INFLATION AND ECONOMIC GROWTH

Paul W. McCracken, Chairman
Council of Economic Advisers

Today I want to discuss some of my thoughts on the nature of the problems of economic policy and the management of economic policy. Inevitably the current state of the economy occupies a substantial part of the time of the Council of Economic Advisers.

The basic question that we find ourselves struggling with in the area of general economic policy is how successful we are going to be in trying to cool an inflation which by now is running well into its fourth year. This gives rise to one of the practical problems in the management of economic policy: the problem of the substantial lags which exist between a change in policy and the visible effect of that change on the economic scene—in a nation not noted for its patience in economic matters. When we read that the Federal Reserve Board has increased the discount rate, we are inclined to check it out in the grocery store the next morning, and if we find it had no effect on prices, to conclude that obviously the policy failed. This tendency leads to a certain amount of "popular" support for direct controls on wages and prices. If the problem is rising prices, some suggest that we just decree that prices cannot rise and thereby eliminate the problem, at least ostensibly so.

One of the interesting current questions has to do with monetary policy. We have a conjuncture of development that has made at least most of us, after quite a period of years, somewhat more Friedmanesque in our thinking. The attention to monetary policy and the propensity to take it seriously is, I think, a wholly worthwhile development, as is the tendency to calibrate the ease or tightness of monetary policy not in terms of rates but in terms of rates of expansion of bank credit and the money supply.

This is all very heartening in my judgment. I think it is moving economic policy in the direction of greater realism. However, now we suddenly find that nobody knows what is happening to the quantity of money. We thought we knew that there had been a rapid rate of expansion in the second half of the year and a very slow rate of expansion since that time. But now we find we can interpret what has happened to the money supply pattern or profile in any one of two or three ways. We can say that monetary policy: (1) continued to be one of fairly active ease through April with some diminution at that point, or (2) was easy up until about December with a pretty tight monetary policy after December, or (3) was some gradation in between depending on what kind of pattern of seasonal adjustment we want to try. In other words, at the time when the message that what is happening to the quantity of money is important apparently has gotten through, we suddenly find that nobody knows what is really happening to the quantity of money.

Before I turn to other matters, I want to say that we have to recognize that the economy does face a difficult transition period. I wish there were some formula for economic policy by which we could foresee a slackening in the rate of increase in the price level and a concomitant settling of the rate of wage increases so that these two would be broadly consistent, with no adverse effect on output, productivity, and so forth. Unfortunately, the history of transition from a period of inflation to one of greater price stability is that all of the wrong things tend to happen early in the game and mostly to those who are not expecting it. This is a very disquieting situation. What we are apt to see is a slowing of the rate of expansion in the money volume of business activity—gross national product in current prices—with a tendency for the price indexes to roll along relatively untouched. Thus, at the early stage of the game we see such things as a diminishing rate of increase in real output; and, since productivity is heavily output oriented, we also see a deterioration in the rate of improvement of productivity with its adverse effect on costs and profits. All of the things that we did not want to have happen are happening, and the thing that we most want to have happen, an early quieting down of the price level, does not seem to happen. This is the kind of sequence of events that we shall have to expect, and we ought not be too startled if some of these things develop.

I would like now to look rather broadly at the management of economic policy. I think we all have to recognize that the whole question of what our national price level objective ought to be is itself in a rather unsatisfactory state. For example, although the language of Section 2 of the Employment Act of 1946, which is our basic declaration of national economic policy, contains no explicit reference to price level stability, the language in all but three of the Economic Reports of the President makes it clear that each administration considered price level stability to be a major objective of national economic policy. The three exceptions appeared in recessions or in periods of fairly slack business activity when the whole issue was simply not as important as other things.

So we have this rather curious situation where the national government will indicate that price level stability is an important objective of economic policy. And yet if we look at the history of the price level through that period, we probably would find only two or three years in which the consumer price index for the year was lower than that for the preceding year. And I suspect in most of those cases the drop was due to a decline in food prices.

In one sense we could say that what we have is a cliche where we recite words without bothering much about the content and without, for that matter, letting the meaning affect our lives very much. However, one also has to say that at this juncture in our history the price level problem and how to deal with it have achieved a degree of urgency far more basic than simply the fact that somebody looked back and saw that over a long period of time the price level tends to rise.

I think we would all agree that we now have a difficult problem, and it arises from the fact that we now see a more hardened skepticism about the longer run value of money, in fixed dollar terms, than we did in the earlier postwar period. I think this grows out of two factors. One is the fact that for about four years, beginning in about 1966, we have had inflation—interrupted almost indiscernibly in 1967. Moreover, the rates of increase in the price level themselves tended to accelerate during most of this period. The rate of increase in the price level in 1966 was about 50 percent greater than in 1965. There was a little interlude in 1967 because we had a slight recession in the first half of the year which dented the upward rise in the price level, but not much more than that. But in 1968 the rate of increase in the price level was about 50 percent greater than in 1967. The rate of increase so far this year has been about 50 percent greater than it was in 1968. I think this has had a profound effect on people's thinking, which I do not recall in the earlier postwar period when we also had price level problems.

Not too long before I came to Washington, I was having lunch with a colleague of mine in Ann Arbor, a Professor of English. He said, "You know, I have a savings account at the Savings Bank and I'm getting 5¼ percent, but I'm not coming out very well on that. I've got to pay income taxes on that and when I look at what's left over and compare it with what's happening to the cost of living, I'm hardly holding even." What was being manifested in his comment is something that we are seeing in a great many forms in our economy now: the growing tendency to think in terms of real interest rates. You see, this fellow was discovering that this nominal rate of interest was giving him a real rate of interest which was less than zero.

The shift from 1967 to 1968 in the increase in the proportion of funds funneled through the capital markets via investment companies and mutual funds is one illustration of the disinclination to take on investment in fixed denominated obligations. A mortgage is all right on an apartment building providing it has an equity kicker or providing, to use the phrase, "you get a piece of the action." But just a straight orthodox mortgage at 7½ percent a year does not now hold much interest. Why? Well, I think, we are seeing the pervasive influence of the growing concern about whether we can continue to count on the price level itself. I think it is important to recognize this situation because we have to realize that inflation, and the growing presumption that it is going to continue, itself starts to have socially disorganizing effects. It inevitably will produce very high interest rates. I need not emphasize that what we are seeing is the classic response of interest rates to sustained inflation and not the deliberate use of high interest rates to control inflation.

This is the kind of thing which an Irving Fisher, or for that matter a John Stewart Mill, would have had no difficulty in understanding. You remember Irving Fisher's comment that the market rate of interest will be the real rate of interest plus the expected change in the price level. This is exactly what we are seeing here. But I think this situation is not only caused by long-run inflation; it is also helped by the fact that we have had three rather highly visible policy episodes in the last three years where we seemed to be facing up to the need for achieving a more stable price level and then we backed away from it. Let me say that I do not mean this in any partisan sense whatsoever, because in many cases or certainly in some of these cases, my counterparts who were in the Council of Economic Advisers at that time were on the side of the angels, and it will come as no surprise if the CEA is still occasionally losing an argument within the administration.

One of these episodes was the failure to go for a tax increase in early 1966 at a time when expenditures were embarking on a course that by fiscal year 1968 would carry them some $25 billion above the revenue-producing capacity of the tax system even at extremely high levels of employment.

Second, we had a moment of truth in monetary policy later in 1966—the period of the credit crunch. But the pressures in the market frightened us so much that we backed off, and from that time until the devaluation of sterling in November 1967, monetary policy was overcompensating for that moment of tightness. All through that period we were having a rate of monetary and credit expansion which was roughly double what would have been consistent with reasonably stable ongoing growth for the economy.

The third episode is the unfortunate easing of monetary policy after the surcharge was passed a little over a year ago. I think this is a particularly unfortunate although interesting episode in economic policy. Members of the Congress were put under great pressure by widely varying segments in our national life, including the monetary authority, to face up to the need for a tax increase at a politically awkward time, namely in a Presidential election year. The ink was hardly dry on this bill before we started getting nervous about overkill. We had a definite easing of monetary policy in the second half of 1968.

This is the kind of problem that we face in economic policy, and it creates an agonizing evaluation for those who have to accept responsibility for the consequences of the policy. It is very tempting to operate on the thesis, for example, that real output, real income, and total employment are the important things and not the price level. However, we have to recognize two things: First, this kind of price inflation itself starts to exact social damage of its own. Second, it inevitably will tend to produce extremely high rates of market interest as a way to overcome declining rates of real interest.

In time we run afoul of interest rate ceilings in our institutional apparatus, which further complicates matters. And it happens to work out, given our institutional arrangements, that one of the major casualties is housing. These are some of the facts of life that emerge as you let this kind of thing run, and it becomes easier to see why economists think in terms of alternative strategies of policy, each of which has painful outcomes. Perhaps one way to state the objective of policy is that we ought to minimize the present value of future economic damage, and this damage is multidimensional.

What does all of this lead to? Trying to get the economy quieted down, to get it moving along the path of reasonable price stability and reasonably full employment creates difficult near-term problems.

What are the implications of this? I still think we must have a far more even-handed management of economic policy than we have had, and than has been called for by our theory or conception of economic policy. The concept of the problem as one of a highly unstable private sector that has to be civilized by vigorous counterswings in policy has not served our interests well because most of these sharp swings in the private sector have had their origin, to a significant extent, in the erratic course of fiscal and monetary policies. Consequently, we have to recognize the need to manage economic policies within narrower and more sophisticated tolerances than in the past. We cannot expect to have the kind of course for the economy that we want if we go from a credit crunch in 1966 to a rate of monetary and credit expansion a few months later, that is at least double what we ought to have for the ongoing growth of the economy.

This year, I think there have been some organizational changes that warrant being pointed out to those who are interested in national economic policy.

One of them is that we now have three key groups at the Cabinet level, apart from the Cabinet itself, presided over by the President, which enable us to see the multidimensional implications of programs and policies more clearly than before. I refer to the National Security Council, the

Cabinet Committee on Economic Policy, and the Urban Affairs Council. While there is always one vote at these meetings that can swamp the others, these groups provide a forum for debate and consensus. For example, it was in the Urban Affairs Council that the new welfare program was hammered out. Consequently, we have national security policy, economic policy, social policy, but each with enough overlap so that we do not look at these things in mutually exclusive terms.

When it comes to fiscal policy, it seems to me that a more evenhanded management of economic policy means that we cannot afford to embark on a program leading to a major disparity between expenditures and the revenue-generating capacity of the tax system under reasonably full employment. This is not to say that we can never afford to have a deficit in the budget. But we cannot afford to have an imbalance of any substantial proportions. Not only does fiscal policy have its own peculiar effects on the economy through the level of aggregate business activity, but it also affects the pattern or distribution of resources just as both budgetary deficits and surpluses carry their own implications about the allocation of scarce resources. Indeed, I think one of the most interesting exercises that we have gone through in Washington was a full presentation before the Cabinet Committee on Economic Policy in regard to the so-called "peace dividend." What we did was to try to make it clear that the pie being considered for allocation is not the budget. It is the total gross national product.

What we are really saying is that fiscal policy must be managed not only to avoid the wrong aggregate demand for output but also to avoid creating conditions where we will get the wrong allocation of resources relative to the commitments we have made at home and abroad.

Of course, that is what economics is all about, and the available budgetary elbow room usually provides for only a small fraction of the ideas for new programs that have some degree of commitment from some important agencies in Washington or some important groups in our national life. This inevitably means that, in order to finance more, someone must persuade the Congress to increase tax rates. Having a certain amount of scar tissue from the 1969 battle over taxes, I would be inclined to say, "More power to you if you can sell that." You may be lucky if you can hold your ground. After all, what is so bad about a deficit? One thing that is bad about a deficit is that it is going to create capital market conditions which will make other goals such as housing almost impossible to achieve.

All of this is merely to say that the key relief to fiscal policy is expenditure policy. It is here that we have to devote increasing attention, and we have been. I think we have made considerable progress in many ways, all the way from cost-benefit analysis to expenditure ceilings. As one who is now in Washington, I do not find it difficult to restrain my enthusiasm for an expenditure ceiling. It is the one way by which the Congress faces up to the discipline of the total budget and this is, of course, crucially important.

Monetary policy is more important than we perhaps had realized earlier. It is powerful, but it also influences the economy with long and distributed lags. This has implications for the management of monetary policy because we cannot see an aberration in the economy, change policy, and hope to have an immediate effect. Instead, the effect may occur so far ahead that the complex of economic development is apt to be something different.

We need to give much more attention to programs that will improve the operation of the market economy. While antitrust policy is important, more fundamental are the manpower training and labor market areas. Manpower policies and institutional machinery to make the labor market work better are needed. We have to move further in these areas, and we also need to be more concerned with programs that cushion generally the differential impact of economic readjustment on individuals. These range all the way from income maintenance programs of some kind to strengthening the unemployment compensation system and manpower training programs. If some people are out of the labor market or not working for a time, they can at least use that time productively in manpower training to upgrade skills.

PART III

Competitive Structure for Agriculture