

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

October 13, 1979

MEMORANDUM TO THE PRESIDENT

From: Charlie Schultze *CLS*
Subject: An Outline of Short and Long-Run Anti-Inflation
Strategy

In recent weeks I have had a good reception for a speech which (i) sets forth an analysis of the inflation problem; and (ii) shows how the Administration's economic policies are based on a short and long-term strategy for dealing with that problem. I have compressed all of this into a condensed set of notes that you might find useful background material.

Attachment

THE PROBLEM

After two years of substantial and well-balanced growth, the emergence of three closely linked problems in late 1978 and 1979 has threatened the economic health of the nation:

- (i) accelerating inflation; (ii) surging energy prices;
- (iii) a sharp slowdown in productivity growth.

I. The Nature of Today's Inflation

- A. Even during the 1974-75 recession, inflation was far from eradicated: 6 to 6½ percent underlying inflation remained.
- B. Recently, inflation (CPI) has sharply accelerated:
 - o 1977, 6½ percent
 - o 1978, 9 percent
 - o 1979, 13 percent rate (continuing into recent months)
- C. Almost all of the acceleration can be traced to two major factors:
 - o energy; the huge rise in energy prices added over 3 percentage points to the 1979 inflation rate, and 4 percentage points in recent months
 - o homeownership costs; added another 2½ percentage points to the 1979 inflation rate. (The CPI substantially overstates the impact of housing prices and mortgage interest rates on the cost-of-living. In effect, it treats such costs as if all homeowners had to renegotiate their mortgage principal and interest payments upward each month in line with rising home prices and interest rates.)
- D. Outside of these two areas (one real, one statistical) the CPI has accelerated very little; the rise in the inflation rate has been confined to a few sectors of the economy
- E. Wage rate increases have also shown little acceleration in 1979.
- F. But, an additional problem has arisen from the sharp decline in productivity growth. Even with wage moderation, the rise in labor costs of production has accelerated because productivity gains have slowed. Consequences not yet fully reflected in consumer prices.
- G. Therefore, major sources of inflation acceleration are:
 - 1. Energy
 - 2. Homeownership costs (partly a statistical illusion)
 - plus, a broader problem:
 - 3. Slow productivity growth.

STRATEGY TO DEAL WITH INFLATION: SHORT AND LONG-RUN

III. Short run: Prevent temporary double-digit "bulge" in inflation from spreading to rest of economy.

- (a) it is absolutely essential to keep highly selective and temporary double-digit inflation from generating a broad based and permanent double-digit wage-price spiral.
- (b) if we can keep this from happening in the immediate future, then today's double-digit inflation will taper off to single-digit inflation; (current 60 to 70 percent annual rate increases in energy prices will moderate; lower inflation rate and softening economy should bring some relief on mortgage interest costs.)

But, even with a successful short-run policy, inflation won't subside to the "old" 6½ percent underlying rate when the temporary "bulge" disappears. A new 8 to 9 percent underlying rate is then likely to prevail. Why? The fall in productivity growth to almost zero has raised the underlying rate of inflation.

- o this is far too high an underlying rate
- o moreover, any bad breaks in the future would add a new inflationary impulse, not to 6½ percent but to an 8 or 9 percent rate;

Therefore

IV. Long-Run Strategy has to aim at:

- A. Gradually reducing the 8 to 9 percent underlying rate
- B. Reducing our future vulnerability to bad breaks.

POLICIES: SHORT AND LONG-RUN

V. Short-Run Policies: Public and private restraint to keep temporary bulge from becoming permanent double-digit wage-price spiral.

A. Budget

- 1. Reduce growth of spending; lower the share of government in GNP (also a key part of long-run strategy; see below).
- 2. Cautious fiscal policy; aim at budget balance as rapidly as economy permits:
 - o careful not to apply premature or excessive economic stimulus even in weakening economy
 - o doesn't mean "head-in-the-sand" approach to

B. Monetary Policy

1. Not Administration's direct responsibility
2. But combination of current restraint and cautious but flexible attitude about applying stimulus later, matches Administration's approach to fiscal policy.

C. Voluntary wage-price guidelines (private restraint)

1. Despite press reports, these have been remarkably successful in keeping the temporary inflation bulge from spreading: most price and wage decisions have been moderate.
2. Admittedly difficult to continue, given this year's history of 13 percent inflation.
3. But recent "Accord," and establishment of Tripartite Pay Committee bodes well for achieving that difficult task.

VI. Long-Run Policies: Designed to moderate underlying inflation rate and to reduce vulnerability to outside shocks.

A. Energy program. The program has several objectives. But from anti-inflation standpoint the most important is to reduce our dependence on imported oil and thereby decrease our vulnerability to new inflationary shocks. This objective is so critical that we are willing to pay a short-run inflationary penalty now (decontrol), to secure less vulnerability in the future. (Spell out major elements of program.)

B. Long-Run Fiscal and Monetary Policies

1. General principle: over the next three to four years we will have to pursue more cautious and restrained monetary and fiscal policies than would normally be the case in a less inflationary era.
2. This does not mean inflexible policies that ignore development of recession tendencies. But for the foreseeable future, monetary and fiscal decisions will have to be approached with an attitude of caution and more (but not exclusive) emphasis on restraint.
3. We have to do this in order to provide a climate in which the underlying rate of wage and price increases (8 to 9 percent) can gradually be pulled down.

C. Federal spending (Release resources for private use)

1. Carter Administration has long-standing policy of reducing spending/GNP ratio. This will free up resources for private use.
2. Over time these resources should go mainly to investment, so as to raise the share of GNP used for that purpose. (Tax reduction of 1978 already aimed in this direction.)
3. This is the most important single thing we can do to help improve productivity growth.
4. (The timing and magnitude of any tax measures designed to accomplish this purpose have to be decided in context of fiscal prudence and caution, as outlined above; i.e. not too early; not too much. But additional resources for productivity-raising investment will be forthcoming from Carter budget strategy.)

D. Regulatory reform (Increase competition and productivity)

1. Economic regulations (air, trucking, rail, etc.):
deregulate
2. Social regulations (environment, health, safety):
we seek two objectives:
 - o proper balance between social gains and economic costs in setting standards;
 - o more cost-effective ways of achieving whatever standards are set.
3. Regulatory reform initiatives help in inflation fight chiefly by raising productivity (e.g. higher load factors in airplanes, fewer truck backhauls; lower costs and less disruptions in environmental programs, etc.)

E. Grain reserves (reduce U.S. inflation vulnerability to worldwide crop shortages, without use of trade-restricting embargos)

1. Wheat and feed grain reserves substantially built.
2. Reserve program already has proven a success:
 - Soviet crop down drastically (225 to 180 million tons).
 - worldwide, 8% reduction in wheat and 3% reduction in feed grain output
 - yet, the resulting rise in grain prices has been quite moderate, unlike 1972-73.

SUMMARY

VII. We do have a comprehensive strategy and a set of short and long-term policies to deal with inflation:

A. Short-run

Objective: isolate "temporary" inflation bulge and keep it from generating long-term double-digit wage-price spiral

Methods: fiscal and monetary restraint; wage-price guidelines with new element of business and labor participation

B. Long-run

Objectives: (1) gradually unwind 8-9 percent underlying inflation rate; and (2) reduce vulnerability to outside shocks

Methods: Energy program (reduce vulnerability)
Grain reserve (reduce vulnerability)
Fiscal and monetary restraint (avoid overheating, reduced pressure for wage and price rises)
Reduce spending/GNP ratio (free resources for productivity raising investment)
Regulatory reform (lower costs, raise productivity, increase competition)

(Note: These long-run policies can and will be filled out, supplemented, and expanded, as the 1981 and later budgets are formulated. Depending on the specific economic circumstances we might, for example;

- o transfer more resources to private investment by investment-oriented tax reductions needs as ADR
- o cut costs by reducing scheduled social security tax increases
- o increase our investment in human resources through improved youth trained programs,
- o etc.

At this present time, of course, we cannot cite or discuss such elements. But even without these, we can present the overall "strategic" framework in which they will be considered.)