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The Perils of Inflation

INFLATION is not a new problem for us, any more than it is a new problem for the peoples of other nations. During the decade of the 1940's, the purchasing power of the dollar was cut in half. Since 1950, we have experienced several lesser but still very troublesome spurts of inflation.

My purpose is to discuss the causes and consequences of the current inflation. Let me begin by calling several major facts about this inflation to your attention.

First, the general price level—that is, the price level of our total output of goods and services—has already risen 10 per cent since mid-1964.

Second, while individual price advances have been uneven, they have been diffused throughout the price system. Every major category of prices in both wholesale and consumer markets has experienced an appreciable advance.

Third, not only has the price level been rising, but the rise has also been accelerating. Between the first quarter of 1964 and the first quarter of 1965, the general price level rose 1.9 per cent. The next year it rose 2.1 per cent. The year after, 3.1 per cent. During the past year, the increase was 3.5 per cent.

Fourth, the advance of wages has also been accelerating.

Address given at Town Hall, Los Angeles, California, April 23, 1968. Reprinted from Tax Foundation's *Tax Review*, May 1968.

The average increase in the initial year covered by collective bargaining settlements came to 3.2 per cent for the agreements negotiated during 1964. The corresponding increase was 3.8 per cent during 1965, 4.8 per cent during 1966, and 5.7 per cent during 1967.

Fifth, the wage-price spiral has lately been working along classical lines, with every rise in prices spurring increases in wages and every rise in wages setting the stage for further increases in prices.

So much for the bare facts concerning the new inflation. Let us turn next to its causes. To what factor or factors in the overall situation can this inflation be attributed?

One popular notion attributes the inflation to the war in Vietnam. The Council of Economic Advisers has put this explanation as follows: "Around mid-1965, the growth of demand for industrial products suddenly accelerated as the direct and indirect consequence of the enlarged commitment of U.S. forces in Vietnam . . . The upward pressures on prices and wages in this period . . . tripped off a price-wage spiral." This explanation has an element of plausibility, but it cannot be readily accepted.

In the first place, the new inflation started before Vietnam was of any financial or economic consequence. Prices of raw materials began moving up in spirited fashion as early as the fall of 1963. By June of 1964, the average level of all wholesale prices began rising. Between that month and June 1965, the wholesale price index rose 3 per cent.

Moreover, price advances spread out over the economy well before mid-1965. During the second half of 1964, twelve of the fifteen major groups of commodities covered by the official index of wholesale prices registered advances. During the next six months, fourteen of the fifteen groups showed price increases. Clearly, inflation had already taken hold and become

widespread many months before Vietnam began adding appreciably to aggregate monetary demand.

In the second place, total federal expenditures, as estimated in January, show an increase of $53 billion between mid-1965 and mid-1968. Less than half of this increase, that is, about $25 billion, is attributable to the war. Hence, if the war expenditures are regarded as a cause of the recent inflation, then nonwar expenditures must be considered a still more important cause.

In the third place, while it is true that spending for Vietnam added powerfully to aggregate demand after mid-1965, this effect could surely have been offset by reducing nondefense spending or by raising taxes or by making credit more expensive and less readily available to private borrowers. The simple explanation that the recent price-wage spiral is attributable to the war in Vietnam must therefore be rejected.

Another popular explanation of the recent inflation is that business firms have lately found it expedient to use their market power—which is a polite term for monopolistic power—more aggressively. If this were actually the case, it would be reasonable to expect profit margins to rise. That, however, has not happened during the past two years. On the contrary, profit margins in American industry, taken as a whole, declined in 1966 and declined again last year.

The main reason for the narrowing of profit margins is that, on the average, prices of late have risen less than unit labor costs of production. And this brings me to a third popular explanation of the inflation, namely, that trade unions have been using their market power irresponsibly during the recent years of low unemployment.

There can be little doubt that some trade unions have lately been able to achieve extraordinary increases in wages, just as some business enterprises have been able to raise prices out of

proportion to the increase in their costs. But the theory of labor monopoly does not hold up any better than the theory of business monopoly.

Between 1966 and 1967, wages rose all around. But where did the sharpest increases take place? Not in manufacturing, mining, or transportation—all of which are heavily unionized. In these industries, the percentage rise was below the national average. On the other hand, in agriculture—where trade unions play practically no role—wages rose most. Abnormally large increases occurred also in retail trade, wholesale establishments, service trades, financial institutions, and the construction industry. Except for the latter, these are industries in which trade unions are notoriously weak.

The pattern of wage increases between 1964 and 1966 was very similar to that from 1966 to 1967. The behavior of wages in recent years cannot, therefore, be explained in terms of monopolistic power, unless one is prepared to argue that trade unions have been using their power to restrict rather than to intensify wage increases.

What has happened of late in the wage sphere can, however, be explained quite simply in terms of a competitive market. As the aggregate demand for goods and services kept growing, the labor market became increasingly tight. Workers in low-wage industries, such as agriculture and the service trades, saw an opportunity to get jobs in high-wage industries, such as manufacturing. The outflow of labor from the low-wage industries therefore tended to raise substantially the wages in those industries, while the movement of workers to the high-wage industries served to moderate the wage increases in that sector. Such shifts in demand, supply, and relative wages express the normal workings of a competitive market.

There is an additional fact that we should bear in mind.

Contrary to a widespread impression, the real income of the average American worker has not improved at all during the past two or three years. Once wages are adjusted for the rise in consumer prices and for social security and income taxes, what we find is that the weekly earnings of the average worker in private nonagricultural employment were actually a trifle lower in 1966 than in 1965 and again a trifle lower in 1967 than in 1966.

Let me turn to still another explanation of the recent inflation, namely, that the Congress is responsible because it has failed to accept the President's repeated request for a 10 per cent surcharge on income taxes. If the Congress had done what the President wanted, so the argument goes, the increase in aggregate demand would have been curbed and the advance in prices would have been much slower.

This explanation again ignores much of recent history. Apart from the suspension of the investment tax credit, which became effective in November 1966, the President did not ask for an increase in taxes before January 1967. By that time the wholesale price level had already been rising two and one-half years. And when the President did ask for higher income taxes, he asked merely for an increase of 6 per cent, to become effective at mid-year. In the face of an explosive increase in federal spending, this request did not convey any great sense of urgency.

Moreover, within a few weeks of asking for a tax increase in the interest of restricting the growth of aggregate demand, the Administration actually stepped up its efforts to stimulate demand. Substantial funds for housing and highways, which had only recently been impounded, were released by March of 1967. In March, also, the President requested the Congress to reinstate the investment tax credit for machinery and equip-

ment. This meant, of course, that the President was now asking for a substantial tax cut for business firms instead of the tax increase he had suggested a few weeks earlier.

The abrupt shift in early 1967 toward a more liberal fiscal policy was accompanied by a shift to a more liberal monetary policy. The Federal Reserve authorities lowered the discount rate. They reduced reserve requirements on time and savings deposits. Most important of all, they now pumped reserves into the commercial banks at so fast a rate that the money supply during 1967 grew more than 7 per cent. This was a faster rate of growth than in any year of the entire period since World War II.

Thus, despite the war in Vietnam, the government acted during much of last year as if a recession were under way, instead of coming to grips with the menacing reality of inflation.

True, in August 1967, the President made another switch in fiscal policy. Announcing that the nation was threatened by ruinous inflation, he then requested from the Congress a 10 per cent, instead of the earlier 6 per cent, surcharge on income taxes. By this time, however, the Congress as well as the rest of the nation was quite confused about the direction and purpose of national economic policy.

Many Congressmen asked: Why is the nation being whipsawed by sudden and apparently capricious shifts in tax policy? Has the danger of inflation now really become more acute? If so, did not the Administration bring on this difficulty by its aggressively expansionist policy since February? If the Administration was wrong then, can its judgment be trusted now? And if the Administration is really so concerned about inflation, why does it not curb the projected increase of federal spending and thereby reduce the need for a tax increase? It is

largely because the Congress has not been satisfied with the answers that it has received to these questions that no increase in taxes has yet taken place.

The delay on the subject of taxes may be regrettable. I happen to think that it is very regrettable. But if Congress is to be blamed for the inflation which we are experiencing, the Administration's entire monetary and fiscal policy must be blamed much more.

When President Kennedy took charge of our government in January 1961, there was considerable slack in the economy, but the price level was steady. In fact, it had been quite steady for two years.

The new administration proceeded to shape its economic policy on the basis of an ingenious theory, namely, that by adjusting taxes or its own rate of spending, the government would be able to keep the aggregate demand for goods and services closely adjusted to what our economy can produce at full employment. According to this theory, as long as a gap existed between actual output and potential output, it was the responsibility of the government to stimulate demand by increasing its expenditures or by cutting taxes, but maintaining in either case an easy monetary policy.

The proponents of this theory realized that inflation could create an imbalance between production and sales or between business investment and consumer spending, and thereby lead to a recession before the gap between actual and potential output was closed. They believed, however, that price increases could be staved off by getting workmen to accept wage increases that equaled the over-all increase in output per manhour and by getting businessmen to set prices so that the ratio of the price of a commodity to its labor cost of production would be constant.

The Administration's economic policy therefore came to rest

on two articles of faith: first, that monetary and fiscal stimuli would serve to expand employment and close the gap between actual and potential output; second, that wage and price guidelines would serve to keep the price level stable while these stimuli were being applied.

This theory worked reasonably well as long as our factories and mines had considerable idle capacity and unemployment was moderately large. Under such conditions, an aggressive fiscal and monetary policy could be pursued without resulting in a wage-price spiral. By 1964, however, the gap between actual and potential output had narrowed substantially. As demand began pressing on available resources, bottlenecks developed and prices rose.

The new wave of inflation did not come without warning. By the late summer of 1964, a large increase had already occurred in the number of business firms reporting slower deliveries. By the end of 1964, the average workweek in manufacturing was already at the level reached during the Korean war, and price increases in wholesale markets—as I previously mentioned—had already become general.

The price increases, however, were as yet small and the Administration paid no attention to them. The official view was that the government's economic policy was working out as expected, that fiscal and monetary stimuli were narrowing the gap between actual and potential output, and that the guidelines were keeping wages and prices in check.

Indeed, since its policy of economic stimulation seemed to be working so well, the government felt it was desirable to push this policy more energetically. Thus, during 1965, when the economy was already advancing rapidly of its own momentum, the government accelerated the application of monetary and fiscal stimuli, instead of moving gradually toward a policy of restraint.

Practically every weapon in the arsenal of economic stimulation was released during 1965. In that year, we had the second installment of the cut in personal income taxes enacted in 1964. In that year, the second installment of the cut in corporate income taxes became effective. In that year, a significant reduction of excise taxes was enacted. In that year, spending on programs of the Great Society was enlarged. In that year, the rate of increase of the money supply and of bank credit was stepped up sharply. All this happened despite the expansion of federal spending on account of Vietnam.

This aggressively expansionist policy did indeed help the nation reach full employment by the end of 1965, but that was not the only result. By that time, wholesale prices were already 4 per cent higher than in mid-1964, and the rise of wages was already accelerating. As experienced observers had predicted, the price-wage guidelines proved a fragile barrier to inflation once labor and commodity markets tightened.

The architects of the policy that produced these results had promised that once full employment was approached, governmental policy would assure that aggregate demand rose no faster than the nation's productive capacity. This promise has not been fulfilled. In these recent years of prosperity and full employment, the federal budget deficit has continued to mount.

The yardstick on which economists nowadays rely to gauge the degree to which federal finances exert a stimulating or restraining influence on the economy is, however, the full-employment deficit or surplus rather than the actual budget deficit or surplus. This yardstick of the economist indicates that the fiscal stimulus applied by the federal government to our economy has grown progressively, year after year, since 1963.

The record of monetary policy has not been much better. True, over an interval of some seven or eight months during

1966, the Federal Reserve authorities pursued a restrictive monetary policy. In the past three or four months, they have also moderated the expansion of the money supply and credit.

However, the broad thrust of monetary policy during the past few years has been more and more expansionist. Between mid-1960 and mid-1964, the money supply grew at an annual rate of only 2.7 per cent. This rate was stepped up to 4 per cent between mid-1964 and the spring of 1965, and to 6 per cent over the next year. During 1967, as already noted, the rate was above 7 per cent.

It is this combination of an accelerating growth of the money supply and an increasingly expansionist fiscal policy that is the basic cause of the wage-price spiral that we have lately been experiencing. It may, perhaps, be debated how much of the responsibility for the recent inflation is to be attributed to the Congress and how much to the Executive Branch. But there can be no escape from the conclusion that the federal government has pursued an increasingly expansionist policy in the face of practically full employment and a soaring price level.

Now, as in other times of inflation, the administration in power has been blaming greedy businessmen, irresponsible trade union leaders, and unruly Congressmen. But the new inflation is mainly the result of the excessively rapid creation of new money and of our unbalanced federal budgets.

Let me now turn, briefly, to the effects of this inflation on our economy.

In recent years, we have discussed extensively the need to reduce the poverty which still exists in our land of plenty. This is an objective that practically all Americans share. Unhappily, much of the public as well as private effort to reduce poverty is being nullified by inflation.

There can be little doubt that poor people, or people of

modest means generally, are the chief sufferers from inflation. Poor people rarely know how to protect themselves against inflation. What little savings they have are apt to be in the form of bank deposits, life insurance policies, or government savings bonds, the purchasing power of which keeps eroding when the price level rises.

Moreover, since bad health, unemployment, irregular work habits, and poverty often go together in life, the incomes of poor people are apt to fluctuate more than the incomes of the well-to-do. Last year, for example, the number of low-income families suffering a loss of dollar income nearly matched the number that experienced a gain. Once we take account of the advance in prices, it appears that the proportion of low-income families whose real income has lately declined may well exceed the proportion whose income has risen. This is a grave injustice.

The injustice of inflation is not confined to poor families. Inflation affects adversely everyone whose money income fails to respond to the rising cost of living or whose savings take the form of fixed dollar assets.

Besides these effects, the recent inflation has worked havoc with our money and capital markets. Last year the Federal Reserve authorities made a strong effort to create monetary ease and to bring interest rates down. They were, however, entirely unsuccessful. Not only did interest rates fail to come down, but some rates—notably, government and corporate bond yields—rose to the highest level in several decades. This rise in interest rates is proving a burden on many home buyers and others who find it necessary to borrow.

One major reason for the upsurge in interest rates is that many prospective borrowers have been fearful that governmental policies would create so great an expansion in aggregate demand that, high though interest rates were, they would

soon be higher still. By anticipating some of their credit needs, businessmen and state and local borrowers have tended to push interest rates up.

Another reason for the upsurge in interest rates is the widening expectation that inflation will continue. Feeling this way about the future, not a few businessmen have been borrowing on the comfortable expectation that they can repay their loans later in cheaper dollars. However, since suppliers of loan funds have likewise been anticipating inflation, they have become less willing to lend at the going interest rate. A 6½ per cent interest rate on a triple-A bond may seem terribly high; but sophisticated lenders know that when the price level rises 3½ per cent a year, the real yield of such a bond is merely 3 per cent.

The recent inflation has had another serious effect on our economy: it has hurt our foreign trade.

In the early 1960's our price level was steady, while much of the rest of the world practiced inflation. In the last two or three years, European countries have been making a moderately successful effort to restrain the advance of prices, while we have been experiencing a new wage-price spiral.

This change in international price trends, combined with the reduced rate of growth of the world economy, has affected adversely our foreign trade. In 1964, we had a surplus on merchandise trade of nearly $7 billion. The surplus shrank to $4.8 billion in 1965, to $3.7 billion in 1966, to $3.5 billion in 1967. During the past few months, the surplus expressed as an annual rate has been less than $2 billion.

This vanishing export surplus is a major reason for the deterioration in our balance of payments. Other factors, of course, have contributed to the deterioration—notably, the large and increasing foreign-exchange cost of the war in Vietnam.

The sorry condition of our balance of payments has led the

government to place restrictions on how private citizens can use their money. In January, the President issued an executive order which limits severely the investments that American firms can make in their foreign subsidiaries or branches. Commercial banks and other financial institutions are now also operating under regulations which restrict the loans that they can make to foreigners.

The decline of economic freedom that we are experiencing may not stop with lending and investing. As you well know, control of foreign travel by Americans has been under active consideration recently.

In spite of such drastic measures to limit the outflow of dollars, there is less confidence now in the external value of the dollar than at any time since 1933. Much has been said in recent weeks about the gold crisis. What we have been experiencing, of course, is an international crisis of confidence in American financial policy.

With inflation proceeding at an accelerating pace in our country, with the balance of payments deteriorating, and with the federal budget deficit likely to exceed $20 billion, it was only natural for holders of dollars to become increasingly concerned about the possibility that the dollar would soon be devalued, just as the British pound was last November.

The flight from the dollar took on such vast proportions that our stock of gold, which was still close to $13 billion last November, fell to about $10½ billion in March. As a consequence, the London gold pool, which had kept the market price of gold close to the official price of $35 an ounce, was discontinued. For a few days in March, Americans abroad found that some banks, hotels, and merchants were unwilling to honor their dollars or traveler checks. They were unprepared for this humiliation.

Fortunately, the leading central banks of the world acted quickly to shore up the dollar in the hope of preserving the present international monetary system. But the dual price of gold which they established is a very tenuous arrangement. Even in the short-run, its viability will depend on how we conduct our national finances. Other governments now have a larger voice in our public policies, both domestic and foreign. They will not cooperate with us in the monetary sphere unless they deem our over-all performance acceptable.

The dual price of gold gives us some time to put our national finances in order, but it does not give us much time. And so I finally come to the critical question: What is the prospect of bringing our inflation under control and of reestablishing equilibrium in the balance of payments?

In view of the recent run on the dollar, our governmental authorities at last recognize that general price stability and the balance of payments deserve a higher priority in our economic policymaking than they have yet received. The Federal Reserve System is now moderating the growth of the money supply. The Administration is also showing some willingness to curb expenditures in the interest of inducing the Congress to accept the 10 per cent surcharge on income taxes.

It is by no means clear, however, that our government is even now ready to adopt the measures of austerity that are needed to slow down the inflation materially.

The tax surcharge has large symbolic significance, but its real power to restrain aggregate demand has been exaggerated in current discussion. Not many corporations will revise downward their capital expenditure plans just because of a temporary 10 per cent increase in their income tax. The effect of the tax surcharge will be greater on consumer spending. But in view of the high savings rate during the past year and the re-

vival of the propensity to spend in recent months, a large part of the increase in personal tax payments will probably be at the expense of savings.

A reduction in governmental expenditures is a much more potent device for restraining aggregate demand than a temporary increase in taxes, but there is little prospect of cutting expenditures in the present political climate. Even if spending plans are cut back by $5 or $6 billion, Federal spending in the next fiscal year is still expected to rise about $10 billion above this year's level.

The fiscal measures that are now being seriously considered might well have achieved their purpose of curbing inflation if they had been adopted a year ago or even six months ago. Meanwhile, the inflation has reached a more advanced phase, the budget has moved further out of balance, and confidence in the dollar has greatly diminished. In view of the prevailing political sentiment, it seems doubtful to me that our government will practice monetary and fiscal austerity on either the scale now needed or over a sufficiently long time to subdue inflationary expectations and restore full confidence in American financial policy.

But if we shun the path of real austerity, how will we deal with the stubborn deficit in the balance of payments? One possibility would be to subject foreign transactions to additional controls and perhaps apply controls to domestic prices and wages as well. If we travel this road, other countries will retaliate with protectionist devices of their own, the efficiency of our economy will suffer, and the broad result is likely to be a constriction of world trade and a lower rate of growth of the world economy.

Whatever we do about additional controls, unless the deficit in our balance of payments is soon corrected, the new dual price system for gold will probably collapse. In that event, we

may have to choose between raising sharply the official price of gold or letting the dollar find its own value on the foreign exchange market.

Either answer would mean devaluation of the dollar and further damage to our international political prestige. If the price of gold is raised, the dollar will be devalued with respect to gold. On the other hand, if the dollar is allowed to float, it will be devalued with respect to other currencies, unless foreign governments choose to support the dollar in the interest of protecting their own export trade.

Foreign support of a floating dollar is conceivable, but it is unlikely to last. After all, a foreign country has an alternative to accumulating dollars that it does not want; namely, it can let the dollar depreciate and protect itself by restricting imports from the United States. In the end, a floating dollar would probably result in extensive unsettlement of business, new restrictions on international transactions, and political turmoil.

On the other hand, an increase in the price of gold would leave the present system of foreign exchange rates virtually intact, so that business could go on as before. This expedient is subject, however, to political criticism, since Russia, China, France, South Africa, and thousands of private speculators to boot, would reap a windfall profit. Moreover, while a substantial increase in the price of gold would give us time to work toward a policy of financial prudence, it will not give us elbow room indefinitely. Once the dollar has been devalued with respect to gold, the financial community will be very alert to the possibility of a second devaluation.

I would like to think that we will be fortunate enough to escape such unhappy developments. Perhaps, the war in Vietnam will come to an end soon and bring larger relief both to the federal budget and to the balance of payments than now

seems likely. Perhaps, foreign countries will step up their own rates of inflation and thereby aid our balance of payments. Perhaps, we will even be willing to practice real austerity.

We cannot count, however, on such favorable developments, and we need to ponder realistically the choices before us. The uncertainties are great. But as far as I can now judge, if we are unwilling to practice austerity on a sufficient scale, then an increase in the price of gold may be the wisest course open to us.

One thing is clear. When a nation permits its economy to become engulfed by inflation, policymakers no longer have any good choices. That is the tough legacy and also the chief peril of inflation.