INFLATION, INTEREST RATES AND THE FED

REMARKS OF

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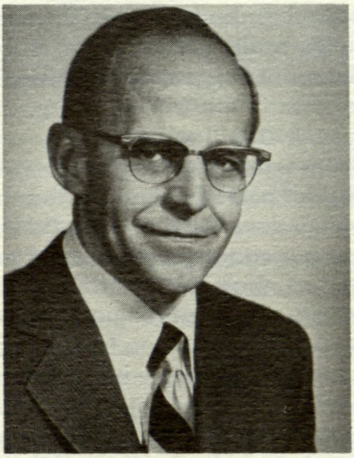

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Americans are continuing to suffer from the "silent yet severe tax" of inflation, says Mr. Balles. The problem can be traced basically to an upsurge in Federal deficit spending, which generated a cumulative deficit of $337 billion over the past decade and a half. This series of budget deficits has frequently pulled monetary policy off target in an expansionary direction, by supporting an excessive growth of money and credit. The resultant inflation has also led to a high level of interest rates, largely because lenders demand an inflation premium to protect themselves against an expected loss in the purchasing power of their money. Thus, he argues, we must work to curb inflation if we want to keep interest rates in check.

I'm glad to have this opportunity to discuss with you the problems of dealing with the high cost of living and the high cost of money. I can't think of a better setting for this talk than Town Hall—an institution which is part New England town-meeting and part Chautauqua, the type of traveling educational seminar that was popular in our country a generation or two ago. In fact, those old-fashioned Chautauquas had a flavor of religious revival about them, and that too I think is appropriate, because I strongly believe that the subject of inflation should be approached in terms of fire and brimstone, with much pounding of the pulpit.

Some experts tell us that we should learn to live with inflation, by such means as indexing our wages and other payments, so that they rise each year in step with the consumer price index. But this stopgap type of solution helps only certain groups, whereas the rising tide of prices undermines everyone's standard of living—and besides, distorts the price mechanism so badly that major inefficiencies develop in the allocation of resources. I hasten to add that the prices of many goods and services can and should increase through the workings of the marketplace, for that is the market's way of signaling people to reduce their consumption and expand their production. But what should concern us is a rise in the general level of prices—the continued escalation in the cost of everything bought by the average household and the average business enterprise.

Costs of Inflation

What then is wrong with inflation? For one thing, inflation weakens productive efficiency. It impairs business management by taking the meaning out of cost-accounting figures, and making it all but impossible to gauge the efficiency of operations by their cost performance. Inflation also perverts business incentives from production to potentially more profitable activities, such as occurred in the inventory speculation of 1973-74. Shortages then develop, and soon all businessmen are hoarding or speculating in the gray market simply to keep production going. Again, inflation obstructs the flow of capital through the economy, by segmenting capital markets, distorting financial prices, and undermining financial values. In all these ways, inflation acts as an insidious disease of the price system.

Inflation also reduces workers' incentives to produce more in order to earn more—acting very much like a regressive type of tax. People might put money aside for future big-ticket purchases or for children's educations, but they then find the value of those savings melting away. With experiences such as this, their willingness to work in order to save becomes gradually undermined. A story I've heard, which helps explain the Germans' strong fear of inflation today, concerns a prosperous German businessman who purchased in the 1890's a large 50,000-mark endowment policy, payable on retirement in 1923. In that year, in the midst of the terrible German hyperinflation, he received his 50,000 marks in the form of two postage stamps.

Inflation consequently creates an atmosphere of broken promises. That man of few words, Calvin Coolidge, probably said it best with the phrase, "Inflation is repudiation." Private agreements to purchase goods and to pay wages and salaries become undermined, along with governmental promises for debt repayment and pensions. People receive the dollars they were promised, but the purchasing-power substance of the promise is missing. In the long run, they get the feeling that someone has been swindling them, and then anything can happen. Witness what happened when hyperinflation hit Germany in the 1920's, China in the 1940's, and (to a lesser extent) Latin America in more recent decades.

Record of Inflation

Our own country has had a long history of inflation, although only at certain periods and with nothing to match the other cases I've just cited. Until recently, there was a certain pattern to these price movements. Before each major war—the Revolution, the War of 1812, the Civil War, World War I and World War II—prices roughly hovered around the same level. During each of those conflicts, prices just about doubled, and then sank back to the original level in a grinding postwar depression. However, the postwar depression didn't happen after World War II, partly because of wise private and governmental actions which offset the dangers of a serious economic downturn. But unfortunately, the inflation problem still persisted, mildly at first and then more seriously.

In the period of a decade and a half that stretched from the recession of the late 1940's to the eve of Vietnam, the general price level increased almost 40 percent, reflecting such developments as the Korean War and the investment boom of the mid-1950's. In the even shorter period which began with the Vietnam War, prices have almost doubled. The worst of course was reached just three years ago, when the inflation that had been suppressed for several years by price controls burst out in all its fury, resulting in a 13-percent annual rate of increase in late 1974. At that point, TV and nightclub humorists began to find that inflation jokes represented their best stock in trade, with such definitions as "Inflation is when you pay a dime for the penny candy you used to get for a nickel." Incidentally, one of the economists at my bank just investigated that particular subject, and reported that the Hershey bar is 20 percent larger today than during the 1950's, but costs four times as much.

We've been congratulating ourselves recently for the fact that the inflation rate has been cut almost in half in the past several years, and many people now claim that we should get used to a "moderate" rise in prices of (say) 5 percent a year for the foreseeable future. One trouble with that scenario is that consumer prices have increased at close to a 9-percent rate since last fall—almost twice as fast as in the preceding six-month period. But let's assume that we get inflation down to 5 percent and keep it there. Where would that leave our children in the early decades of the next century? With constant 5-percent inflation, in the year 2020 your average $4,600 car would cost over $40,000, and many other examples could be cited. Wages of course would rise also, but under our progressive income-tax system, the Federal tax bite for the worker now earning $3 an hour would rise from roughly zero to 30 percent of income, cutting deeply into real income and representing a major transfer of resources from private to government control. Here again we see the regressive nature of this worst kind of tax.

We hear from some quarters that we have to live with a certain amount of inflation in order to reduce the unemployment rate to respectable levels—a concept enshrined in many textbooks under the name of the Phillips curve. But our experience several years ago, when prices shot up in the middle of a recession, should have convinced us that something was wrong with that simple textbook relationship. Indeed, the economists on my staff now argue that the typical response to a high rate of inflation is more rather than less unemployment, because that inflation reduces consumer confidence, forces households to save more and spend less, and thereby reduces the level of business activity. As a policy matter, therefore, we are not faced with a choice between competing alternatives, but rather with a straightforward imperative to fight inflation if we want to conquer unemployment.

Causes of Inflation

The obvious question is: How did we in the 1970's ever get involved in such a serious inflationary problem? Only by answering this question can we avoid going through another bout of double-digit inflation. Some experts blame the problem on a collection of one-time misfortunes, such as crop failures and the upsurge in oil prices. Others lay the blame on basic changes in the structure of the U.S. economy, such as the growth of nationwide unions and the increasing concentration of industry. Closer to the mark, we can trace the severity of the inflation problem to a worldwide conjunction of easy monetary and fiscal policies in the late 1960's and early 1970's. Governments, by providing too much money and too much stimulus to purchasing power, fueled a worldwide price explosion throughout this period. In this country, the upsurge in prices during the inflationary boom reflected pressures on the Federal Reserve to accommodate much larger increases in the money supply than it would ordinarily sanction. The nation's money supply, defined as currency plus bank demand deposits, grew at a 5.6-percent annual rate over the 1965-75 period, compared with a 2.4-percent growth rate over the preceding decade.

Here indeed is the crux of the problem, for the severe inflation of the mid-1970's can be traced primarily to governmental policies first adopted a decade before. I noted earlier that the price level doubled during each of the nation's wars. In the past decade, the price level again practically doubled, but Vietnam was only part of the reason. Prior to the war, during the war, and especially after the war, the Federal government undertook a number of stimulative measures, many of them involving open-ended income-security and health programs. The pressures on available resources generated by that series of strongly expansionist measures were accommodated for a time by a liberal monetary policy, and the rest is history.

Our fiscal problem was serious enough, but it was made worse by a fatal flaw in the conventional economic thinking of our generation. Theoretically, there was nothing wrong with the idea that substantial tax cuts and deficits should be incurred in recessions, because they would be matched by spending cuts and surpluses in business expansions. Practically, the prescription didn't work, especially since it lacked an enforcing device. Policymakers eagerly adopted part of the advice and ignored the rest, because of their natural eagerness to increase spending and their comparable reluctance to increase explicit taxes. Practically, too, policymakers could not easily reduce programs once they got under way, because each program quickly developed its own political constituency, within both the bureaucracy itself and the groups being served.

Many traditional programs, such as defense spending, are now rising strongly. But the most worrisome increases, which are not even reviewed by Congress, are in what budget makers call "uncontrollable" categories—certainly a very apt description. Most of these programs involve the automatic transfer of money to anyone eligible under entitlement formulas written into law. In the past two decades, Federal government payments to individuals have risen from $17 billion to $172 billion, and various grant payments to state-and-local governments have jumped from $4 billion to $61 billion. Net interest on the Federal debt—another kind of "uncontrollable" item—meanwhile has climbed from $5 billion to $29 billion, equal in amount to the entire economy of a country the size of New Zealand.

For all these reasons, total Federal spending has grown at an unparalleled pace in the late 1960's and 1970's. The country was 186 years old before the government spent $100 billion a year, but by the time of the Bicentennial it was spending almost $400 billion annually. And since revenues have failed signally to keep up with this spending upsurge, deficits have been recorded in 15 of the last 16 years. The cumulative deficit in that period, including spending of off-budget agencies, has amounted to $337 billion. The Federal government, through its heavy demands on both financial and real resources, in this way laid the basis for today's severe inflationary problem. By failing to increase direct taxes to cover its increased expenditures, the government decided in effect to impose a silent yet severe inflation tax.

Inflation and Interest Rates

Again, by generating these inflationary pressures, government programs have helped to push up the price of money—interest rates. This point is worth emphasizing because of a general misunderstanding of how interest rates operate, as we saw during this spring's controversy over the rise in the prime rate which bankers charge their best commercial customers. Many pundits argued at that time that basic credit demands were not strong enough to cause any rise in rates, and moreover, that the Fed had unnecessarily added to borrowers' costs by tightening monetary policy and pushing up rates in response to this spring's sharp rise in the money supply. One response involves a matter of fact; despite sluggishness in business-loan demand at some big-city banks, total bank loans increased at a 13-percent annual rate in the first quarter of the year—twice the average growth of 1976—and the lending pace has continued to strengthen in later months.

Our second response involves a basic theoretical explanation of what causes interest rates to rise and fall. One of our country's greatest economists, Irving Fisher, once said, "Probably the great majority of businessmen believe that interest is low when money is plentiful, and high when money is scarce. This view however is fallacious, and the fallacy consists in forgetting that plentiful money ultimately raises the demand for loans just as much as it raises the supply, and therefore has just as much tendency to raise interest as to lower it."

What Fisher tells us is that we should distinguish between two kinds of rates—the real rate and the nominal rate which is quoted in the marketplace. The real rate is measured in terms of *real* purchasing power over goods and services, and the nominal rate is measured in terms of *nominal* purchasing power. The difference between nominal and real purchasing power is the inflation rate. If lenders and borrowers all believed that the purchasing power of money would remain constant, the two interest rates would be the same. But in recent years, they haven't been able to make that supposition. In this inflationary atmosphere, money rates have risen considerably above the real rate. With prices expected to rise at (say) 5 percent a year, lenders have demanded the real rate plus 5 percent, so that they would be protected against an expected loss in the purchasing power of money. Borrowers meanwhile have been willing to pay this 5-percent (or whatever) inflation premium, because they expect to repay their loans with dollars that are worth 5 percent less each year than the dollars they originally borrowed.

Many authorities in Congress and the press (and even some money-market participants) have had trouble understanding the connection between inflation and interest rates, as the recent controversy has demonstrated. Most people understand the role of business fluctuations in pushing rates up and down. In recent decades, interest-rate peaks have roughly coincided with business-cycle peaks, and interest-rate lows have usually followed recession lows after a few months' time. Most people also understand (at least dimly) the short-term ability of the Federal Reserve to push rates down through easier money conditions or to push rates up through tighter policy.

Yet too few people clearly understand the long-term effects of price expectations on interest rates, and the way in which such expectations can offset other market influences. Our recent experience should teach them that monetary restraint can drive up the real rate by reducing the supply of funds—but that it can also drive down the inflation premium by reducing inflation expectations. This spring, for example, in the wake of a modest tightening of monetary policy, short-term rates went up but long-term rates went down, as market participants showed their appreciation for the Fed's anti-inflation stance. This suggests that money marketeers at least are now learning the lesson that rates can move down rather than up in the event of tighter credit conditions. Slow learners apparently don't survive as long in the money market as they do elsewhere.

Cure for Inflation

The point of all this discussion is that we should put the horse before the cart and work to curb inflation if we want to keep interest rates in check. As we have seen, our severe inflation has been generated by a series of budget deficits that have consistently pulled monetary policy off target in an expansionary direction, by supporting excessive growth of money and credit. Basically, these deficits have created demands for goods and services without at the same time adding to the supply of goods and services. To cure the problem, then, we must act to bring the Federal budget into reasonable balance, while gradually slowing the rate of growth of the money supply. President Carter has recognized the need for meeting the fiscal objective, while Chairman Burns, in each of his quarterly appearances before Congress, has emphasized the need for bringing the long-run growth of the money supply down to rates which are compatible with general price stability.

There are hopeful signs in the reform achieved under the Congressional Budget Act of 1974, which created an effective link between Congressional tax and expenditure decisions. We should be well served by the new element of order and discipline introduced into fiscal deliberations by the House and Senate Budget Committees and the Congressional Budget Office, since this system gives us a mechanism for determining Congressional priorities and relating expenditures to prospective revenues. Yet strict vigilance will be needed to keep that mechanism in working order—beginning right now. Despite the expansionary environment we expect in fiscal 1978, the Administration projects a deficit in that year of about $62 billion, which approaches the worst recession figure and exceeds the likely 1977 deficit by more than $13 billion.

On the monetary side, the founders of the Federal Reserve early in this century introduced a measure of discipline into the system by ensuring the independence of the central bank within the structure of the Federal government. With our mode of operation, we have shown the ability to make prompt and (if need be) frequent changes in monetary policy, in contrast to the necessarily ponderous processes of fiscal policy. We have also shown the ability to make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. Certainly, the Fed has stumbled on some occasions, but it's hard to imagine that our problems would have been solved if the control of the monetary authority had been turned over to the Executive branch or to Congress. Indeed, if the spending propensities of Federal officials had been given freer rein through easier access to the "printing press," our inflation problem of the past decade would probably have been even worse. As evidence, consider the fact that the two major nations with the strongest central banks—Germany and the United States—are the two with the strongest records of curbing inflation.

Concluding Remarks

From these remarks, I hope you now have a better understanding of what inflation does, why it is a serious evil, and how it can be curbed. I repeat that to reduce inflation, we have to reduce the growth of money—but we can't reduce money growth sufficiently if we don't cut back significantly on Federal deficit spending. If we fail to do that, the combined credit demands from the government and private business will exceed the nation's long-term flow of savings. In that case, the demand for additional funds can be met only through an accelerated growth in the money supply—and in the rate of inflation. And as we've seen, inflation nowadays won't help cure unemployment and other ills, but instead will only aggravate such problems.

In the last analysis, we have to realize that the people responsible for inflation are the people in the voting booth, because they ask their Congressmen for more benefits in the form of new spending programs, but resist having taxes raised to pay for those benefits. Yet the only way that Congress can spend more without increasing taxes explicitly is through inflation. We in the Fed have long recognized this point, and I believe that fiscal policymakers are now beginning to see it too—that in the words of that old Pogo comic strip, "We have met the enemy, and they is us."