Statement of

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There should be no release of this statement before its delivery, scheduled for 10:00 a.m. (EST), April 25, 1979.

Inflation is our number one economic problem. The Consumer Price Index increased 9 percent in 1978 and has been double-digit so far this year. And the recent experience has not been an isolated occurrence. Over the past decade, the annual rate of inflation has been more than triple the rate in the previous 20 years. Rapidly rising prices cause dislocations in the economy and strain social and political relationships as people scramble to maintain their customary living standards. The need for an effective anti-inflation policy is great.

Unfortunately, however, the search for an effective anti-inflation policy has been hindered by a growing mythology about the causes of inflation. One myth heard frequently today is that government deficits always cause an acceleration of inflation. There certainly have been times when deficits have aggravated inflation, but fiscal policy is not the whole story. A corollary myth is that balancing the federal budget would cure the current inflation.

## Government Deficits and Inflation

Federal fiscal policy can be one cause of inflation, but the relationship is more complex than the simple myth suggests. A government deficit increases total spending in the economy. Like any other rise in spending--by consumers, businesses, or foreigners--its impact on inflation depends on at least two factors:

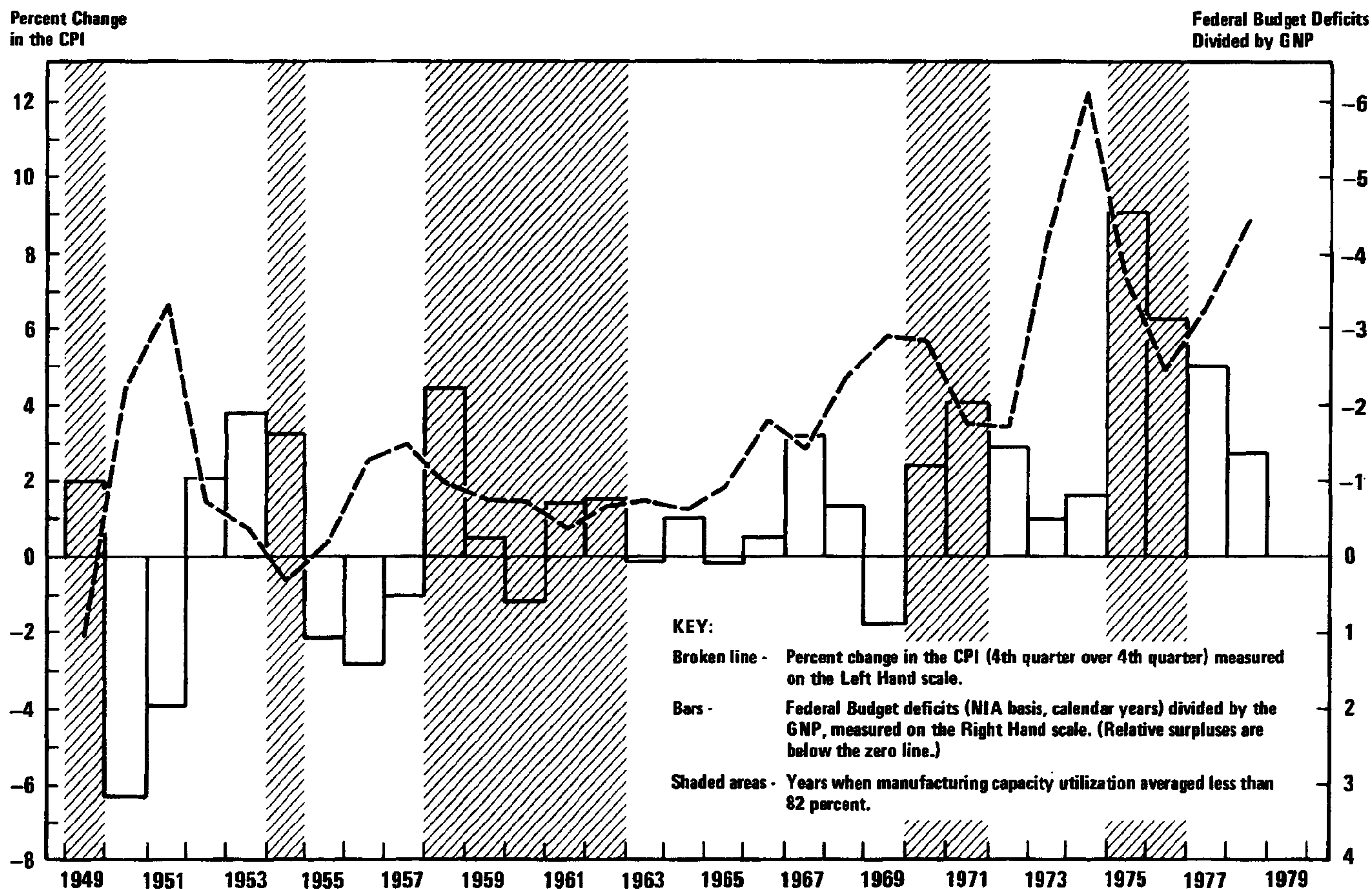
- First, if the increased spending is to aggravate inflation, the Federal Reserve must accommodate it--at least to some extent--by permitting faster money growth. If there is no accommodation, then the financing of the deficit will drive up the cost of borrowing and choke off some private-sector spending--eventually relieving the upward pressure on prices caused by the deficit.

- Second, the economy must be operating generally near the limits of its available productive capacity. If the economy is experiencing widespread unemployment and factories are idle, then an increase in spending--from any source, including government deficits--will result in greater production with little impact on prices.

Let's look at the record. Figure 1 shows the annual federal deficit relative to the GNP and the annual rate of change in consumer prices for the postwar period. Contrary to the popular notion, most jumps in the federal deficit are associated with a deceleration--not an acceleration--of inflation. This was especially true in 1975-1976, but it was also the case in the late 1950s, the early 1960s, and the early 1970s. The common characteristic of these periods is that they were periods of recession--marked by widespread underutilization of labor and capital. These declines in total output both relieved the upward pressure on prices resulting from capacity limitations and increased the federal budget deficit, as revenues slowed and unemployment-related expenditures rose. The postwar experience makes clear that it is not possible to assess the inflationary impact of a federal deficit without considering the state of the economy.

Figure 1.

The Annual Federal Deficit Relative to the GNP and the Annual Rate of Change in Consumer Prices, 1949-1979.



If, however, the economy is encountering significant capacity limitations, a federal deficit--or even a too-small surplus--will aggravate inflation. This leads to the second message of Figure 1: there is a growing tendency over the postwar period to continue deficit spending even in an economy operating close to full capacity. Thus, fiscal policy contributed to the acceleration of inflation in the late 1960s and in 1973-1974. From the perspective of macroeconomic policy, it was a serious mistake to run deficits in those years of relatively high economic activity. Deficits in these years aggravated--but were not the only cause of--the continuing inflation of the recent era.

Causes of the Recent Inflation

Since by all measures the economy had substantial unused productive capacity in the three years that followed the trough of the last recession (see Table 1), the continued rapid rates of inflation cannot be attributed primarily to deficit spending by the federal government in those years. Rather, the persistent inflationary momentum resulted largely from two other types of factors:

- First, upward pressure on prices came from a variety of outside shocks, including the oil cartel, the beef cycle, health and safety regulation, and the depreciation of the dollar;

- Second, the widespread attempt by groups in the economy to increase their incomes in order to catch up to past inflation pushed up costs and prices.

Such catch-up behavior is the principal force that has maintained the inflationary momentum since 1975. The most obvious example here is the cost-of-living escalators included in most multiyear collective bargaining contracts, but the practice is also widespread outside the union sector. Many firms informally index the wages of nonunion employees to past inflation and attempt to maintain real profit margins. The government also works to sustain the momentum of inflation by protecting the incomes of a number of groups against the eroding effects of higher prices. A partial list of such government actions during this period would include increased farm price supports, the higher minimum wage, the indexation of social security payments, the regulation of market entry and pricing in the transportation industry, the steel price referencing plan, and the various orderly marketing agreements limiting imports.

The desire to protect living standards against erosion by inflation is understandable. But a widely indexed economy allows inflation to build up great momentum, continuing even during periods of substantial economic slack, and makes it most difficult to design an effective anti-inflation policy.

## The Current Situation

Recently, an additional factor has been added to the inflation picture. Over the past year, the economy has tightened significantly--especially in factory operating rates (see Table 2). Capacity utilization in manufacturing in the first quarter of

TABLE 1. MEASURES OF ECONOMIC SLACK, 1972-1978

| Economic Variable | Postwar Average | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 |
|---|---|---|---|---|---|---|---|---|
| Capacity Utilization (percent) | | | | | | | | |
| Manufacturing | 0.83 | 0.83 | 0.88 | 0.84 | 0.74 | 0.80 | 0.83 | 0.84 |
| Primary Processing | 0.85 | 0.88 | 0.92 | 0.88 | 0.74 | 0.82 | 0.84 | 0.87 |
| Vendor Performance a/ | 0.52 | 0.63 | 0.88 | 0.66 | 0.30 | 0.54 | 0.55 | 0.64 |
| Manufacturing Overtime Hours (per week) | N.A. | 3.5 | 3.9 | 3.2 | 2.6 | 3.1 | 3.5 | 3.6 |
| Unemployment Rate (percent) | 5.1 | 5.6 | 4.9 | 5.6 | 8.5 | 7.7 | 7.0 | 6.0 |
| Married Men, Wife Present | N.A. | 2.8 | 2.3 | 2.7 | 5.1 | 4.2 | 3.6 | 2.8 |
| Women Who Head Households | N.A. | 5.4 | 5.3 | 5.5 | 7.6 | 7.5 | 7.1 | 6.2 |

a/ Percent of purchasing agents reporting slower deliveries.

TABLE 2. TIGHTENING OF THE ECONOMY FROM THE FIRST QUARTER OF 1978 TO THE FIRST QUARTER OF 1979

| Economic Variable | 1978 | | | | 1979 |
|---|---|---|---|---|---|
| | Q1 | Q2 | Q3 | Q4 | Q1 |
| Capacity Utilization (percent) | | | | | |
| Manufacturing | 0.82 | 0.84 | 0.85 | 0.86 | 0.86 |
| Primary Processing | 0.84 | 0.86 | 0.88 | 0.89 | 0.89 |
| Vendor Performance | 0.62 | 0.65 | 0.62 | 0.67 | 0.75 |
| Manufacturing Overtime Hours (per week) | 3.6 | 3.6 | 3.5 | 3.7 | 3.8 |
| Unemployment Rate (percent) | 6.2 | 6.0 | 6.0 | 5.8 | 5.7 |
| Married Men, Wife Present | 3.0 | 2.8 | 2.7 | 2.5 | 2.6 |
| Women Who Head Households | 6.2 | 6.7 | 6.3 | 5.6 | 5.8 |

1979 was just over 86 percent, 4 percentage points above the level one year earlier. Both operating rates and some key labor-market indicators show greater capacity pressures today than in 1972; by 1973, widespread production bottlenecks had occurred. Although the bottlenecks are not yet as severe as in 1973, it is clear that the economy today is encountering some capacity limitations. This is especially evident for some products--such as aluminum, where out-dated, high-cost facilities were recently brought back on line--and for some skills, primarily in the South and West.

Therefore, it seems clear that continued deficit spending this year is contributing to the acceleration of inflation. With an ideal fiscal policy, stimulus would be reduced before widespread bottlenecks are encountered, because fiscal policy affects inflation with a lag.

Unfortunately, even though a sharply tighter fiscal policy would alleviate some of the upward pressure on prices, it would not bring about a miracle cure of our inflation problem; indeed, such medicine would cause the patient great discomfort. The basic reasons for the ineffectiveness of fiscal policy in dealing quickly with inflation include the great momentum imparted to inflation by the widespread formal and informal indexing of incomes to past price changes, as well as the tendency of rising inflation to generate additional upward price shocks, such as dollar depreciation and OPEC price increases.

Under these circumstances, a restrictive fiscal policy can still slow the rate of growth of total spending but at the expense of lower production and employment. Inflation will decelerate only gradually as the slack in the economy grows.

Simulations with large econometric models suggest that it requires an additional 1 percentage point of unemployment for an entire year to slow inflation by about 1/3 of a percentage point; if the extra joblessness is maintained for three years, the models indicate that inflation may drop by 1 to 1 1/2 percentage points. In addition to the direct costs of higher unemployment, restrictive macroeconomic policies may adversely affect the longer-term growth in productivity and real income. This could happen if high operating rates are not maintained long enough to encourage businesses to invest in expanding their productive capacity. For example, for much of the upswing that followed the last recession, business fixed investment lagged badly. But, in the past year, capacity utilization climbed to relatively high levels, and firms have greatly increased their spending on new plant and equipment. If operating rates were to drop sharply in a recession, a major impetus to this greater capital investment would be lost.

Thus, the economic costs of relying solely on restrictive macroeconomic policies to slow inflation are large. As a result, fiscal policy is limited in its ability to reduce inflation quickly. I know that this is not good news. But inflation is a complex problem--deeply rooted in our social and political institutions--and it is not surprising that such a problem is not amenable to simple solutions.

To achieve a more rapid deceleration of inflation with less cost in terms of lost output and jobs, more restrictive monetary and fiscal policies need to be accompanied by structural reforms. These would directly attack the widespread indexing that sustains the momentum of inflation during periods of economic slack. Furthermore, the Congress should carefully investigate the inflationary effects of proposed indexing plans--such as indexing the income tax system.

## Longer-Term Policies

My comments so far have concerned the short-term impact of changes in fiscal policy on inflation. Some fiscal policy changes, especially those that influence saving and investment, could have longer-term effects on prices. For example, the mix of government spending or of the tax burden could be changed in order to encourage greater investment in physical and human capital. Tax changes such as accelerated depreciation and investment tax credits would encourage more spending on plant and equipment. And effective skill-training programs would help improve the match between available workers and the labor needs of business. The more effective use of our labor force and higher productivity growth would help satisfy aspirations for rising standards of living without rapid inflation.

## Conclusion

In conclusion, an examination of our economic history supports quite clearly two points about fiscal policy and inflation:

- Inappropriate fiscal policy can cause inflation, but it is not the only cause. Nor has it been, over the past few years, the most important cause.

- o Restrictive fiscal policy can slow inflation. But it can induce a rapid deceleration only at great cost in terms of lost jobs and social and economic dislocations.

The unhappy truth is that there is no easy way to reduce inflation quickly. Fundamentally, inflation results when the growth of total income claims exceeds the growth of goods and services. Corrective policies must increase the productive capacity of the nation--a slow process--while restraining the growth of income claims. Although income claims may be reduced quickly--through higher unemployment, mandatory controls, lower farm price supports, more liberal import policies, and so on--such actions present economic, political and social problems.