



**A REALISTIC PRESCRIPTION FOR INFLATION**

**Address by  
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My subject this afternoon is fiction . . . 20th century American fiction. By fiction, I do not mean the stories which make the weekly best-sellers list or pack people into movie theaters. The fiction I am talking about is of a different sort and carries a special meaning for us all because it poses a serious threat to our well-being. I refer to the current fiction surrounding the inflation that we are presently experiencing and the options we have for dealing with it . . . the popular misconception that inflation is being aggravated by self-serving actions of businessmen and wage earners and the belief that businesses and unions can be made, through the imposition of wage and price controls, to reduce their demands on the economy and thus reduce inflationary pressures.

Now, I am not opposed to fiction in its proper place. Few would deny that a good story can serve a therapeutic purpose now and then, temporarily diverting our attention from the pressures of everyday life and letting us occasionally "escape from it all."

However, we must be alert to the temptation of taking fanciful stories too seriously, especially when the subject involves us directly. We must remain alert to the dangers of blindly accepting stories which set up false heroes and attribute what goes wrong to supposed enemies. Fiction can become our view of reality when it plays on our sympathy for explanations which involve not fact, but the way that we want things to be. When this happens, when fiction prevents us from dealing with reality . . . from directly facing a problem which threatens our individual and collective survival . . . it becomes a serious liability.

National economic events are particularly amenable to interpretations which are very appealing to common sense but which are really serious distortions of reality. While finding solutions to national economic problems is always difficult, its complexity is intensified by a misunderstanding of the issues involved. Inflation, unemployment, the balance of payments, interest rates, and the energy situation, to name a few, are economic issues that affect us all, and we listen when people offer explanations of them. The danger is that we are tempted to hear only what we want to hear and to concentrate our

attention on points of view which fit our own particular prejudices. We have an understandable tendency to accept what fits into our individual experience and to be skeptical of arguments which involve abstract relationships and technical jargon. Unfortunately, simplicity does not always mean accuracy, and our individual experience is often a very poor guide to the choice of national economic options.

In dealing with inflation, fiction can very easily replace reality. A case in point is the frequently-stated notion that inflation is caused or aggravated by the self-serving actions of various individuals and groups within the private sector of the economy. In general terms, it has become popular to blame inflation on rising costs of producing goods and services, implying some combination of greed, market power and other selfish behavior in defiance of the laws of supply and demand. Such reasoning sees the traditional tools of monetary and fiscal policy as being almost impotent in the face of price pressure which results from arbitrary increases in costs. From this point of view comes the belief that we can control inflation and avoid severe restriction of production and employment only if we clamp a lid on wages and prices.

Almost everyday we see examples of this so-called "cost-push" view of inflation. One day we are told that wholesale food prices have risen as a result of actions of farmers and cattlemen, or some mysterious middleman in the food industry, and that this is the source of the inflation on that day. The next day, rising interest rates on mortgages supposedly decreed by avaricious lenders are cited as harbingers of inflation. Energy costs, corporate profits, wage settlements, or even a decline in the international value of the dollar provide convenient excuses for inflation. Such interpretations carry with them the implication that, if we could only directly control each of these various factors, we could conquer inflation.

To the average citizen, this line of reasoning seems very plausible and is very appealing because it is easily understandable. After all, don't the increased costs of the food we eat, the clothes we wear, and the energy we use erode the purchasing power of our dollars?

To an individual consumer, these day-to-day price increases are inflation, for these are easily linked to the higher prices that we personally encounter. In simple terms, it is easy to view inflation as being caused by the person who raises prices. If that person pleads that prices had to rise to cover an increase in costs, then the blame is shifted back one notch to those who caused the increase in costs. The process can be carried on endlessly, and an easily-identifiable villain can always be perceived. Furthermore, the assumption that inflation is caused by rising costs of production diverts our attention from its real cause, and this seriously impedes our ability to correct the problem.

Once we accept this line of economic fiction, however, we are trapped in a vicious circle which leads to an almost irrational "us-versus-them" attitude. By identifying each alleged cost-stimulated cause of inflation, people are encouraged to blame each other for causing their economic problems. They are encouraged to sweep the economic horizon with radar, locking onto every factor which comes onto the screen. The actions of others become convenient scapegoats, as in our frustration with inflation we search for convenient ways out of our predicament. Business and labor blame each other and both blame foreign competition. Consumers blame producers, workers blame nonworkers, and everyone has a case for why they are being exploited by others. This situation gets out of hand very quickly and often develops the characteristics of a political witch-hunt.

One very elementary question is left, however. Why are costs of production rising so dramatically? Are there mysterious new forces at work that defy the old laws of economics? Despite the loud and widespread protestations to the contrary, I do not think so. The inflation we face today should not come as a surprise, for it follows more than a decade of inflationary monetary policy. Today's cost pressures and persistent price increases are the legacy of yesterday's policy actions that erred in tolerating limited inflation in the first place.

What, then, is the true cause of inflation? There is no question that rising costs and prices are the most visible factors in the erosion of purchasing power, and it is not

fiction to assert that wages and prices have an impact on one another. Their movements are very closely related. The element of inflationary expectation . . . boosting prices or making higher wage demands in anticipation of continued inflation . . . does contribute to maintaining the momentum of inflation as people try to insulate themselves against further losses by demanding greater compensation for their labor and increased prices for their products.

But it is fiction to view rising costs and prices as independent forces which somehow in themselves cause inflation. Without the infusion of more money, efforts to raise costs and prices encounter the discipline of market forces, and either prices are forced down or reduced demand leads to reduced production and increased unemployment. Rising costs and prices are the result of inflation, not the source of it. What we are currently observing in the economy is the effort of people in the private sector to protect themselves from further losses. They are not causing inflation; they are trying to escape its heavy economic burden, and they will continue to push up costs until they become convinced that the basic source of inflation has been turned off. Confident assurance, stern rhetoric or threatening gestures will not be enough.

Research clearly demonstrates that costs and prices have not, cannot, and will not persistently move upward without more and more money being pumped into the economy. It is the continued infusion of money which stimulates high levels of demand that are required to make these cost increases stick across the economy. Cost problems only occur when the trend of money growth has been excessively rapid! To illustrate what I mean, we might look at the period from 1953 to 1965, the pre-inflation years. During that period money supply growth averaged only 2% per year . . . and prices and labor costs grew roughly at a very similar and modest annual pace of 1.5%. From 1965 through 1978, however, when money supply grew at a brisk 6% a year, prices rose an average of 5.5% and labor costs 6% per annum.

Strong empirical evidence shows that the rate of inflation reflects primarily the

trend of money growth over any prior five-year period. While all sorts of factors, including conditions in labor markets, can cause short-term price fluctuations, the inflation returns to a fundamental, underlying pace consistent with the rate of monetary expansion.

Those who would have us believe that individual wage and price increases are the fundamental causes of inflation suggest that, by controlling the upward movement of wages and prices, we can reduce inflation. I firmly believe that controls, guidelines, quotas . . . call them what you will . . . only serve to redistribute the burden of inflation capriciously across the economy. They will not reduce the inflation. Controls only dam up the flow of the economy, causing it either to seek other channels . . . such as black markets or similar evasions . . . or simply to gather momentum for a new burst of inflation once controls are lifted and the floodgates opened. Trying to combat inflation by focusing attention on individual rises in wages or prices is like attempting to deal with a nuclear accident by recapturing individual particles of nuclear matter already loose in the atmosphere, while failing to cool the overheated nuclear core which caused the accident.

The futility of controls is not hypothesis; it is documented fact. In the period immediately prior to 1943 when wartime controls were imposed, consumer prices were rising at a 6.1% annual rate. The year after controls were lifted, prices zoomed upward 14.4%. In 1961, before guidelines were introduced, prices were increasing 1.1%, a figure the economy could live with. In 1967, after the guidelines had failed, prices more than doubled their earlier growth rate. In this decade, the same thing has happened. Prices rose 4.3% in 1970 before the Nixon controls were imposed. They shot up 9.1% after controls were lifted.

Before any real progress can be expected in the struggle against inflation, we must separate fact from fiction and zero in on the real, not imagined, causes of the problem.

What, then, can we do to reduce inflation? There is only one fundamental cause of inflation and that is excessive monetary growth. There is only one way to reduce inflation without causing a recession and that is by gradually reducing the rate of growth of the money supply.

There is nothing dramatically new about this suggestion. For more than a decade, eminent economists have demonstrated through empirical research that there is a definite and predictable relationship between the rate of growth of money and the increase in the general price level. Several years ago, the Federal Reserve's Open Market Committee gave credence to this relationship by regularly establishing ranges for money growth. The recently-enacted Humphrey-Hawkins Act gives statutory status to the relationship by requiring the Federal Reserve to establish annual rates of growth for the monetary aggregates and to report semiannually to the Joint Economic Committee of Congress the progress in meeting its monetary targets. Slowly, but surely, policymakers are recognizing that monetary restraint is a necessary condition for reducing inflation.

Nevertheless, the change is occurring painfully slowly. There is still more rhetoric than substance in our willingness to control the growth of money. Under current Federal Reserve procedures, if achieving monetary targets has meant destabilizing interest rates, interest rate stabilization has come first and monetary control has been relegated a position of secondary importance. And all the while, inflation continues to accelerate!

The time has come to stop relying on measures which have repeatedly failed us in the past. Inflation is sufficiently important to be viewed realistically. It is time to try something that will bring results.

Specifically, monetary policymakers and others who formulate national economic policy should lay aside the fiction of "cost-push" as the primary cause of inflation and

instead, face up to the real cause of the problem, excessive money supply growth. The Federal Open Market Committee should cease its preoccupation with day-to-day stabilization of short-term interest rates and concentrate instead on achieving a gradual reduction in money supply.

Finally, policymakers should "level" with the public and admit that there is no painless way to reduce inflation or any prescription which will bring immediate results. The current inflationary psychology which has been created by the excesses of more than a decade of excessive money growth assures that a period of 18 - 24 months is certain to ensue between a permanent reduction in the rate of growth of the money supply and a measurable effect on inflation.

There is a workable way to reduce the growth of the money supply. The Federal Reserve can readily increase or decrease the money stock through its open market purchase or sale of Treasury securities. All that is needed is a commitment to do what needs to be done!

We face a choice. We can continue to try to adapt to 7% or more annual inflation. . . live with it, complain about it, but nonetheless, accept it as a necessary illness which we can live with more comfortably than if we subject ourselves to a cure. If we choose this course, we must be prepared to accept arbitrary changes in income distribution, slower economic growth, permanently higher unemployment and a reduced standard of living.

Or, we can attack inflation at the source . . . the spigot that controls the flow of dollars into the economy. Certainly there would be costs here, too, but I believe that these would be far less burdensome in the long run than a continued tolerance of inflation.

I am painfully aware that the point of view I have expressed does not enjoy universal acceptance. But the plain truth of the matter is that the economic policies we have tried in the past have not been effective in avoiding or reducing inflation. Inflation is

not a mysterious plague defying a cure. It can be corrected, and we can restore the economic stability upon which our future progress depends.

To do so will require the wisdom to substitute economic realism for fiction; it will require courage to endorse a modicum of temporary discomfort in order to achieve an ultimate cure, and it will require a determination on the part of each of us to reject seemingly simple solutions in the interest of assuring the long-term economic well-being of our Nation. I hope and pray that we have the wisdom and courage to act before it is too late!