



INFLATION: TRUTHS AND HALF-TRUTHS

Address by
Lawrence K. Roos
President
Federal Reserve Bank of St. Louis

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I am pleased to have the opportunity to talk with this distinguished group of business economists because you, in your responsibilities of interpreting economic events for the management of American business, are among the Nation's most important economic opinion-molders.

This afternoon, I would like to focus on inflation, a phenomenon which is very much on the minds of all Americans these days, and one which is widely misinterpreted and misunderstood, even by economists and policymakers.

In recent weeks, inflation has once again become a major topic of economic and political concern. Public opinion polls show that voters consider inflation to be the number one problem in our society. Politicians fear that inflation will become a major campaign issue. And, economists argue about what causes inflation and how it can best be dealt with.

This sudden outburst of concern about inflation once again demonstrates that history repeats itself, that we seldom learn from experience and that our time horizons are disturbingly short.

I can recall, as recently as one year ago, at a time when the recovery from the recession of 1973-74 was progressing rapidly, that many policymakers were urging that the economy needed additional stimulation, that inflation was not a serious problem, and that even if inflation were to accelerate, it could be dealt with quickly if it became a serious threat. So we held down short-term interest rates, permitted the money supply to expand, and suddenly, (and I might add, as some of us anticipated) inflation has once again emerged as the Nation's top priority economic problem.

In today's hue and cry to do something about inflation we are being subjected once again to a familiar laundry list of suggested anti-inflation measures--tired old prescriptions like voluntary wage and price restraints, a national incomes policy, reduction of oil imports, etc.

One thing that puzzles me is how seldom rapid money growth is mentioned as a cause of inflation. This is curious because, basically, inflation is nothing else but "too

many dollars chasing too few goods." Time and time again, in nation after nation, it has been demonstrated beyond doubt that acceleration in the growth of money produces acceleration in the rate of inflation.

But instead of blaming inflation on rapid money growth, many pundits insist on dusting off the old familiar palliatives. Labor blames management for causing inflation by earning excessive profits. Management blames unions for demanding excessive wage increases. Others blame government for running huge deficits. Some even place the full blame on the Arabs for increasing oil prices.

Each reminds me of the child who excuses his misbehavior by saying, "The devil made me do it." Each identifies a different devil, and they all refuse to accept any of the blame themselves or to face up to the real cause of the problem.

I think the time has come to separate fact from fiction in dealing with inflation. Under the category of fiction are claims that the principal causes of inflation are excessive wage and price increases, government deficits or the decline of the dollar on foreign exchange markets. I do not deny that all of these factors may have adverse effects on the economy, or induce policies leading to accelerated money growth. But, none of them is a fundamental cause of inflation.

Let me illustrate what I mean. When wages increase, the cost of doing business increases. Under such circumstances, businessmen have two choices. They can either pass along their increased costs in the form of higher prices to their customers or they can absorb the increased costs which means reduced profits and eventually a curtailment of operations. If prices are raised, sales and output tend to decline. Obviously, whenever production is reduced, unemployment will temporarily increase. But neither alternative, by itself, causes the overall price level to rise.

Wage increases, and resulting price increases, cause inflation only if the money supply is expanded for the purpose of avoiding increased transitory unemployment. Since we all, understandably, want to keep unemployment to a minimum, any arbitrary increase in wages does create pressure on monetary policymakers to increase money growth. If policymakers yield to that pressure, inflation results. However, inflation results only if they yield to that pressure. Thus, wage increases cause inflation only when policymakers, in an effort to prevent unemployment, increase the growth of the money supply.

Similarly with government deficits. A government deficit, when financed through the sale of government debt in private credit markets, raises interest rates but it does not generate inflation. If, however, policymakers, in order to prevent interest rates from rising, inject money and credit into the economy, then inflation will result. Thus, government deficits cause inflation only when policymakers refuse to tolerate higher short-term interest rates.

The villains currently cited as being the main cause of inflation--high wage settlements and large government deficits--by themselves, do not, and I repeat, do not generate inflation. They only cause inflation when there exists an implicit policy of resisting any increase in unemployment, however temporary, or any increase in short-term interest rates.

If it is public policy that monetary actions be designed to avoid increases in unemployment or rises in short-term interest rates under all circumstances, and if monetary policymakers must always place considerations of unemployment and interest rates above all else, monetary policy cannot be an effective tool for fighting inflation.

At this point I want to make it unmistakably clear that it is not my purpose in any way to minimize the seriousness of unemployment or to suggest that under certain circumstances increases in short-term interest rates may not have a dampening effect on economic activity. What I am saying is that, before embarking upon inflationary monetary policies for the purpose of preventing any rise in unemployment or preventing rises in short-term interest rates, careful consideration should be given to the relative costs of such actions in terms of increased inflation, and those costs should be compared with the costs of unemployment and rising interest rates that would result if the stimulating actions were not taken. Only after policymakers and the public in general have compared the relative costs and benefits of alternative monetary actions can rational policy decisions be made.

Let me illustrate what I mean. Let's assume that a top priority concern of the American people is the reduction of inflation and that the trend rate of inflation can be reduced by a gradual reduction in the growth of money. Furthermore, let's assume that a reduction in money growth can be expected to cause a temporary increase in unemployment. Before accepting or rejecting monetary restraint as a tool to reduce inflation because such action might increase unemployment, policymakers should ask: How much

unemployment could be expected from slowing the rate of money growth? How long would such an increase last? How would future wage demands be affected if inflation were actually reduced? What ultimate increases in unemployment might be expected if monetary stimulus caused inflation to accelerate to an extent that would necessitate severe monetary restraint at a later time? Until specific questions such as these are considered and the anticipated consequences of alternative policy options are carefully weighed, intelligent monetary policy decisions cannot be made.

Similar factors must be considered when deciding whether or not to expand the money supply in order to hold down short-term interest rates in time of strong credit demand. Recognizing that the only way to avoid increases in short-term interest rates under conditions of strong credit demand is to pump more money into the economy, and that such stimulus has long-term inflationary consequences, the relative costs of alternative options should be carefully examined before policy is formulated. Factors such as these should be addressed: Just how much higher could short-term interest rates be expected to rise if markets were permitted to operate free from monetary intervention? What impact would a resulting increase in short-term interest rates have on the economy? Would inflationary expectations of the consequences of money supply expansion to counter increases in short-term interest rates not lead to increases in long-term interest rates? Are increases in short-term interest rates any less threatening to the economy than increases in long-term interest rates?

These are the kinds of questions that must be answered before monetary policy can be effectively designed to deal with inflation, unemployment, interest rate fluctuations or similar subjects of economic concern. If we fail to address fundamental issues such as these, we eliminate from public choice a whole series of policy options in which the public has a legitimate right to participate. What's more, we tend to make snap judgments based on old bromides and half-truths and usually end up with short-lived solutions to our problems.

Ours is a Nation dedicated to the belief that free men and women can and must make the choices that determine their collective destiny. Economic choices are no different from others. Whether or not the average citizen has read Adam Smith's "Wealth of Nations" or listened to debates between Friedman and Galbraith, he does read the total of his bill at the check-out counter of his supermarket and thus, he does know the meaning of inflation. All that remains for Americans to rationally decide what to do about inflation is for them to have a realistic knowledge of its causes and effects.

The cause of inflation is a consistent growth of the money supply that exceeds the growth of economic output. It is not excessive wage demands, large government deficits or the adverse balance of trade that causes inflation. These are the results of inflation. It is the growth of the money supply, itself, that is the direct cause!

Only when Americans separate fact from fiction and fully understand the policy trade-offs surrounding the issue, will they be in a position intelligently to decide whether reducing inflation is worth the cost. I, for one, believe that it is!

But I am not asking you, or anyone else, to blindly accept my opinion. All I am asking is that the issue be fully and honestly presented to the public, and that various policy options, their costs and the tradeoffs involved, be carefully considered in the advocacy of monetary policy. If that is done, I feel confident that the American people, assisted by able professionals such as you in this audience, will arrive at decisions which are in the best interests of all of us as individuals and this great Nation as a whole.