ON CARTER'S ANTI-INFLATION POLICY

Alan Greenspan, Alfred E. Kahn,
Marvin H. Kosters, and Rudolph Oswald

JOHN CHARLES DALY, moderator of the forum and former chief of ABC News: For nearly a decade and a half, the United States has been struggling with an inflationary economy at home, while keeping a wary eye on the often dramatic struggles with inflation going on abroad. There is the sense that, as with the common cold, we are not sure where inflation came from or what we can do about it.

At the beginning of 1978, President Carter initiated a voluntary program under which government, business, and labor, inspired by persuasion and publicity, would cooperate in an anti-inflation effort. But the results were disappointing. So, on October 24, 1978, the President issued an urgent call to battle. First, he promised to cut the budget deficit, restrain the federal payroll, delay further tax cuts, remove needless regulations, and encourage more competition. Second, he asked labor and business generally to limit wage increases to 7 percent and price increases to 5¾ percent. And third, he proposed, in order to encourage labor cooperation, a real wage insurance plan under which workers who observed the program's wage standards would be eligible for tax rebates if the inflation rate should exceed 7 percent. These, then—if the Congress approves the necessary legislation—are the principal weapons in our arsenal against inflation.

Dr. Kahn, recently President Carter said that "with more than a thousand different kinds of decisions to be made, there will be some flexibility." Do you and the President anticipate any major modifications in the program?

ALFRED E. KAHN, adviser to the President on inflation: One could not legitimately characterize the two modifications we have in mind as major. The first would be a response to the almost unanimous criticism by business and labor that our treatment of fringe benefits—and in particular of the catch-up costs of maintaining existing levels of benefits—is simply too stringent. We are thus contemplating a number

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of possible ways of introducing a modicum of flexibility in this area. The second modification would be a response to an obvious point made by labor—and one I made in testimony back in 1971—that a standard permitting both the pass-on of uncontrollable costs and a fixed percentage margin in effect permits additional profits to be earned on additional costs. We are trying to devise ways of preventing this.*

MR. DALY: Dr. Greenspan, how does President Carter's program compare with President Ford's WIN program?

ALAN GREENSPAN, president, Townsend-Greenspan and Company: If I can divide President Ford's WIN program into two parts—one, a call for severe restriction on federal spending and thus on the budget deficit, and the other, something of a vague freeze—I would say the two programs are quite similar, with similar problems. In my view, all that is desirable—and, in fact, all that is necessary—to restrain inflation comes in the first part of both programs, that is, in the restraint on federal spending and indirectly on government's credit-creating capacities. The second part of the programs—the guidelines—is counterproductive. Indeed the guidelines, rather than being anti-inflationary, will ultimately add to inflation. They were a wholly inappropriate response to inflation under WIN, and are again today.

MR. DALY: Dr. Oswald, would you summarize labor's objections to the President's program?

RUDOLPH OSWALD, director of research, AFL-CIO: Organized labor objects that the wage controls are not voluntary, but mandatory. There is an enforcement mechanism for wages because every employer will be willing to enforce the wage guideline of 7 percent. On the other hand, contrary to what you said in your introduction, there is not a 5¾ percent guideline on prices: the only price guideline mentioned is 9½ percent. Moreover, the program provides for a half percent deceleration from the rate of price increase that took place in 1976–77—which says that those who raised prices the most in those years can do so again, and those who were most socially responsible can do less now. That hardly seems equitable. Moreover, there is not really a mechanism for controlling prices: there is no manpower to do it, the consumer does not know what an appropriate price increase is, and no other source of income is controlled except wages. It is for this reason that the labor movement has asked for mandatory controls, established by legislation, effectively enforced and applying to all segments of the economy, not just to wage-earners.

MR. DALY: Dr. Kosters, drawing on your experience at the Cost of Living Council, do you think the program will work?

MARVIN H. KOSTERS, director, Center for the Study of Government Regulation, AEI: There are two ways of addressing that question. The first is to ask, Is the program likely to break down?—that is, might there be a wage or price increase that seems so much out of line with the standards that the whole program is discredited? That of course can happen in any program. In the program I was involved in from 1971 to 1974, we said cases like that were "the last cows in the barn," and they had to be let out on equal terms with the cows already out. But one can say that only so long before the explanation wears thin. Nevertheless, there are good reasons for above-average increases. It is insufficiently appreciated that any average of wage increases, or of price increases, involves a great deal of variation—with some below and some above the average. And a large wage increase or a large price increase can make a program appear to fail.

The second way to address the question is to ask, Is the rate of inflation likely to be lower after the program than it was before? By virtue of the standards themselves, that is quite unlikely. All the experience I know of in Europe and the United States is negative, and I see no reason for expecting this program to fare any better.

MR. DALY: The man who was chairman of the Council of Economic Advisers from 1971 to

*EDITOR'S NOTE: On December 13, 1978, the Council on Wage and Price Stability (1) relaxed the 7 percent wage guidelines and (2) tightened the price guidelines. Certain increases in the costs of pension plans will be exempt. Increases in costs from previously negotiated health benefits will be deemed to be 7 percent unless they are less. Companies whose circumstances preclude their following price increase restrictions must limit increases in pretax profits to 6.5 percent plus whatever is produced by increased volume.

1974, Herbert Stein, has written that two lessons from the last decade of struggle with inflation are relevant today: "One, do not think we can flirt with controls and not get them. And, two, do not think that the ineffectiveness of controls, which has roots deep in the American economic and political system, can be overcome by sufficiently enthusiastic operators."

How say you to that, Dr. Kahn?

DR. KAHN: The notion that any kind of controls or incomes policy can only do harm seems to me to spring from an assumption that the wage increase which, for example, the Teamsters settle for is somehow God-given or competitive-market-determined in the same way the free price of natural gas would be if gas were uncontrolled. But there is an enormous difference between these two. If we hold the price of natural gas below its marginal cost, we will have shortages. But does anyone on this panel believe that if we can induce the Teamsters (by one device or another) to reduce their wage settlement from 11 percent to, say, 7 percent we will have a shortage of Teamsters? Is there anyone here who believes this is a competitive market which by University-of-Chicago/God-given standards should not be interfered with? That view, I submit, would be an absurdity.

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I am not suggesting these weapons are the total answer. I am not, as you know, an enthusiastic supporter of the guidelines. I have been quoted correctly as referring to them as "those stinking wage-price guidelines." On the other hand, I do not believe it is right to speak of many of these prices and wages as though they were determined in a competitive market in such a way that to interfere would produce enormous distortions in the economy. Moreover, the notion that all of the European experience is negative is, I submit, a piece of folklore. The British experience does suggest that it is possible for an incomes policy to induce certain restraint—if only because both sides are equally frustrated. It is not accidental that every Western democratic capitalist country has attempted some kind of incomes policy.

Conclusion: This incomes policy is not the part of the program that turns me on, and it will not do any good in the absence of monetary and fiscal restraints. And I would emphasize that we intend to mount a comprehensive attack on structural defects in the economy and on government interventions that inflate costs and prevent competition.

DR. OSWALD: But this is really a controls program put into effect on the wage side without any legal basis, which is not the way such matters should be handled. There should be an appropriate body with sufficient manpower to hear cases. There should be a legal basis for punishing those who do not conform—not just vague threats without legal basis, or attempts to use laws for purposes other than those for which they were designed. If we are going to have controls or guidelines then we should do it right, by law, and equitably.

DR. KAHN: When a lawyer tells me I am not following due process, I tend to hold onto my wallet. When an economist tells me the same thing, I hold onto my checkbook too. Now I am not an expert on the law, but our lawyers tell us it is perfectly reasonable for the government to use its regulatory authority to prevent the passing on of inordinate wage or cost increases.

DR. GREENSPAN: I would like to go back to some fundamental questions that Dr. Kahn raised. I agree that the Teamsters do not strike one as a union characterized by extreme competition, but I would not therefore conclude that the solution to the problem is guidelines. There are obviously far more effective and long-run solutions—such as deregulating the truckers—which, working through the market mechanism, would have a surprising impact on the Teamsters themselves.

The question whether the European experience is valid is an extremely difficult one. I tend to agree with Dr. Kosters but grant that it is extraordinarily hard to read some of the evidence. Certainly the hypothesis that guidelines

work is extremely difficult—I personally believe, impossible—to prove, though it is also difficult to prove the opposite.

The reason democratic societies attempt controls when confronted with inflation is that the approach is perceived to create short-term political benefits—and in certain instances it does. President Nixon's freeze in August 1971 did in fact slow the rate of inflation. But the problem is that while there are short-term benefits, there are invariably longer-term costs. One of the difficulties in societies like ours is that politicians tend to overemphasize short-term benefits without fully comprehending the long-term costs.

A major problem with controls—mandatory or voluntary—is that they give the illusion of success while creating difficulties far greater than we can imagine. One of the more recent examples—in this case from the Nixon years—lies in energy price regulation and the difficulties that have emerged with unleaded gasoline. Controls tend to create huge bureaucracies, which for the most part shuffle paper and cannot be demonstrated to have significant impact on the overall price or wage level. In the longer run, because they thwart productivity, because they generate imbalances in the system, they tend to produce rather than fight inflation.

DR. KOSTERS: We should recognize here that wage and price controls, whether voluntary or mandatory, are only one of the many policies that are being carried out. This, of course, is what makes it difficult to assess the impact of any given program at any time.

Take, for example, the British case. It is true that inflation came down while the policy was in force, but it is also true that there was a good deal of fiscal belt-tightening already going on when the policy was put in force. The fact that other policies are being carried out at the same time as wage and price controls creates one of the main dangers of such a program.

Back in 1971 and 1972 it was often said that the controls then in force helped to make possible a more vigorous expansion than we could otherwise have had. And today, it is often said that we need to make a choice between voluntary controls (or, if they are not successful, perhaps mandatory controls) and recession. When one is talking about that kind of choice, one is talking about more stimulus to the economy with the controls in force than would otherwise be considered prudent. That seems like a formula for more inflation rather than less, from everything we know.

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DR. KAHN: There is no question that when the mandatory controls were imposed in August 1971 in anticipation of an election fifteen months ahead—and, of course, I am not impugning the motives of the Republicans any more than those of the Democrats, who would have done the same thing if they had been in power—

MR. DALY: Nor suggesting that history will repeat itself?

DR. KAHN: Precisely.

The imposition of controls at that time was obviously part of a deliberate attempt to inflate the economy, and for obvious reasons. We were making unsatisfactory progress in reducing unemployment and it was thought that, if controls were imposed, we could have massive monetary expansion and budgetary looseness. But that is clearly not the same thing as imposing far looser, far less massive, less bureaucratically enforced controls—with a bureaucracy not of 6,500 people but of only 100—and doing so in the context of a determination to reduce federal spending and thus the size of the deficit, to increase interest rates, and to reduce the rate of growth in the money supply.

I concede that our guidelines still are, to some extent, restrictions and controls. But we are talking now about controls in a context where macroeconomic restraint is being followed. The guidelines simply represent an unwillingness on the part of the government (and I think the country) to rely exclusively on a jamming on of the monetary and fiscal brakes. The distortions are far less likely to be serious than they were in 1971–73—though I would not

welcome permanent controls with any more enthusiasm than Dr. Greenspan does.

DR. KOSTERS: It is important to recognize that from our current perspective, it looks as though there was a deliberate attempt to overstimulate the economy back in 1971 and 1972, and as though it was widely recognized at the time that the economy was being overstimulated. I don't think that was the case. If we look at what was said then, we will find a broad consensus among economists that it was important to stimulate the economy, and not dangerous. I am not referring to late 1972 but to 1971, when the controls were imposed. Whether we turn out to be in similar difficulty a year from now will depend largely on what happens to monetary and fiscal policy in the meantime, just as it did then.

DR. OSWALD: But it is important to look at the difference between 1971 and now. In 1971, the inflation rate was a little over 4 percent; now it is over 9½ percent. In 1971, food prices were relatively stable; now they are going up at a 12½ percent rate—and they are a major factor in the consumer price index. In 1971, energy costs had not yet been pushed sky-high by the OPEC cartel; now they too are going up rapidly and are expected to continue to do so for the next few years. Moreover, medical care costs were rising rapidly in 1971 and they still are. Finally, interest rates have been going up substantially, which has been pushing up the cost of housing.

Monetary and fiscal policy will not address the problems of food price increases, will not directly address sectoral problems. To say that cosmetic wage-price guidelines, along with a strong monetary and fiscal program, will take care of our inflation is to neglect the pressures in different segments of the economy, pressures that are pushing up the price level much more rapidly than was the case in 1971.

DR. GREENSPAN: What basically concerns me, Dr. Oswald, is that President Carter's program will beget yours. The reason I say this is that I think it is unrealistic to presume that we can have a stable, unchanging guidelines program. We are already beginning to see the tendency of the Council on Wage and Price Stability staff to make the mistake of answering the questions being put to them. What that does is to create an ever-increasing body of decisions, or quasi-judicial regulations. One decision creates another and, before we know it, we will have—maybe not 6,500 bureaucrats, but certainly many more than 100. Moreover, a program of guidelines or standards must of necessity be politically comprehensible, but even a skillfully crafted effort can at best scarcely pick up more than 95 percent of the possible types of wage and price decisions being made. If we try to bring the last 5 percent under the guidelines, we will get an extraordinarily burgeoning system which will be made mandatory because it will have all the characteristics of mandatory controls except the authorizing legislation.

In fact, I think the present approach is already beginning to unwind. As time passes, we will be inexorably pushed towards more and more regulation. Ultimately, I fear, we will get what Dr. Oswald wants. And what he wants will not be good for the country.

DR. KAHN: On the question of energy prices and food prices, I agree that the solution is not mandatory price control or any kind of price control. To the extent that prices would be set below some sort of equilibrium point, we would simply be concealing from consumers what the real marginal costs of those supplies are—and that way lies disaster.

The part of the program that I find attractive is—and, again, I recognize the difference between promise and performance—that we are attempting to look systematically at those sectors that have been preponderantly responsible for the increase in the cost of living. We are attempting to identify the restrictions on competition, the insanities of methods of organization (such as the way we pay for medical care), the interferences with the free market (such as we have in agricultural policy or trucking regulation), the building codes and land use restrictions and inadequate taxes on land held out of use. There are millions of things that can be done. But the thing that should not be done is to try to use rigid controls to hold down the price of oil when the incremental cost to the U.S. economy is $14 a barrel.

DR. KOSTERS: Dr. Kahn has indicated it is important to let the market work its way with oil. On the other hand, he has indicated he thinks there would not be a shortage of Teamsters if

their wage increases were held down somewhat. Now that, it seems to me, poses a problem for Dr. Oswald. A case can be made for saying that there will be a lot of business firms with an incentive to enforce the 7 percent wage guideline, whereas it will be difficult to determine just how much compliance there is with a voluntary price guideline (which is an enormously complicated thing to audit or even to compute). Thus, if one feared the possibility that the wage guidelines might bite harder than the price guidelines, would he not favor a reduction in the recent increases in aggregate demand so as to avoid the prospect of wages being held down, while prices floated upward in response to fairly buoyant demand?

DR. OSWALD: That assumes our recent price increases have been purely the result of excess demand, and no one is saying that today. There may be one or two small sectors in the economy where there is excess demand—cement, for example—but, by and large, we have continuing high unemployment, nearly 6 percent, and a large amount of unused industrial capacity. Demand is not excessive compared to what we can produce. Therefore, a reduction in aggregate demand will not ensure reductions in prices, and it might compound the problem. We might have a continuation of very high inflation at the same time that monetary and fiscal policy are pushing the economy towards recession.

MR. DALY: Dr. Kahn, how will Congress respond to the request for enabling legislation for real wage insurance?

DR. KAHN: That plan was formulated before I came on the scene, but I am informed there were numerous soundings with the Congress and that the response was generally favorable. There have, of course, been some criticisms.

I find real wage insurance a very attractive and imaginative idea. The general notion is that workers who settle for wage increases within the 7 percent standard—making an act of faith that they will not suffer from a failure of others to follow—will be insulated against an increase in the cost of living beyond 7 percent by receiving a tax rebate for the difference between the 7 percent and the increase in the cost of living. This is like the tax incentive plans that are designed to cause people to behave in a socially responsible way in areas not subject to perfect competition.

DR. OSWALD: Even after that description, I am still not sure what real wage insurance is. But I like the response of the person at the Council on Wage and Price Stability who, in essence, said, "Don't bet on it, because it has to go to Congress." The plan has also been described by the worker who said, "What have I gained by taking the money from one pocket and putting it into another?" In other words, he pays for it in taxes and gets it back in taxes.

DR. KAHN: If he gets a wage increase above 7 percent, he pays a tax on the increment as well. I do not see any inequity in making the real wage insurance subject to taxes—though it has not yet been decided to do that.

MR. DALY: Might Congress consider the plan seriously if a limit were put on the amount of the tax rebate?

DR. KAHN: Obviously, the fiscal exposure is worrisome. However, we have this simple litany: the more people that sign up, the greater the budgetary exposure, but also the less the likelihood of having to pay, because so many will have settled at 7 percent. If that works out, the fiscal exposure is reduced, and vice versa.

DR. KOSTERS: Superficially, real wage insurance has a nice ring to it. But the more one looks at it, the worse it appears. One reason is that wage increases occur every year in a wide variety of sizes. In 1977, for example, first-year wage increases for major unions averaged about 8 percent, but about 30 percent of the workers getting increases under those agreements got increases of less than 7 percent and about 20 percent got increases of more than 9 percent. The 30 percent would benefit from real wage insurance, but those who received more than 7 percent would have little interest in a program that allowed them only to keep up with inflation, because they could probably do better in their own bargaining. So the program would have haphazard distributional consequences.

The program would also be extremely difficult to carry out because of the kind of information that would be needed. What we now report on our income tax returns is, in general,

earnings. But, to make the appropriate calculation here, we would need the wage and the time spent at work, so that we could assess wage rate changes. We would also need all the fringe benefits and other forms of nonmoney income —assuming this were included in the standard. If it was not, then of course there would be an incentive to move away from wages toward fringes. Resolutions to all these complex problems would have to be spelled out in sufficient detail so that IRS auditors could look at the situation the way they now look at individual income tax returns.

DR. KAHN: The Treasury experts assure us there would be no significant difficulty in employers' reporting on W-2 forms what has happened, ex post, to average hourly pay (including fringe benefits) from third quarter to third quarter, let's say, after removing overtime. On new contracts, it would be necessary to have some sort of a certification by the Council on Wage and Price Stability. But I had understood that Dr. Kosters, for example, was for years in the business of certifying whether a settlement fell within certain guidelines. This is not a debating point. I am only suggesting he may be exaggerating the difficulties.

DR. GREENSPAN: I think the Treasury experts are oversimplifying. What they are basically saying is that the system would use an average earnings figure. The difficulty is that it would be hard to know whether one was looking at a promotion or a wage increase. And there would be problems of part-time workers and of bonus workers. This has all the earmarks of a tremendously complex program, and what we are seeing is only the tip of an iceberg. I suspect that when the congressional committees hold hearings, these complexities will baffle them.

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DR. OSWALD: I just want to add that the control mechanism of the program reaches down through the smallest employer (even those with only one or two employees) to every last employee, while on the price side, there is nothing.

MR. DALY: Dr. Kahn, will you describe how you think the new Regulatory Council is going to work?

DR. KAHN: The Regulatory Council is, of course, the organization of the regulators and, frankly, I am uncertain to what extent one can count on the regulators to reform themselves. The council may play an important role in reconciling conflicting agency approaches. But, from my standpoint, the important body is the Regulatory Analysis Review Group, which is a separate group trying to apply economic standards of cost effectiveness and cost-benefit analysis to major regulations. How effective this scrutiny is will ultimately depend upon the amount of force the President is willing to apply.

MR. DALY: In recent years, we have heard a great deal about monetary policy as a principal and most effective weapon against inflation. Should monetary policy have greater weight than other policies?

DR. GREENSPAN: What we know is that excessive monetary growth is invariably accompanied by inflation, and vice versa. Where we have difficulty, often, is in defining which is cause and which is effect.

In my view, one of the major forces creating our present inflation has been the extraordinary credit expansion of recent years. This has induced major problems for the Federal Reserve Board, requiring it either to accommodate a sharp rise in interest rates or to supply credit to the system—which, essentially, expands money supply in an inflationary way. What the board has done of late—and it does this, I suspect, all the time, irrespective of the rhetoric—has been to compromise.

Money supply is critical, but I would not focus on it as something to be turned on and off, because it, too, is critically determined by other things. Before we can get a grip on money supply growth and, hence, on inflation, we must reduce the economy's aggregate credit requirements—federal borrowing requirements (which come from the budget deficit and from off-budget financing) and private-sector credit requirements (which the federal government

indirectly imposes on the private sector by mandating safety and environmental standards that businesses cannot meet without borrowing). Also many federal grant programs induce state and local governments to borrow. Finally, the most important thing at this stage is the tremendous expansion in the mortgage market, which has occurred largely as a result of government subsidy, direct and indirect. Unless we can come to grips with these things, the Federal Reserve will not be able to restrain the growth in money supply to noninflationary dimensions without an explosive increase in interest rates.

DR. KAHN: The administration is obviously concerned about the rapidity with which the money supply is increasing and the apparently omnivorous demand for credit, fueled by many of the policies Dr. Greenspan has mentioned. What I have difficulty understanding is why, then, we do not see—as Dr. Oswald points out—evidences of really severe demand pull.

DR. GREENSPAN: The reasons are that, along with this expansion in money supply, we have extremely high degrees of risk and uncertainty within the system, which are inhibiting plant and equipment expenditures, inventory accumulation, and a variety of other things historically associated with an expansion in money supply. If we had lower risk premiums, if we had lower degrees of uncertainty, if we had a more stable environment in which to function, we would be confronted with a major demand-pull situation.

DR. OSWALD: To amplify a bit what Dr. Greenspan said, I think some of the money is being used for corporate mergers, for expanding the new gambling activities in New Jersey and other places—for things that are not productive. What we have may be more a shifting of money than a demand for goods and services. And I am not at all sure that traditional Federal Reserve Board actions reach some of the credit creation that has taken place through the stock markets, through options markets, through futures markets, through all sorts of new means of creating credit. I am also not sure that we are really addressing these problems, except for raising interest rates—which is, moreover, harmful to many people.

DR. KOSTERS: I am surprised at the view that there is no evidence of demand pull. The rate of inflation this year—about 9½ percent compared to 6 or 7 last year—is itself some evidence of demand pull. Recall that prices went up before wages. According to industrial production capacity utilization indexes, the economy is in a situation roughly similar to that in late 1972.

DR. KAHN: That is simply a tautology. What we are trying to explain is why prices go up in an economy with 6 percent unemployment and industrial capacity utilization of something like 85 percent. Another way of saying it is that nobody denies we could stop inflation in its tracks if we were willing to cut the rate of growth in the money supply and tighten federal spending. But that would cause—as far as we can tell—serious unemployment. It is this stagflation dilemma we are trying to explain.

MR. DALY: Now that we have laid a very broad base on the Carter administration's wage and price program, it is time to move to questions and answers.

LAWRENCE ROSENBERG, National Science Foundation: My question is primarily for Professor Kahn. Many of the suggested solutions to inflation are of a longer-term structural nature, particularly the suggestions for making markets more efficient and competitive. Do you see any possibilities for shorter-range targets?

DR. KAHN: The targets will be very short-range. Within the course of a year, I expect definite movement toward deregulation of trucking and more thorough deregulation of the railroads. There will also be active discussions of the extent to which we can have more competition in maritime shipping. In the area of farm policy, while no one should expect a millennium, certainly we can move toward less restrictive ways of maintaining farm income. In the trade area, the President just vetoed cotton textiles protective legislation and the beef quota bill. We are also interested in state regulation of insurance. Do you know that in the states with open filing—which means a greater possibility of price competition—rates for liability and property insurance are markedly lower than in other states? In other words, I expect to pro-

duce short-term results in those areas where the government subsidizes, protects, and limits competition.

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> **—Alfred E. Kahn**

DR. OSWALD: But this is not really a change from what government has always tried to do in the way of affecting the economy. Moreover, I see no reason to anticipate results from these types of efforts in the next twelve months.

DR. KAHN: I am not promising miracles, but we had an airline regulation system for forty years, and we changed it this year. Perhaps people will learn that deregulation is not so bad after all. The airlines can make more money, can bring bargains to travelers, can even reduce fares by 3 percent at a time when the CPI goes up 7 percent.

DR. KOSTERS: These can be constructive actions and helpful in reducing inflation. They would in fact be worthwhile even if inflation were not the immediate problem. But one needs to bear it in mind that the government has always tried to do these things to some extent, as Dr. Oswald said, and that the favorable effects can be swept away quickly by a wave of excess demand.

JOHN KENDRICK, George Washington University: Dr. Oswald, given that labor costs constitute such a large share of total product costs, can we wind down inflation without reducing the rate of increase in average hourly earnings?

DR. OSWALD: Dr. Kendrick has written widely on the possibility of real economic gains from productivity. Now, part of the gains from productivity can be used to slow down inflation.

With respect to Dr. Kahn's emphasis on sectoral problems, there are certain sectoral problems that can be addressed that are not directly wage-related. And, in general, wage changes have not really been pushing prices up in the last three years. Rather what we have seen have been substantial attempts to raise wages to catch up with prices: after all, when someone works, he expects to be able to purchase something with what he worked for.

DR. KAHN: Could I make two points here? First, I have no intention of ascribing blame to one part of the economy or the other, but Dr. Oswald has missed Dr. Kendrick's basic point. If 70 percent of a sales price, or of the gross national product, goes to labor, then there is absolutely no way in which there can be wage increases of 9 or even 7 percent a year, when long-range productivity increases have never been more than 3 percent (and are now more nearly 2 percent), without getting something like 6 percent inflation. It is a matter of simple arithmetic.

Second, on the matter of catch-up: In any given year, at least 50 percent of the population will not have done as well as the other 50 percent. Now, if everyone who has fallen behind has a right to catch up, we have a permanent engine of inflation. Catch-up equals inflation.

DR. KOSTERS: I certainly agree we cannot slow inflation without having a commensurate slowdown in the rate of wage increase. But, as I understand this program, something more is intended. I understood Dr. Kahn to say that the program plans to look at situations where competition in the labor market is less prevalent. Now that makes sense, if we can induce the institutional changes needed to make the situation more competitive. But to use wage controls or some kind of wage-price policy to get a result that we would not get through competition in that industry is to court failure.

DR. KAHN: We were asking before, Where are the signs that excessive aggregate demand is pulling wages up? And we found very few signs in most parts of the economy. It is said, for example, that there is excessive spending for housing, but construction wages have risen much less than the average. My answer is that the basic problem of inflation is a social problem. It is the mark of a society in which people are constantly increasing their income claims—in the wages they demand, in the profit margins they add to their wage costs, in the demands they place on government for tax preferences, or subsidies, or various spending programs. All these add up to more than we can supply at constant prices. Some justify their claims on the

grounds of catch-up, others on the grounds that they are in industries with above average productivity.

The problem is not easily solvable simply by imposing monetary and fiscal restraints, because that will cause great unemployment. Of course, it would be simple enough to throw 20 million people out of work, and one knows they would then moderate their wage demands. But since we do not want to throw 20 million out of work, we have to do something to induce a general spirit of social discipline—which can come, in my judgment, only by recognizing that we are all like hamsters in a cage, running as fast as we can and staying in the same place. But I think there *is* a general recognition that we all have to moderate our demands if we are to moderate the rate of inflation without causing serious unemployment.

DR. KOSTERS: It seems clear to me that our problem in 1978 has not been one of wages rising faster than prices and, as a result, pushing prices up. It has not been one of workers' saying to themselves, "We've got to catch up, or we've got to do better." Instead, the problem has come from the price side: prices have risen a good deal more than wages this year. So it is difficult to argue that our problem stems from wages pushing themselves up autonomously rather than from demand pushing prices up.

MR. DALY: What part do inflationary expectations play in pushing prices up?

DR. GREENSPAN: Let me combine the answer to that question with a response to Dr. Kahn's very learned comments a few moments ago. Our problem is one for which we have no firm theoretical understanding. For the last six or seven years, we have been endeavoring to establish a theoretical framework for a condition of chronic inflation in a period of less than full utilization of resources. It is not an explanation to say that there are excess demands in the social system because that, translated into economics, is simply demand pull. Our problem is not something we fully understand. When we endeavor to relate wages and prices in our econometric models, we find the models wholly inadequate.

But I would not conclude, therefore, that because we see a relationship between wages and prices, we can somehow treat the symptoms of the problem and presume the issue will be resolved. Whenever we have endeavored to bring down inflation by bringing down wages or to bring down wages by bringing down prices, we have invariably failed. All we can say is that these particular efforts at treating the symptoms have not worked. So, in my view, to call for a particular form of restraint that somehow will simultaneously bring prices and wages down flies in the face of experience.

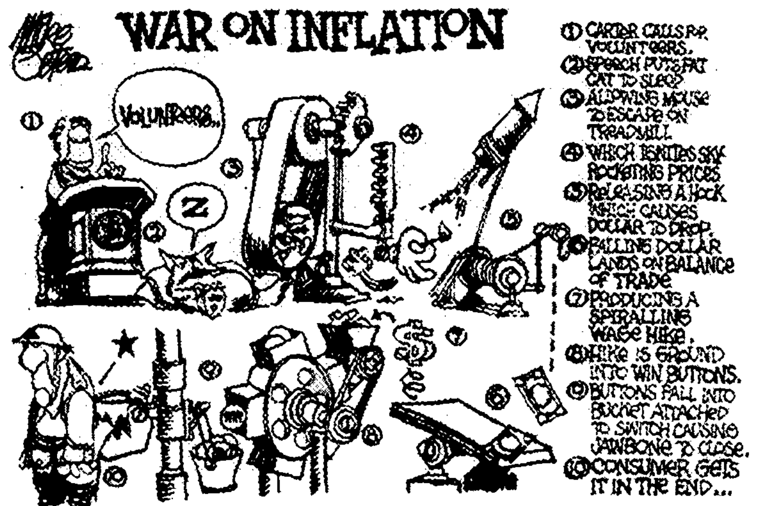
The idea of inflationary expectations has been seized on as though it explains the phenomenon. But it does not, because the fact that people expect prices to rise further, though it will certainly induce them to take certain actions, will not necessarily induce them to spend more. In fact, our experience is that they will save more, which is actually anti-inflationary.

The problem is tremendously serious. I am very much concerned that we all agree there are fundamental solutions but keep saying that, to reach them, we would have to create 20 million unemployed—which I find rather rhetorical, to say the least. The fact is that we know the solution, but we say it is politically, socially, and otherwise unacceptable. And each year we procrastinate, the problem gets worse, as does the socially and politically unacceptable alternative. At some point, we will have to come to grips with this problem, work hard to resolve it, and stop looking for costless solutions.

DANIEL SKARTVIDT, Fairchild Publications: When the President announced his program, he said the federal government would encourage compliance by not buying from contractors who violated the price guidelines. Subsequently, he urged the nation's mayors—and governors too, I think—to do the same thing. Dr. Kahn, are you moving toward asking consumers to boycott firms that violate the price guidelines?

DR. KAHN: We have not done so explicitly and, though I have not yet reached the point where I can give a full answer, you must recognize that our program is, in very large measure, voluntary. We are determined to fashion a program that will not require any more than 100 people, which means there will have to be a tremendous amount of self-enforcement. The "enforcement agencies" will consist largely of auditors and CPAs employed by companies, par-

ticularly the big companies. (The latter, I predict, will give us 98 to 100 percent compliance.) We are, as I have observed several times, creating a kind of WPA for CPAs.



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DR. OSWALD: That is to expect from consumers something the guidelines do not allow anyone to know. For example, on November 16 the price of *Newsweek* was raised from $1 to $1.25. But there is no way an individual can know whether that violated the guidelines, even though it was a 25 percent increase. The expectation given by the President's message is that the government is concerned, has set guidelines, and will do something. But, while employers will do something on the wage side, nothing will be done on the price side.

DR. KAHN: I think that is absurd. The limitations on our enforcement mechanisms apply to both wages and prices. I often hear it stated that profits are not subject to the same sort of standards as wages and prices are. But there is no way in the world one can regulate prices and markups without regulating profits. I concede that our program does not set up an army of auditors all over the country, but that limitation applies to wages and prices equally.

DR. OSWALD: Except that on the wage side, there is an organized group of enforcers—the employers. There is no organized group of consumers.

DR. GREENSPAN: That is not true. The presumption that employers somehow would like to keep wages down, no matter what, misrepresents the way wages are set in the nonunion area. Wages are set not by the benevolence of employers but by the employers' need to keep a good work force. If an employer arbitrarily holds wages below some particular market level, he will find a substantial part of his most productive workers going to his competitors. The view that employers are the wage enforcers badly misreads how the system functions.

DR. KOSTERS: There is an oddity about the way the plan's enforcement mechanism works. It requires the government, when it reviews procurement bids, to take the higher bid if the low-bidding firm has granted a wage increase in excess of the guideline. But it seems to me the government should *not* be encouraging firms that charge high prices and pay small wage increases—and also should not be encouraging consumers to patronize that kind of firm.

WILLIAM BROWN, Ford Motor Company: Dr. Kahn, earlier you mentioned some of the things the Regulatory Council and the Regulatory Analysis Review Group might do about regulatory costs. But neither of these is a major effort. Is there not some initiative government might take to bring these significant costs under control?

DR. KAHN: I think we would all agree, as a general proposition, that the goals of environmental, health, and occupational safety legislation are unexceptionable. But any objective observer would also have to agree that there are extremely large costs here that, in many cases, have not been subjected to the kind of scrutiny for cost-effectiveness that ought rationally to be applied—billions and billions and billions of dollars of such costs. Government, as well as the people at large, *must* recognize that inflation is now our most serious problem, and that we cannot any longer afford to ignore costs in achieving these unexceptionable goals. We must recognize that when we impose costs for this purpose, we are making less food available, less medical care. In short, our resources are limited.

I regard it as one of my most important jobs to try to introduce this kind of consciousness into government decision-making, and I think the President agrees with me. Whether we succeed is something that only time will tell.

DR. OSWALD: Recently though, some of the discussion on this matter has emphasized costs and said very little about benefits. The fact is that, particularly in the occupational health area, we have been derelict this whole century in not addressing the impact of carcinogens and other substances on the health of workers. To say that we should continue to neglect areas such as this is to disregard a very important element of what life is all about. And that is to live a healthy life, not just a life in which someone is able to make more money or sell a product at a lower price.

DR. KAHN: Dr. Oswald, I feel very strongly about the necessity of looking at benefits as well as costs. You are perfectly right that our society has been derelict in the past in ignoring those values, and this dereliction undoubtedly explains their sudden recognition, which has led to the imposition of these costs. Yet I could cite instances of billions of dollars of totally unnecessary and irrational costs being imposed to achieve the goals you are talking about. There are prescriptive regulations which require that a goal be achieved at 20-50-100 times the cost at which it could be achieved by other means. I share your sentiments, but I will not let you ignore the cost/benefit calculation that must be made.

JOSEPH KIRK, ICF, Incorporated: Would you elaborate, Dr. Greenspan, on the relationship between monetary policy and interest rates in the consumer price index? Second, what changes would you recommend in the administration's monetary policy?

DR. GREENSPAN: The first question implies—in part, quite correctly—that as interest rates rise, so does the official CPI which includes interest rates as one of its components. But I would not, by any means, conclude from this that higher interest rates are a cause of higher inflation. The process by which inflation is reined in will, in the short run, induce an increase in interest rates. But that is a by-product of bringing the monetary aggregates down from inflationary levels of increase to more moderate ones.

On the second question I would say that, theoretically at least, the administration, per se, does not have a monetary policy. It has views, but it is the Federal Reserve that has a monetary policy. And, at this particular stage, the Federal Reserve is in an extremely difficult position, with very little leeway either to lower interest rates or to lower the increase in money supply—and, hence, inflation. The problem comes about because of actions taken in recent years. At this point, the Federal Reserve would not create much in the way of an anti-inflationary policy if it slammed on the monetary brakes before defusing the excessive credit demands that are creating the problem. We must unravel the excess credit demands first and then the board can slow the growth in money supply. It cannot come to grips with inflation simply by trying to restrain the money supply.

BRADLEY GERMAN, Whaly-Eaton News: Dr. Greenspan, you noted that the short-term political attractiveness of wage-price guidelines mask long-term costs. What long-term costs do you anticipate from our current program?

DR. GREENSPAN: Let me give you an example. Recently, a success was claimed when a percentage point was knocked off the freight rate increase that the railroad carriers had initiated. Now, one of the major imperatives of this country is to restore some viability to our railroads, and one way of doing that is to give them—at least for the short run—significant flexibility to raise rates where they have extreme losses, and to put themselves in a position where they can create some profitability without government subsidies. To be sure, a percentage point cut in the announced freight rate will have some small negligible effect in the overall price increase for this particular period. But this short-run benefit could be extremely costly in the long run if it created further deterioration in railroad profitability.

DR. KAHN: I agree with Dr. Greenspan's observation that the apparently intractable problem of inflation is difficult to understand. But it certainly seems to have, as one important component, the fact that wages tend to be based on the behavior of the cost of living in the preced-

ing period, and prices tend to be based on those wage costs, with an add-on—in some cases a very healthy add-on. And, as another component, there is a tendency to set wages on the basis of an expectation that the rise in the cost of living will continue—which, thus, becomes a self-fulfilling expectation. This comes at a time when we are confronted with some major labor contracts—I recognize this is a very short-run view—that might be settled anywhere in the range of 6 percent to 12 percent.

We cannot ignore the short-run difficulties created even by things I strongly favor—such as deregulating gasoline, or letting the price of crude oil rise to the level imposed by OPEC. There is a loss of real income from increased energy prices, but if everyone in the economy decides he or she must have the same real income as before, we have a built-in inflationary mechanism. There is the same problem, too, with environmental protection costs. Environmental protection is highly desirable in most cases, but we cannot have a cleaner environment and more occupational safety and the same flow of other goods and services as we had before. We have to make choices.

DR. GREENSPAN: I think we can overemphasize the relationship between cost and prices and the cycle that goes on. The amount of actual escalation in wage contracts for the total private nonfarm economy is small. Union employees now number roughly 20 percent of all production workers, and only about half the union employees are under escalator clauses. Certainly there is some evidence that price indexes affect nonunion wages, but the relationship is not clear. And it is by no means obvious that wages are feeding prices, or vice versa.

But this is precisely the theoretical framework on which the guidelines are based. It is assumed that if the process can be slowed, inflation can be reduced. I submit that the evidence for this framework is extremely uncertain. And, in fact, having observed very sophisticated statistical analyses endeavoring to capture this effect so very unsuccessfully, I have little sympathy with this general point of view. I would especially not like to see a major U.S. economic policy resting on what amounts to very thin conceptual reeds.

To be sure, we can always give reasons why we have to take this action or that action, because the short run is important and the long run is far away. But, inexorably, the short run turns into the long run. We have found ourselves, much too often, saddled with the consequences of those short-run imperatives.

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—Alan Greenspan

DR. KAHN: Again, I agree with much of what you say. But economists have a tendency to ignore the noses on their faces. The fact is that there was in England an inflation rate in the 20 to 30 percent range, and there was a reaction in which the major unions accepted a guideline or incomes policy limiting wage increases. I am not an expert on the British experience, and I agree that the mere fact that the incomes policy and the reduction in inflation occurred simultaneously does not prove that one caused the other. But when the unions, for three years I believe, reduced their wage demands from over 20 percent to under 10 percent, I find it difficult to believe that this did not have a close relationship to the sharp reduction in the rate of inflation. Am I missing something?

DR. GREENSPAN: How are we, then, to account for the recent turnaround? If there actually was a working de-escalation, would not the British Ford situation be incomprehensible?

DR. KAHN: I do not know the answer to the British Ford situation.

DR. OSWALD: Why limit the discussion to Great Britain? Our neighbors in Canada have had three years of controls and, while there were initial decreases in prices and while wages have been held down, prices have accelerated in the last year—even though, I repeat, there has been no acceleration in wages. There has *not* been a close wage-price relationship in all changes in wages and prices, and we cannot pick one particular situation to justify saying, "By holding down wages, we're going to resolve our inflation problem."

DR. KAHN: I concede that control of wages is not the only answer to the problem, but neither is it the sole plank in the President's program.

DR. KOSTERS: It is always beguiling to think one can somehow directly influence a wage settlement here or a price increase there. Often, the idea is linked with the notion that if we do that, we will avoid the need for a recession—avoid producing unemployment. But that is a kind of false choice.

The problem of guiding an economy is somewhat like the problem facing the poor golfer. He does not know how far his shots will go or whether they will land on one side of the fairway or the other; and if the fairway has a dogleg and his shot goes out too far, there is a good chance he might have to backtrack. Now, the idea of standards is that they will enable us to move straight to the green, reducing the probability of a recession—or of having to backtrack —when we need to make a turn to reduced demand. But wage and price standards can help very little in that regard. The British experience provides the most plausible example that they might, but, for the most part, they have not worked very well at all.

EDWARD COWAN, *New York Times:* Dr. Kahn, if the problem is a wage-price spiral that is feeding itself and not an excess of general demand, if inflation is a social problem and not an economic problem, how useful will it be to bring down government spending and shrink the deficit?

DR. KAHN: That is a terribly good question, one I have great difficulty answering precisely because I do not see clear-cut signs of excess aggregate demand.

First, there is the burden of financing the federal deficit, to which Dr. Greenspan referred earlier, and which surely plays a role in the tightness of money markets and in the high interest rates. We should reduce the pressure of federal financing demands on money markets.

Second, if the problem of inflation is, in considerable measure, a consequence of people's maintaining aggregate demands on the economy that exceed what the economy can supply at constant prices, then this federal deficit comes to be a symbol. That is, there is a general, rather smug belief in the country at large that it is those bloated bureaucrats who are living on the fat of the land and somehow expanding these programs out of a diabolical desire for self-aggrandizement. I tell these people, who applaud wildly when I say that the President intends to reduce federal spending, that they will probably be the first to complain, because federal programs are one way in which they themselves establish large claims on the economy. In short, there will not be a general belief in the necessity for toning down our demands all around, unless limits are placed on the demands we exert through government spending.

I am not totally satisfied with that answer.

DR. OSWALD: Inflation is a social problem, but many of the proposals for cutbacks in the federal budget would be a social catastrophe. The cutbacks seem to be aimed precisely at those groups that are weakest and need the most help —the people who need jobs, people who need help in housing, people who are on the bottom of the income scale. That is where the impact of cutbacks will be.

DR. KAHN: That is not really fair. I cannot tell where the cutbacks are going to be, and I have sat in on three budget sessions. So how can Dr. Oswald tell?

DR. KOSTERS: It would be a real mistake to regard inflation as mainly a social problem and to think that its solution is to be found in some sort of social policy. If one looks to that explanation, one is overlooking important managerial responsibilities of government. That is, we ought to expect the government to do more than merely set an example. Of course, it should set an example—for instance, by balancing its budget to a greater extent than it has in the past—but it needs to do that not so much to teach individual households to balance their budgets as to reduce the strains in financial markets and, hence, permit a more responsible monetary policy.

MR. DALY: This concludes our discussion. On behalf of AEI, heartfelt thanks to our distinguished panelists and guests. ■

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