation.

Of course, we could take even more comfort if the FOMC were living up to its intentions. While it has gradually lowered its target range for M_1 , there has been no appreciable decrease in actual growth of the money supply. Indeed, the money supply increased more in 1976 than in 1975. Clearly, the Committee has to do better at delivering on its promises.

Now I don't want to be too harsh on my new colleagues. The environment in which monetary policy has been conducted has been very difficult.

There are many, in fact, who have argued that the inflation of the period since 1973 was forced upon us by nature and the OPEC cartel. You will recall the crop failure of 1972, particularly in Russia, and the less serious failure of 1974. Those failures resulted in sharp food price increases, and those increases got reflected in wage demands and thereby in a subsequent general increase in prices. And you will recall the unprecedented oil price increases of late 1973. They too got reflected in wage demands and thereby in a more general increase in prices.

So it is in a way right to say that the inflation of recent years was forced on us. But it is in another way wrong to say that inflation was forced on the United States. What I mean is that with restrictive enough monetary and fiscal policies, the food and oil price increases might have been offset at least in part by decreases in prices of other things.

Of course, if our policies had been that restrictive, unemployment would for a while have averaged more than it did. When policies become more restrictive, the immediate effect is a decrease in output and employment. Prices respond only with a longer lag. So the Federal Reserve followed a course of moderation. It perhaps felt -- and if so, rightly -- that with a policy that was too restrictive, it might win a battle and lose the war. That is the clamor resulting

from even higher unemployment than we had might have resulted in changes in our governmental and other policies and institutions that could have haunted us for a long time.

But it is extremely important to recognize the nature of the inflation of recent years. An increase in one price will be inflationary only if accommodated by an increase in the money supply. Consequently, we must not get into the habit of equating an increase in some prices with a general increase in prices. For example, the increases in energy prices implied by President Carter's recently announced energy program do not have to result in inflation, but rather only a change in relative prices, or the relationship of energy prices to the prices of other things. And perhaps the time has come to ensure that the energy price increases that must come do not result in inflation. Perhaps the time has come for the Federal Open Market Committee to be less accommodating than it has been. For with each bout of inflation, restoration of price stability becomes that much more difficult.

Conclusion

I am under no illusion that restoring and then maintaining price stability will be easy. We in this country, and those in other countries as well, seem to have developed unrealistic expectations about the standards of living we can have. That is in part the fault of governments that have promised too much. It will take a while for us to unlearn, to change our expectations. And doing so will be painful. Yet the Federal Reserve must, it seems to me, do what it

can to get the economy back on a path of stable prices. It must resist the pressures born of disappointed expectations. If it does not, then we likely will end up with a much more regimented economy, and with less of that most precious of all commodities, freedom.