Racquet Club on Thur

Part II

Remarks

Harvard Alumni Group
November 1, 1974

I. Nature of Inflation

A. Let me now turn to the question about the nature of the inflation ill we're trying to cure and the appropriateness of the remedy. The main thrust of the Administration against inflation is back to the "old time religion," that is, balanced budget and tight money. Critics contend that the old time religion makes sense for the old time inflation--excess demand inflation. But they say, we don't have excess demand inflation, we have cost-push inflation, food inflation, and Arab inflation. The old time religion approach won't cure these types of inflation; it will only cause a housing slump and unemployment. There is an ounce of truth to this view. The old time religion should be modified, but its whole doctrine shouldn't be tossed out in the current fight against inflation.

B. I find it useful to break inflation into two parts: basic inflation and extraordinary inflation. There is an old truth in economics which says that basic inflation cannot be sustained for long periods without the money to finance it. Excess demand can't prevail without the money to finance it; cost-push can't prevail without the money to finance it; and so on. Extraordinary inflation, on the other hand, is caused by sharp increases in particular prices outside the normal workings of the economy, e.g. crop failures in the mid-west, Arab oil cartels, etc. These special events come and go and have throughout our history. The striking feature of the current period is that we have so many extraordinary occurrences at once on top of an already sizable monetary inflation.

C. Some estimates have been made of how much of the double digit inflation is monetary induced, or basic, and how much is extraordinary. A crude guesstimate is that about half is basic, and half is extraordinary. In other words, without the harvest problem and oil problem, we'd still have a basic inflation rate of 6 or 7 percent. Some economists would put it a bit higher. But the half and half split is probably not a bad guess.

D. This kind of analysis tells me, therefore, that we cannot throw out the old tools for fighting inflation. We have to modify them, to be sure, but the fight against inflation, to be successful, must include a program for moderating the growth in money and keeping the federal deficit within reasonable bonds.

II. Strategy Against Stagflation

A. On top of the mixed inflation bag we face, we are also in a recession, which I've indicated, will probably get worse before it gets better. So, not only do we have to fight basic and extraordinary inflation, we also have to fight rising unemployment. There may have been a period in our history when we've faced these seemingly paradoxical problems simultaneously, but I do not recall them from my studies of economic history. So, we really do have a unique set of problems which are crying for a unique set of answers--indeed, if such a set exists. We also have to be realistic in our approach, we cannot say if we do this or that we'll solve our problems in the long-run because in the long-run we're all dead. Mankind exists in series of short-runs. So, at a minimum, we have to find policies which make sense for the long-run and can still be lived with in the short-run.

B. Having said that, let me hasten to add I am no oracle--I do not have the final answer to our economic problems. But, there are a few general thoughts I'd like to leave with you.

1. There are no ideal, quick, painless cures. There will have to be trade-offs.
2. The strategy will have to include some lessons from the old economics and some experimentation with "new" economics.
3. Economics and politics are bedfellows, for better or worse, and it makes no sense in the policy area to talk about one and not the other.
4. Some sort of social compact will have to be struck among the various elements in our society--labor, business, rich, poor, middle class, etc.

C. Let me be more specific about the ingredients of an anti-stagflation policy.

1. Will have to increase productive capacity--from oil to agriculture to building materials.
2. Restrictive practices which add directly to inflation will have to go--milk prices, artifically high construction costs on public projects, etc.
3. The disadvantaged will have to be more insulated from the burdens of unemployment and inflation.
4. Some kind of wage-price guidelines--less than full controls but more than patriotic pronouncements--will have to emerge.
5. Growth in money will have to be slowed very, very gradually over a period of several years.
6. Federal budget will have to become more flexible as an instrument of micro policy--coming to the aid of housing, for example, more forcefully and quickly than has been the case. Federal budget will also have to become more flexible as an instrument of macro policy--shifting from deficit to surplus or vice versa more quickly in order to be more responsive to changes in broad economic conditions.

In short, as recession ~~outstrips~~ catches up on inflation as Public Enemy #1, policy will have to concentrate on both.

This is more difficult, but possible.

Of course, a price must be paid. Some actions to make inflation better make unemployment worse; and vice versa. So there's always a trade-off.

Result: those who believe inflation should receive all-out attention are disappointed

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Requires broad viewpoint – not just of economy, but of social issues.

III. Wrap Up

A. Will we do any or all of these things? My guess is we'll do some and some we won't. The President's program has some of this, but not enough. I think we'll be hearing more from him on the economy.

B. So, we'll likely muddle through the next several years--earning some high marks from historians and earning some bad ones as well.