

INFLATION AND ITS CONTROL

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The authors of the many speeches and writings on inflation can be divided roughly into two opinion groups. One group argues that a little inflation is good because it stimulates economic growth and benefits most people and that steps can be taken to care for those few who are injured. The second group holds that *any* inflation is bad, that creeping inflation will get out of hand, and that stable prices are consistent with full employment and economic growth. The following quotations are typical of current writings on inflation:

Let us not minimize the explosive potentials of this economic outlaw. In its exaggerated form—when inflation shifts from a creep to a gallop—it has bred dictators, toppled governments, ruined nations. And, when it gets so out of hand, it can kill the goose that lays the golden eggs of economic growth by discouraging the savings with which we buy the machines to increase our productivity.

Even in its creepiest form, inflation robs the needy by decreasing the purchasing power of money. The things that a pension or small salary will buy shrink with each creep forward of an inflationary movement. Thus, schoolteachers, pensioners, and those elder citizens who live upon income from a fixed amount of capital, find themselves poorer and poorer.

The savings upon which so many of our people rely for their support in old age, or to gain earlier independence, are constantly diminished in value. If the inflation gains sufficient power it can easily offset any interest which the ordinary savings account or insurance policy can pay. Workers who are beneficiaries of large investments in private and public pension funds find themselves among the principal victims.²

In recent years, and increasingly in recent months, the most powerful organs of Government, reinforced by powerful private propaganda, have been engaged in a wrongful campaign against inflation.

Their spurious campaign has misused the inflationary threat to defeat or retard our most profound national objectives. It has led us to neglect our paramount national priority, adequate protection of the country from the threat of totalitarian aggression. It has repudiated all fair measurements of progress toward the adequate education of our young people; the fair treatment of our old people; the needed expansion of health and housing facilities; the forward-looking conservation of our national resources. It has stunted our long-range rate of economic growth, provoked enormous waste in the form of idle manpower and other productive resources, and consequently undermined the basic source of our domestic strength and our international security. And in the face of the current economic re-

¹This report was prepared with the assistance of the following members of the work group: George M. Beal, C. E. Bishop, Robert F. Frary, and Maurice Taylor. The material in this report is based largely upon four papers written for this conference by: Tilford Gaines, Federal Reserve Bank of New York; A. Stuart Hall, University of Nebraska; Raymond McEvoy, Montana State University; and Richard G. Ford, Federal Extension Service.

²T. V. Houser, "The Cruellest Tax," Committee for Economic Development, 711 Fifth Avenue, New York 22, New York, July 1958, pp. 3-4.

covery, we are now threatened by redoubled revival of the repressive policies which converted the recovery of 1955 into the stagnation of 1956 and 1957 and the recession of 1957-58.³

RECENT INFLATION IN AMERICA

What Is Inflation?

Inflation as used in this paper will refer to a persistent increase in the general level of prices. This means that some over-all inclusive index of prices continues to rise. In a growing and changing economy some prices must go up and some must go down as supply changes in response to changes in consumer tastes and desires and in national needs. If the over-all price level is to remain stable, individual prices of commodities, services, wages, etc., must be free to move up and down.

A more limited and technical definition, which is sometimes used, holds that the term "inflation" should not be used to indicate any and all rises in the general price level, but should be restricted to a rise in general prices only after full employment has been realized. Because of the lack of agreement among business, labor, and government economists regarding the precise statistical measure of "full employment"—whether the commitment of the government to promote "maximum employment" in the Employment Act of 1946 is 2, 4, or 6 percent unemployment or some other figure—the term inflation, in this paper, will refer to a persistent rise in the general level of prices, regardless of the magnitude.

Prices, Production, and Unemployment

Using either the Consumer Price Index (CPI) or the Wholesale Price Index (WPI), the general level of prices has more than doubled since 1939, and has increased by more than a fifth during the last ten years. This means that the dollar will buy less than half (48 percent) of what it would buy in 1939. The 1958 dollar will buy only 80 percent as much as the 1947-49 dollar.

The inflationary path since 1940 is graphically shown in Figure 1. This inflationary period is divided into six segments. The CPI is used as a measure of inflation and is shown together with the WPI.

Inflationary Segments I and II show the result of defense preparations beginning in 1940 and the effects of World War II continuing to September 1948. Segment I differs from Segment II only in the rate of increase. Actually Segment I was a continuation of a slow and persistent price rise having its origin in the very depths of the Great Depression beginning May 1933. Segment II begins with July 1946, immediately following the removal of most consumer price controls.

³"Inflation—Cause and Cure," Conference on Economic Progress, 1001 Connecticut Avenue, N.W., Washington, D. C., July 1959, p. 1.

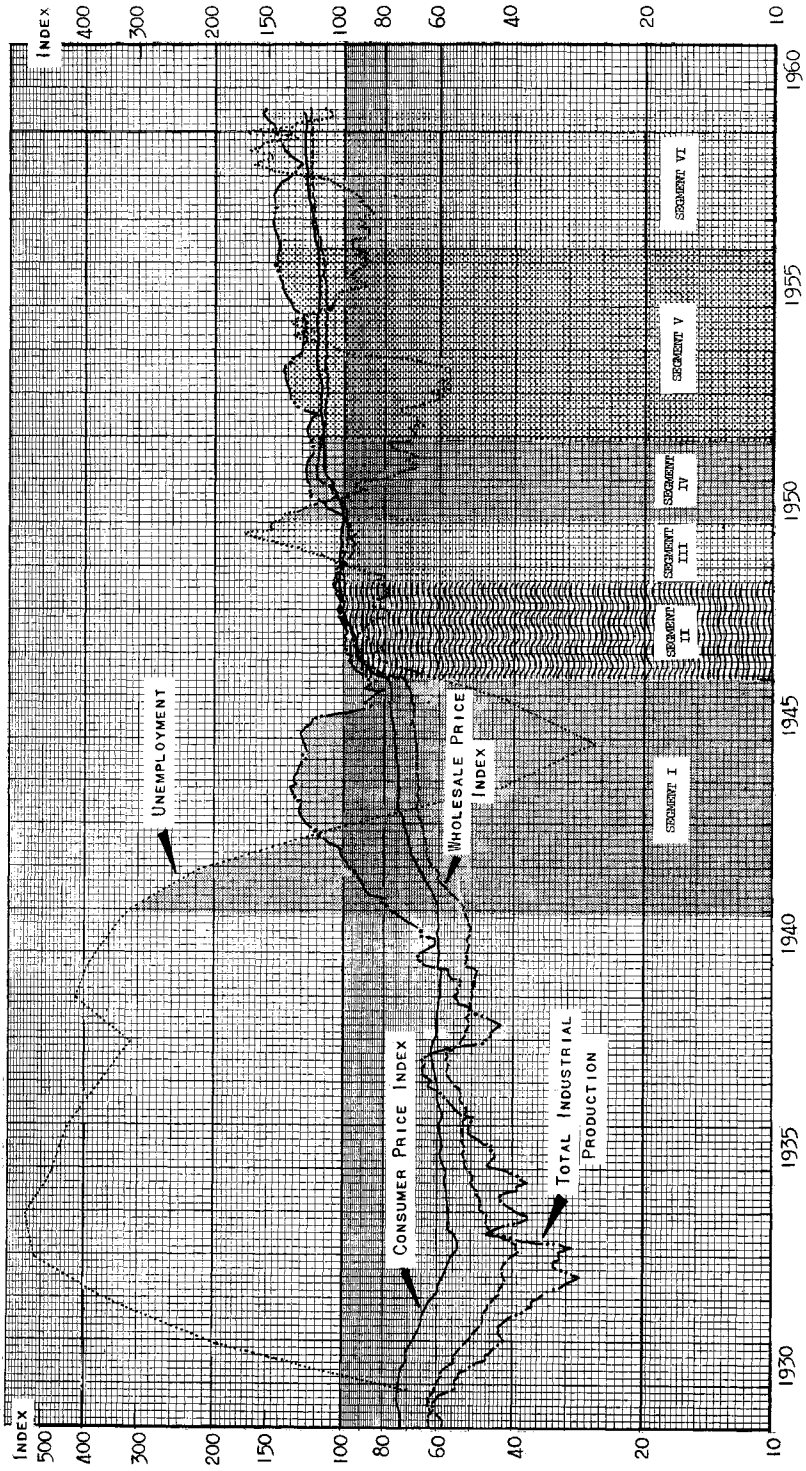


Figure 1. Industrial Production, Unemployment and Price Levels (1947-49 = 100)

Bolstered by very large reserves of private savings and relatively small civilian production (period of peacetime recovery) the price level increased at record rates during the period of Segment II leveling off about mid-1948. Segment III was a mild deflationary period beginning October 1948 and continuing through February 1950. This period was characterized by unemployment and a decline in total industrial production of about 6 percent. Recovery from the 1948-49 recession was well underway when the Korean conflict kicked off the inflationary surge shown in Segment IV. This segment (March 1950 to January 1952) was a period very similar to Segment II—rising prices, expanding industrial production, and increasing employment.

Segments V and VI are not so easily understood, particularly when we consider that during 1953-54 unemployment was mounting and that in each quarter of 1954, GNP was less than in 1953. This was also true during the 1957-58 portion of Segment VI. During the period of Segment V the CPI was relatively stable, increasing only about 3 points (1947-49=100) in about four and a half years. However, during this period total industrial production increased 21 points (1947-49=100), and unemployment increased from an index of 68 to 133 then dropped to 87.

One of the major reasons for the current apprehension concerning inflation is that while prices did not decline during the 1953-54 and the 1957-58 recessions, unemployment became serious. This phenomenon has led to the emergence of the “cost push” and “administered” price theories of inflation. These theories are used to justify the argument that we must have a national policy of gently rising prices if we are to maintain high employment and an expanding economy.

Price Changes and Economic Growth

The claims of the “creepers” that rising prices are essential to continued economic growth have not been conclusively substantiated. Several studies find no definite correlation between a rising, falling, or stable price level and economic growth.⁴ Historically the United States and other countries have enjoyed unusual growth during periods when the price level was either rising or falling.

INFLATIONARY FORCES AND CONDITIONS

History records a number of “natural” inflations stemming from crop failure and the resulting food shortages in nations. Inflations of

⁴G. L. Bach, Milton Friedman, and Otto Eckstein—three separate papers in *The Relationship of Prices to Economic Stability and Growth*, Joint Committee Print, 85th Congress, 2nd Session, March 31, 1958, pp. 33-49, 241-57, and 361-75 respectively; “Inflation and Economic Development,” *Monthly Review*, Federal Reserve Bank of New York, August 1959.

this sort normally have occurred in very primitive societies where both demand and supply are highly inelastic in the relevant ranges. These societies are usually characterized by employment of a high proportion of the population in agriculture and poorly developed markets for food and fiber products. Under these conditions, those who are dependent upon the farmers for food and fiber bid prices to extreme heights during periods of famine. Although these inflations may be quite serious from the standpoint of price increases, they usually have no serious income transfer effects since in such societies people have little monetary assets, and a relatively small proportion of the goods and services goes through the market. This kind of inflation results from a decrease in supply with constant or increasing demand.

A second traditional type of inflation results from rapid increases in demand during periods in which supply is relatively stable. This type of inflation usually has been true monetary inflation. In large part, it has stemmed from the failure of the monetary authority to use the power vested in it to maintain the value of the monetary unit. Some inflations of this type were "legitimate" in the sense that they stemmed from gold discoveries. When countries based their monetary system on a gold standard, discoveries of gold in the 16th and 19th centuries contributed to the serious inflation problems in some countries. The really serious inflations have generally occurred when people have concluded that monetary action or inaction was going to result in progressive devaluation of the monetary unit, thereby creating "flight from money." This type of panic typifies situations where governments run the money printing presses to obtain money to meet government obligations.

Sources of Creeping Inflation in the United States

Perhaps the most important source of creeping inflation in the United States is the tendency for government to increase its expenditures without offsetting tax increases. This deficit financing on the part of government increases prices of consumer goods and services because: (1) the transfer of goods from the civilian sector to the government sector reduces the quantity of goods and services available for consumption, and (2) the increase in government expenditures places additional money in the hands of the public.

The effect of government expenditures depends, to a large extent, on how the government obtains money to meet its obligations. If the government sells bonds to individuals, purchasing power is transferred from individuals to the government with no increase in the supply of money. This type of borrowing, therefore, is not likely to be infla-

tionary, but its use depends upon the willingness of individuals to buy government bonds. Recently, long-term government bonds have been hard to sell because other types of investments yield higher returns. When the government has difficulty selling long-term bonds to individuals, it is forced to borrow from banks, thus creating deposits for the Treasury. This increase in deposits provides the basis for multiple expansion of credit because banks are required to hold only fractional reserves. The result is essentially the same as if the government had operated the money printing presses.

The attitudes of businessmen and consumers toward the future can have important effects upon price changes. If people expect prices to rise sharply in the future and wage rates to increase accordingly, they are likely to buy more on credit. In effect, this is an increase in demand and creates additional upward pressure on prices.

The main cause of the current inflation, according to many businessmen, is the increase in wage rates obtained by organized labor. They argue that wage hikes have exceeded labor productivity gains, resulting in higher costs per unit of product, which in turn call for higher selling prices to cover these costs.

Labor, on the other hand, attributes inflation to monopoly elements in the economy and administered pricing of products in non-farm industries. Spokesmen for labor argue that the U. S. economy, except for the primary industries, is characterized by firms of sufficient size to be able to set the price of their products and to regulate output to maintain these prices. We need to recognize, however, that the extent to which prices can be increased as a result of wage increases depends upon whether demand is sufficiently strong to maintain high employment.

The United States Government is now required by law to maintain "maximum employment" in the economy. This policy increases the bargaining power of labor and removes some of the incentive for industry to resist wage demands since both know the government is required by law "... to promote maximum employment, production, and purchasing power."

In a sense, the government has been placed in a vulnerable position by the Employment Act of 1946 while at the same time it is committed to a policy of maintaining a stable price level. The major question confronting the government is whether industry and business can be restrained from following inflationary price-setting policies if the fear of unemployment and loss of markets from higher prices is removed.

WHO BENEFITS, WHO LOSES?

Inflation changes the distribution of wealth and income in society, but all groups do not share equally or proportionately in it. Higher prices and incomes to one group often constitute higher costs and lower real incomes to other groups.

Effects on Major Economic Groups

1. **AGRICULTURE.** The agricultural sector of our economy was favorably affected by the "galloping" inflation of World Wars I and II and adversely by the "creeping" inflation of the later 1920's and 1950's. In each war period, the initial rise in demand exceeded agriculture's supply response; farm prices rose much faster than costs, and real income increased. Later, with lower export demand, increasing farm production, and rising costs, real farm income declined 16 percent from 1946 to 1958, while income to nonfarm occupations rose from 17 to 35 percent during the same period.

2. **WAGE EARNERS.** Real incomes of highly organized wage earners in manufacturing, construction, and mining, increased 30 to 35 percent from 1946 to 1958; in the wholesales and retail trades, the gain was 17 to 18 percent. Wage earners in general appear to have held their own with "proprietors" in the distribution of national income. The share of national income going to labor declined from 68 to 64 percent from 1946 to 1951, but has increased since then, while the share to profits has diminished.

3. **SALARIED AND FIXED INCOME WORKERS.** Employees of state and local governments have enjoyed substantial gains in real income since the end of World War II, but made little progress during the war. These workers appear to have realized the smallest rise in real income among wage earners over the whole war and postwar period.

Fixed income groups, such as retired individuals and widows, suffer the greatest loss of real income as a result of inflation. For example, the maximum monthly benefit under the old age and survivors insurance program rose from \$85 in 1940 to \$116 in 1958, but the purchasing power of the \$116 in 1940 dollars was only \$56.

4. **MANAGEMENT OR PROPRIETORS.** During World War II, the managerial or proprietorship share of the national income increased, while labor's share declined. In the postwar period, profits are being maintained at a very high level, but the returns of proprietors have not gained relative to those of labor. Property owners have maintained their share of the national income by revision of contractual arrangements.

Impact Upon International Trade and Diplomatic Relationships

Inflation tends to handicap domestic producers because U. S. products are gradually being priced out of foreign markets. Imports increase as foreign exporters take advantage of rising prices in this country. When the value of imports exceeds that of exports, gold is shipped abroad to balance payment.

Continued increases in imports may lead to greater pressure for trade restriction against friendly nations. This could impair America's position as the economic and political leader of the free world.

Government Financing

Under inflationary conditions, governments like individuals, must pay more for wages and supplies. Unless the government reduces its services, it must obtain more revenue. If the added revenues are obtained through deficit financing, further inflation will result. If taxes are increased, particularly in the form of higher levies on property or on sales, the incidence will not be in line with ability to pay, and some groups will be penalized more than others.

Savings and Investment

If continued inflation becomes accepted as probable, savers will tend to shift their investments from bonds and savings accounts to stocks and real property, which offer a prospect of appreciating in value roughly at the same rate as the "creep."

As a hedge against expected continued inflation, many businessmen and individuals will attempt to step up their rate of investment in durable type goods. To the extent that interest rates do not rise sufficiently to offset the prospect of rising prices, investors will try to borrow the money to make these purchases. This may result in insufficient total savings to provide all of the additional financing demanded. In the scramble for limited investment funds, some of the most important needs, such as schools, research, roads, etc., will fall behind in the competition.

CONTROL OF INFLATION AND CONSEQUENCES OF CONTROL MEASURES

Increases in output have averaged 3 percent per year since the end of World War II, while money expenditures have risen an average of 6 percent per year. The difference between the rise in output and the rise in spendings can result only in inflation, that is, in higher prices of the output.

If inflation is the result of too great an expenditure of money, then the control of inflation must be to restrict the growth of money

expenditures to the same rate as the growth of output. The two main controlling devices are monetary policy and fiscal policy.

Monetary Policy

Monetary policy refers to measures influencing the amount of money in circulation in the economy. By money we mean paper money and coin plus the larger amount of bank deposits held by businesses and individuals. Monetary policy means, primarily, the control exercised over the money-creating powers of the 13,000 commercial banks in our economic system. Monetary policy affects rates of interest and the ease with which loans are obtainable, but the heart of the matter is control of the quantity of money in existence.

1. OPEN MARKET OPERATIONS. When inflationary pressures in the economy are so great that creation of money by banks needs to be restrained, the Federal Reserve Banks may sell some of their large holdings of U. S. securities to the public, in particular to security dealers. The security dealers pay for these securities by writing checks on deposits at commercial banks. This has a powerful effect upon the banking system, because the deposits of the commercial banks at the Federal Reserve Banks are the legal reserves of the commercial banks. When these reserves are reduced by open-market sales, the commercial banks are obliged to restrict their lending and security-buying activities, thus restricting the growth or even forcing a reduction in the quantity of money.

In a growing economy, some year-to-year growth in the quantity of money is necessary. Only under quite severe inflationary conditions would we normally expect large or prolonged open-market sales. By vigorous open market sales, even without the aid of any other tool of policy, the Federal Reserve could not only *prevent all peacetime inflation*, but could also at any time *throw the economy into a severe recession*. The really tough problem is to walk a monetary tight-rope, to prevent inflation without causing recession.

2. RESERVE REQUIREMENTS. A much more easily understood tool of monetary policy is changes in reserve requirements. These requirements refer to the amount that a commercial bank must have on deposit with the Federal Reserve Bank to back that bank's deposit holdings for the public. If the reserve requirement is lowered, the banks can then lend more freely, creating money which they could not otherwise have created. If the requirement is raised, banks must restrict their loans, restraining growth in the quantity of money, or even reducing it.

Reserve requirements are subject to change only within the legal limits set in 1935. Since at present they are below the upper limits,

some anti-inflationary potential exists. Any major change in reserve requirements would have a very sudden and substantial effect upon bank reserve positions and credit conditions. The Board of Governors of the Federal Reserve System seems to prefer to use the open market tool for most day-to-day and week-to-week operations, and to use changes in reserve requirements for more infrequent and far-reaching adjustments.

3. **REDISCOUNT RATE.** The rediscount rate is the rate of interest charged by one of the twelve Federal Reserve Banks when it lends funds to a commercial bank. A commercial bank borrows from its Federal Reserve Bank by offering its own promissory note. In exchange its deposit account is increased at the Federal Reserve Bank. The rediscount rate determines the cost to commercial banks of gaining additional reserves, and hence of sustaining a larger volume of loans and deposits than would otherwise be possible.

When inflation threatens, the Federal Reserve authorities normally raise the rediscount rate. This makes it more costly for banks to borrow reserves from the Federal Reserve, and hence tends to cause the banks to raise rates of interest to their own customers. This higher rate discourages borrowing, which tends to restrain the growth of the quantity of money.

For the banking system as a whole, the rediscount rate must be regarded as an adjunct to open market operations and changes in reserve requirements rather than as an independent tool of monetary policy. Perhaps its greatest importance at the present time is as an announcement to the financial community of how the Federal Reserve officials view economic developments. A raise in rate implies that the Federal Reserve is now concerned with inflationary dangers and that other anti-inflationary monetary policies may be anticipated.

Fiscal Policy

By fiscal policy is meant changes in government spending and taxation. Expenditures by government have by now become a quite substantial part of that total flow of money which must be held in check if inflation is to be avoided. In wartime, especially, the unusually large government expenditures (financed by newly created money when the government borrows from banks) are the root of the inflation problem.

If the tax revenues of government rise, less of the income of people and of corporations is left to be spent (or saved). The degree and nature of the effect of a tax increase would vary with the kind of tax, but any tax increase would reduce the spendable income of some-

one. Accordingly a tax increase is anti-inflationary, and if this were accompanied by a reduction in government expenditures the effect would be double-barreled.

“Built-in” Fiscal Policy

To some degree, government expenditures and tax revenues respond automatically to inflation and recession in the economy, and in ways that tend to counteract the ups and downs in economic conditions. Reduction in some government expenditures and increases in revenues produce desirable anti-inflationary results. Such automatic effects cannot by themselves prevent inflation, however, because their operation takes place only when inflation is occurring.

Also, by executive decision of the President, the spending rate of government funds already appropriated can be increased in periods of recession or be decreased in inflationary periods. To combat a severe inflation with fiscal policy, Congress should cut appropriations for government spending (except, of course, in wartime) and raise tax rates or levy new taxes.

The foregoing discussion suggests that an appropriate set of monetary and fiscal policies to control inflation should include: (1) automatic fiscal policy, which would occur as soon as inflation begins, (2) monetary restraint by the Federal Reserve, which would be applied promptly and quickly reversed when no longer needed, and (3) deliberate fiscal policy by acts of Congress only if inflation were severe, prolonged, and persistent.