

For release on delivery
Wednesday, April 15, 1981
10:30 AM CST; 11:30 AM EST

DEALING WITH INFLATION: OBSTACLES AND OPPORTUNITIES

Remarks by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

Alfred M. Landon Lecture Series on Public Issues

Kansas State University

Manhattan, Kansas

April 15, 1981

I am both delighted and honored to come to this great University this morning to take part in the Alf Landon Lecture Series. I understand the Governor refuses to think of himself as in retirement. Rather, he properly points out that, at his age, no one can question his comments and policy pronouncements as being motivated by personal ambition or political purpose. He certainly long ago reached the eminent status of elder statesman; he defines that as the point at which "you've outlived all your adversaries -- and people pay attention to what you say."

I cannot claim that exalted status. But I can take as my keynote a remark he made, reminiscing about his political career: "I said inflation was like a whirlpool, it kept growing bigger and bigger all the time. No one benefitted except the nimble speculators, and that's still an issue today." Well, what was still an issue in 1972, when that remark was made, has become the issue in economic policy today.

My thesis today can be summed up in a few sentences. We need to bring down inflation and restore price stability, not just for its own sake but because lack of confidence in our currency is incompatible with a productive, growing economy. Monetary policy and the Federal Reserve have an indispensable role to play in restoring price stability by slowing growth in money and credit. In the near-term, that

process can be painful, given the momentum of inflation and the pressures on financial markets resulting from the inflationary process. The period of transition to more stable prices and sustained growth will be greatly speeded and eased to the extent other policies, public and private, are brought to bear on the same objectives.

The need to reduce and eliminate budgetary deficits, reductions in tax rates, and reform of regulatory policies all have relevance in that connection. And in the end -- and it should be sooner rather than latter -- attitudes and patterns of private behavior that reinforce and sustain the inflationary process will have to be changed.

Any successful attack on inflation must build upon the clear recognition and understanding by the public of the tremendous costs of price instability -- that prerequisite is already in place. In poll after poll -- including that important poll on November 4 -- inflation has been identified as the number one economic problem facing the nation today.

Obviously, as human beings, we do not resist -- and even welcome -- higher salaries and wages for ourselves, or rising prices for the home we already own. But we have come to recognize that those gains, when they are not grounded in real growth and productivity, are a kind of economic "shell game" in which rising incomes disappear at the super market or the shoe store, and the price of the new house we would like to buy rises as fast or faster than the one we already

have. We correctly sense something is fundamentally wrong when the interaction of rising prices and high taxes erodes our savings, impairs business planning, and induces us to look toward speculative and exotic forms of investment to stay ahead of the game.

I think it fair to say that that "man-in-the-street" perception is now shared by most professional economists. It was not always so. In the 1950s and 1960s, a substantial number of economists -- taking on a role of social philosopher -- defended a "little" inflation as a kind of social solvent, helping to reconcile competing political and economic pressures. Claims on total output, the argument ran, would almost inevitably exceed what was actually being produced. Social conflict over the exact size of each group's slice of the national pie could be avoided by giving everyone a little extra in nominal income. The general price level would be allowed to rise to reconcile the irreconcilable. It was a game of mirrors, but it seemed acceptable for a while -- more acceptable than imposing the degree of fiscal, monetary and other restraints necessary to deal with inflation.

But, of course, the game was up when the public would no longer accept nominal gains as a substitute for the real thing. Worse yet, the accumulated evidence indicated that inflation, instead of being a relatively benign social solvent,

is instead a degenerative disease, progressively undermining the economy's potential for real growth. We have learned that inflation feeds on itself, and each upward ratchet in the rate of price increase brought with it more distortions in the tax system, reduced incentives to save and invest, and impaired economic efficiency. From an unemployment rate generally of less than 5 percent and productivity growth of almost 3 percent a year through the mid-1960s, we have seen unemployment rise to a range of 6-8 percent and productivity drop toward zero.

Building on the public perception that, after 15 years of bitter experience, inflation must be ended, an essential element in the battle against inflation -- a reduction in the growth of money and credit -- has been put in place. The exact relation between money and inflation -- and the definition of money itself -- can be debated almost endlessly. But there can be little doubt that, over reasonable periods of time, the rate of inflation is related to the growth of the money supply. If we are serious about inflation, the growth in the number of dollars available for spending must be adjusted to the sustainable real growth rate for the economy. That is our job in the Federal Reserve, and we are determined to carry it through.

We plan to make the needed reduction not all at once, but over a period of several years. The purpose is to permit some time for the economy, for personal behavior, and for

existing contracts to adjust to the prospect of a slower rate of price increase and eventual stability. "Shock treatment" may be more dramatic -- but not necessarily more effective over time. What is essential is that there be widespread appreciation of our intentions, and our ability and will to carry them out.

From one point of view, it could be said that nothing else needs to be done about the inflation problem -- reductions in the rate of growth in the money supply should, sooner or later, inevitably bring reductions in the rate of increase in prices. But the question arises as to the costs and strains involved in the process, and whether those strains might be minimized and progress speeded by accompanying the needed monetary restraint with other complementary policies. After all, my distinguished predecessors in the Federal Reserve did not deliberately and willingly increase the money supply and encourage inflation; quite the contrary, they resisted inflationary forces but faced difficult "trade-offs" and economic pressures in their decision-making.

The present inflation really started in the mid-1960s, when the government decided to increase expenditures without raising taxes. An unpopular war in Vietnam was combined with greatly expanded social spending at home, and in neither case, was the citizenry asked in a timely and straightforward way to pay the bill in higher taxes. Large Federal deficits added to

burgeoning demands for private credit as inflation took hold. On at least three occasions -- in 1966, 1969, and 1974 -- restraint on credit by the Fed bit hard -- but it stopped short of permanently turning back inflation when severe financial pressures and recession developed.

We as a nation cannot afford any longer to compromise with inflation. Indeed, with expectations in financial markets and elsewhere so sensitive to any suggestion of policies that might lead to more inflation, expansionary monetary policies would incite higher, not lower, interest rates. What we can do, however, is reduce the demands on the economy from fiscal policy and deal with other sources of price and cost pressures.

One aspect is the competition for money from the Federal deficit. This year, about one-quarter of our domestic gross savings -- and over one-half of net savings -- will be absorbed by the Federal Government to finance the gap between its expenditures and revenues and its "off-budget" credit programs. If this \$80 billion or so of financing were not required by the Treasury, more capital would be available for the additional private investment we sorely need -- including modernized plant and equipment, new energy sources, and new homes.

But it also makes a difference how we balance the budget. Taxes are themselves an element in costs, and high tax rates impair incentives; under the pressure of inflation, effective tax rates have been rising, working against price stability and productivity. From the standpoint of economic policy, the best way -- and the only realistic way -- to reduce the deficit is to cut expenditures, and do it on a much more massive scale than has been possible in the past.

I am greatly encouraged by the fact that our political leadership is grasping this opportunity to make major savings. At the same time, we must not underestimate the magnitude of the job. The proposed cuts of \$40 to \$50 billion for the next fiscal year sound and are substantial, but they still amount to only 7 percent of the budget total. Defense spending is rising, and the net reduction would be relatively small in real terms. Moreover, further large budget cuts will be required in future years to make room for the tax reduction that we need -- and those additional cuts in Federal programs to which we have all become accustomed may be even more difficult to achieve than those currently under consideration. The effort is dictated by only one overriding fact: I see no other way to reduce the inexorable pressure that the Federal budget places on our financial and economic system.

The next year or two will be a severe test of our political will to sustain the anti-inflation drive.

Expenditure reduction and tax relief moving in harness are essential to the substance and to the credibility of the economic program. If we can both reduce taxes and realistically look toward a balanced budget and surplus as the economy regains more normal levels of production and growth, we will have a critical new element of policy in place.

Monetary restraint, a lower trend of Federal spending, and tax reduction provide the financial framework for a successful effort to control inflation. How quickly and effectively these policies bring results will depend upon other actions, both public and private. We simply cannot afford regulatory or other policies that inhibit competition, add unnecessarily to costs or prices, or excessively shelter some groups from economic risks of their own making.

In that connection, we should all realize that private decision-making -- wage bargaining, pricing policies, and efforts to improve productivity -- will have a direct bearing on the speed with which we return to price stability and the strains and difficulties that process will imply. In recognition of that reality, this nation and others have attempted, with varying degrees of formality, to explicitly influence wage and price decisions through so-called incomes policies. They have had little or no lasting success here, and indeed have been counterproductive when considered substitutes for other policies. We do not want to travel down that route again. But what we can do is develop and communicate a better understanding of where

economic policy is heading, and encourage, on the basis of that understanding, responses in private life that are consistent with both individual and national interests.

It is up to the Administration and the Congress to make clear what their intentions are for tax and budget policy. It is up to us at the Federal Reserve to communicate clearly what will happen to the growth of money and credit. And it is up to the private sector to understand the change in national direction these policies imply, and to take account of them in their own decision-making.

One important implication of monetary policy is that the rate of growth in the nominal GNP should slow. That is, of course, consistent with real growth, provided inflation declines. Financial policies are designed to produce that result. The issue is how fast, and how smoothly.

Wages and salaries account for about two-thirds of the national income; they are the dominant share of business costs. So long as the momentum of high wage settlements continues, there is a clear danger that real activity, as well as prices, will be squeezed as financial restraint is brought to bear. On a national level, the result is an excessive level of unemployment and slow growth; on a local or industry level, lay-offs, plant closings, and even bankruptcies would be the symptoms.

In the broadest terms, the present difficulties of the auto industry are instructive. The acute problems of that

industry can be traced to a number of factors -- including government policies. But surely those difficulties are related in a significant degree to wage and cost pressures building over a number of years.

As early as the 1950s, a pattern of wage contracts was set providing, in essence, for inflation adjustments plus a productivity improvement factor designed to achieve gains in real wages. So long as national productivity was rising and import competition was limited, these gains could be and were achieved, consistent with the health of the industry. In the 1970s, however, the economic environment changed. Productivity growth in the economy as a whole declined and oil prices rose dramatically. As a result, real wages for the average worker could not rise so rapidly as before, and in recent years have actually declined. The auto industry itself met with fierce foreign competition.

The result of these forces was that relative wages of auto workers and costs for the industry increased at the same time that American cars had to compete with increasingly efficient foreign producers. Throughout the 1950s and 1960s, U.S. automobile industry wages were about 30 percent more than the manufacturing average -- a differential related to higher-than-average skill levels and the nature of the work. But between 1970 and 1980, U.S. auto wages rose about 150 percent, as opposed to 120 percent for manufacturing as a whole, bringing them 60 to 70 percent above the national average. Moreover,

with average labor compensation at Ford and GM approaching \$20 an hour this year, the industry is at a distinct competitive disadvantage.

I recite these circumstances not because the auto industry is entirely unique, but because the trends are symptomatic of the larger problem. If inflation is to be unwound, and our industry is to restore full competitiveness and provide high levels of employment, private behavior in wage bargaining and containing costs generally will need to reflect the new realities of the marketplace. With restrained monetary and fiscal policies, that will happen. It seems to me both in the individual and in the national interest for it to happen sooner rather than later.

Historically, wage and pricing decisions, particularly in sectors of the economy characterized by large firms and large unions, have responded sluggishly to changes in financial conditions and the inflation outlook. Businessmen and labor alike tend to look back, to where we have been, and make their decisions accordingly. There is a natural tendency to want to "catch up" with past inflation. When productivity growth is poor, as in the recent past, there is little or no growth in real wages, so attempts to "keep ahead" are all the more intense. For workers and industry as a whole, the effort is futile so long as productivity is not growing. But the efforts themselves reinforce the momentum of inflation.

A change in that "mind set" can smooth the return to price stability. Expectations are critical; to the extent policies to fight inflation are credible, there will be a

strong self-interest in curbing individual behavior that adds to costs and prices. Moreover, to the extent productivity is increased, higher real income and profits can reduce pressures for nominal wage and price increases. Finally, to the extent regulatory costs are reduced, and the government refrains from protecting industry and workers from the forces of competition at home and abroad, the incentives for efficiency and reduced costs will increase.

These propositions seem to me to point directly to appropriate policy approaches:

- The case for "free trade" depends not just on abstract propositions of comparative advantage and long-run increases in national income, but on the advantages, here and now, in reinforcing pressures toward price stability.
- Reduced costs of regulation, and removal of restraints on internal competition, will be reflected not just in the lower costs for individual products, but also in improved national economic performance.
- Productivity deserves the high priority it is being given, again not only because of its long range implications, but because the gains in real income associated with a rise in productivity will make it easier to wind down the price/wage spiral.

- And most important, we, in the Federal Reserve, need to be convincing in our commitment to monetary and credit restraint. We need to build on the consensus that inflation is at the core of our economic problems -- that it is public enemy number one. We need to resist temptations to stimulate the economy through money creation, recognizing that, in the end, faster growth of money and credit will impair performance, not improve it.

So far, the fight on inflation has been a "holding action" -- if we cannot see many signs of progress, neither has it gotten noticeably worse over the past year or two. I am not at all discouraged by that record. After all, the momentum of cost and wage increases has been enormous, expectations of more inflation are deeply ingrained in behavior, and we have absorbed a huge new round of energy price increases. We should be aware that the hardest part of the job is to get the strong inflationary trend -- built up over 15 years or more -- stopped, and then turned around. I believe we are in that process now. Within the next year, we should begin to see some tangible progress.

If you interpret my remarks as suggesting that process can be painful, you are right. It already has been. Monetary and fiscal restraints are never easy -- they are only essential. They directly affect those dependent on credit and those benefitting from government programs. They may involve harsh

adjustments for those who have been accustomed to inflation or who actively seek methods to profit from it.

But any pain will inevitably be much greater if we do not act. Then, we would only face the dismal prospect of further deterioration of economic performance over time. Conversely, to the extent our policies convince the nation that inflation will be brought under control -- encouraging early changes in expectations and behavior patterns -- the quicker and smoother will be the transition to price stability.

I realize I cannot "prove" to you today that we will be successful. Many will become believers only when they see evidence that inflation is in fact receding. At that point, the momentum of events should make our job easier.

But I can point out that, more than at any time in my experience, the necessary elements of public policy are in place, or are being put in place. On that basis, there are strong new grounds for questioning the presumption of so many private decision makers that inflation will continue. Indeed, there should be new calculations of the balance of risk and advantage in inflationary behavior. And, as those calculations do change, the tide of events will turn in a more favorable direction.

Those of us responsible for monetary policy do not intend to forget a key ingredient for success and confidence. We have set our course to restrain growth in money and credit. We mean to stick with it.

* * * * *