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# The Problem of Inflation

Arthur F. Burns

SUBSTANTIAL progress has been achieved during the past several decades in understanding the forces of economic instability and in devising policies for coping with them. Severe depressions in economic activity, which earlier generations knew and feared, are no longer a serious threat. And although recessions are still troublesome, their amplitude has diminished and they occur less frequently than they did earlier.

Our very success in limiting declines in business activity has become, however, a major source of the stubborn inflationary problem of our times. As recent experience has demonstrated once again, inflation damages the national economy. Confidence of businessmen and consumers in the economic future is shaken, productive efficiency falters, export trades languish, interest rates soar, financial markets become unruly, and social and political frictions multiply. We in the United States can have little hope of sustaining vigorous economic growth, or using our resources with maximum efficiency, or restoring equilibrium in our international accounts, or attaining a more salutary distribution of personal incomes, unless the powerful forces that have been pushing up costs and prices are subdued.

The current inflationary problem has no close parallel in economic history. In the past, inflation in the United States was associated with military outlays during wars or with investment booms in peacetime. Once these episodes passed, the price level typically declined, and many years often elapsed before prices returned to their previous peak. In the economic environment of earlier times, business and consumer decisions were therefore influenced far more by expectations concerning short-term movements in prices than by their long-term trend.

Over the past quarter century, a

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rather different pattern of wage and price behavior has emerged. Prices of many individual commodities still demonstrate a capability of declining when demand weakens. The average level of prices, however, hardly ever declines. Wage rates have become still more inflexible. Wage reductions are nowadays rare even in ailing businesses, and the average level of wages seems to rise inexorably across the industrial range.

The hard fact is that market forces no longer can be counted on to check the upward course of wages and prices even when the aggregate demand for goods and services declines in the course of a business recession. During the recession of 1970 and the weak recovery of early 1971, the pace of wage increases did not at all abate as unemployment rose, and there was only fragmentary evidence of a slowing in price increases. The rate of inflation was almost as high in the first half of 1971, when unemployment averaged 6 percent of the labor force, as it was in 1969, when the unemployment rate averaged 3.5 percent.

The implications of these facts are not yet fully perceived. Cost-push inflation, while a comparatively new phenomenon on the American scene, has been altering the economic environment in fundamental ways. For when prices are pulled up by expanding demands in times of prosperity, and are also pushed up by rising costs during slack periods, decisions of the economic community are apt to be dominated by expectations of inflation.

Thus, many businessmen have come to believe in recent years that the trend of production costs will be inevitably upward, and their resistance to higher prices—whether of labor, or materials, or equipment—has therefore diminished. Labor leaders and workers now tend to reason that in order to achieve a gain in real income, they must bargain for wage increases that allow for advances in the price level, as well as for the expected improvement in productivity. When individuals and families set aside funds for the future, they tend to do so in full awareness that some part of their accumulated savings is likely to be eroded by rising prices. Lenders in their turn, expecting to be paid back in cheaper dollars, tend to hold out for higher interest rates. These new patterns of thought are an ominous development.

I do not wish to minimize the substantial progress that has been made since August 1971 in suppressing inflationary forces, and in altering public attitudes about the inevitability of inflation. The shock therapy applied by the president in the summer of 1971 has had lasting benefits. The pace of business activity strengthened almost immediately after the announcement of the New Economic Policy, and it has gathered momentum over 1972. Moreover, inflation has been cut from an annual rate of about 5 percent in the first half of 1971 to about 3 percent toward the end of 1972. That improvement reflects the widespread support by the American public, including the trade unions, of the recent controls on wages and prices. It must be recognized, however, that the controls were aided by continued slack in resource and product markets and by a pronounced rise in output per manhour.

In 1973 further progress in moderating inflation will be more difficult to achieve. The backlog of unused resources has been gradually declining, and there is good reason to expect less unemployment and fuller utilization of plant capacity as 1973 unfolds. Market forces may thus be exerting upward pessure on wage rates and prices at a time when productivity gains will probably be diminishing. If

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major collective bargaining agreements in 1973 call for pay increases that appreciably exceed the growth of productivity, the upward pressure on costs and prices will intensify.

Extension of the benefits from the recent hard-won decline in the pace of inflation thus hangs in the balance. A further reduction during 1973 in the rate of increase in wages and prices is essential if the inflationary trend that has so long plagued our economy is to be brought to a halt in the near future. If that does not happen and cost and price pressures intensify in 1973, the nation's economic future may be adversely affected for a long time to come.

In fact, the outcome of our struggle with inflation is likely to have worldwide repercussions. If we continue to make progress in solving the inflation problem, our success will bring new hope to other countries of the Western world where inflationary trends stem in large measure from the same sources as ours.

Almost the entire world is at present suffering from inflation, and in many countries—for example, Canada, France, the United Kingdom, West Germany, and The Netherlands—the pace of inflation is more serious than in the United States.

In Canada, unemployment has been rising since 1966, but it has had little visible effect on wage rates. Actually, during the third quarter of 1972, the Canadian unemployment rate reached 6.7 percent—the highest quarterly figure in many years; yet, new settlements in unionized industries still provided for annual wage increases on the order of 8 percent. Prior to the recent freeze, wages in the United Kingdom were rising at a rate of 10 percent or more, in defiance of an unemployment rate that had gone up over a number of years and was still abnormally high.

These countries have discovered, as we in the United States have, that wage rates and prices no longer respond as they once did to the play of market forces.

As I have already noted, a major cause of the inflationary bias in modern industrialized nations is their relative success in maintaining prosperity. Governments, moreover, have taken numerous steps to relieve burdens of economic dislocation. In the United States, for example, the unemployment insurance system has been greatly strengthened since the end of World War II: compensation payments have increased, their duration has lengthened, and their coverage has been extended to a wider range of industries. Social security benefits have also expanded materially, thus easing the burdens of retirement or job loss for older workers, and welfare programs have proliferated.

Protection from the hardships of economic displacement has been extended by government to business firms as well. The rigors of competitive enterprise are nowadays blunted by import quotas, tariffs, price maintenance laws, and other forms of governmental regulation; subsidy programs sustain the incomes of farmers; small businesses and home builders are provided special credit facilities and other assistance; and even large firms of national reputation look to the federal government for sustenance in times of trouble.

Thus, in today's economic environment, workers who become unemployed can normally look forward to being rehired soon in the same line of activity, if not by the same firm. The unemployment benefits to which they are entitled blunt their incentive to seek work in an alternative line or to accept a job at a lower wage. Similarly, business firms caught with rising inventories when sales turn down

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are less likely to cut prices to clear the shelves—as they once did. Experience has taught them that, in all probability, demand will turn up again shortly, and that stocks of materials and finished goods—once depleted—nearly always have to be replaced at higher cost.

Institutional features of our labor and product markets reinforce these wage and price tendencies. Excessive wage increases tend to spread faster and more widely than they used to, partly because workmen have become more sensitive to wage developments elsewhere, partly also because employers have found—or come to believe—that a stable work force can best be maintained in a prosperous economy by emulating wage settlements in unionized industries. In not a few of our businesses, price competition has given way to rivalry through advertising, entertaining customers, and other forms of salesmanship. Trade unions at times place higher priority on the size of wage increases than on the employment of their members, and their strength at the bargaining table has certainly increased. The spread in recent years of trade unions to the public sector has occasioned some illegal strikes which ended with the union demands, however extreme, being largely met. The apparent helplessness of governments to deal with the problem has encouraged other trade unions to exercise their latent power more boldly. And their ability to impose long and costly strikes has been enhanced by the stronger financial position of American families, besides the unemployment compensation, food stamps, and other welfare benefits that are frequently available to strikers.

In view of these conditions, general price stability would be difficult to achieve even if economic stabilization policies could prevent altogether the emergence of excess aggregate demand. But neither the United States nor any other Western nation has come close to that degree of precision. In fact, excess aggregate demand has become rather commonplace. In country after country, stabilization efforts have been thwarted by governmental budgets that got out of control, and central banks have often felt compelled to finance huge budgetary deficits by credit creation.

There are those who believe that the hard struggle to rid our economy of inflation is not worthwhile and that it would be better to devise ways of adjusting to inflation than to continue fighting it. On this view, social security payments, insurance contracts, bank deposits, and other contractual arrangements should be written with escalator clauses so as to minimize the distortions and hardships that inflation causes.

This is a counsel of despair. Those who are hurt most by inflation are nearly always the poor, the elderly, the less educated—those in our society most in need of shelter from economic adversity. I doubt if there is any practical way of redesigning economic contracts to deal with this problem satisfactorily. In any event, if a nation with our traditions attempted to make it easy to live with inflation, rather than resist its corrosive influence, we would slowly but steadily lose the sense of discipline needed to pursue governmental policies with an eye to the permanent welfare of our people.

The only responsible course open to us, I believe, is to fight inflation tenaciously and with all the weapons at our command. Let me note, however, that there is no way to turn back the clock and restore the environment of a bygone era. We can no longer cope with inflation by letting recessions run their course; or by accepting a higher average level of unemployment; or by neglecting programs whose aim is to

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halt the decay of our central cities, or to provide better medical care for the aged, or to create larger opportunities for the poor.

A modern democracy cannot ignore the legitimate aspirations of its citizens, and there is no need to do so. The rising aspirations of our people are consistent with general price stability if we only have the will and the good sense to pursue an appropriate public policy. Our needs are, first, to restore order in the federal budget and strengthen the stabilizing role of fiscal policy; second, to pursue monetary policies that are consistent with orderly economic expansion and return to a stable price level; third, to continue for a while longer effective controls over many, but by no means all, wage bargains and prices; and fourth, to reduce or remove existing impediments to a more competitive determination of wages and prices.

The single most important need at the present time is to curb the explosive growth that has marked federal spending in recent years. Some shock therapy may be needed here, such as a freeze or near-freeze for a year or two of federal expenditures. The president is struggling to hold budgetary outlays to $250,000,000,000 in the current fiscal year. Even if he succeeds, as I trust he will, federal spending will still have more than doubled during the past 8 years, and it will still exceed last year's outlays by $18,000,000,000.

*Contrary to a widespread impression, this burst of federal spending reflects only in small part the Vietnam war. The fundamental cause has been political indulgence of the theory that most social and economic problems can be solved by quick and large expenditures of federal monies.* We have tried to meet the need for better schooling of the young, for upgrading the skills of the labor force, for expanding the production of low-income housing, for improving the nation's health, for ending urban blight, for purifying our water and air, and for other national objectives, by constantly excogitating new programs and getting the Treasury to finance them on a liberal scale before they have been tested. The result has been that we have hastily piled one social program on another, so that they now literally number in the hundreds and defy understanding—beyond the obvious fact that they have disappointed our expectations and frustrated our fiscal calculations. In view of this experience, a tax increase—even if that were immediately attainable—would hardly be a suitable alternative to tightened expenditure controls.

Significant progress in curtailing the future growth of federal spending will require major reforms of a budgetary process that has long been badly outdated. The executive establishment does not yet have adequate devices for evaluating the benefits of individual programs relative to their cost, such as would be needed in zero-base budgeting. More serious still, the Congress continues to consider individual appropriation bills in isolation, without regard to any controlling total. Consequently, there is little incentive or opportunity to compare the contribution of alternative programs to the public welfare, or to consider systematically whether the nation would be better off if the resources now absorbed by government were larger or smaller.

Recognizing the need to focus on the overall budget, the Congress wisely decided, in October 1972, to reexamine its procedures. A logical first step would be to establish a Joint Congressional Committee on Expenditures and Revenues. Such a committee would review and evaluate the budget proposed by the administration each January for the next fiscal year. It would seek to determine

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whether the proposed total of expenditures was in keeping with the nation's needs and capabilities, whether new sources of revenue would be required or if some taxes could be lowered, thus returning resources to the private sector. Determinations of this character would serve as a useful guide to the individual committees of the Congress, and so too would projections of the growth of revenues and expenditures over the next three to five years, given existing federal programs and new initiatives under consideration.

Besides such a joint committee, formal congressional procedures for controlling total expenditures are needed. Legislative budgets merit fuller and more careful consideration than they have yet received. For example, the Congress might act on a single conprehensive appropriation bill instead of the dozen or so bills that it now handles. Another procedure might be to legislate an overall budget total, with outlays specified for a limited number of major categories, before turning to the appropriations process. Then, if any individual appropriation bill involved expenditures exceeding the limit already established for that category, a two-thirds vote in the House and the Senate might be required to enact that appropriation.

Alternatively, the Congress could impose a rigid ceiling on total expenditures, and require the executive to adjust outlays on individual categories so that they would be consistent with the ceiling. Such an approach was considered by the 92nd Congress, but rejected because of concern that too much power over the purse strings would be ceded to the president. There is some justification for that view. But it should be noted that a ceiling also limits the ability of the president to spend as much as he might desire, and that restrictions might be placed on his power to readjust spending priorities. A vigilant Congress could, I believe, take steps to ensure that congressional control over the direction of spending would not be weakened by a legislative budget ceiling.

Formal and systematic control over federal expenditures would, as I have already suggested, do a good deal to eliminate recurring bouts with excess aggregate demand. But there are times when overheating of the economy originates in the private sector. At such times, better fiscal tools are needed to curb private spending. In a recent report to the Congress, the Federal Reserve Board argued that it would be wise to enlarge the role of fiscal policy in short-run economic stabilization, and that a promising way of doing this would be to vary the investment tax credit in the light of business-cycle developments.

To facilitate timely adjustments, without which stabilization policy cannot be effective, the president might be given the authority to initiate changes in the investment tax credit. At the same time, Congress could retain its traditional control over taxes and act as a full partner in making the needed adjustments. For example, the president might be permitted to change the tax credit within a specified range, say between zero and 10 or 15 percent, subject to modification or disapproval within 60 days by either House of Congress.

Experience since 1966 suggests that variation in the rate of the investment tax credit would influence significantly the behavior of business investment over the course of the business cycle. Such a fiscal tool would therefore reduce the burden on monetary policy, and make possible some improvement in the management of aggregate demand.

There has been a tendency throughout the postwar period—both in the United States and in other countries

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—to rely heavily on monetary policy to adjust to shifts in private spending propensities, and even to expect monetary policy to offset the impact of unwanted fiscal stimulus. It is difficult, however, to maintain adequate control over aggregate demand when primary reliance is placed on monetary policy, first, because its effects occur with variable lags, and second, because its influence on economic activity is disproportionately large in particular industries such as housing. If improved fiscal instruments were used side by side with monetary policy to influence total spending, the chances of avoiding excessive bursts of aggregate demand, with their inevitable inflationary consequences, would be greatly enhanced. Furthermore, undesired effects on the structure of real output would be reduced, greater stability could prevail in financial markets, and the monetary managers could focus more consistently on maintaining a course conducive to sustainable economic growth and reasonable price stability over the longer run.

This conception of the role of monetary policy has guided our thinking at the Federal Reserve over the past several years. During this period, more careful attention has been given to the monetary aggregates because we recognize that excessive amounts of money and credit might inadvertently be supplied in a period of rising credit demands if attention were focused primarily on interest rates. We recognize, however, that changes in the cost and availability of credit affect the nation's economic activity, and we therefore cannot neglect the conditions of financial markets.

Monetary policy since early 1970, when judged by any of the major monetary aggregates, has favored moderate economic expansion. During the past three years, the narrowly defined money stock—that is, currency plus demand deposits—has grown at an annual rate of about 6 percent. Defined more broadly so as to include also consumer-type time and savings deposits of commercial banks, the stock of money has grown at an average annual rate of 10 percent. Between the third quarter of 1971 and the third quarter of 1972, the narrowly defined money stock increased 5.6 percent. This was well below the growth rate of total real output, and far below the increase in the current dollar value of output.

Monetary policy has thus provided the funds needed for a good expansion in production and employment, and it has done so without fostering a condition of excess aggregate demand. We at the Federal Reserve expect to continue a policy of supporting economic growth, but we are firmly resolved to do this without releasing a new wave of inflation.

Responsible monetary and fiscal policies are clearly essential for coping with the current inflationary problem. However, as the incomes policy initiated in August of 1971 has demonstrated, efforts to influence wages and prices directly can play a constructive role when cost-push inflation reaches serious proportions. The energy released by the New Economic Policy has been abundantly evident to businessmen, workers, and consumers. True, the control program did not bring inflation to a halt, but any such expectation would have been unrealistic.

There are those who believe that the time is at hand to abandon the experiment with controls and to rely entirely on monetary and fiscal restraint to restore a stable price level. This prescription has great intellectual appeal; unfortunately it is impractical.

If some form of effective control over wages and prices were not retained in 1973, major collective bargaining settlements and business ef-

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forts to increase profits could reinforce the pressures on costs and prices that normally come into play when the economy is advancing briskly, and thus generate a new wave of inflation. If monetary and fiscal policies became sufficiently restrictive to deal with the situation by choking off growth in aggregate demand, the cost in terms of rising unemployment, lost output, and shattered confidence would be enormous. As a practical matter, I see no alternative but to pursue for a while longer the experiment with direct controls. I trust, at the same time, that reasonable steps will be taken to reduce the distortions and inequities that are beginning to accumulate.

But the greater need in the year ahead will be to use the breathing spell afforded by the control program to seek ways to improve the functioning of our labor and product markets, so that wage rates and prices become more responsive to the balance between market demand and supply.

There has been much discussion recently of the need for structural reform—by some, because they see evidence of abuse of economic power by large business firms; by others, because they see trade unions forcing up wage rates well beyond productivity gains and raising costs otherwise through restrictive work practices; by still others, because they see a multiplicity of governmental regulations that restrict productivity and impede the workings of competition. While opinions may differ as to which of these several areas merits primary attention, I believe that informed observers of the current economic scene would agree that structural reforms are needed in all of these areas in the interest of weakening the built-in forces of inflation. In any event, given the realities of political life, genuine progress is likely only if we move on all fronts simultaneously.

It will take courage for the Congress and the executive to deal with the issues of structural reform in forthright fashion. The ground to be covered is difficult and enormous. We need to reassess the adequacy of our laws directed against monopolistic practices of business, the enforcement of these laws, the power of trade unions at the bargaining table, restrictions on entry into business or the professions, the restrictive practices of trade unions, the subsidies to farmers, the federal minimum wage—particularly for teen-agers—restrictions on the activities of financial institutions, the welfare system, import quotas, tariffs, and other legislation that impedes the competitive process. We need also to reevaluate our extensive manpower training programs and the feeble effort to establish computerized job banks, for it is clear that our labor market policies have thus far failed to contribute sufficiently to the objective of expanding employment and yet avoiding the inflationary effects that monetary and fiscal policies so often tend to generate.

There is no quick or easy path to meaningful structural reform. But I see no real alternative if our national aspiration for prosperity without inflation is to be realized, while free enterprise and individual choice are being preserved.

In conclusion, let me remind you that in August of 1971, confidence of our citizens was at ebb tide. The measures then taken created hope that our government had the will to halt inflation and move the nation's economy forward. It is time now to take the further steps needed to consolidate the progress already achieved. In the measure that we succeed we will not only protect our domestic prosperity, but we will also facilitate the rebuilding of the international monetary system and the economic growth of our sister nations around the world.

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