

INFLATION- CAUSE AND CURE

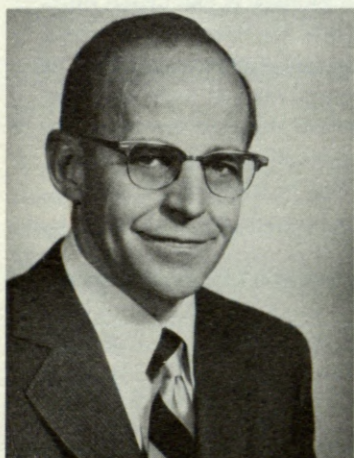
Remarks of

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Meeting with San Diego Community Leaders
and Board of Directors, Los Angeles Branch,
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Mr. Balles says that fiscal policy should play a larger role in the struggle against inflation, through a slowdown in Federal spending and a consequent reduction in Treasury borrowing pressures on credit markets. Our current problems are related to our inability to curb spending. In this fiscal year, for example, Federal spending is scheduled to rise by \$41 billion—a sharp increase of almost 10 percent. Further, he argues, monetary policy cannot carry the anti-inflation burden alone. If forced to do so, monetary policy would have to be so restrictive that it would severely affect those sectors most vulnerable to a credit squeeze—agriculture, housing, small business, and state and local governments.

I'm delighted to be here in San Diego once again, and glad that San Diego's community leaders can have this chance to get together with the directors of our Los Angeles office. Our directors are an able and diverse group of individuals, as you can easily see, and they help in many ways to improve the performance of the Federal Reserve System.

The directors at our five offices are concerned with each of the major jobs delegated by Congress to the Federal Reserve. That encompasses the provision of "wholesale" banking services such as coin, currency and check processing; supervision and regulation of a large share of the nation's banking system; administration of consumer-protection laws; and above all, the development of monetary policy. We are fortunate in the advice we get from them in each of these four areas.

Our directors constantly help us improve the level of central-banking services, in the most cost-effective manner. Most of all, they help us improve the workings of monetary policy. As one means of doing so, they provide us with practical first-hand inputs on key developments in various regions of this District and various sectors of the economy. Our directors thus help us anticipate changing trends in the economy, by providing insights into consumer and business psychology which serve as checks against our own analyses of economic data.

Uncertain Outlook

We need their insights now more than ever, because of the vast uncertainty which surrounds the outlook for 1979. In view of all the developments of the past several months, many analysts are now forecasting a recession for next year. While the possibility of a

recession cannot be ruled out, I do not view it as inevitable. Nevertheless, I think everyone will agree that, as a minimum, business activity in 1978 is likely to be noticeably slow.

A sluggish economy seems likely for several reasons. The nation is now at practical full employment of skilled and even semi-skilled labor. Similarly, the nation is at practical full utilization of cost-effective plant capacity. Finally, recent policy-tightening moves have been vitally necessary because of strong inflationary pressures.

We're not seeing today the obvious danger signs that we witnessed in the 1973-1974 period, such as a sharp buildup in inventories. In fact, most business firms have adopted a very cautious attitude to inventory-building during the past several years. But we have seen some excesses in a credit-fueled consumer buying boom. Indeed, in the 1977-78 period, new funds raised by households have been running about 50 percent higher than the 1976 rate, and almost double the rate reached in any earlier year. Consequently, with tighter credit and more cautious household planning, spending in the consumer sector should begin to decelerate.

The real danger doesn't lie with a slowdown in business activity. After all, some slowdown should be expected after 3 1/2 years of the longest and strongest peacetime expansion of the past generation. The danger rather lies in a continuation of the severe inflation, which threatens to make the 1970's the most inflationary decade in the nation's peacetime history. For years now, this insidious disease of the price system has been distorting production and investment decisions, and leading to speculative excesses, such as Wall Street's

splurge this year in gambling stocks. If we don't soon control this inflationary disease, recession will be a certainty rather than just a possibility.

Inflation: Farm and Imported

Let's consider some of the sources of inflation pressure that have made 1978 such a disappointing year, and consider how we can curb those pressures in coming years. Family budget makers have been complaining most loudly about the upsurge in food prices, which have risen twice as fast as the experts predicted a year ago, at about a 10-percent annual rate. (Incidentally, the somewhat chastened experts now expect food prices to rise rapidly again in 1979, in the range of 6 to 10 percent.) We're familiar with many of the causes of the upsurge, such as poor growing weather and high distribution costs, and by now most of us are experts in the intricacies of the cattle cycle. We may not be able to do much about the weather or cows' breeding habits, but we can do something about some of the government programs which have boosted supermarket prices—such as those programs which pay farmers not to plant and which set minimum prices for certain crops.

The international situation has also contributed to 1978's price pressures. Before the November 1 turning point, the trade-weighted value of the dollar had dropped about 15 percent from the year-before levels, and of course far more steeply against the yen, the mark and the Swiss franc. This dollar depreciation has helped raise the domestic price structure in several different ways. Higher prices of imported finished goods directly raise the prices paid by consumers. Higher prices of imported materials raise the costs

of domestic manufacturers. Moreover, higher prices of foreign goods reduce the pressure to hold down the prices of domestically-produced goods with which they compete in the markets. Altogether, that 15-percent dollar decline, by itself, probably added about 2 percentage points to the past year's consumer-price rise.

The fight against imported inflation received a big boost on November 1, with the \$30-billion package of dollar-propping measures and (especially) the further tightening of credit policy. But there are other steps we should take, such as reducing the outflow of dollars created by our massive trade deficit. To reduce oil imports, we should build on the recently enacted energy bill and develop a policy which, through the price mechanism, does more to curb consumption and to bring more sources of supply into production. To expand our exports, we should put more resources into research-and-development and new production equipment, so that we can maintain a constant flow of products capable of competing in world markets. But bolstering the exchange rate also requires attracting a steady inflow of foreign funds into the American market, and that will happen only if foreigners are certain that they are dealing with a stable, low-inflation economy. Thus, if we want to curb imported inflation, we must put more effort into curbing our domestically-generated inflation.

Inflation: Cost-Push

The Administration has prepared a program trying to halt the leapfrogging of prices and wages, which make up the vast bulk of industry's costs. In 1977, labor compensation increased about 9 percent while labor productivity rose about 3 percent, and the resultant

jump in unit labor costs became translated into increased inflation. In 1978, the increase in compensation is likely to be larger and the increase in productivity considerably smaller, with worsening consequences on the price front. In the absence of guideline pressure, further large increases in compensation costs would be almost certain in 1979, considering the size of next year's bargaining calendar, which features such "heavy hitters" as the Teamsters and Autoworkers.

Against that background, the Administration in late October unveiled its set of wage and price guidelines, designed to put a 7-percent lid on annual wage increases and (essentially) a 6-to-6½ percent lid on annual price increases. The program included several other actions, such as a further reduction in the Federal budget deficit to about \$30 billion in fiscal 1980. But the Administration's program failed to win any plaudits in Wall Street or in overseas financial markets, judging from the late-October declines in stock prices and in the value of the dollar. Thus, the other shoe had to be dropped on November 1, with the package of monetary and fiscal measures designed to bolster the dollar at home and abroad.

The Administration's guidelines represent a worthwhile attempt to curb the growth of labor compensation, and hence the rise of business costs. Over the long run, however, the more promising avenue is to work with the other blade of the scissors—that is, to boost productivity, which in the past decade has risen only about half as fast as in the several preceding decades. (Incidentally, the wage guidelines of the 1960's were set no higher than the growth rate of productivity, which suggests that today's 7-percent guideline is far too high). Now, the passage of time may help bring

about a more productive labor force. The postwar baby-boom generation, much to their parents' amazement, has now been transformed into a reasonably mature and productive group of workers. But those workers can't live up to their potential without new tools, and those tools won't become available without new investment-stimulating tax measures—and without an inflation-free environment of greater certainty for business planning.

In the absence of those two factors, business spending has been held back in recent years—which means that we now have to play catch-up ball in the investment field if we hope to boost productivity enough to offset inflationary wage settlements. For this reason, Federal Reserve Chairman Miller has been arguing recently for a sharp increase in the investment share of GNP. As he says, it isn't enough simply to reach the past peak levels of 10½ or 11 percent of GNP. Instead, we should try to allocate (say) 12 percent of our total output for investment purposes for a long period of time—first to make up for past deficiencies, and second to narrow the gap between ourselves and our major industrial competitors. If the Germans are willing to spend 15 percent of GNP on investment—and the Japanese 20 percent—certainly we should be willing to spend 12 percent of output for that important purpose.

Inflation: Government Regulation

Increased investment, of course, would help overcome the inflationary bottlenecks created by shortages of equipment and materials in various industries. But speaking of bottlenecks, let's turn to the problems created in the bottleneck-manufacturing capital of the world, Washington, D.C. Problems arise in many cases because worthwhile goals tend

to be pursued through imperfectly drafted or even counterproductive regulations. Again, some of the newer regulatory agencies, although having jurisdiction over the bulk of the private sector, still focus on only narrow sectors of each industry—such as (say) trucks' effects on the environment. Their charters don't force them to consider industry's basic mission to provide goods and services to the public—and don't force them to consider such broader matters as productivity, economic growth, employment, costs to the consumer, and inflationary impacts.

The direct cost of staffing and operating these agencies is considerable, but this represents only the tip of the iceberg. The really huge costs are those imposed on the private sector—the added expenses of business firms which must comply with government directives, and which inevitably pass on these costs to their customers. According to some students of this problem, the total cost probably exceeds \$100 billion a year. As many as 87 Federal entities now regulate U.S. business, and their 4,400 different forms require 143 million hours of executive and clerical effort each year.

Now, substantial benefits flow from many regulatory activities, but we don't have a good measure of their overall costs and benefits. For that reason, I support Commerce Secretary Kreps' proposal to establish a "regulatory budget." With more information available on total Federal and private costs, we could concentrate our regulatory efforts in those areas that will do the most good for the overall economy, and reduce or eliminate those regulations that needlessly reduce productivity and push up household living costs. I'm sure that Mr. Alfred Kahn sees the problem in this same light, because as he re-

cently said, his present role is "not Mr. Wage and Price Regulator, but rather Mr. Efficiency in Government and Mr. Deregulator."

Many observers believe that Congress legislates inflationary pressures not only from the creation of new agencies but also from various programs directed toward other legislative purposes. Thus, cost and price increases flow from minimum-wage legislation, social-security and unemployment-insurance taxes, the steel "reference-price" system, sugar and grain price-supports, postal rates, energy policy, and so on. This coming January alone, employment costs will ratchet upward because of sharp increases in the minimum wage and in social-security taxes. By some calculations, government actions of the type I've listed add a full percentage point or more to the basic rate of inflation.

Inflation: Deficit Financing

Even more importantly, I would argue that the most important source of our severe inflation is the stimulus generated by a long series of large Federal budget deficits. These deficits in turn have pushed monetary policy off course in an expansionary direction, measured by the trend of either M_1 (currency plus bank demand deposits) or M_2 (currency plus all bank deposits except large time certificates). Both measures of the money supply have increased about 8 percent over the past year—close to or even above the upper limits of their target ranges. 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.

The fiscal 1978 deficit was \$49 billion, and the Administration plans a smaller (\$39 billion)

deficit in fiscal 1979, even with the \$19-billion tax cut recently signed into law by the President. Yet that means that the 1970's will end with a mind-boggling \$326-billion combined deficit for the decade—more than in the entire earlier history of the Republic. The problem lies basically with our inability to curb spending. In this fiscal year, for example, Federal spending is scheduled to rise by \$41 billion—a sharp increase of almost 10 percent.

During the Vietnam War period, defense spending was the major contributor to the spending upsurge. But more recently the rise has been concentrated in civilian programs, especially the aptly named “uncontrollable categories.” Most of these programs involve the automatic transfer of money to anyone eligible under entitlement formulas written into law. As a result, we've seen the Federal government's annual transfer payments to individuals jump from \$27 billion to more than \$180 billion within the past decade and a half. Loose legislative drafting of these open-ended programs helps account for spiralling (and frequently unexpected) costs; for example, the \$6-billion food-stamp program could be several times larger if all those eligible participated, and if they all received benefits meeting the nutrition standards written into the law.

Improvement is also called for in managing the \$492 billion of Federal spending this year, to make sure that our taxpayers actually get what they're paying for. According to the Inspector General of the Health-Education-Welfare Department, that department last year wasted \$6 1/2-7 1/2 billion—roughly 5 percent of its total budget. But more basically, we and our elected representatives must perform the most difficult management task of all—curtailing or eliminating government programs which have long since lost their reason for

being. We can and must improve on that record, through "sunset" laws and other means.

Concluding Remarks

In closing, I'll admit that I've painted a pretty dismal picture in many respects, but I've done so mainly in order to highlight the steps I feel we must take to curb the evil of inflation. In many other respects, our performance has been superb in recent years, with this country acting as the major "locomotive" of the industrial world. Since the dismal days of early 1975, the \$2-trillion U.S. economy has grown 19 percent in real terms, and in the process has created 10 million new jobs. And despite inflation, per capita disposable income—a key measure of personal well-being—has increased 13 percent in real terms since that recession low. But all those accomplishments may yet go for nought if we don't get inflation under control.

Our checklist for the fight against inflation can be fairly lengthy: Cut back on those farm programs which boost consumer food costs. . . curb oil imports through a broad-based energy program which emphasizes the price mechanism. . . adopt tax programs which encourage productivity-enhancing investment . . . develop regulatory budgets which ensure that the benefits exceed the costs of regulation. . . reduce proposed increases in the minimum wage, at least for teenagers. . . reduce costs of government programs through better legislative drafting and better management, and so on.

The prime necessity, however, is to reduce the inflationary pressures generated by massive Federal budget deficits. Monetary policy can't carry the entire anti-inflation burden alone, because policy would have to be so

restrictive that it would severely affect those sectors most vulnerable to a credit squeeze—agriculture, housing, small business, and state and local governments. So it's essential that fiscal policy carry its share of the burden, through a slowdown in Federal spending and a consequent reduction in Treasury borrowing pressures on credit markets. We're engaged in an all-out war on inflation, and that means that we have to utilize every single weapon in our armory.

