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THE ENVIRONMENT OF MONETARY POLICY

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We are now standing at the top of another year. I should like to take advantage of the perspective to look over our accomplishments and our shortcomings and to indicate why it is imperative that we solve the problem of inflation.

Before I talk about problems, let me say a word about accomplishments. Overall, the American economy has acquitted itself well since the war - better than many expected, with the depression still fresh in memory. Our gross national product in real terms has increased about 40 per cent, or about 3 per cent a year. Unemployment has been relatively low, averaging about 4 per cent.

We have thus far won at least three battles over mass unemployment and depression. Our economy has shown a remarkable resiliency in adjusting to new conditions. Last year was not typical. Unemployment was high and gross national product fell slightly in real terms. Fortunately, conditions improved considerably by the end of the year. Production bounced back after the middle of 1958; and unemployment, though still high, began to decrease. Most observers expect 1959 to be better than 1958. There is every reason to expect that growth, which has characterized the American economy, will be resumed.

Our chief shortcoming has been the erosion in the value of money. Our price level is about 30 per cent higher than it was in 1947. Some would have us believe that economic growth and inflation go hand-in-hand. Others go further and maintain that inflation in moderate doses stimulates economic growth.

Experience does not give conclusive answers concerning the relationships between growth and inflation. We have had rapid growth: (1) with inflation, as in the decades before the First World War; (2) with price stability, as during the 1920's; and (3) with deflation, as during the quarter-century following the Civil War, when gross national product doubled while the level of prices fell substantially.

Experience does not warrant us in burdening ourselves with inflexible strictures because of assumed relationships between growth and inflation. I should like to indicate why there is good reason <u>not</u> to do so. Inflation produces obvious injustices. There is reason to believe that especially where it becomes a "way of life" inflation tends to undermine efficiency and economic growth in real terms.

Although I shall concentrate today on efficiency and growth or the production of wealth, I hope you will excuse brief quotations concerning the effects of inflation on the distribution of wealth.

The "most striking consequence" of inflation "is its <u>injustice</u> to those who in good faith have committed their savings to titles to money rather than to things." "If we are to continue to draw the voluntary savings of the community into 'investments,' we must make it a prime object of deliberate State policy that the standard of value, in terms of which they are expressed, should be kept stable . . . "

If you are interested in this aspect of the problem, I suggest that you read <u>MONETARY REFORM</u>, written thirty-five years ago by J. M. Keynes, from which I have extracted these quotations.

My primary concern today is in the effects of inflation on economic efficiency and growth. You might be interested, incidentally, in Keynes' view on this aspect of inflation. He wrote: "Inflation has not only diminished the capacity of the investing class to save but has destroyed the atmosphere of confidence which is a condition of the willingness to save. Yet a growing population requires for the maintenance of the same standard of life, a proportionate growth of capital."

The kind of economic system that we have will function most efficiently when the value of money remains constant. Prices are of strategic importance in our free market economy. They allocate our resources into those employments in which they can most profitably be used. When competition is keen, resources are allocated into those employments in which our consumers want them to be used. There are imperfections and frictions, of course. Things do not work so smoothly or so quickly as Adam Smith and some others believed. Nevertheless, as I see it, this is basically the way in which our economy operates; the consumer dictates, the quest for profit motivates, and the price system allocates.

Countless decisions to earn and spend, to borrow and lend are channelled through the cold exacting calculus of a free market to allocate our resources. The standard unit of these calculations, of course, is the dollar. Balance sheet and income statements are written in dollar terms. They can reflect change accurately only if the dollar itself - the unit of measurement - remains reasonably constant.

An outstanding American economist once gave an excellent illustration of how inflation leads to faulty decisions and obscures inefficiencies. In the 1920's he bought a shirt from a woman shopkeeper on the outskirts of Berlin. The woman, who wished to prove she was not a profiteer, told him: "I am charging you only as much as it will cost me to replace the shirt. I have, of course, made my usual profit on that shirt, which I bought for less."

Let us analyze some economic implications of this transaction. In one accepted accounting sense, the woman had made a profit. Her selling price was greater than her bookkeeping cost. But it is clear that if she used this "profit" to meet her living expenses, she would not be able to replace her inventory. Instead of living off income she would be living off her inventory. In real terms she had no income even though in money terms she had a profit.

If this were the only implication, one might feel sorry for the poor woman and pass on. I have introduced the transaction, however, to illustrate some principles. In an intricately balanced market system, such decisions have wider effects.

Competitors, even those who are not fooled by the money illusion, will have to meet her price or lose business. They may be more efficient, but they cannot compete, except at a loss.

Inflation tends to obscure such inefficiencies. It can rescue for a time some businesses which otherwise would be forced to correct their errors or fail. On the other hand, efficient businessmen may be put in jeopardy because they face competition that does not permit them to raise prices while their suppliers may not face such competition. Or businessmen who are otherwise efficient may find themselves in trouble simply because they do not understand the destructive impact that inflation can have on capital.

If we accept inflation which thus frustrates efficiency and seems to reward illusion, I doubt that our economy can grow up to its potential. You are all familiar with illusory profits that really come from capital as a result of understating depreciation because of higher replacement costs.

Accountants can, of course, adjust their methods crudely to allow for inflation. Accelerating depreciation on fixed assets, valuing inventories on the basis of last-in, first-out, and adjusting for changes in the price level are illustrations. In the nature of the case, however, the adjustments cannot be complete. One reason is that not all of them are allowable deductions from income in the computation of taxes. Even if most businesses could and did take advantage of all possible accounting adjustments, I wonder if this would not, in and of itself, aggravate the inflationary problems. I suspect that prices would tend to move up more uniformly and perhaps more quickly.

It should also be recognized that all those efforts are non-productive. They would be included in gross national product but they contribute nothing that society would not have had without them, had the price level remained stable. At best, all these efforts would achieve indirectly and crudely what could be achieved directly with a stable monetary unit.

I should like next to make a few comments on the view that inflation is destructive only when it is rapid and that creeping inflation, of say 2 per cent or 3 per cent a year, brings net benefits. My first comment concerns the power of compound interest in the long run even though the rate is low. A price level that rises at 2 1/2 per cent a year compounded will double in about twenty-nine years.

Do not underestimate the effects of such creeping inflation on large groups of people. Recently a Federal Advisory Council, composed of representatives of industry, labor and the public, issued a report on the Social Security system. The Council unanimously reported that the method of financing Old Age and Survivors' insurance is sound. But the Council issued a warning:

> ". . . the trusteeship is so large, and the number of people involved so great that the defeat of beneficiaries' expectations through inflation would gravely imperil the stability of our social, political, and economic institutions."

Some advocates of creeping inflation recognize such hardships and recommend that the sufferers be compensated - but compensated by whom? Many persons have relatively fixed income contracts other than their benefits from Social Security.

But I wonder if we could really hold inflation to 2 1/2 per cent a year, if the idea that inflation had become a way of life were held universally. There are forces at work in our economy that tend to turn a creeping inflation into a leaping inflation.

Perhaps the most powerful force spurring an inflation into a walk, a trot, and a gallop is man's perverse ability to turn his fears into reality. Once people begin to expect a rising price level they do things that tend to bring it about.

If they are afraid that prices will rise next month, they have a real incentive to make next month's purchases this month. They have an incentive to trade money for goods, real estate, stock, and anything else they think will rise in value. When many people think and act this way, prices are certain to rise - not next month, but this month, and by more than originally expected.

Inflation, whether gradual or galloping, is not a uniform process. As we all know, some prices and incomes increase faster than others. Some do not increase at all. Schemes to protect the purchasing power of victim groups - workers, public utility stockholders, government bondholders, and others - have been adopted or proposed here and in foreign countries.

By and large, I think cost-of-living and other purchasing power adjustments contribute to inflationary pressures by increasing costs. But, as an ethical matter, I think the special arguments made for special groups are all equally good. All groups deserve protection. Wouldn't we save a good deal of economic and political conflict, though, by preventing inflation in the first place?

I am not one of those who believe that inflation is inevitable. It is a human phenomenon and people can do something about it. Once it is understood, they will do something about it. For my own part, I do not find the reasoning of those who say inflation is inevitable any more convincing than the reasoning of those who in the 1930's concluded that we were a mature economy incapable of full use of our resources. The words inevitable and perpetual are too powerful to describe future human behavior.

Inflation is a result of varied and complex forces and it must be attacked on a wide front. Our output of goods and services is moving to new record levels. Certainly under these circumstances, as Chairman Martin said recently, here in Chicago: "We must face up to the reality of either raising taxes or revising our tax structure to produce more revenue or reducing the priorities of some other programs until we can get things in better balance."

Just a year ago, Carl E. Allen, President of the Federal Reserve Bank of Chicago, indicated forcefully what is needed in the private sector of the economy. He said: "It is human nature, when we overreach ourselves and have no one to blame for our excesses other than ourselves, to seek out a culprit on the one hand and a savior on the other. I believe that elements in labor are doing just that today. They turn to industry as the culprit and to the Government as their savior. And there are elements in industry which have priced themselves out of a market. They have themselves to blame for their excesses, so they look to labor as the culprit and to Government as their savior. The culprits are different, but unfortunately the hoped-for saviors are the same - the Government. . . . We can hope that management and labor in the months ahead will recognize that lasting rewards cannot come from constantly increasing prices, but rather that their mutual interests and the well-being of the country both require price stability."

We need also to understand the role of flexible monetary policy. We have had such a policy for eight years, easing credit when declines have been under way, as in 1957-1958, and moving away from ease as business recovers. Monetary restraint is never popular. To be effective some borrowing and spending must be restrained. It may be, as some have urged, that certain areas of the economy should be sheltered somewhat from the impacts of credit restraint. But I should like to emphasize that expansion of the sheltered areas necessarily reduces the unsheltered areas and thus makes the impact on them greater. This in turn can create new "hardships," leading to attempts to extend the sheltered areas. Special dispensations for special groups tend to weaken general credit restraints. If special dispensations become widespread, general credit restraint becomes meaningless.

I have said I do not believe that inflation is inevitable. If we understand its erosive effects and how it operates, we will as a people attack it on the wide front that is necessary. We can achieve the goal on which we all agree - stable economic growth in real terms.

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