FEDERAL RESERVE BANK OF SAN FRANCISCO
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INFLATION AND THE YOUNGER GENERATION

Remarks of
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Inflation and the Younger Generation

I'm glad to be in Portland once again, and delighted to see an audience that's much younger and better looking than those I usually speak to. Of course, I'm not sure that all of you are vitally interested in economic affairs. Indeed, some of you may have an absolute abhorrence of matters economic, and may have been dragged kicking and screaming to this event by a friend. This situation is quite normal, since for any particular area of human knowledge, one would expect to find a widely varying degree of interest on the part of the population as a whole.

What is also quite normal is that most people do care about those things which affect them personally. I would guess, to take an obvious case, that most of you care very much about the prices you must pay for your textbooks and cafeteria food -- and about the chances you have of landing a job when you leave this campus. It's these two questions -- employment and (especially) inflation -- that I'd like to discuss today.

Employment Problems

Many of you who are seniors will be out on the job market in only six to eight months. Others have somewhat more time to spend with the books before you make your entry into the world of work. What is it going to be like? Well, that of course depends upon your area of specialization, but I can tell you that in general it will not be as good as it was for those who got their degrees some 10 to 15 years ago. That was a sort of golden age for the college graduate. Employers of all sorts would scour the campuses in search of graduates of all sorts. Today, you hear stories on every hand of history majors driving cabs and english majors working as short-order cooks.

A part of this lies in the difficulty of high-school seniors (or anybody else) making predictions about the future. You may have noticed that the market for accountants (to take one example) has been very strong recently. Will that market be just as fantastic four years from now? Well, that depends upon future business requirements for accountants -- and also upon today's students' decisions about what business demand will be. In other words, if every third person entering college this September decided that accounting was where the action was, then you would find that four years from now there would be a lot of accountants driving cabs along with those history majors.

Now, the type of job problems which we have been discussing are extremely important, but are outside the realm in which we in the Federal Reserve System have any direct influence. In other words, we cannot tell students which fields will be characterized by good or bad job markets several years from now. What we can do is to work to achieve a healthy and growing economy that can, on average, provide jobs for all of the new entrants to the market each year.

Over the past three and a half years, our economy has been able to create new jobs for roughly 11 million people. This included people who had been laid off during the previous recession, but also high-school and college graduates, as well as a large number of women who decided to re-enter the labor force after a period of homemaking and child rearing. This is one of the most rapid creation of jobs recorded in this country, and quite frankly, this recovery is getting a little old to keep up that sort of pace. Indeed, many experts now fear a recession next year, partly because of the distortions created during a 3 1/2-year-long expansion, and partly because of the policy-tightening moves that have been adopted to support the value of the dollar at home and abroad. We can't be sure when (or if) a recession will occur. We can be sure, however, that a serious recession will strike if we don't bring under control the severe inflation that's been undermining our economy for so long.

Inflation Problems

Well, what about the fact that the prices you pay for tuition, for books, for food, and for everything else have been rising at what seems an unmanageable pace? There is no doubt that inflation has replaced famine and pestilence as one of the major scourges of modern civilization. No one is immune. Every year, the value of those dollar bills in your purses and wallets falls a little bit farther. Sure, you get paid a little bit more for those summer and part-time jobs, but generally you can consider yourself lucky if you just manage to keep your head above water.

After taxes and inflation, the average person in this country is less than 10 percent better off than he or she was a half-decade ago. That represents only about half the real growth in living standards achieved in the preceding half-decade. And students may be in even worse shape, since the prices of the items which dominate your budgets -- things like food, tuition, books and rent -- have been rising even more rapidly than the overall rate of inflation. In fact, I know of only one place in the world where it is still comfortable to be a student. In Saudi Arabia, students get totally free tuition, plus free room and board and $200 a month for pocket money.

Of course, the Saudis have something that we do not -- a huge quantity of highly priced exportable oil, whose price has increased eight-fold just since the beginning of this decade. Among the beneficiaries of the surplus oil revenues have been Saudi students. We too have been blessed in the past by similar bountiful resources, and we have translated them into higher living standards through the productivity of our workers and machines. But our living standards have lagged recently because of lagging productivity -- which suggests a strong need for us to overhaul our tax and other policies to stimulate productivity growth.

One policy area where we've gone astray in the past has had to do with the relation between jobs and prices. For some time, we believed that we had a choice between one of two evils -- inflation and unemployment. Specifically, faced with high unemployment, we thought all we had to do was to turn on the switch labeled deficit spending and easy money, which would create a little inflation and pull down the unemployment rate. The implicit judgment, of course, was that society was better off with full employment and a little inflation, than with high unemployment and no inflation.

Unfortunately, we have found lately that life isn't that simple. Indeed, most recent studies seem to show that rapid money growth and inflation actually create unemployment. I won't go into the technical details, but I'll give you an example which may help. During the 1973-75 period, this country went through the deepest and longest recession since the Great Depression of the 1930's. There was a time when that sort of event would be accompanied by an actual decline in prices. Not so this time -- in fact, prices rose more rapidly during that period than at any other time since the price surge following World War II. This experience of double-digit inflation accompanied by double-digit unemployment destroyed whatever faith we may have had in a strict trade-off between inflation and unemployment.

Inflation and the Young

But suppose the earlier belief was true, that we could obtain some improvement in jobs at the expense of constantly rising prices. Could we live with the resultant inflation? Let's look at the historical record, and what may lie in store for us. Needless to say, we've experienced inflationary episodes before in our history, but most were associated with major wars. But now prices have continued their unrelenting ascent for several decades, in wartime and peacetime alike, and it has gotten worse with each decade. During the 1950's, consumer prices rose at a modest 2.1-percent annual rate. The rate began accelerating in the mid-1960's -- and now, to date in the 1970's, prices have been rising at a sharp 6.8-percent average annual rate.

Let me make this a bit more concrete. As you know, it's very difficult to get a decent pair of levis for less than $20, or a decent pair of shoes for less than $40. Well, if this rate of inflation we experienced during the 1970's continued for the next 20 years -- about the time that your own children will be turning college age -- those $20 levis will then cost more like $75, and that $40 pair of shoes will cost almost $150.

Now, of course your incomes will be rising as well, so paying $150 for shoes will not seem so outrageous 20 years from now as it does today. But, if you are not careful, inflation will allow Uncle Sam to take such a substantial chunk out of your income that purchasing those shoes, or anything else for that matter, would be rather painful. The problem, which has been largely ignored until recently, is that inflation pushes people into higher tax brackets even when there has been no increase in their real incomes.

Let's take an example closer to home. Suppose that each of you seniors gets a job next June paying $13,000 -- a pretty good income for a new graduate. Now suppose that your boss, being a kindly person, promises to increase your salary each year by the rate of inflation (which we assume to be 6.8 percent) in order to preserve the purchasing power you had when you began work. With such an arrangement, in 20 years you'd be making roughly $48,000 -- though this income would buy no more food, clothing, shelter or anything else than $13,000 did back in 1978. Worse still, after taxes you would be buying considerably less than you did 20 years earlier, because you would then be up in those income-tax brackets which we think only apply to fat cats. To be precise, within 20 years you would be paying some 36 percent of your income to Uncle Sam, compared to roughly 20 percent today. So, unless we alter our system of taxation, or get rid of inflation, you all may become victims of the silent squeeze.

How to Handle Inflation

Judging from all the polls, the public has now come to recognize that inflation is a severe disease that could undermine our entire economy, and so people are now looking to their political leaders in Washington for some solution to the problem. But that raises the question -- what kind of solution? Several different approaches have been tried just within the past several months, so let's consider how they relate to the problem.

In late October, the Administration unveiled a set of wage and price guidelines, designed to put a 7-percent lid on annual wage increases and (essentially) a 6-to-6 1/2 percent lid on annual price increases. This move represented an attempt to stop the leapfrogging of prices and wages, which make up the vast bulk of industry's costs. But the guidelines program failed to win any support in Wall Street or in overseas financial markets, because stock prices continued to drop and the value of the dollar continued to sink against other major currencies. At that point the authorities had to take stronger measures -- especially, a tighter monetary policy -- to curb inflation and to support the dollar.

That episode should draw attention to where the basic problem lies. Too many dollars have been created in recent years, not because the Federal Reserve delights in doing so, but because of the pressures generated by a series of massive budget deficits. Some of those deficits could be explained by the need to stop a severe recession several years ago, but in the ensuing business expansion (against the advice of all the textbooks) we continued to overstimulate the economy through deficit spending. The Administration could balance its books this fiscal year if it simply kept spending at last year's level -- but instead it proposes a $41-billion (10 percent) spending increase, so we're in for another substantial deficit. That means that the decade of the 1970's will end with a mind-boggling $326-billion combined deficit -- more than in the entire earlier history of the Republic.

Deficit spending of that magnitude obviously has pushed monetary policy off course in an expansionary direction, because the Federal Reserve has been forced to meet the Treasury's deficit-financing requirements on top of the normal financing needs of households and businesses. For example, both major measures of the money supply -- M_1 (currency plus bank demand deposits) and M_2 (currency plus all bank deposits except large time certificates) -- have increased more than 8 percent over the past year. This is considerably more than is safe over the long term. The Federal Reserve is committed to reducing money growth over time, to a level consistent with relative price stability, but that goal will be difficult to achieve as long as Treasury deficit financing continues at its recent pace.

Concluding Remarks

Finally, what can you personally, as one of the most informed segments of our electorate, do about the problem? Well, some of you will become economists, and spend much time studying the problem of inflation. Others will become journalists and TV commentators, occasionaly dealing with inflation and other economic phenomena. To these people, I would urge that you spend several days in the coming year just trying to sort out for yourselves the causes and cures of inflation. I would urge you to read several good articles or books on the subject -- if your professors haven't already given you a bibliography, we'll be happy to send you some Federal Reserve materials on the subject. If you need additional motivation, you might want to do an interview or article for the college newspaper or one of your local papers. But you owe it both to yourselves and your future public to develop a solid understanding of this problem.

Now for the rest of you -- you chemists, geologists, artists, historians and the like. Even though you may never even come across the word inflation in your professional lives (which now seems increasingly unlikely), you should remember that the effects of inflation will bear down on you no matter where you are living or what you are doing. You can, however, do something about it. First, I would urge you also to make a brief intensive study of inflation, since it is important that you develop a basic understanding of the problem. Then, I would urge you to write those people you sent to Congress and express your concern about inflation. As it stands, most letters to Congress simply ask Senators and Representatives to spend more money for this or that pet project, which of course only means votes for more inflation. What they need are some votes for less inflation. But above all, remember that inflation is not an act of God; it is a man-made problem with man-made solutions. With a little bit of work devoted to understanding and acting on the problem, you -- all of you -- can be part of the solution.

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