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THE INLATION OUTLOOK FACING THE REAGAN ADMINISTRATION

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Summary

(1) The mandate of the Reagan Administration with regard to domestic economic policy is unclear. Is it to restore economic growth or fight inflation? President-elect Reagan's advisors do not have a clear-cut view of these issues other than opposition to wage-price controls or guidelines. The new President will have to make a decision to resolve the conflicting viewpoints of monetarists, budget-balancers, and so-called "supply-side" advocates.

(2) Undoubtedly, the new President will want to take a "hands-off" approach to wage negotiations. The collective bargaining calendar is relatively light in 1981, which will aid in this objective. However, a number of contracts will expire which are particularly prone to federal involvement in the event of a strike. These are agreements in railroads, coal, the Postal Service, and West Coast longshoring.

(3) Under the impact of accelerating price inflation in 1980, wage increases have also accelerated. Compensation per hour was running in the 9 to 10 percent range in 1980, and there is little to suggest a deceleration in 1981. Acceleration of wage increases in unionized construction — despite the recession — is particularly notable.

(4) To make significant progress against inflation, the Reagan Administration will need luck. If the consumer price index turns out to be relatively well behaved in 1981, a cooling of inflationary expectations could follow. A reduction of price inflation to 7 to 8 percent is possible for 1982. So far, however, long-term bond yields do not suggest that the prospect of the new administration taking office has itself cooled such expectations.

Presidential Inflation Fighting in Perspective

President Carter was elected four years ago on a promise that he would not lie. Ronald Reagan was elected in 1980 on a promise that he would not be inept. It is not clear — beyond that general promise — exactly what the Reagan mandate is, particularly with regard to anti-inflation policy, or how it will be perceived by the administration itself and carried out. The electorate had an impression under the Carter Administration that the President had lost control on both domestic and foreign policy issues and that a change was warranted. Certainly, the recent record of U.S. inflation contributed to the demise of the Carter Administration both directly and indirectly; directly, because inflation is considered a Bad Thing, and indirectly, because the acceleration of inflation led the Carter Administration to induce a recession. Presidents don't do well at the polls when they threaten the jobs of their constituents, especially Democratic presidents who rely heavily on blue-collar support.

If we date the mid-1960s as the beginning of the era of inflation, then

a total of four Presidents have so far dealt with inflation unsuccessfully. Yet, all of them appeared to place a high weight on controlling inflation. Ford and Carter both ran deliberate recessions for anti-inflation purposes and both were defeated by the electorate. This history ought to be sobering to the new President.

Anti-inflation statements are easy to make, but hard to implement. It has become a commonplace for political leaders to announce that "inflation is the number one problem" or words to that effect. But it is unclear what such statements mean. If it means that any cost will be paid to make the Consumer Price Index (CPI) stop rising, then the technology for doing so has long been known. Twice in our history we have established programs to stop the CPI from rising after a period when it had risen rapidly. I am referring to the wage-price controls of World War II and the Korean War. Both programs, and especially the World War II version dwarfed the Nixon controls program in terms of resources used and made the voluntary guidelines efforts of Presidents Kennedy and Johnson and President Carter seem insignificant.

The World War II program, in particular, required a virtual army of bureaucrats, allocative mechanisms, and rationing systems for implementation. But the CPI rose only about 2 percent per annum during the heyday of the system. The Korean War controls produced a similar movement in the CPI. If all we wanted was a quick fix of the CPI, we could have it. The reason we don't have it is that we have other objectives, too, such as avoiding distortions, misallocations, and shortages, and the retaining of a decentralized economy with restricted federal government involvement.

"Hands Off" on Labor Contract Negotiations

It is unlikely that the Reagan Administration will choose to deal with inflation with a program of "raise your price, go to jail." Indeed, one of the few agencies the President could get rid of upon taking office is the Council on Wage and Price Stability - the agency administering Carter's wage-price guidelines — since COWPS is currently operating under a precarious temporary authorization. The guidelines program might well have faded in 1981 anyway, even if Carter had been re-elected. It will certainly be abandoned by Reagan even if COWPS is continued as an agency to implement a de-regulation drive. (COWPS, it should be recalled, was originally started under President Ford to analyze and criticize new government regulations.) Yet, it will be hard to the new President to remain totally aloof from wage determination.

For example, in July, as shown in Table I, the U.S. Postal Service will be negotiating with the major postal unions for a new labor contract. Union leadership has grown more militant in the Postal Service since the last agreement was negotiated. And postal management may want to place a cap on the escalator clause which an arbitrator uncapped in the expiring contract, a position the unions would resist. Would the Reagan Administration simply take a hands-off approach to these negotiations? Even if an illegal strike occured?

In the private sector, labor-management relations in the coal industry — where a major contract will expire in March — are reported to have improved since the 1977-78 strike that caused so much turmoil for the Carter Administration. But a strike is never impossible. What would Reagan's posture be

Table 29. Selected Major Contract Expirations, 1981

Contract	Date of expiration	Duration of expiring contract	Escalator clause?	Annualized rate of wage increase experienced under expiring contract
Bituminous coal industry & UMW	March	3 years	No	11 % [1/]
West Coast longshore industry & ILWU	July	3 years	No	9.3 % [2/]
Postal Service & APWU, NALC, LIU	July	3 years	Yes	10.0-10.7 % [3/]
Railroads & various unions	March	3¼ years	Yes	10 % [4/]

1/ Source: Council on Wage and Price Stability, Quarterly Report, 1978-II, p. 7.

2/ Source: Current Wage Developments, vol. 30 (September 1978), p. 1. Wages only.

3/ Source: Current Wage Developments, vol. 30 (October 1978), p. 1. Range reflects assumptions of CPI increases of 9 percent and 12 percent in third year of contract. Wages only.

4/ Source: Current Wage Developments, vol. 30 (October 1978), p. 1. Wages only.

Note: Wage increase figures are author's estimate based on source materials.

in regards to a strike in a sector which is supposed to be a major component of U.S. energy policy? The West Coast longshore industry is scheduled for a contract expiration in July. In 1971 a strike in longshoring triggered a Taft-Hartley injunction requested by President Nixon. Would the new President take a hands-off approach? What will be the President's attitude in the event of a dispute involving 400,000 railroad workers scheduled to negotiate in March? In short, it's easy to begin with a hands-off approach on wage determination issues for an incoming President, as President Nixon did. It's harder still to maintain that posture, as the Nixon experience demonstrates.

Reconciling Perceptions and Realities Requires Tough Choices

The Reagan Administration faces tough choices on economic policy, many of which have inflation implications. Republican administrations probably have an inherent advantage in appearing to be business-like and efficient in their day-to-day affairs. One need only compare the conventions of the two

parties last summer to make this point. However, before much time passes, style will matter less than perceived results.

In many respects the need to deal with perceptions is unfair to the incoming administration which can hardly be expected to rid the country of a 15-year inflation problem overnight. Yet, the public has high hopes that a new set of leaders will somehow be able to produce dramatic results, hopes which could easily be disappointed by factors which are largely outside the administration's control. For example, a further disruption in the Middle East could trigger OPEC price boosts which could quickly boost the rate of domestic inflation. Food prices for next year, which at this point depend heavily on supply conditions that are already determined, are unfortunately forecast to rise at rates which will hinder efforts to reduce inflation.

If it can be safely assumed that the Reagan Administration will eschew wage-price guidelines and controls, then economic policy is inherently focused on a decision to stimulate or depress. In the short run, the rate of inflation will not respond much to either policy, if past experience and econometric evidence is any guide. But in the medium term, restrictive demand policies will tend to reduce inflation, albeit slowly. Stimulatory policies will tend to accelerate inflation, but would relieve currently depressed industries such as autos and construction from the recession doldrums. What is the Reagan mandate, given these choices?

Can Mixed Bag of Economic Advisors Produce Unified Policy?

President-elect Reagan's economic advisors are a mixed group who follow or lean towards various doctrines. Some are monetarists, who believe that control of the money supply is the critical policy variable and that other policies matter little as regards inflation. A monetarist approach poses a problem for a President; the Federal Reserve Board is an independent entity whose policies need not accord with administration views. Pure monetarists do not put much emphasis on fiscal policy except to caution that the money supply should not be expended to finance budget deficits.

It is evident, however, that many in the incoming administration — probably including the President-elect himself — do put great weight on balancing the budget. Budget balancing can have important long-term effects in making more resources available for investment, since budget deficits represent a form of dissaving. The linkage with inflation is less obvious. And the budget poses some difficult problems.

For example, suppose the target were to hold federal spending constant in real terms. Defense spending accounts for about one-fourth of the budget. If defense spending were raised by 5 percent in real terms (the reported goal), a 1- to 2-percent cut in nondefense spending would be required. But 50 to 60 percent of federal spending involves entitlement programs such as Social Security, interest on the national debt, and other "uncontrollable" items. Thus, the 1- to 2-percent nondefense cut becomes a 5 to 8 percent real cut in controllable nondefense spending. Such cuts would require Congressional assent which might be difficult to obtain.

On the revenue side, a 10-percent cut in personal and corporate income taxes — the magnitude currently being discussed — will barely offset the

impact of inflation on taxpayers. Moreover, Social Security taxes are scheduled to rise substantially on January 1, 1981, with more increases scheduled in coming years. If a tight monetary policy is chosen for anti-inflation purposes, the depressed economy will generate less tax revenue, making budget balancing that much more difficult.

Apart from monetarists and those who emphasize budget balancing, some of the President's advisors include so-called "supply-side" advocates. It is hard to argue with the proposition that stimulating productive investment (a form of "supply") is a worthy objective of federal policy and that adjustments in the tax code can be used to further this objective. However, new investment cannot be brought on line immediately, and even if it were, its connection with the rate of inflation is indirect. To make the connection, one must argue that the new investment will raise the capital-to-labor ratio fast enough to influence the growth of productivity significantly, and that this productivity growth will in turn decelerate the rise in unit labor costs and therefore in prices. This cost-limiting approach to inflation control would probably be rejected by most monetarists as a diversion from the monetary policy, although they might applaud increased investment for other reasons.

Investment stimulation is the most respectable of the supply-side approaches. Less respectable is the view that any tax cut will stimulate such an outpouring of individual effort that more revenue will necessarily return to the Treasury. Labor-force participation rates have been rising under the current tax structure. Would they really rise more rapidly if income taxes were cut? Is it not more likely that the major impact of a tax cut would be a stimulation of demand rather than supply? And if that were the case, would not the impact be inflationary?

In short, the economic advisors to the Reagan Administration are not of one mind on anti-inflation policy, except that most would oppose wage-price guidelines or controls. Some would propose restrictive policies of the type associated with British Prime Minister Thatcher. Others might favor a more gradual, but definitely demand-restricting approach. Budget balancers may be leery of tax cuts, while monetarists remain indifferent, and supply-siders eagerly push for them. A consensus may not be possible, but a Presidential decision will be required. It is interesting to note, however, that long-term bond yields suggest that those who make a living by forecasting the inflation outlook doubt that the new administration will make much headway in bringing inflation down to levels which only a few years ago were deemed to be intolerably high.

Wage Increase Negotiations may be the Key

The notion of inflation momentum has permeated economic discussion in recent years. It appears that recent price inflation has begun to put upward pressure on wage adjustments. Table II provides selected comparisons of current and past wage change. In the union sector, all the indicators suggest an upward trend in wage adjustments, with notable pressures in the unionized contruction industry despite the recession. The broader indicators — which are heavily weighted by the nonunion sector — also show an acceleration. Labor compensation has been moving in the 9- to 10-percent range during the

Table 30. Recent Wage Trends

	Current Period	Previous Period
Bureau of National Affairs, Inc. - New Union Wage Settlements 1/	1980 through mid-November	1979 through mid-November
All industries	9.5 %	8.3 %
Non-construction	9.4 %	8.3 %
Construction	11.3 %	8.5 %
BLS - New and deferred Adjustments in Union Construction Wages and Benefits	Oct. 1979 - Oct. 1980 9.1 %	Oct. 1978 - Oct. 1979 7.0 %
BLS - Effective Major Union Adjustments Wage Rates	Jan. - Sept. 1980 10.2 %	Jan. - Sept. 1979 10.0 %
BLS - Nonescalated first-year major union settlements	Jan. - Sept. 1980	Jan. - Dec. 1979
All industries	12.1 %	10.0 %
Nonconstruction	10.6 %	10.3 %
Construction	13.4 %	9.4 %
BLS - Hourly Earnings Index 2/	Oct. 1979 - Oct. 1980 9.4 %	Oct. 1978 - Oct. 1979 7.7 %
BLS - Compensation per hour 3/	1979 - III - 1980 - III 9.8 %	1978 - III - 1979 - III 8.9 %

1/ Excludes escalator adjustments

2/ Private, nonfarm sector. Adjusted for overtime in manufacturing and interindustry employment shifts. Excludes fringes.

3/ Nonfarm business sector. Includes fringes.

SOURCE: Daily Labor Report, November 14, 1980, and various Bureau of Labor Statistics press releases.

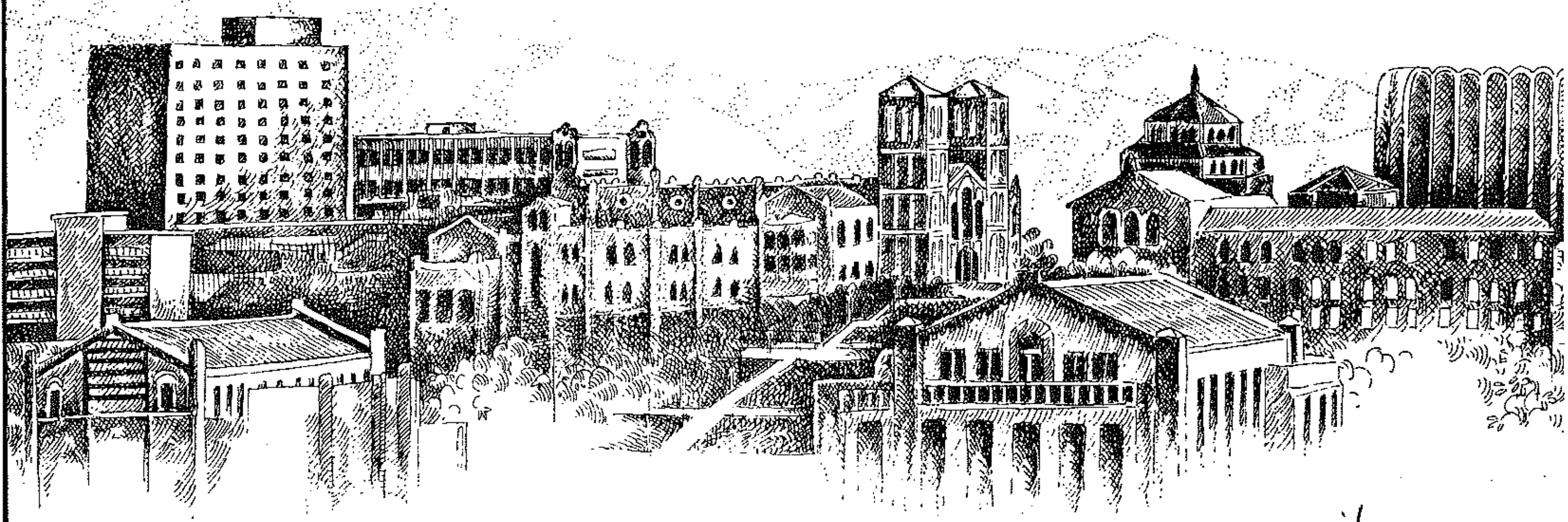
past year. There is little to suggest that there should be significant deceleration from this range in 1981. Indeed, in the early part of the year, there will be upward pressure from an 8-percent increase in the minimum wage and a significant jump in Social Security taxes. Moreover, productivity improvements

would easily be delayed if the recovery is aborted or stagnates.

The incoming administration arrives in a relatively light year on the collective bargaining calendar, although as already noted, some of the contracts which are coming up have potential for federal involvement. This means that much of the union sector will receive either predetermined or escalator adjustments under existing contracts. Thus, increases in the Consumer Price Index will have significant effects on the actual wage outcomes for many union workers, but no effect whatever for others.

In the major union sector (agreements involving at least 1,000 workers) which covers 9.3 million workers, about 2.6 million will experience a contract expiration. Not all of these workers will have had increases of the magnitude shown in Table I. Their mean wage increase has been a little over 8 percent per annum. Thus, many will have suffered loss of purchasing power and will press for "catch-up" adjustments.

Basically, what the incoming Reagan Administration needs on the inflation front is luck. Suppose that the CPI turns out to be relatively well behaved in 1981, dropping into the 9- to 10-percent range. A drop in mortgage interest rates could help bring this about. Suppose that these developments cool inflationary expectations, thus helping decelerate both wage and price inflation. In that case, price inflation rates in the 7- to 8-percent range might be possible for 1982. Put another way, the experience of the period following the 1974-75 recession could be repeated.



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