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### CHAPTER THREE

## Controlling Inflation

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IN ALL BUT ONE of the previous editions of *Setting National Priorities*, the problems of inflation—and the policies established to combat them—have not been the subject of a special chapter.<sup>1</sup> Rather, anti-inflation policies have been subsumed in chapters on general economic policy and the budget. Last year the administration was “faulted for giving inflation control little emphasis in its various initiatives” and for not dealing with the wage-price spiral.<sup>2</sup> It became clear in 1978 and early 1979 that inflation had become the dominant economic issue. The tax revolt that began with California’s Proposition 13 and led to strong pressures for constitutional amendments requiring balanced budgets was the product of an anti-inflation backlash as well as of concern about tax burdens per se. Responding to these pressures, the Carter administration submitted an austere budget for fiscal year 1980 and announced new voluntary wage-price guidelines; the Federal Reserve pushed up interest rates until the growth rate of the money supply was drastically reduced. This

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1. The exception is the chapter by George L. Perry in a special edition that provided a longer-range perspective. See “Stabilization Policy and Inflation,” in Henry Owen and Charles L. Schultze, eds., *Setting National Priorities: The Next Ten Years* (Brookings Institution, 1976), pp. 271–321.

2. Joseph A. Pechman, ed., *Setting National Priorities: The 1979 Budget* (Brookings Institution, 1978), p. 20.

chapter reviews these developments and evaluates the prospects for containing inflation.

### Inflation: An Overview

Inflation is a general rise in the price level, a phenomenon more easily measured than understood. Nevertheless, public opinion polls in recent years have consistently shown that inflation is perceived as a major economic problem.<sup>3</sup>

Since World War II the consumer price index has generally moved upward. In only two periods did the CPI actually decline slightly (1948-49 and 1954-55). From 1952 to 1967 the annual inflation rate never exceeded 4 percent. Since that period the inflation rate dropped below 4 percent only in one year (1972). But even in recent years the rate of inflation has varied considerably. On a year-over-year basis it has been as high as 11.0 percent (1973-74) and as low as 3.3 percent (1971-72). Between 1977 and 1978 the increase in the CPI was 7.6 percent. Most forecasts at the end of 1978 anticipated an inflation rate in the 7 to 8 percent range for 1979, but large price increases in early 1979 led to upward revisions of these forecasts.

### The Causes of Inflation

The inflation that began in the mid-1960s has many causes. The initiating cause was excessive stimulus from monetary and fiscal policy—traditional demand pull—during the Vietnam War buildup. To the surprise of many, however, a mild recession in 1970 did not halt the inflation. During 1971-72, a period of wage-price controls, inflation was reduced, but in 1973-74 it burst out again. The 1973-74 episode was initiated by special cost-push factors, including world crop shortages, dollar devaluation, and foreign oil price hikes as well as renewed monetary-fiscal pressures.<sup>4</sup> This experience cannot be attributed to a domestic struggle for income shares, since much of the impetus was international. And, in particular, it cannot be attributed to domestic wage gains. The deep 1974-75 recession, which

3. "Inflation, Unemployment Dominate the Agenda of Important National Problems," *Gallup Opinion Index* (May 1977), pp. 22-24.

4. Commodity inflation was estimated to account for 45 percent of the rise in the consumer price index in 1973. See Joel Popkin, "Commodity Prices and the U.S. Price Level," *Brookings Papers on Economic Activity*, 1:1974, p. 256.

was reinforced by monetary and fiscal restraint, slowed inflation but left it at historically high rates. Thus the search for an initiating cause, though of interest, does not explain the persistence of inflation. For the late 1970s, the interesting question is not what starts inflation, but what maintains its momentum.

### The Momentum of Inflation

The notion of a self-perpetuating wage-price spiral is based on the simple observation that wages are a major element of total costs and that prices determine the purchasing power of wages. Although there are various models of firm behavior, it can be safely assumed that cost increases to the firm will be reflected in price adjustments. In the labor market the impact of prices on wages is more difficult to define. It is true that the price level will determine the "real" value of nominal wages. Often it is said that workers will demand wage increases to match price increases in order to sustain real purchasing power. But only workers in the unionized sector are in a position formally to *demand* such adjustments, and even in that sector a demand does not necessarily produce acquiescence by employers.

Although there are important differences between the union and nonunion sectors, available evidence suggests that wage adjustments in response to price inflation are a common feature of both types of employment. Even in relatively depressed labor markets, nonunion employers do seem to respond to price inflation with wage increases that at least partially offset the loss of real purchasing power. Nonunion employers act as if they had some obligation to protect real wages and to insulate their workers' incomes from fluctuations in labor-market demand. In the union sector, of course, these tendencies are more pronounced, since worker demands can be backed up with strike threats.<sup>5</sup>

In both the union and nonunion sectors, therefore, wage behavior does not accord with simple textbook models. The labor market does not function as an auction in which workers daily sell their services to the highest bidder. Employers find turnover of labor expensive, since new employees must be screened and trained. Workers find involuntary turnover (layoffs) costly, since they must engage in

5. For more discussion on union and nonunion wage-setting practices, see Daniel J. B. Mitchell, "Union Wage Determination: Policy Implications and Outlook," *BPEA*, 3:1978, pp. 537-82.

job search, which, in a world of imperfect job information, can involve the loss of regular income. Both parties have an incentive to enter into implicit long-term relationships in which notions of equity play an important part. Workers—even nonunion ones—may view it as the employers' duty to keep wages in line with inflation, and employers hoping to retain their workers over long periods of time will take account of such perceptions.<sup>6</sup>

The degree to which the past rate of inflation affects current wage determination will vary with the institutional setting. Collective bargainers without cost-of-living escalators are likely to consider past inflation in formulating expectations about inflation during the lives of their contracts. Contracts with partial escalator protection will reflect both current and past inflation. Nonunion employers typically set wages annually or more frequently; they have the least need for projections of future inflation and can base wage decisions on very recent or current price inflation. In all sectors, past and current inflation becomes embodied in future wage decisions, which are eventually reflected in future price increases.

Inflation perpetuates itself not only in the interaction of the labor and product markets. In financial markets, for example, interest rates will reflect—among other influences—expected rates of inflation. Firms bidding on long-term sales contracts must include an allowance for the rising prices of materials as well as for wage inflation. The income channel is also important. Wage increases that protect purchasing power permit wage earners to continue buying products whose nominal prices have risen. Nonwage incomes are also affected. Most transfer payments, such as social security and federal employee pensions, are automatically adjusted for inflation.<sup>7</sup> And, as noted, inflationary expectations tend to boost interest rates, thus raising the nominal incomes of interest recipients.

At one time, inducing a recession through monetary and fiscal policy may have reminded people of the Great Depression, when prices fell and economic ruin seemed at hand. This memory may

6. Arthur M. Okun, "Inflation: Its Mechanics and Welfare Costs," *BPEA*, 2:1975, pp. 366-67.

7. The Bureau of Labor Statistics estimated in late 1977 that more than one-half of the U.S. population received some income that was subject to automatic escalation geared to the consumer price index. However, only about 15 percent of all income was subject to escalation. See Julius Shishkin, "A New Role for Economic Indicators," *Monthly Labor Review*, vol. 100 (November 1977), p. 4.

explain why the recessions just before and after the Korean War were able to produce actual price declines. Thus monetary and fiscal policy could halt the wage-price spiral in that period; inflation's tendency to perpetuate itself was less of a problem then than in the 1970s. Although a market for prophecies of doom still exists in some circles, there is now a whole generation that has no memory of severe and prolonged depression. Moreover, the social insurance programs that began in the 1930s provide cushioning in the event of economic decline.

### *The Costs of Inflation*

In an inflationary situation, any stickiness in prices and wages will have both distributional and allocative effects. Interest rate ceilings under state usury laws provide an excellent example. If market interest rates climb above the usury ceilings, borrowers will have trouble obtaining loans and lenders will be forced to seek out new areas of investment. Wage stickiness may hold down real wage rates and thus temporarily transfer income from wages to profits and to job seekers who might otherwise have had difficulty in finding employment.

Some transfers of income may occur between taxpayers and government. To the extent that revenue is raised from progressive income taxes, rising nominal incomes will push taxpayers into higher tax brackets and lower the real value of personal exemptions and the standard deduction. On the other hand, those taxes that are assessed in absolute terms against volume measures (for example, 5 cents of tax per gallon) decline in real terms during inflation.

In the case of property taxes, inflation and speculation intertwined to produce income gains for local governments and an eventual taxpayer revolt. It has become part of the folk wisdom on inflation that homeownership is a hedge against rising prices. The belief that home buying would be a good investment helped fuel the inflation of house prices. And since property taxes are geared to assessments of house value, collections tended to rise. Homeowners began to worry about whether they could expect their incomes to keep pace with their property taxes. (This is an example of the difficulty inflation creates for all long-term planning decisions, such as saving for retirement.) In California the outcome of these fears was Proposition 13, an amendment to the state constitution that not only cut property taxes but drastically limited the rates at which they could

increase. During 1978 proposals of this type were considered or adopted in other states and localities.

To the extent that political decisions are required to correct for inflation, questions of income distribution that might otherwise be suppressed come out in the open. If it becomes necessary, for example, to enact income tax cuts periodically to offset the revenue-increasing effect of inflation, political debate over the desirable degree of progressivity and the treatment of certain sources and uses of income must be renewed. This increase in the costs of political transactions is mirrored in private-sector contracts. For example, increased strike activity accompanied the inflation that built up in the late 1960s. And landlord-tenant disputes have resulted in pressures for rent control.

One of the important economic rules of thumb that inflation disports is the aversion to reduction in wages in periods of slack demand for labor. When combined with the rule that the most senior employees are the last to be laid off in a business downturn, the aversion to wage cuts can be seen as an income-maintenance guarantee. The degree of protection provided by the guarantee grows as the employee demonstrates loyalty to the employer by remaining on the job, and can be viewed as part of the implicit labor agreement. This guarantee applies to nominal wages, not real wages, a consideration of no consequence when prices are stable.

In a period of inflation, however, an employer can cut real wages without taking any overt action against nominal wages. Thus income-security arrangements are disrupted, and worker insecurity grows. The fact that real wages can reflect downward labor-market pressures during inflationary periods may be regarded as "efficient" by economists. But it creates resentment among workers. In the early 1970s, for example, previous changes in birthrates as well as taxpayer resistance created adverse labor-market conditions for schoolteachers. Real wages for secondary-school teachers fell about 6 percent from 1972 (the peak for real earnings) to 1977, despite a 36 percent increase in nominal wages.<sup>8</sup> Had the rate of price inflation been zero during this period, a 6 percent wage cut might have been more difficult for school boards to accomplish and, indeed, might not have occurred at all.

8. U.S. Bureau of the Census, *Statistical Abstract of the United States, 1977* (GPO, 1977), p. 147.

Inflation makes contractual relationships—explicit and implicit—more difficult to maintain, increasing the potential for disputes about economic relationships and obligations, decreasing economic security for senior members of groups for whom labor markets are weak, and forcing more open recognition of income distribution issues in the political arena. In addition, a major cost of inflation is an increase in social tensions, another cost that cannot be meaningfully reduced to a dollar equivalent. But even though its social and economic costs defy measurement, inflation is a serious problem and economic policy must deal with it. Ultimately, the political process provides the index of public unhappiness with inflation. Imperfect though that index is, the anti-inflation mood of the electorate has been demonstrated in a range of recent political developments.

#### Aggregate Demand Policy and the Short-Term Economic Outlook\*

By the end of 1978 virtually all economic forecasters were expecting a slowdown in real economic growth during 1979. Opinions differed, however, on the timing and severity of the slowdown and on whether it would technically meet the necessary qualifications for a "recession." Table 3-1 shows a series of such forecasts. Administrative estimates tended to be significantly more optimistic about real growth, but still conceded a slowdown. The range of predicted inflation rates is close to that of the third quarter of 1978, when prices increased at an annual rate of 6.9 percent. Thus the forecasters were essentially projecting a continuation of the most recent inflation experience (the third-quarter figures were the latest available when these forecasts were made), despite an expected slowdown in real growth. The administration's forecast was more pessimistic about inflation than four of the others, perhaps because it assumed a better real growth performance. All seven forecasts recognized the limitations of macroeconomic policy. That is, all expected economic policy to create economic slack, but none anticipated that the rate of inflation for 1979 would fall below 6 percent.

Evaluation of current and proposed aggregate-demand policies must be made within the context of considerable uncertainty about the economic outlook. However, it is clear that monetary policy

\* Joseph J. Minarik contributed to this section.

Table 3-1. Selected Economic Forecasts, Late 1978 and Early 1979

Source	Date	Inflation rate, 1978:4 to 1979:4 <sup>a</sup>	Growth of real GNP, 1978:4 to 1979:4	Peak unemployment rate, 1979 <sup>b</sup>
Data Resources	January 1979	7.4	-0.5	7.1
Manufacturers Hanover Trust	Winter 1978-79	7.2	0.2	7.2
UCLA Business Forecast	December 1978	6.2	0.9	7.1
Wharton	December 1978	6.9	1.4	6.1
George L. Perry, Brookings Institution	January 1979	6.8	0.8	6.4
Goldman Sachs	January 1979	7.8	0.7	7.1
Carter administration	January 1979	7.4	2.2	6.2

Sources: "Data Resources U.S. Forecast Summary" (Data Resources, Inc., January 1979), table 7, p. 8; Irwin L. Kellner, "Economic Forecast for 1979," *Business Report* (Manufacturers Hanover Trust Co., Winter 1978-79), p. 4; "The UCLA National Business Forecast: Executive Summary" (December 1978), p. 2; "The Wharton Quarterly Model Forecast, December 28, 1978, Control Section Update" (Wharton Economic Forecasting Associates, Inc.), p. 1; data supplied by George L. Perry, January 2, 1979; *Economic Research*, "The Pocket Chartroom" (Goldman Sachs Economic and Financial Research Group, January 1979), p. 3; *The Budget of the United States Government, Fiscal Year 1980*, p. 35.

a. Change in the GNP deflator.

b. All forecasts expect highest unemployment rate in 1979 to occur in the fourth quarter.

definitely became tighter in the second half of 1978. And the Carter administration's budgetary proposals for fiscal year 1980 also represent a tightening.<sup>9</sup> These shifts in direction are the consequence of fears of accelerating inflation and the related concern over the value of the dollar in international exchange markets.

### Fiscal Policy

Fiscal policy could affect the rate of inflation in three ways. First, the standard analysis suggests that a decrease in spending or an increase in tax rates is contractionary. The problem in the past has been that much of the contractionary effects associated with a tightening of fiscal policy have fallen on real output rather than on inflation. In the short term, say over a period of a year, a 1 percentage point increase in unemployment might slow the inflation rate by 0.3 percentage point. At current levels of production, a loss of real GNP of over \$200 billion would be required to reduce the inflation rate

9. See chapter 2.

### Controlling Inflation

by 1 percentage point.<sup>10</sup> The burden of that cost will not fall on the population in a proportional manner.

A second aspect of fiscal policy relates to taxes that have a direct influence on prices. The most obvious examples of such taxes are state and local sales and excise tax levies. A substitution of income taxes for sales and excise taxes would directly lower the price level. Since the federal government has no general sales tax and the importance of excise taxes in federal receipts is small, there is little room for such adjustments by the federal government. Unless the federal government were prepared to compensate state and local governments for lost sales or property tax revenues, the only major tax cut available for direct cost effects would be a cut in social security payroll taxes. It is often assumed that a reduction in labor costs resulting from reduced payroll taxes would be passed on in lower prices. However, such cuts would raise significant questions about social security financing, questions that Congress is unlikely to face during 1979. Thus the chance for any direct downward fiscal pressure on the price level in the near term is unlikely.

A third possible influence of fiscal policy on inflation could operate through an induced effect on monetary policy. It is sometimes argued that large budget deficits force the Federal Reserve Board to finance the deficit through monetary expansion. Were the monetary authorities to feel obligated to buy a substantial fraction of the net issues of Treasury obligations, large deficits would indeed have substantial monetary implications. However, there are no legal or institutional obligations forcing the Federal Reserve to finance the deficit. And, as table 3-2 illustrates, the statistical evidence does not show any close links between Federal Reserve purchases of Treasury obligations (column 2) and Treasury issuances of such obligations (column 1). In some years the Federal Reserve bought only a small fraction of the change in net federal debt; in others it bought more than 100 percent. Deficits do not automatically determine the policy of an independent Federal Reserve, nor should they.

The alleged monetary effect of fiscal policy is really the only channel through which the budget deficit itself—as opposed to spending and tax decisions—could play an important role in aggregate demand policy. Obviously, it is those tax and spending decisions that

10. See Arthur M. Okun, "Efficient Disinflationary Policies," *American Economic Review*, vol. 68 (May 1978), pp. 348-52.

Table 3-2. Changes in Federal Debt Held by the Public and by the Federal Reserve, Fiscal Years 1955-78

Amounts in billions of dollars

Fiscal year	Net change in federal debt held by public <sup>a</sup> (1)	Net change in federal debt held by Federal Reserve (2)	Ratio, col. 2 to col. 1 (percent) (3)
1955	2.1	-1.4	-66.2
1956	-4.3	0.2	-4.6
1957	-2.8	-0.8	28.5
1958	6.9	2.4	34.6
1959	8.6	0.6	6.9
1960	2.2	0.5	23.0
1961	1.4	0.8	56.1
1962	9.8	2.4	24.6
1963	6.1	2.3	38.2
1964	3.1	2.8	89.5
1965	4.1	4.3	106.0
1966	3.1	3.1	99.8
1967	2.8	4.6	160.3
1968	23.1	5.5	23.9
1969	-11.1	1.9	-16.7
1970	5.4	3.6	67.1
1971	19.4	7.8	40.1
1972	19.4	5.9	30.4
1973	19.3	3.8	19.5
1974	3.0	5.5	181.7
1975	50.9	4.3	8.5
1976	83.4	9.7	11.7
1977	57.2 <sup>b</sup>	8.2 <sup>b</sup>	14.4
1978	59.1	10.0	16.9

Sources: Annual Report of the Secretary of the Treasury on the State of Finances, various issues; Economic Report of the President, various issues.

a. "Public" includes the Federal Reserve and all other holders except federal government agencies.  
b. Figures for fiscal year 1977 reflect an extra "transitional" quarter. Data have been adjusted by multiplying them by 4/3.

determine the deficit at any given level of economic activity. But the recent concentration by the public on the deficit as the source of inflation is too one-sided. Over the long term the deficit does have significance for the rate of national saving and investment. Yet even from that perspective, an expanding economy with good prospects for investors is a precondition for a high rate of investment.

For the present, federal fiscal policy is largely a matter of spending decisions. Tax policy has already been laid out. The reductions

in expenditures proposed by the administration for discretionary components of the budget (see chapter 2) can have only a small effect on inflation in the short term, perhaps a reduction of one- or two-tenths of a percentage point in the inflation rate.

### Monetary Policy

Monetary policy is currently in a paradoxical position. On the one hand, it is the more flexible of the two aggregate demand policies because it can be changed quickly in response to economic developments. But on the other, changes in the institutions surrounding the financial sector have made the response of the economy to monetary policy more uncertain than ever. For example, the development of money market mutual funds and payment drafts for savings accounts provided consumers with interest-bearing substitutes for checking accounts. Such developments have changed the relationships of the money supply and interest rates to economic activity.

In the past a major element in the responsiveness of the economy to monetary contractions was through the flow of funds out of the savings institutions (disintermediation), a shortage of funds to the housing industry, and a resultant construction crunch. The disintermediation occurred as market interest rates surpassed legal ceilings on interest rates paid on deposits in savings institutions, thus enticing savers to move into such assets as Treasury bills. But the introduction in June 1978 at savings institutions (and banks) of new "money-market" certificates geared to six-month Treasury bill interest rates appeared to shelter the housing industry from the impact of disintermediation. Savings institutions retained their deposits—although at considerable cost—and borrowers were able to obtain mortgage loans, except in states with restrictive usury ceilings. This development was somewhat ironic, since housing prices were clearly an area of overheated speculation. A cooling off of such speculation would have been especially desirable. In March 1979 interest rates on the new certificates were moderately restricted in order to dampen housing demand.

Whether one prefers interest rates or monetary aggregates as indicators of the financial consequences of Federal Reserve actions, it is clear that in the last quarter of 1978 a dramatic shift occurred. During the first half of 1978 the Federal Reserve appeared to be in a reactive posture allowing gradual interest rate increases, especially

Table 3-3. Indexes of Monetary Policy, 1977-79

Period	Annual rate of growth of money supply <sup>a</sup>			End-of- period federal funds rate	Discount rate (New York)
	M-1	M-2	M-3		
December 1976-December 1977	8.0	9.3	11.3	6.56	6.0
December 1977-June 1978	8.6	7.8	8.0	7.60	7.0
June 1978-September 1978	9.5	10.8	12.4	8.45	8.0
September 1978-December 1978	0.2	4.5	7.4	10.03	9.5

Source: *Economic Report of the President, January 1979*, pp. 251, 259.

a. M-1 = circulating currency plus demand deposits (excluding domestic interbank and U.S. government deposits); M-2 = M-1 plus bank time and savings deposits other than large negotiable certificates of deposit; M-3 = M-2 plus deposits at mutual savings banks, savings and loan associations, and credit unions.

in the second quarter. Growth in the monetary aggregates tended to exceed the goals established by the Federal Reserve for 1978, a pattern that continued into the third quarter. As table 3-3 shows, M-2 was rising at an annual rate of over 10 percent during that quarter. By that time, however, the Federal Reserve had moved toward a more restrictive position and was pushing up interest rates, partly in response to depreciation of the dollar. The interest rate on federal funds was substantially higher at the end of the third quarter than at the beginning of the year.

International considerations produced a dramatic policy reaction in the fourth quarter, when it became apparent that foreign-exchange traders were not satisfied with the prospects of the newly outlined anti-inflation program. Domestic actions included an increase in the discount rate from 8.5 to 9.5 percent and an increase in required reserves on large time deposits. (International actions are discussed below.) The Federal Reserve pushed interest rates to new peaks and continued this tighter stance into 1979. Partly because of Federal Reserve policy and partly because of unprecedented shifts out of money into other assets, growth in the conventional definitions of the money stock slowed substantially in the fourth quarter.

Given the uncertainties over monetary policy and the economic outlook, it would be unwise for the Federal Reserve to react to each month's announcement of high inflation rates with a further tightening of monetary policy. The short-term response through the housing industry and disintermediation was initially attenuated. Monetary

mechanisms can be expected to work more gradually under the new institutional arrangements, mainly through the effect of interest rates on investment decisions and financial markets. Because of the lags involved in this mechanism, the Federal Reserve could easily overshoot, pushing the economy into a deeper recession or slowdown than intended. Indeed, some monetarist economists would argue that the sudden slowdown in the growth of the monetary aggregates in late 1978 indicated an excessively tight policy.

Finally, it is important to note that the channels through which monetary policy affect inflation are much the same as those of fiscal policy. That is, monetary policy restrictions will primarily slow the growth of real output, producing only a small anti-inflation dividend, especially in the short run. The boom in agricultural prices in early 1979 and the effects of the oil price increase by the Organization of Petroleum Exporting Countries (OPEC) and of the production shortfall in Iran cannot be considered responsive to monetary policy. And, perversely, the impact of increased mortgage interest rates has a dramatic worsening effect on inflation as measured by the consumer price index.

#### International Aspects of Anti-Inflation Policy\*

As 1978 progressed, movements in the exchange rates of the dollar vis-à-vis other currencies began to play an important role in decisions regarding monetary policy. Table 3-4 shows that the U.S. dollar declined in value relative to most other important currencies during the first ten months of 1978. By late October there were many indications of a loss of international confidence in the dollar. For the first time in the post-World War II period, domestic monetary policy was heavily influenced by international exchange markets.

#### The Policies of November 1, 1978

On November 1 the Federal Reserve and the Treasury announced a series of moves to reverse the decline. For the first time the President spoke of the exchange rate as a policy goal and supported a tighter monetary policy as an instrument to pursue that goal. Swap arrangements with foreign central banks were increased by \$7.6 bil-

\* Lawrence B. Krause contributed to this section.

lion to \$15 billion. A plan was unveiled to sell abroad Treasury securities denominated in foreign currencies. Arrangements were made for drawing from the International Monetary Fund and for other borrowing. Increased U.S. gold sales were announced, presumably to attract foreign currency and lessen the attractiveness of gold as a vehicle to speculate against the dollar. All these actions, in addition to their actual or potential effects, were intended as symbolic gestures showing the resolve to defend the dollar.

Finally, the Federal Reserve raised the discount rate from 8.5 percent to 9.5 percent and lifted the goal for the federal funds rate. The latter action had the immediate effect of making returns on assets denominated in U.S. dollars higher—thus increasing the attractiveness of such assets to foreign investors and Americans thinking of investing abroad—and of signaling a willingness to fight inflation, even at a cost in U.S. real output. As a result of these various steps, the dollar showed a substantial gain in price relative to foreign currencies in November. Much of this gain was retained through the first quarter of 1979.

Foreign central banks apparently were willing to intervene to stem the dollar's decline initially. During the last quarter of 1977 and the first quarter of 1978, foreign central banks increased their dollar holdings in the United States by over \$31 billion. In the second quarter, however, when the dollar appeared to stabilize, these holdings were reduced by \$5.7 billion. Foreign official net acquisitions of U.S. dollar assets increased in the third quarter by \$4.9 billion, which was not enough to stem the decline of the dollar. In the fourth quarter of 1978, official holdings of dollar assets rose by over \$19 billion, a sign of renewed confidence.

#### Exchange Rates and Inflation

The post-World War II system of fixed exchange rates was officially abandoned in early 1973. The U.S. policy after that date was primarily to let the dollar float against other currencies. Domestic policy was determined largely by domestic objectives, and the exchange rate was left to adjust for any inconsistency between U.S. policy and economic conditions and those of other countries. Hence the 1978 decision to defend the dollar marked a notable change in emphasis from the prevailing direction of U.S. policy after 1973. Policymakers concluded that the level of the exchange rate was an

Table 3-4. Value of Foreign Currencies Relative to the U.S. Dollar, 1970-78  
Indexes of value (December 1977 = 100)

Month and year	German mark	Italian lira	French franc	Swiss franc	British pound	Japanese yen	Canadian dollar	Composite average of 10 major currencies <sup>a</sup>
December 1970	59.0	140.5	86.9	48.1	128.9	67.4	107.8	72.5
December 1972	67.2	150.2	94.3	55.1	126.4	80.0	110.1	88.8
December 1977	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
March 1978	105.8	102.4	102.0	109.4	102.7	104.0	97.8	103.9
June 1978	103.2	101.9	104.8	110.1	99.1	112.7	94.1	104.0
September 1978	109.2	105.6	109.9	132.4	105.7	126.9	94.1	109.2
October 1978	117.1	107.9	114.0	135.3	108.2	131.3	92.8	113.8
November 1978	112.9	103.9	110.1	124.1	105.7	125.5	93.5	108.5
December 1978	114.4	103.9	111.2	123.9	107.1	123.0	93.0	110.2

a. Index of the dollar relative to the weighted average of currencies of the other Group of Ten countries plus Switzerland, weighted by 1972-76 global trade. Source: Federal Reserve Bulletin, various issues.

important additional objective that acted as a constraint on overall macroeconomic policy.

The exchange rate affects the domestic price level and the internal rate of inflation and is also affected by them. It is estimated that a 10 percent devaluation of the dollar ultimately produces a 1 to 2 percent increase in the consumer price index, because of the resulting increases in import prices and the secondary effects on the prices of domestic substitutes.<sup>11</sup> If the dollar is maintained at a given value on the exchange markets rather than permitted to depreciate, inflation caused by internal disturbances will tend to be dampened. Internal demand pressure—if that is what is causing inflation—will spill over into increased imports and possibly into reduced exports. Less of the demand pressure will go into bidding up domestic prices. But if the demand pressure continues, the eventual surplus of imports over exports must be financed by depleting U.S. foreign assets or by U.S. borrowing abroad. Unless foreigners have an insatiable appetite for U.S. liabilities, the use of the exchange rate to dampen inflation cannot go on indefinitely. At some point the internal demand pressures must be reduced.

Exchange-rate movements may affect the speed and timing at which internal demand pressures are felt. As the economy approaches full utilization of capacity, a series of stages in the relationship of the internal price level to the exchange rate may occur. Initially, imports are stimulated relative to exports, but currency traders may be slow to perceive that a fundamental weakening of the competitiveness of U.S. exports and import-competing goods is occurring. Indeed, if internal demand pressures raise U.S. interest rates, a sufficient capital inflow from abroad may be created to maintain a balance between the demand for and the supply of dollars at existing exchange rates. Thus initially the exchange rate may act as a dampener of inflation.

As the perception of U.S. inflation becomes more widespread and expectations are created that inflation will continue, the offsetting capital flows may cease and reverse. The dollar may begin to sink in value more or less in proportion to the inflation differential between

11. *Economic Report of the President, January 1979*, p. 43; Peter Hooper and Barbara Lowrey, "Impact of Dollar Depreciation of the U.S. Price Level: An Analytical Survey of Empirical Estimates," International Finance Discussion Paper 128 (Board of Governors of the Federal Reserve System, January 1979), p. 44.

the United States and other countries. Thus the inflation-dampening effect comes to an end because foreign prices—measured in dollars—are rising at the same rate as U.S. domestic prices. Moreover, the inflation expectations of currency traders may worsen and lead to a run on the dollar, especially if monetary growth is not held down for domestic reasons. At this point the further decline in the dollar set in motion by asset-market shifts out of dollar-denominated assets can itself add to inflation, since it exceeds the difference between the inflation rate of the United States and those of other countries.

Obviously, it is easier to identify such stages of the inflation-exchange rate relationship conceptually than empirically. In recent years inflation has had components that are not directly due to internal demand pressures. These have included disturbances originating abroad (for example, foreign oil price hikes), and cost-push originating at home (for example, regulatory costs and social security tax increases). Therefore, policymakers may have difficulty determining at any given moment whether the economy is truly overheated. This uncertainty makes policy decisions about exchange rates complicated. If the exchange rate has depreciated more than is warranted by general economic conditions at home and abroad—including inflation—intervention to boost the value of the dollar in exchange markets could be justified on anti-inflation grounds. If the depreciation is occurring because of shifts in general economic conditions at home or abroad, however, attempts to prop up the dollar may simply result in a larger devaluation at a later date and capital losses to the government. It is often only in hindsight that a decision to intervene in the exchange market can be evaluated.

When anti-inflationary internal policies are followed, the exchange rate plays a similar role in affecting the timing of inflation. After a prolonged period of inflation, the exchange rate may not react fully to a change in policy. But this lag in the perception of currency traders caused by lost confidence in the dollar—which initially reduces the effectiveness of anti-inflation policy—will ultimately be made up when confidence is restored.

If policymakers are sure that they are willing to follow restrictive policies for an extended period, and if they are sure that the exchange markets are reacting to past inflation and not to the new anti-inflation resolve, deliberate actions to boost the dollar exchange rate can be justified. Boosting the exchange rate under those circumstances could

dampen inflation. This was evidently the kind of analysis that supported the strong moves to boost the dollar in November 1978.

#### *The Simultaneity Problem for Domestic Policymakers*

In a textbook demand inflation, a steady state is possible in which all prices are rising at the same rate—plus or minus differences that reflect relative changes in demand and supply—and the exchange rate is depreciating at a rate determined by domestic and foreign inflation. Capital movements are not seen as playing a destabilizing role. But because the exchange market tends to move unevenly during periods of inflation, this steady state never arrives. Even if U.S. demand policies were aimed at maintaining a given rate of inflation, there would probably be periods in which exchange-rate movements either slowed that rate or caused it to accelerate. Thus a policy aimed at perpetuating a rate of inflation would nevertheless be forced to react to the exchange rate. In particular, if the dollar exchange rate began exacerbating the rate of inflation, domestic demand policy would have to become more restrictive. And vice versa.

Dollar exchange-rate movements, however, are not merely reactions to internal U.S. policies. Since each rate is the relative price of the dollar against some other currency, the policies and conditions in other countries inevitably affect the dollar. Indirectly, therefore, U.S. domestic policy must respond to events in other countries just as their domestic policies must respond to developments in the United States. The fundamental interdependence of national economies creates a need for coordination of objectives across countries and domestic macroeconomic policies.

Trends in international trade have increased the importance of the foreign sector to U.S. economic activity. In 1968 U.S. exports amounted to 5.7 percent of GNP; by 1978 the figure had reached 9.7 percent. The figures for imports are 5.5 percent and 10.3 percent respectively.<sup>12</sup> Corresponding interdependence has grown in capital markets. These data suggest that the United States needs to consider the foreign sector in formulating its domestic policy.

Recent events further illustrate this need. In 1976 net exports fell \$13 billion below their level the previous year. Although such declines are often referred to as "deteriorations," they are not neces-

12. These figures are based on national income and product accounts data. Exports and imports include both goods and services.

sarily bad. It could be argued that, given the large OPEC surpluses, the large net export surplus of the United States in 1975 (\$20.4 billion) was inappropriate. However, unless there were strong reasons to believe that the decline in net exports was temporary, the decline could have been viewed as a forerunner of eventual dollar decline on the exchange market. The fact that the economy of the United States was expanding more rapidly than those of its important trading partners suggested that the decline in net exports was more likely to be an ongoing process than a one-shot event. A further decline in net exports in 1977 of \$18.5 billion confirmed this hypothesis.

During 1977 other countries accumulated dollar reserves in an effort to keep their own currencies from rising in value relative to the dollar. But basically the U.S. policy was to avoid intervention in the exchange markets. The result was a rapid adjustment of the exchange rate during 1978 rather than the more gradual change that might otherwise have occurred over the whole period 1976-78.

After witnessing a declining net export surplus trend, the United States had two policy choices if it acted promptly. It could have taken steps to slow down the domestic expansion, thus reducing the rate at which imports were being drawn into internal markets and having some moderating effect on the rate of inflation. Or it could have decided to continue the expansion and to discourage foreign support of the dollar, thus producing a gradual fall in the dollar's value abroad rather than a sudden one. At a minimum, however, the United States should not have ignored the foreign sector and then been surprised by the inflationary fallout and other consequences of dollar devaluation in 1978.

#### *Foreign Price Shocks*

In 1973 OPEC quadrupled the dollar price of crude petroleum. Two immediate consequences of this action are especially worth noting. First, the value of imports of crude petroleum, petroleum products, and other energy supplies was suddenly raised. Second, despite the controls imposed on prices of domestic oil, the U.S. price level rose sharply, resulting in a loss of real income for most Americans.

Since the increased value of imports had to be paid to foreigners, the United States had to increase net exports or borrow abroad.

Initially the apparent desire of the oil-producing countries to hold their increasing wealth in American assets—that is, to lend to the United States—was sufficient to sustain the exchange value of the dollar. However, the OPEC trade surplus began to decline as the oil-producing countries displayed a surprising appetite for increased imports as well as an interest in a diversified portfolio of assets not wholly confined to the dollar.

All this meant that eventually the United States would have to divert more resources into the production of exports and import substitutes. Thus there would have to be a reduction in U.S. domestic absorption of goods, relative to the level that would have been sustained at high employment, to accommodate the resource shift. That is, Americans would have to live within their reduced means. This is of course more easily said than done. For which component of absorption is going to be cut—consumption, investment, or government spending? And which groups in society will bear the burden of the reduction in real national income?

The immediate price level effects of an OPEC-type shock create a difficult issue for public policy. Clearly, a big difference exists between such an exogenous price increase and one resulting from general excess demand. In theory, the OPEC price increase could have been neutralized if other prices had been made to fall. But the ability of monetary and fiscal policy to produce absolute price declines sufficient to offset a quadrupling of oil prices is questionable. Some inflation after the OPEC increase was inevitable and simply reflected the real income loss in the face of the downward inflexibility of American wages and prices.<sup>13</sup>

### *The Dollar Overhang*

Throughout the postwar period, the dollar has served as the world's primary reserve currency, that is, the currency in which foreign monetary authorities held their nations' international reserve balances. For the most part these holdings represent voluntary accumulations. At times, however, foreign central banks have sought to prevent the appreciation of the currencies through purchases of dollars in the exchange market, even in periods when the United States

13. As noted in the text, the initial loss of real income was primarily a matter of accruing liabilities to OPEC. When OPEC increased its demand for imports and transferred some of its holdings into nondollar assets, a real transfer of output was necessary.

did not wish to resist dollar devaluation. Foreign officials have therefore acquired a larger volume of dollar balances than they would ordinarily choose to hold. These balances—sometimes called the dollar overhang—constitute dollar holdings that foreign governments might not normally wish to hold for their portfolios. The overhang has been estimated at \$60 billion.<sup>14</sup> Should these dollars be released into the currency markets rapidly, the dollar would be further devalued, thereby adding to the upward pressure on prices. Furthermore, if foreign central banks attempt to unload unwanted dollars whenever the dollar appreciates, significant appreciations will not take place. Speculators will then view the dollar as having only a downward option, and the dollar will be prone to unstable downward movements.

One option for the United States would be to squeeze domestic absorption sufficiently to be able to buy back the dollar overhang. A second would be to transfer the overhang to the International Monetary Fund in exchange for special drawing rights or some other nondollar assets. A third would be to persuade foreign central banks simply to retain the overhang until the volume of world trade became large enough to create a demand for the unwanted dollars as transactions balances. Obviously, all these options involve international cooperative arrangements.

### *Domestic and International Economic Policy: The Interaction*

At present the objectives of domestic and international policies coincide. The United States needs to reduce its inflation rate. To make this reduction, it has adopted a series of policies aimed at inflation restraint. These include a restriction on budget expenditures, a boost in interest rates, and a reduction in monetary expansion. Also included is a policy of direct intervention in wages and prices and other supplementary programs.

To the extent that these policy actions are perceived as anti-inflationary, the exchange value of the dollar will be supported. Inflation restraint will tend to reduce relative costs of production in the United States, thus stimulating exports and reducing imports. The somewhat greater slack in the economy that will result will permit transfer of real resources into export and import-competing production.

14. Lawrence B. Krause, "The 1979 International Business Outlook," *Economic Research* (Goldman Sachs Economic and Financial Market Research Group, February 1979), p. 6.

From the standpoint of foreign and domestic asset holders, a reduction of the inflation outlook improves the dollar's usefulness as a vehicle for investment. To the extent that the value of the dollar rises on exchange markets—or at least stops declining—the inflation outlook is improved, although possibly at a cost of a greater loss of U.S. output. It is to be hoped that participants in the foreign-exchange market are under no illusions as to the speed with which the measures adopted by the United States will slow the rate of inflation. By any reckoning, the road back to price stability will be a long one.

#### Direct Intervention in Wage and Price Setting

Because of the limited response of inflation to demand-restraining policies, governments in all industrialized countries have sought other means to influence wage and price decisions directly. The diagnosis of a wage-price spiral suggests that inflation will perpetuate itself unless some outside force changes inflationary psychology and puts downward pressure on a large number of wage and price setters simultaneously. This type of diagnosis ultimately led to the guidelines program announced in October 1978, after a milder effort to promote deceleration of inflation through exhortation was abandoned.

The new guidelines program is nominally voluntary; it is not backed by the force of law. Pains are taken to distinguish the program from mandatory controls. Yet the distinction is one of degree. Larger government contractors are required to certify that they have complied with the standards. The legality of this aspect of the program has been challenged. But even without it, large firms and contractors would probably feel compelled to comply. Although the program is voluntary, the Council on Wage and Price Stability filled the *Federal Register* with rules of good behavior that are hard to distinguish from regulations. Larger companies were requested to send in reports to the council, just as they would be required to do under controls.

It is important to avoid dogmatism in assessing the new program. A common response to the effort has been the assertion that "controls don't work." Yet the evidence is mixed. During the Korean War, wage-price controls were accompanied by relatively stable prices and no bubble of repressed inflation escaped when the con-

trols were lifted. Since the mid-1960s there have been episodes of controls, other forms of direct wage-price intervention, monetary restraint, and fiscal restraint. It is hard to say which policy didn't work in recent years. No policy was highly effective.

#### Specifics of the Wage-Price Guidelines

Under the new guidelines, firms must decelerate their annual rate of price increase by 0.5 percent relative to the increase experienced in the base period 1976-77, with a maximum increase of 9.5 percent allowed. In addition, a minimum increase of 1.5 percent is permitted without question. Firms that cannot comply with the deceleration standard because of uncontrollable cost increases are permitted cost-justified price increases. Under cost justification, firms are required to limit their profit markups to the margin experienced during the best two of the three fiscal years preceding October 2, 1978. Their profits per unit of output, however, are not to rise more than 6.5 percent. Special rules apply to certain industries and to state and local agencies.

On the wage side, pay adjustments are limited to 7 percent a year unless they were set forth in contracts or pay practices before the guidelines announcement. Union contracts can include 8 percent wage increases in the first year of multiyear contracts averaging 7 percent a year. Maintenance of benefits increased by such factors as rising insurance premiums is chargeable only up to 7 percent. Certain costs of maintaining pension benefits cannot be charged at all. And union escalator clauses must be charged as if the inflation rate were 6 percent, regardless of the actual experience.

Both the pay and price standards allow exceptions for "gross inequities." But the pay standard also provides exceptions for pre-guidelines tandem relationships, post-guidelines tandem relationships, productivity bargaining, and labor shortages. In addition, low-wage workers (those earning four dollars an hour or less) are exempt from the 7 percent standard. Special rules cover certain types of executive compensation, such as stock options. Professional fees are limited to an average annual increase of 6.5 percent.

#### Administration of the Guidelines

The guidelines program is very ambitious. It is apparent that the program's administrators really wish to concentrate on larger firms

and wage-determining units. But the rules nominally apply to firms and units of all sizes, including governments. The Council on Wage and Price Stability (COWPS) is requesting funding for an additional 90 staff members, which would bring the total to 233. By comparison, the wage-price controls of Phase II (late 1971 to early 1973) involved a staff of about 4,000 people. And the Phase II controls exempted small businesses (in most industries) with 60 or fewer workers.

COWPS faces a dilemma under the current arrangements. Even with 233 staff members, the council will be swamped with work. And even if there were a desire to increase the staff further, there are limits to the speed at which an agency can expand. The new program does impose obligations on wage and price setters, despite its voluntary label. Therefore, COWPS must be prepared to answer questions, hear appeals, and generally regularize procedures. If regularization does not prove to be possible, a reduction in coverage of the program—given the staff size and workload—must be seriously considered.

Obvious areas for the reduction of program coverage are small businesses, public utility prices, and rents. A small business exemption would have to be carefully worded to avoid exempting small firms covered by major union contracts involving many employers. But in general, small businesses are not likely to be sources of strong, administered wage or price pressures. (If they become sources of demand-induced pressures, COWPS can do little about it.) Public utility rates are already regulated by governmental agencies on a cost-markup basis; additional regulation is superfluous. Rent coverage is virtually meaningless. There are simply too many rental housing units for COWPS to undertake meaningful rent controls. Such controls would probably have undesirable consequences, even if they were possible. Rent complaints took up an inordinate amount of time and resources during Phase II of the controls program under the Nixon administration.

Before the announcement of the guidelines, COWPS had an ongoing program of review of regulatory decisions and general research into cost problems of certain industries. A certain tension exists between the guidelines operation and the regulatory activities. For example, COWPS may find itself asking for guidelines cooperation from firms and unions with which it has a disagreement concerning regulatory policy. Therefore, it would be useful to insulate the regu-

latory and guidelines components of COWPS activities from each other.

### *Can Guidelines Help?*

By itself, the guidelines program is obviously not a cure-all for inflation. But movements in real economic growth are expected to be in an anti-inflation direction by late 1979. Slower growth would reinforce the guidelines effort. It is possible, however, that economic forecasters have underestimated the momentum of expansionary forces. Output in the fourth quarter of 1978 rose at a surprisingly rapid 6.9 percent annual rate. Continued fast growth could turn 1979 into a repetition of 1966 and 1973, when strong expansionary forces destroyed efforts at direct intervention in wages and prices.

With good luck, the guidelines could reduce the inflation rate by as much as one percentage point. With moderate luck, the guidelines might at least prevent short-run inflationary impulses from food and fuel from becoming permanently embodied in the wage-price spiral. With bad luck, the guidelines could be blown apart by a food-fuel price explosion, leading to a rejection of the guidelines in a major collective bargaining situation or to simply a loss of confidence in the program by the public.

In short, whatever success occurs is likely to be modest. The public must be told not to expect miracles. The guidelines authorities should avoid the temptation to grasp at food-fuel problems that are beyond their reach. In 1973 attempts to control meat prices quickly emptied supermarket meat counters. Attempts to prevent world oil prices from being reflected at U.S. service stations led to gasoline lines and informal rationing. These mistakes should not be repeated.

Clearly, attempting to operate a wage-price program with only a limited threat of sanctions in a period of inflation requires a deft touch. A repudiation of the standards, especially by a powerful union, could so severely compromise the entire effort that it would be difficult to ask for continued compliance from other unions and firms. The surge in price inflation in early 1979 accentuated this dilemma. Inflation makes it more difficult for union leaders to sell a moderate contract to their constituents. One possibility for the guidelines authorities would be to adjust the wage standard so as to avoid such confrontations. This could involve preserving the nominal 7 percent wage standard while allowing exceptions for keeping up with

inflation. Another option is simply to continue the program as it was established in late 1978, on the assumption that the inflation surge is temporary and that it will recede in the latter part of the year. Such a stance preserves credibility but makes the program more vulnerable to confrontation and possible collapse.

#### *Real Wage Insurance*

The most novel feature of the wage-price guidelines program was a proposal for real wage insurance. Under this plan, workers in employee units that negotiated within the wage standard would receive a tax rebate designed to protect the purchasing power of their wages if price inflation climbed above 7 percent. It was the view of the designers of this concept that, by limiting the risk and cost to workers of wage restraint, real wage insurance would induce more voluntary compliance than the simple announcement of a wage standard. This expectation accounts for the surprising combination of a system of tight wage restraints applicable to the entire economy but carried out by a very small staff.

Prospects for real wage insurance were dimmed by a number of factors; two are specially worth noting. First, as a piece of tax legislation, the proposal had to be submitted to a skeptical Congress that was concerned about the potential loss of tax revenue. When the concept was first proposed in October 1978, the administration's projection of the rate of inflation for 1979 was below 7 percent. Hence real wage insurance was not anticipated to involve an actual revenue loss. But by the end of 1978 it was apparent that the earlier estimate was too low and that real wage insurance would probably involve significant rebates.

Second, the implementation of real wage insurance is a complex matter. Labor compensation is received in various forms, including fringe benefits, and wage increases sometimes occur through such mechanisms as merit plans, bonuses, and promotions. Rules must be established and written into the tax code dealing with all these characteristics. Special complications also arise because taxpaying units are not identical to wage-determining units. Sometimes wage units include more than one firm. In such industries as apparel, lumber, longshoring, trucking, railroads, and steel, employers have banded together in formal associations to establish uniform wage contracts. In other industries firms may not be formally linked, but may have a

de facto relationship through pattern bargaining. The Internal Revenue Service is not accustomed to dealing with such matters.

Congressional skepticism delayed action on real wage insurance. Since the plan was designed to influence wages over the twelve-month period beginning October 1, 1978, the delay in enactment tended to reduce the likelihood of enactment. More and more wage setters were forced to make their decisions in the absence of real wage insurance. Thus the incentive effects of the proposal were diminished. Besides, labor support was not enthusiastic. Some unions endorsed the concept, subject to particular adjustments that they wished to see included. The AFL-CIO initially opposed the plan, mainly because it was seen as an appendage of the detested wage guideline. Later the AFL-CIO gave the proposal qualified support, but only if the plan were liberalized to include more workers and combined with an excess profits tax. Business groups did not support the plan. Members of Congress, therefore, felt little urgency about handling the proposal; the main source of support came from the Carter administration itself.

The specific real wage insurance plan presented to the Congress in mid-January by the administration contained three major limits on the potential dollar outlay. First, it limited the maximum rate of inflation that was to be insured to 10 percent over the period October–November 1978 to October–November 1979. Thus a worker with a \$10,000 income in 1979 could have received no more than \$300 (10 percent minus 7 percent times \$10,000), even if inflation exceeded 10 percent. Second, a worker could have received no more than \$600 a job. Third, the rebate itself would have been taxable (just as wages paid under a cost-of-living escalator would be). In addition, only wage and salary earners would have been eligible. Self-employed persons and pensioners were to be excluded. The administration estimated that real wage insurance would reduce tax receipts by \$2.3 billion a year and raise outlays by \$0.2 billion at an assumed 7.5 percent inflation rate. But obviously the cost could have been much higher—or zero—depending on price movements and the number of workers qualified.

A number of compromises were made in drafting the plan. Since COWPS was not prepared to certify the wage increases of every employer in the country, the proposed costing rules for wage increases had to be both understandable to the employer and verifiable to the

Internal Revenue Service. As a result, the rules did not reflect certain exceptions for wage increases permissible under COWPS rules. Furthermore, there were differences between the proposed real wage insurance rules and the guidelines with regard to low-wage workers, fringe benefits, and other costing technicalities. So it was possible for workers to qualify under one program but not under the other. The tension between administrative feasibility for a tax program and the need for flexibility in a guidelines program made these discrepancies inevitable.

Anomalies would have resulted from the treatment of two special groups. Low-wage workers were exempt from the guidelines program but covered by real wage insurance. Increases paid to such workers above 7 percent (like the 9.4 percent increase in the minimum wage on January 1, 1979) might or might not have prevented low-wage workers from being eligible. This depended on such factors as whether they were a significant portion of the firm's work force and what kinds of increases were granted to higher-wage workers. Workers under union contracts signed before the guidelines were announced were to be eligible if their pay increases were 7 percent or less. Thus low-wage workers might have been rewarded for complying with a program from which they are exempt, while workers under pre-guidelines contracts might have been rewarded for complying with a program that did not exist when they negotiated. On the other hand, a decision to exclude these two groups of workers would also have produced results that some would find strange or inequitable.

Despite the anomalies, the plan presented by the administration seemed capable of being administered. But amendments to the plan to deal with the problems of particular groups, to reflect individual circumstance, or to track the COWPS standards more precisely could have easily pushed the plan beyond administrative feasibility. As a result, Congress had to accept the administration's plan more or less as presented or reject it; there was no significant room for compromise. In April the House and Senate Budget committees eliminated real wage insurance from their proposed budget resolutions, an action that made passage of the measure highly unlikely.

#### *Future Use of Direct Intervention*

The pressures on government to use direct intervention techniques to deal with inflation are strong. Thus it seems safe to predict that no

matter what happens to the particular guidelines program announced in October 1978, there will be other such programs. As for the 1978 program, its fate will be partially determined by price developments in sectors in which direct intervention can have little or no effect. These include prices set in international markets and agricultural prices. The public does not make sectoral distinctions in viewing such programs as successes or failures.

One area of speculation is the possibility that the guidelines program would become a formal, mandatory controls program. Actually, the distinction between a formal controls program and a voluntary program is a matter of degree. Larger corporations appeared to view the program as equivalent to controls, although their cooperation seemed partly predicated on a desire to avoid formal, mandatory limits on prices. They reported to COWPS as requested and followed the detailed rules in the *Federal Register*. The biggest potential for overt noncompliance came from the major collective bargaining settlements due to be reached in 1979.

If the guidelines are to remain practical for an extended period, greater formalization of procedures will be necessary. There will need to be more staff for wage and price monitoring, a formal and acceptable review process for appeals, and a resolution of legal issues, such as the right of the federal government to require its contractors to comply with the standards. Since the program is especially aimed at influencing major collective bargaining settlements, better communication links will need to be established between the administration and the labor movement. The program's administrators will have to prepare themselves to deal more flexibly with sensitive cases than was the original intent when the program was announced. Furthermore, difficult decisions will have to be made about the numerical wage guideline in 1980 and beyond.

#### **Government Regulatory Activities and Inflation\***

Traditionally, the federal government's priorities have been set through the budgetary process. For example, after the launching of the first Russian satellite in the late 1950s, public attention was focused on supporting U.S. education and research. This concern

\* Robert W. Crandall contributed to this section.

was a major factor in the tenfold increase in federal support to education between 1960 and 1978. But increasingly, important national priorities are being set and policies are being followed in ways that are only marginally reflected in the federal budget. This extrabudget activity is occurring through government regulation. Federal regulations are issued to achieve such goals as improved worker safety or a cleaner environment. These regulations impose costs on private industry rather than on the federal budget, thus making the costs more difficult to detect. To the extent that these added costs are not absorbed by lower profits or wages, they increase the price level.

### *Types of Regulation*

Government regulation is not new. A body of old-style regulatory measures that has existed for many years was often intended to have a direct effect on prices or costs. Farm price supports, as an example, were established to raise agricultural prices in order to benefit farm incomes. Minimum wage laws were enacted to raise the incomes of low-wage workers. Tariffs raise the prices of imported goods, thus providing protection to U.S. import-competing firms.

Some of the newer regulatory agencies like the Occupational Safety and Health Administration (OSHA) and the Environmental Protection Agency (EPA) are not principally interested in price effects.<sup>15</sup> But since the actions of new agencies do affect costs, their decisions affect prices and the efficient use of resources. This fact does not imply that all regulatory actions that have a price-raising effect should be banned; it means simply that the price effect should be considered in determining whether the result is worth the cost.

Two issues arise in connection with old-style regulations designed to influence prices and costs. First, for those policies meant to raise incomes, it can be asked whether alternative income security measures—especially those involving transfer payments—might be both more effective and less inflationary. There has been a long-standing controversy, for instance, over the employment and inflation effects of the minimum wage. Statistical studies suggest that minimum wage floors reduce employment opportunities, so that while those who remain employed (at the same number of hours) receive higher in-

15. The classification of regulatory agencies as old-style or new-style is by no means precise. For instance, federal regulation of food and drugs, which began in 1907, would be a new-style program in this classification, despite its age.

comes, others suffer income losses.<sup>16</sup> According to this argument, the minimum wage is deficient as an income raiser for low-wage workers; at the same time, it tends to raise costs and ultimately prices. It has also been noted that programs that raise farm prices benefit larger and wealthier farmers along with the small low-income farmer who is often viewed as the target.<sup>17</sup>

Even when regulations have adverse or unintended side effects, there is a political obstacle to the adoption of alternatives. It is possible that the income redistributions resulting from price-raising policies would not be acceptable through the standard budgetary process. A natural tendency exists for those who currently benefit from price-raising policies to prefer the more indirect regulatory approach to income support.

Economic conditions and the nature of the regulations can change, producing results contrary to the original intentions. In the late nineteenth century, railroads had a monopoly on long-distance transportation in many parts of the country. Since that time, however, alternative means of transportation—notably trucking—have developed. The regulatory methods of the Interstate Commerce Commission have tended to limit the ability of railroads to initiate price reductions. Moreover, because railroads were regulated, regulation naturally spilled over into interstate trucking, an industry that would otherwise be competitive.<sup>18</sup>

Regulation of airline transportation poses a related dilemma. The Civil Aeronautics Board (CAB) claimed to benefit the consumer by providing incentives for airlines to offer regular and frequent flights, even to areas of comparatively little traffic. This goal was accomplished by keeping prices high and stable, and by permitting airlines to compete in terms of service or by simply requiring minimum levels of service. Inhabitants of a city who themselves rarely fly nonetheless benefit from knowing that a regular flight is available should they suddenly need it. But airlines cannot recapture the costs of providing these benefits except from those who do fly. Hence the CAB

16. Edward M. Gramlich, "Impact of Minimum Wages on Other Wages, Employment, and Family Incomes," *BPEA*, 2:1976, pp. 409-51.

17. Robert W. Crandall, "Federal Government Initiatives to Reduce the Price Level," *BPEA*, 2:1978, pp. 408-14.

18. In 1974 over 65,000 establishments were reported to be in local and long-distance trucking. The average number of employees per establishment was less than sixteen. Only about 37 percent of all truck drivers in 1970 were employed in the "trucking service" industry.

effectively built the service costs into airline price schedules and prevented price competition from eroding those schedules. Although a service-price trade-off exists, the tilt of public policy toward service was viewed as excessive by new leadership at the CAB even before the passage of the Airline Deregulation Act of 1978. In passing that legislation, Congress effectively decided that the benefits from extra service did not justify the costs in terms of higher air fares. The CAB was instructed to be less protective of existing carriers by allowing more entry and fare competition.

#### *Measuring Costs and Benefits*

In recent years economists have pressed the newer regulatory agencies to use more explicit cost-benefit analyses in making their decisions. A standard response to arguments relating to costs and price effects of regulation is that evaluations of the benefits receive a lesser emphasis. Measures of social output often omit such benefits; the value of cleaner air is not included in the GNP directly. But there are also difficulties in assessing costs. Nor is it entirely true that the benefits from regulation are omitted from all official measurement. For example, the addition of smog devices to automobiles is implicitly treated as a benefit to the consumer in the consumer price index, that is, as a quality improvement that offsets the added cost. The measured rate of automobile price inflation would have been substantially higher in recent years had not government-mandated equipment been assumed to provide a benefit to the consumer equal to the cost of its production. Indeed, the consumer price index has not been adjusted (upward) for a degrading of quality (from the consumer viewpoint) inherent in the reduced performance, the requirement to use more expensive unleaded gasoline, and the downsizing of larger models. It could be argued that the consumer price index both overstates the quality and understates the costs of new cars.

Even the most ardent proponents of regulation are hard put to come up with specific benefit estimates. Perhaps an estimate can be made of death and illness rates associated with certain levels of air pollution and perhaps the costs associated with deaths and illness can be measured. (Even these suppositions are heavily dependent on data that often do not exist in reliable form.) But how does one measure the value of a clean atmosphere to persons who would neither die nor become ill if pollution controls were relaxed?

From a pure inflation standpoint, the cost side of regulation is especially hard to measure. What matters for overall price effects is the degree to which costs are ultimately reflected in prices. Since some costs could be absorbed by labor or capital, the impact on the consumer price index could be less than the total cost of compliance would initially suggest. If working conditions in an industry are made less hazardous, for example, wages may reflect the greater attractiveness of the job by increasing more slowly than they otherwise would.

Despite these qualifications, estimates of the costs of some of the newer regulatory programs are impressive. For instance, the prospective annual costs of environmental controls for industry required to be in place by 1977 were \$2.5 billion. The cost of OSHA's actual or proposed regulations for nine major health standards have been estimated at more than \$4 billion a year. These costs are likely to increase substantially as OSHA moves aggressively to limit possible carcinogenic exposure and as EPA moves toward various statutory deadlines required under the Clean Air Act, the Federal Water Pollution Control Act, and the Toxic Substances Control Act. In 1977 dollars, EPA's regulations are likely to be costing more than \$44 billion a year by 1983, excluding emission controls on automobiles.<sup>19</sup> Denison has estimated that in 1974 and 1975 pollution abatement and health and safety expenditures had reduced the measured rate of growth of total factor productivity by 0.3 percentage point a year, a significant reduction in a series that grew at a 2.6 percent rate from 1948 to 1969.<sup>20</sup> Even though these estimates are only approximate, it is evident that substantial resources are being directed by the federal government outside the budgetary mechanism, thereby raising questions of efficient resource utilization as well as of inflationary impact.

The lack of executive review and the difficulties in measuring the results of new-style regulations present a serious problem for government policy. A suggestion has been made that a budget for regulation be created and that each agency be assigned a dollar quota of costs it can impose on the economy. The agency would live within its quota just as conventional agencies live within their budgets.<sup>21</sup> Of course, this proposal assumes that reasonable cost estimates can be

19. Crandall, "Federal Government Initiatives," pp. 420-22.

20. Edward F. Denison, "Effects of Selected Changes in the Institutional and Human Environment Upon Output Per Unit of Input," *Survey of Current Business*, vol. 58 (January 1978), pp. 41-42.

21. Crandall, "Federal Government Initiatives," pp. 429-30.

made. Undoubtedly, were a regulatory budget system established, a bargaining process would develop between the regulatory agencies and whatever group—perhaps the Congress—allocated the dollar volume of costs included in the budget. Ultimately the budget would have to reflect public feelings about regulatory activity, feelings that may be more favorable to it than economists have tended to acknowledge.<sup>22</sup>

#### *Current Anti-Inflation Policies Concerning Regulatory Costs*

So far, no attempt has been made to implement a full-fledged regulatory budget. The establishment of such a system would require congressional consent and executive direction. But a more modest program begun in the Ford administration has been expanded by President Carter, most recently as a component of the anti-inflation policies announced last October. The Carter administration formed a regulatory analysis review group to consider economic impact analyses for major new regulations and to make recommendations to the President. An agency must submit these analyses for each regulation with an aggregate impact of \$100 million per year. This process has affected some proposed regulations, but the ultimate outcome has yet to be determined.

#### *Deregulation*

Deregulation of the airline industry began with a series of administrative reforms at the Civil Aeronautics Board. The new stance taken by the CAB was officially endorsed by Congress in 1978 with passage of the Airline Deregulation Act. From April 1978 to October 1978, airline fares fell at an annual rate of 2.6 percent, whereas from April 1977 to April 1978 they had increased 6.3 percent.<sup>23</sup>

It appears that moves to deregulate ground transportation, chiefly trucking and railroads, may be seriously considered in this Congress. These two sectors pose a more complex problem for the deregulation strategy than airlines do. Trucking and railroads compete for the same customers in many cases, so that a two-industry deregulation

22. A recent survey suggests that a substantial part of the public may be disposed toward the imposition of high costs entailed in pollution control and other environmental programs. See Robert Cameron Mitchell, "The Public Speaks Again: A New Environmental Survey," *Resources* (Resources for the Future, September-November 1978), pp. 1-6.

23. Data refer to the airline fares component of the consumer price index.

approach will be necessary. The trucking industry causes special problems because of the multitude of truck operators and the divergent interest groups within the industry. Regulation of trucking has embedded economic rents in the balance sheets of firms in the industry and in the wage rates they pay. A return to unregulated competition would eliminate these rents. Clouding the prospects for deregulation is opposition from the Teamsters.

Related to deregulation is the ongoing effort to lower tariff and nontariff barriers in world trade. As part of the Tokyo Round of the Multilateral Trade Negotiations, U.S. tariffs on imports are expected to be cut by 30 percent. Such cuts would be phased in over a period of time. The impact of such cuts on aggregate price measures like the consumer price index would be quite small. In any case, the agreement would have to be approved by Congress. And there is always a possibility that pressures for trade protection could build—especially during a period of rising unemployment—thereby obstructing congressional passage. Moreover, pressures for special import-limiting actions could come from certain industries. Under existing authority of the President, import-restricting measures have been undertaken in recent years for shoes, television receivers, and steel. Therefore, the extent of deregulation to be expected in the international trade area is uncertain.

Projected expenditures in fiscal 1980 for farm price support programs are a little more than half of the expected 1979 expenditure levels. This decrease does not signal substantial deregulation in agricultural price support policy. Rather, it reflects an expectation of high farm prices, which reduce the amount of government activity needed to support a particular level of farm income. Farm income is highly volatile, but on a per-farm basis, real income in calendar 1978 rose significantly over the previous year. Compared with the 1973 period, when farm income soared in response to a dramatic rise in world food prices, current farm incomes may seem disappointing to farmers.<sup>24</sup> As in the case of tariffs, government policies affecting farm prices are politically sensitive. A major effort to increase farm income levels could easily overwhelm the effects of deregulation elsewhere.

24. Though it did not reach the peaks of 1973, real farm income was 15 percent higher in the third quarter of 1978 on a seasonally adjusted annual basis than in 1977.

Despite these pitfalls, in several important sectors of the economy a strategy of deregulation can have beneficial effects in an anti-inflation program. And apart from the anti-inflation effects, deregulation can promote increased economic efficiency in the use of resources. However, with increased economic efficiency could come reduced incomes to some participants in target industries. Thus, to ease the transition, it may be necessary to phase in deregulation over an extended period, a strategy that would reduce the anti-inflation impact in any given year. Alternatively, some form of compensation to injured parties may have to be provided.

On April 5, 1979, the President announced a plan for the gradual deregulation of domestic oil prices. Controls on energy prices create a dilemma for the administration. Deregulation will raise prices initially. But controls have produced inefficiencies in usage and production that could lead to cost savings if alleviated. Decreased oil imports would result from higher domestic production and lower consumption, possibly raising the value of the dollar in international markets. This would help moderate the price pressures.

#### Inflation and Unemployment in the Longer Term

In October 1978 the President approved the Full Employment and Balanced Growth Act, better known as the Humphrey-Hawkins Act. As originally introduced, the act would have mandated achievement of specified employment targets. In its final version the bill simply set forth various objectives and required reports from the President and the Federal Reserve. Indeed, the bill became a hodgepodge of mixed objectives relating to unemployment rates, inflation, the ratio of federal spending to GNP, and "parity" for farm prices.

The targets for unemployment were specified as 4 percent for the overall rate and 3 percent for the rate for workers aged twenty and over. These rates are supposed to be achieved by the end of 1983, and the President is required to set a series of interim goals to accomplish this reduction in unemployment. The 1979 Annual Report of the Council of Economic Advisers (CEA) has dutifully set forth such goals as required.<sup>25</sup> But the targets raise some questions.

First, there is a technical question of the consistency of the unemployment targets. The overall target of 4 percent and the adult

25. *Economic Report of the President, January 1979*, p. 109.

Table 3-5. Unemployment Rates for Selected Groups and Deviation of Real GNP from Trend, 1960-78  
Percent

Year	Unemployment rate					Deviation of real GNP from trends
	Workers aged 16 and over	Workers aged 16-19	Workers aged 20 and over			
			Total	Male	Female	
1960	5.5	14.7	4.8	4.7	5.1	-3.8
1961	6.7	16.8	5.9	5.7	6.3	-4.7
1962	5.5	14.7	4.9	4.6	5.4	-2.6
1963	5.7	17.2	4.8	4.5	5.4	-2.2
1964	5.2	16.2	4.3	3.9	5.2	-0.6
1965	4.5	14.8	3.6	3.2	4.5	1.7
1966	3.8	12.8	2.9	2.5	3.8	4.1
1967	3.8	12.8	3.0	2.3	4.2	3.3
1968	3.6	12.7	2.7	2.2	3.8	4.1
1969	3.5	12.2	2.7	2.1	3.7	3.2
1970	4.9	15.2	4.0	3.5	4.8	-0.7
1971	5.9	16.9	4.9	4.4	5.7	-1.2
1972	5.6	16.2	4.5	4.0	5.4	0.9
1973	4.9	14.5	3.8	3.2	4.8	2.8
1974	5.6	16.0	4.5	3.8	5.5	-2.1
1975	8.5	19.9	7.3	6.7	8.0	-6.6
1976	7.7	19.0	6.5	5.9	7.4	-4.6
1977	7.0	17.7	5.9	5.2	7.0	-3.4
1978	6.0	16.3	4.9	4.2	6.0	-3.0 <sup>b</sup>

Source: *Economic Report of the President, January 1979*, pp. 184, 216-17.

a. Trend estimated logarithmically over 1947-78.

b. Based on preliminary data.

target of 3 percent are roughly consistent. They imply a rate of unemployment for those sixteen through nineteen years of age of about 13 percent, which rate, historical evidence suggests, would be achieved if the adult rate were to fall to 3 percent.<sup>26</sup> For example, as shown in table 3-5, in recent years the adult rate has differed from the overall rate by about 1 percentage point.

26. Regression analysis suggests that a 1 percent increase in the ratio of real GNP to trend will lower the unemployment rate for adults by about 0.3 percentage point and the teenage unemployment rate by about 0.6 percentage point. Thus the adult unemployment rate would have fallen to about 3 percent in 1978 had the ratio of real GNP to trend been about 6 percent higher (see table 3-5). If the ratio had been 6 percent above its actual value, the teenage rate would have fallen to a little over 12 percent. The combination of the two rates would have produced an overall rate close to the 4 percent target. These estimates were derived from annual regressions—which also included time trends and autoregressive corrections—run over the period 1948-77.

A second, and more fundamental, question is the achievability of a 4 percent overall rate. Table 3-5 shows that the overall unemployment rate dipped below 4 percent during the late 1960s, but has never done so since. A number of factors contributed to the drop in unemployment at that time, including the military draft and the development of a variety of government-supported employment and training programs.<sup>27</sup> Also of importance was the dramatic expansion of the economy into a clear excess-demand boom. As a measure of demand pressure, table 3-5 includes the deviation of real GNP from its trend value as estimated over the period 1947-78. During the late 1960s, the period of the Vietnam War buildup, real output as measured by GNP was 3 to 4 percent above its trend value, indicating an unsustainably high utilization rate of economic resources. The period of the late 1960s was also marked by a substantial acceleration in the rate of inflation. Thus a stimulation of the economy to the labor force utilization rates achieved in the late 1960s would probably lead to an acceleration of the current inflation rate.<sup>28</sup> Yet the Humphrey-Hawkins target for the inflation rate is 3 percent by 1983 and zero by 1988.

In recent years it has been argued that the level of demand pressure associated with a given unemployment rate has risen. This change is usually related to demographic changes in the labor force, notably the relative growth in teenage and female participation. As table 3-6 shows, by 1977 the proportion of teenagers (sixteen through nineteen) in the civilian labor force had risen from 8.4 percent to 9.5 percent and the proportion of adult women had risen from 32.9 percent to 36.6 percent. If 1967 is used as a base, these changes alone

27. From 1964 to 1969 the number of people in the armed forces increased by 767,000—substantially drawing from the labor market. Some of these people would otherwise have been employed or not have been in the labor force. Nevertheless, it is likely that the draft did significantly lower the unemployment rate. The Manpower Development and Training Act of 1962 initiated a period of increased federal employment and training efforts. By fiscal year 1969 the Department of Labor reported a total of 889,500 "enrollment opportunities" in training and employment. About 44 percent of these were special summer jobs for youths. One author estimates that the draft and direct government job programs accounted for about three-fourths of the decline in unemployment during 1964-69. See Charles C. Killingsworth, "The Fall and Rise of the Idea of Structural Unemployment," *Proceedings of the Industrial Relations Research Association, 1978* (Madison, Wis., 1979), p. 9.

28. It is impossible to be certain of this statement. During the Korean War utilization rates were also high and yet inflation rates were moderate, partly because of the imposition of wage-price controls.

Table 3-6. Demographic Changes in the Labor Force and Unemployment Rate in Selected Age and Sex Groups, 1967, 1977, 1985, and 1990

Group	Proportion of civilian labor force				Unemployment rate	
	1967	1977	1985	1990	1967	1977
Young people aged 16-19	8.4	9.5	7.6	7.0	12.8	17.7
Males aged 20 and over	58.6	53.9	51.9	51.0	2.3	5.2
Females aged 20 and over	32.9	36.6	40.5	42.0	4.2	7.0
Total	100.0	100.0	100.0	100.0	3.8	7.0

Source: Data from Paul O. Flaim and Howard N. Fullerton, Jr., "Labor Force Projections to 1990: Three Possible Paths," *Monthly Labor Review*, vol. 101 (December 1978), p. 29; *Employment and Training Report of the President, 1977* (GPO, 1977), pp. 139, 167; *Monthly Labor Review*, vol. 102 (February 1979), p. 76. Figures are rounded.

would add about 0.3 percentage point to the unemployment rate. For many reasons teenagers and women typically have higher unemployment rates than adult males.<sup>29</sup> Hence, as the proportion of women and teenagers in the labor force rises, the average unemployment rate tends to rise.

Projections of the labor force to 1985 and 1990 suggest that this demographic effect will taper off. The proportion of teenagers in the labor force will drop as a result of the lowering of the birthrate that began in the 1960s. By 1990 this change will just about offset the projected increased participation of adult women in the labor force, a long-term trend.<sup>30</sup> But other factors, such as unemployment compensation and similar social benefits that reduce the economic burden of unemployment, are sometimes cited as contributing to the unemployment rate.<sup>31</sup> Even if these factors are dismissed, a 4 per-

29. Teenagers and women have usually had a looser attachment to the labor force, in part because of school and home responsibilities, respectively. Other factors may include the influences of minimum wage and child labor laws, discrimination, and the availability of other sources of family incomes. As women join the labor force in greater numbers, it is possible that their labor force behavior (as well as employer attitudes) will shift. If so, the use of a base period unemployment rate would overstate the demographic effects. The estimates in the text were made using ten sex-age classifications. For an early paper on this subject, see George L. Perry, "Changing Labor Markets and Inflation," *BPEA*, 3:1970, pp. 411-41.

30. CEA estimates for 1983, however, suggest that most of the demographic effect will still be present in that year. See *Economic Report of the President, January 1979*, p. 119.

31. Other less tangible influences—such as changes in the work ethic—are also sometimes cited.

cent unemployment rate under 1983 conditions would probably be inflationary.

In its 1979 annual report, the CEA expresses as much skepticism about achieving the Humphrey-Hawkins goals as is acceptable in an official report. It notes that the twin goals of 4 percent unemployment and 3 percent inflation by 1983 "are very ambitious" and "would demand not only a performance by the American economy that is unprecedented in peacetime history, but also government programs that can deal effectively with some of our most intransigent problems."<sup>32</sup> Further, the CEA states that "we cannot reach the goals for unemployment and inflation simultaneously by relying solely on monetary and fiscal policies."<sup>33</sup> To supplement these policies, the CEA suggests continued direct intervention in wage and price setting and special targeted programs to deal with high unemployment rates (in particular demographic groups) that seem resistant to substantial lowering through demand policies.

The suggestion of reliance on direct intervention raises two important issues. If the guidelines program were to be continued until 1983, it would necessarily have to operate in a period of economic expansion. According to CEA projections, real GNP would have to expand at an annual rate of about 4.5 percent during 1981-83 to achieve the 4 percent unemployment target. Thus the guidelines program would face the difficulty of rising demand pressures. The initial outline of the guidelines program suggested a temporary effort; extending the program to 1983 would require a more permanent structure and considerable deftness by the administration.

The CEA report suggests that a number of current programs dealing with structural problems could be helpful in lowering the unemployment rate. In particular, the report singles out efforts to aim public-service jobs more effectively at unemployed, and especially long-term unemployed, persons and a special tax credit to employers hiring disadvantaged persons aged eighteen through twenty-four. However, the CEA does not assert that these programs, and others that are currently being planned, will be sufficient to reconcile the Humphrey-Hawkins objectives. The implication is that as-yet-unknown programs might be needed. This is a diplomatic way of warning the public that the CEA does not believe the targets will be met.

32. *Economic Report of the President, January 1979*, p. 110.

33. *Ibid.*, p. 117.

### Concluding Observations

Many uncertainties about anti-inflation policies remained in early 1979. Fiscal policy as it appeared in the President's budget was definitely austere. Congress has the last word on the budget, however. Some components of the budget—such as certain cuts in social security benefits—were rejected by Congress almost immediately. Real wage insurance is unlikely to be adopted. Thus the guidelines themselves will be the sole method of direct intervention in wage and price decisions. And the guidelines authorities will be confronted with the task of seeking labor cooperation in the face of considerable price inflation. Indeed, the price fallout resulting from the disruption of Iranian oil exports could easily destroy any possibility of an accommodation with organized labor. Finally, the interpretation of monetary policy is complicated by new institutional structures in financial markets.

The presence of uncertainty in economic decisionmaking is not unusual. But the diversity of viewpoints and forecasts in early 1979 was wider than at any time since 1973, also a year of price pressures. If there is one lesson that can be learned from 1973, it is that inflation forecasts can be badly mistaken, especially if there are strong external sources of price pressures. Under these circumstances, contingency planning can be especially valuable. If prices surge above the levels forecast, or if the economy slows down faster than expected, the President and Congress will be pressured to "do something." Therefore, it is important to consider options in advance of possible events, lest events dictate shortsighted and reactive responses. One possibility, of course, is that there are no feasible, untried options in reserve. But if there are new options, they should be viewed in probabilistic terms; any move has some chance of failure or undesired consequences, even if a successful outcome is expected. Following a given policy always involves some risk, and sometimes the risks outweigh the anticipated benefits.

Both monetary policy and the guidelines program illustrate the dilemma. The Federal Reserve Board could respond to the price surges in early 1979 by a further boost in interest rates. If demand continued to expand rapidly, failure to respond could encourage classical demand-pull inflationary pressures. If, however, monetary policy was already sufficiently tight—but was simply acting with a

lag—a further boost in interest rates could precipitate an unwarranted degree of economic slack. Similarly, the guidelines authorities could respond to the price surge by holding tightly to the standards already announced. Such a stance increases the risk of a confrontation with a major union. On the other hand, a loosening of the wage standard increases the risk that what might turn out to be a temporary price surge becomes incorporated in the wage-price spiral.

Since there are risks to any policy, it would be well if these were communicated to the public. Traditionally, statements of economic policy are made with assurance and optimism. Shifts in policy then appear to be repudiations of past assertions, when they actually represent responses to unexpected economic events or outcomes. Given current uncertainties, the temptation to proclaim future victories over inflation must be avoided. It will be a long, hard struggle.

# SETTING NATIONAL PRIORITIES

THE 1980 BUDGET

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