INFLATION—CAUSES AND PROSPECTS

Remarks of

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We need a greater fiscal-policy role in the anti-inflation fight, says Mr. Balles. The minimum we should expect would be smaller budget deficits than we have seen in the past few years or which are now in prospect for the near future. It may not be desirable (or even possible in practice) to rely on monetary policy alone to combat inflation, especially when that problem is aggravated as it is by heavy deficit financing in a period of high employment.

I am indeed honored to be invited to appear on this lecture series, which has featured in the past so many distinguished authorities. And needless to say, I'm happy to be here again in the Pacific Northwest, one of the fastest-growing sections of the nation's Sun Belt. (I'm speaking of course in economic terms, not in meteorological terms.) In recent years, Washington's strength in aircraft, aluminum, agriculture, and forest products has made this state one of the major success stories of the current business expansion.

Washington's success deserves wider attention, but so too does the success of our broader national economy. We are now completing the fourth year of the longest and strongest peacetime expansion of the past generation. The Korean War boom was somewhat stronger, and the Vietnam War boom was somewhat longer. But no other expansion of the past generation could match the economy's recent performance. Total output (after price adjustment) has grown at more than a 5-percent annual rate ever since the dismal days of early 1975, and the expansion has proceeded fairly evenly throughout, with only several quarters of substandard growth. In the process, more than 11 million new jobs have been created during this burst of growth.

Yet this prosperity has been badly undermined by a sharp decline in the value of the dollar, in the world's financial markets and in our domestic supermarkets. 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 of the items in question. But what should concern us is the rise in cost of nearly everything bought by the average household and the average business enterprise. Inflation has acted as a disease of the price system—disrupting the signals in that central nervous system upon which all our production and consumption decisions ultimately depend.

Results of Inflation

Inflation weakens productive efficiency, making it all but impossible to gauge the efficiency of operations by their cost performance. In addition, it perverts business incentives from production to speculation, as we saw last year when gambling stocks suddenly became the hottest issues on Wall Street.

But 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 education, but they then find the value of those savings melting away. 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 hyper-inflation, he received his 50,000 marks in the form of two postage stamps.

Inflation consequently creates an atmosphere of broken promises. In the words of Federal Reserve Governor Henry Wallich, "Inflation is like a country where nobody speaks the truth". 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 hyper-inflation hit Germany in the 1920's and China in the 1940's. Even Great Britain, which we used to consider a rock of stability, in recent years has been disrupted by the attempt of many sectors of society to catch up with the losses caused by double-digit inflation.

History of U.S. Inflation

Our own country has had a checkered history of inflation, but until recently, there was a certain cyclical pattern to price movements. Before each major war—the Revolution, the War of 1812, the Civil War, World War I and World War II—prices generally hovered around the same basic level. (For example, the average price level in 1914 was almost exactly where it was in 1790.) During each of those conflicts, prices just about doubled, and then sank back to the original level in a grinding postwar depression. But 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. Inflation persisted after that war, however, at first mildly and then more seriously.

In the 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 ensuing decade and a half, prices have more than doubled—rising by fits and starts, but always rising. The worst was reached in 1974, when consumer prices rose more than 12 percent as the inflation that had been suppressed for several years by price controls burst its bounds. Following a severe recession, price increases decelerated to below 5 percent in 1976—but now, in early 1979, we find prices breaking into double-digit territory again. And as always happens when problems become really serious, the TV and night-club comedians have begun to discuss it—for example, with the definition, "Inflation is when they make you show your driver's license if you want to pay cash."

As we approach the end of the 1970's, which threaten to become the most inflationary decade in the nation's history, we obviously must give more thought to the causes and cures of inflation. Some analysts blame the problem on a collection of one-time misfortunes, such as international financial problems, crop failures, or petroleum shortages. (About a decade ago, a government official was asked at a press briefing about the latest month's rise in the consumer-price index. He said that "special factors" were involved; then he paused, and added, "but new 'special factors' seem to crop up *every* month.") Other analysts stress the cost-push elements of inflation, with wages and prices chasing each other in a never-ending spiral. Most economists, however, cite as the basic cause an excessive growth of the money supply in relation to the volume of goods and services produced. They argue that in the last analysis, inflation is principally a monetary phenomenon, even though inflation may be aggravated by special problems and extended by cost-push factors. Their view has much to commend it, supported as it is by the experience of the U.S. and many foreign countries over a long period of time.

Monetary Causes of Inflation
Why, these economists ask, has serious inflation been such a pervasive phenomenon throughout the industrial world ever since

World War II? If excessive monetary expansion is the root cause of inflation, why, they ask, don't the central banks of the world, including the Federal Reserve System, simply adopt more conservative policies and aim at a slower growth of money and credit? This is a question which deserves examination.

It seems to me that the present Age of Inflation dates back to the end of World War II, when many countries, including the United States, adopted national economic policies aimed vigorously at full employment. This is understandable in the context of the economic and human ravages of the Great Depression which dominated the world economy in the decade prior to World War II. At later stages in the postwar period, the full-employment goal was augmented by programs of social welfare, income maintenance or redistribution, and environmental protection. These goals were achieved largely through an increasingly active government intervention in the economy, especially in the form of greatly enlarged government spending programs. More often than not, these programs were financed through budget deficits, which were then monetized (at least in part) by the central bank. Policy makers apparently believed that the resulting rapid monetary expansion could provide the necessary stimulus to achieve economic growth potentials, while the margin of unused labor and capital resources would preclude significant inflation.

As time moved on, however, growth in spending programs—which always start small—became large and self-perpetuating, creating a large portion of the electorate with a vested interest in their continuation. What was far less popular, however, was an increase in taxes to finance the rapid escalation of government spending. As a result, chronic large-scale deficit financing has become a way of life in many countries—including the U.S., which has recorded Federal budget deficits in 18 of the last 19 years, irrespective of the stage of the business cycle.

When economic resources are substantially under-utilized, it can be constructive to achieve fiscal and monetary stimulus through well-designed government spending programs, financed through budget deficits and an accompanying increased growth of money and credit. However, when such programs are continued (as they inevitably are) in periods of relatively full utilization of resources, inflation is the result. And once the inflation process begins, it is extremely difficult to reverse without creating severe economic dislocations, including recessions.

In short, large budget deficits financed by excessive monetary expansion in periods of full employment produce the worst tax of all—namely, the tax of inflation—which is unplanned, hits hardest at the weakest elements in our society, and breeds severe economic uncertainty and instability. If our citizens truly demand the present scale of government spending, and also wish to avoid the corrosive effects of inflation, they would be better off economically to support higher taxes, smaller deficit financing, and slower monetary growth.

It is far from clear, however, that the electorate today supports the present scale of government spending and deficit financing. One clear evidence of this is the well-publicized "tax revolt," which began with Proposition 13 in California and has now spread elsewhere—including the 28 states that have now voted for a Constitutional Convention to balance the

Federal budget. Many observers interpret the "tax revolt" as actually reflecting a revolt against excessive government spending and the ravages of inflation. This suggests at least the possibility that we may be moving into a new era of decelerating inflation, with the electorate insisting on bringing under control the large-scale deficit financing and the accompanying overly-rapid monetary expansion during periods of high employment.

Central Banks' Problem

But let's consider the monetary-policy task faced by the central banks of the world. In the face of huge government deficits in periods of high employment, why don't they simply maintain a rate of monetary expansion which is consistent with price stability, and thus at least partly offset the inflationary effects of fiscal policy? A brief review of the institutional setting provides several key clues as to why, in practice, monetary restraint is unlikely to offset inflationary fiscal stimulus.

In the first place, central bankers are not publicly elected—they are appointed by, and responsible to, the central government. In many countries, central banks in practice report to finance ministries, that is, to the executive branches of their central governments. They have little, if any, independence of action. In some such countries, we have seen the worst examples in recent decades of double-digit or even triple-digit inflation.

In some countries, including the United States, central banks maintain a greater degree of independence *within* government—but not *from* government, which would be unacceptable in a democratic society. In the United States in particular, the Federal Reserve System is responsible to, and derives its powers from, the Congress—even though the top policy body, the Board of Governors, is appointed by the President with the advice and consent of the Senate. The Congress can, and has, changed those powers from time to time.

More importantly, in recent years the Congress has become more assertive in its oversight of monetary policy, to help ensure that monetary policy will promote national economic goals and programs as determined by the elected representatives of the people—namely, the President and Congress. The most recent manifestation of this was the passage of the Humphrey-Hawkins Act (the Full Employment and Balanced Growth Act of 1978.) Among other things, it calls for the Federal Reserve to make semi-annual reports to the Congress as to whether planned monetary policy will produce results that are consistent with the economic goals or targets announced by the President.

In short, the "independence" of some central banks is a fragile thing, even in the United States. In the last analysis, no central bank has the authority, nor should it have in a democratic society, to nullify over an extended period the programs and policies of the nation's elected representatives—no matter how short-sighted or unwise those policies may be in the eyes of the central bank.

But this doesn't mean that "independent" central banks shouldn't speak forcefully and publicly on their views of sound financial policy, nor that they shouldn't act decisively, within the limits of their authority, to follow appropriate policies to achieve such results. In practice, therefore, disputes concerning appropriate monetary policy occasionally arise within the central bank, and between the central bank and the elected leaders of the central government. These disputes usually occur in periods of increased inflationary pressure, when central banks traditionally try to follow a more restrictive policy than the executive or legislative branches desire. In the United States, for example, serious public disputes, involving Administration criticism of "overly-restrictive" Federal Reserve policy, have taken place on a number of occasions over the years. Such disputes occurred during the post-World War II inflation, again during the Korean War, in the boom of the mid-1950's, in the Vietnam escalation of the mid-1960's, in the inflationary period of the early 1970's, and finally during the accelerating inflation of the 1977–78 period.

Given all the institutional considerations, it is not unnatural that elected representatives, who must be re-elected periodically, will tend to look to near-term achievements in the way of economic expansion and growth. By the same token, it is not unnatural that central banks, not having to face public election, will tend to be more concerned over the longer-term with the delayed but inevitable inflationary consequences of overly rapid or unsustainable economic expansion and the threat of "boom-and-bust." Hence the tension between the two groups on appropriate monetary policy comes to be built into our political system, as part of a larger structure of checks and balances. At the same time, some of the tension can be resolved through proper institutional change. For example, there are now some early signs—and there is certainly a need—for more multi-year budget planning by the Administration and the Congress.

Other Aspects of Problem
Other factors involved in the formulation of monetary policy lend themselves, in retro-

spect if not always in prospect, to excessive monetary expansion in periods of high employment and concurrent large Federal deficits. First, policymakers must contend with lags in the impact of monetary policy on the economy. The economy does not respond instantly to a change in the cost and availability of money and credit, but only with a lag—which, unfortunately, is not constant and predictable. The lag tends to be shorter (perhaps 6–12 months) in terms of effects on income, production, and employment, and it is almost always somewhat longer (perhaps 1–2 years) with regard to prices.

Moreover, the lagged impact of policy can be aggravated by the uncertainties of economic forecasting, resulting frequently from such outside shocks as oil crises and crop failures. These factors thus can lead policymakers to over-stay a policy of monetary ease, since there is no way of predicting in advance, with any scientific precision, that it will eventually prove to be inflationary. Again, while central banks have a responsibility to strive for noninflationary economic growth, they also have a responsibility to avoid policies which produce sub-normal growth and excessive unused resources. At any point in time, with respect to the future outlook, there is almost always a large "gray area" in the range of appropriate monetary policy, no matter how clear the proper policy may appear in restrospect to economic historians.

There is a final reason why monetary policy is unlikely, in practice, to offset the inflationary effects of large budget deficits in periods of high employment. This has to do with the fact that fiscal policy and monetary policy affect the economy in different ways. Fiscal policy is much more direct and broader-based. Changes in tax rates, for example, can quickly inject or withdraw purchasing power across a broad front in the economy, affecting most or all consumers and business firms. Monetary policy, on the other hand, operates indirectly and on a narrower front, by influencing the rate of growth of bank credit. With fiscal policy, specific sectors of the economy can be directly affected; with monetary policy, the markets (rather than policymakers) determine where the impact occurs.

Let's consider the way in which monetary policy operates. Although currency in circulation is one component of the money supply, checks drawn on commercial-bank demand deposits constitute the great bulk of all spending. Moreover, for the commercial-bank system as a whole, demand-deposit growth occurs as banks extend loans or purchase securities, creating new deposits in the process. In turn, the banking system's ability to expand earning assets and thus create new money in the form of demand deposits rests on Federal Reserve actions to create new "cash" reserves which banks must hold as a required fraction of their deposits. In essence, all of the technical instruments of monetary policy in the U.S. affect the volume and rate of growth of commercial banks' "cash" reserves, and hence affect the banking system's ability to expand loans and investments and create new demand deposits in the process.

Thus, when the Federal Reserve adopts a policy of monetary restraint, it quickly affects the cost and availability of bank credit. Not all sectors of the economy are equally dependent on bank credit. Moreover, not all bank borrowers have equal economic power or credit standing. Very large companies and the Federal government also obtain funds from such sources as the money and capital markets. But those markets are not as readily available, if at all, to small business, consumers, farmers, home builders and state-and-local government units. Hence, those groups are usually affected first and most heavily by a program of monetary restraint, in contrast to the broader impact achieved by a program of fiscal restraint.

Therefore, for reasons of both equity and economic stability, there are distinct limits on the use of restrictive monetary policy as a means of offsetting expansionary fiscal policy in periods of inflation. In brief, it may not be desirable, or even possible in practice, to rely on monetary policy alone to combat inflation, especially when that problem is aggravated as it is by heavy deficit financing in a period of high employment.

Monetary policy, while a powerful instrument, is for all these reasons unlikely to succeed in maintaining reasonable price stability unless fiscal policy is also brought to bear on the problem. The minimum we should expect would be smaller budget deficits than we have seen in the past few years or which are now in prospect for the near future. Even better would be the elimination of such deficits and a switch to budget surpluses in periods, such as today, which are characterized both by full employment and strong inflationary pressures.

Monetary policy cannot be expected to offset all the pressures created by over-stimulative fiscal policy. Indeed, monetary policy today appears to me to have been pressed to the fullest extent that it's safe to go. The Federal Reserve's discount rate is now at 9½ percent—the highest level in history. Also, money growth (no matter how defined) has slowed dramatically since late 1978. In fact, over the last five months, money growth has fallen well below the 12-month target ranges established by the Federal Reserve. And Federal Reserve Chairman G. William Miller, in Congressional testimony last week, announced a significant reduction in the Fed's money-growth target ranges for the year ahead. In my view, monetary restraint has been pushed to the limits of safety; indeed, some observers now worry that the Federal Reserve may be "over-correcting" and thus risking an economic downturn.

Non-Monetary Inflation Factors
Now, let's consider some of the non-monetary factors that can affect the rate of inflation over short periods of time, such as supply "shocks" to the economy. A good example is the recent upsurge in food prices. Retail food prices rose almost 12 percent last year—twice as fast as Agriculture Department experts had predicted—as poor weather disrupted production and distribution plans. The same factors may be at work this year. Moreover, we continue to suffer from one of the most severe liquidations of cattle herds in history, which presages further price boosts even though cattle prices have already risen 50 percent over the past three years.

Another supply shock occurred a half-decade ago, when the OPEC oil cartel quadrupled oil prices at the time of the 1973 Middle Eastern war. Indeed, this reference to quadrupled prices actually understates the basic problem. OPEC prices have actually increased ninefold since 1970—a date which marks a "silent revolution" in the world energy market, in the words of Alan Greenspan, the former chairman of the Council of Economic Advisers. Prior to that date, the U.S. was the marginal supplier in the world market; after that date, the locus of power shifted from Texas and other Mexican Gulf states to the Arabian (Persian) Gulf states. As U.S. production began to level off, this country lost the leverage it previously had in resisting OPEC price increases.

A different form of supply shock can be seen in the form of increased government regulation, which has increased in intensity in recent years. Business costs have risen not simply because of the restrictions surrounding (say) the rail, maritime and trucking industries, but also because of the advent of new agencies which become involved with the operation of the economy as a whole. (The Occupational Safety and Health Administration is a prime example of this type.) The costs of regulation indeed are considerable, going far beyond the $5 billion a year needed for staffing and operating these agencies. By some estimates, business firms incur expenses of roughly $100 billion a year in complying with government directives, and they inevitably pass on those costs to their customers.

In another category is the so-called cost-push inflation—the leapfrogging of wages and prices in a never-ending spiral. Cost-push pressures become evident in that lengthy period between an initial monetary expansion and its effect on the general price level. But in addition, these pressures become reflected in the difference between labor compensation and labor productivity. Last year, for example, labor compensation per hour increased more than 9 percent while output per hour increased hardly at all—and the resultant jump in unit labor costs was reflected in increased inflation.

These and other non-monetary sources of inflation, being relatively specific, suggest rather specific cures. Indeed, practically every commentator has a long checklist of actions which need to be taken. For example: 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 scheduled increases in the minimum wage, at least for teenagers . . . and reduce costs of government programs through better legislative drafting and better management.

Concluding Remarks
In the last analysis, however, the key requirement is to slow the over-rapid pace of monetary expansion generated by the long series of massive Federal budget deficits. This year, we will complete what may be the most inflationary decade in the nation's history. It is no coincidence that the 1970's will also end with a mind-boggling $324-billion combined deficit for the decade—more than was recorded in the entire earlier history of the Republic. I'd like to emphasize again that large budget deficits financed by excessive monetary expansion in full-employment periods produce the worst tax of all—namely, the tax of inflation.

The perceptive news commentator, David Broder, recently said, "The cliche is that inflation has made the country more conservative—but inflation damages the conservative social values which are essential to the country's future. Stability, savings and investment are all undermined by inflation." I share these views of the damage caused by inflation to our society. Indeed, without price stability, we cannot be certain of the long-run stability of any of our institutions.