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Dealing with Inflation

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Dealing with Inflation

Dealing with inflation is not a simple assignment for citizens or public officials who are responsibly and particularly involved. Though inflation is hardly a rare economic malady, doing something about it still involves overcoming complex and intractible political obstacles and avoiding excessive strains on financial institutions and credit-vulnerable sectors of the economy.

Almost everyone's attitude toward inflation is affected to some degree by the coloration of personal involvement in inflationary or anti-inflationary measures. But doing something about inflation is not seriously thwarted by pro-inflation self interest. The major hurdles for an effective anti-inflationary public policy are achieving a timely consensus on the economic forecast, diagnosis and treatment. And a consensus is all the harder to reach because of imprecisions in our analytical techniques and tools for measuring economic activity and inflationary developments.

For those who can agree that inflation should not be a deliberately considered policy alternative there are two choices, to avoid it in the first place or to arrest it once it gets under way. For those who believe inflation's advantages outweigh its disabilities and that it should be here for an indefinite stay, there is but one choice in the long run--the "institutionalization" of inflation. This involves restructuring saving and investment instruments and institutions into equity formats and providing institutional devices for continuously readjusting wage, price, interest rate, tax and annuity relationships in some politically and socially tolerable manner.

While no government, to my knowledge, has explicitly set out to continuously inflate its price level for an indefinite period of time, many have about slipped into such a posture by adopting year after year less than adequate measures to confine inflationary forces. Such measures are usually defended on the ground that inflation is best curbed by gradual steps which do not risk social and political upheavals or disturbances inherent in more drastic measures.

It is not necessary to go far in time or space to illustrate the problems that arise when inflation is persistent if not endemic. The cases of Argentina, Brazil or Chile are all illustrative of persisting inflation of serious proportion over the past twenty years or more. This is evident in the annual percentage increase (December to December) cost of living in these countries since 1956.

	Argentina	Brazil	Chile
1957	26	14	15
1958	50	22	33
1959	102	43	33
1960	12	32	6
1961	19	43	9
1962	31	61	27
1963	28	81	45
1964	18	85	39
1965	38	41	26
1966	30	46	17
1967 (annual rate to date)	25	28	25

In all of these countries anti-inflationary policy has been a continuing public issue and there is no better way of savoring the nature of the inflation problem and controversy than to quote some of the polemics. Let me start with a quote from Ambassador Alsogaray of Argentina, who was the architect of economic policy in Argentina (Minister of Economy) in the period when the annual rate of increase in prices dropped from 102 to 12:

"Our problem stems from the fact that we have had 20 years of inflation which has generated in the country certain expectations that are very hard to fulfill. You cannot measure those expectations with the same yardstick as you measure inflationary signs that crop up in many other countries, including the United States. Here you think in terms of stable money; inflation is considered a pernicious ill that must be combatted, and it is taken for granted that once the source has disappeared, everything will be back to normal. That way of thinking, in itself, already constitutes a stabilizing mechanism. In argentina, on the other hand, we speak of checking inflation, but few really believe in the probability of doing it. Still fewer are prepared to make the necessary sacrifices. They have forgotten, besides, how to live and to work under a stable regime. They think and reason with an eye on inflation, which in itself also tends to unbalance the system even more.....

"There is a strong tendency among some officials and in certain spheres of economists and public opinion, to proceed 'gradually'. This idea is expressed thus: 'inflation must be checked, but it must be done "gradually" so as not to become enslaved to monetary orthodoxy, keeping in mind all the objectives of the economic policy and defending those principles to the International Monetary Fund, international organizations, countries or groups of countries, and pressure groups that act within and without the Government'.

"I do not agree with this thesis and much less do I believe that it is applicable to the Argentine case, where, as I have said, we have become accustomed to living with inflation during the past 20 years. The first thing we must do there is to convince public opinion that inflation is really going to be attacked and, in view of the climate that has been created, the problem requires a very special treatment that positively rejects the adoption of 'gradual' measures.....

"Checking inflation is to the social body what surgery is to the human body. No one thinks of performing an operation gradually and by easy stages. The patient is not given anesthetic the first day, the area to be operated on is revealed the second and the tumor is removed a week later. Everything is done quickly, in one session, the quicker the better, which does not mean to say that the patient will be 'drastically' cured. It is quite probable that he will have to undergo a long and difficult convalescence. But, if everything goes according to plan, energetically and decisively done in order to get to the root of the trouble, it is also quite probable that he will be cured and that after a while he will regain his maximum strength.

"The social body is no different. Inflation is a cancer that must be removed as soon as possible, cutting in as deep as is necessary. Moreover, the operation should be performed in as short a time as possible, however painful and risky it may be. This is the only way to avoid worse ills in the future and to ensure that the patient suffer as little as possible, in this case the worker, the businessman, the consumer, the man in the street."

Ambassador Alsogaray's "gradualism" is not without its advocates as well as detractors. Official anti-inflationary policy in Chile in recent years is often termed "gradualist" and Carlos Massad, Vice President of the Central Bank of Chile, so described it in that Bank's Monthly Bulletin in 1965. He makes a case for it as follows:

"Faced with an inflation problem which must be tackled in an integral manner, that is to say, as much in its basic factors as in the mechanisms through which it is transmitted, there are at least two alternatives for anti-inflationary strategy.

"The first is an alternative of violent and drastic character: to end inflation with one stroke, crush all of the sources of inflation and, from this moment on, continue functioning in a stable economy.....

* * *

"What would the adoption of the strategy of a drastic approach against inflation signify in Chile?.... Unless we use external resources to an extraordinarily important extent, it would involve an excessively high level of unemployment, a very heavy loss of purchasing power for salaried groups and a most grave decline in the levels of production.

"All of this would not be too serious if, after a period of readjustment of six months or a year, inflation were eliminated or diminished and there followed a recovery of the purchasing power of the least protected sectors and a return to the current level of production.

"The problem is that, in Chile, the drastic approach does not give time to resolve the basic problems of the Chilean economy; and as long as these problems are not resolved, inflationary pressures will continue to exist. The drastic approach would involve, purely and simply, a sacrifice, for a brief or long period, but with a very high probability that it could be a sacrifice wasted. In short, so long as the basic defects of the economy are not corrected in order to avoid the inflationary pressures that they generate, we do not have any hope of maintaining an economy with permanent stability.

"The second alternative is one which could be called that of gradualism and firmness. This is a difficult alternative. To choose it implies, on the one hand, a recognition that the basic weaknesses of the economy must be resolved concurrently with the efforts to contain gradually the rate of inflation. This alternative consists of an every day struggle against inflation; and a policy which must be pursued with all firmness. And, what is more important, it requires efforts in a large number of areas, concurrently. It must be in effect in the area of the foreign trade, in agriculture, in wage policy, in price policy, in monetary policy, in brief, in all of the areas of the national economy.

"And since it is a policy which requires such a complete focus, and of necessity opening so many fronts in economic policy, this alternative requires the collaboration of all of the sectors of the community.

"This alternative--in my view perhaps the only reasonable one in the case of the Chilean economy--requires in a special way the understanding, the effort and the sacrifice of all the sectors of the community.

To the extent to which some groups are ready to make the sacrifice and others are not, those that are ready to make it are really and effectively swindled. Because if this national collaboration does not exist, then the group ready to make sacrifices will do its part and will make them, in spite of which the global program will not be able to succeed, or at least will succeed only with difficulty."

It is apparent from these quotations that the "gradualists" rely on essentially the same basic measures for curing inflation that are used by those favoring the shock treatment. Such measures would include reduced government deficits, achieved by expenditure reduction or re-direction and by tax reform or a higher level of taxation, reduced rates of expansion of money and credit and direct controls in those sectors of the economy which are contributing to inflation but are relatively untouched by general fiscal and monetary actions.

The difference is that the "gradualists" think the impact of drastic action involves socially and politically intolerable stresses to institutions and imposes disproportionate sacrifices on some segments of the community. They claim, too, that only a gradual stabilization allows sufficient time for avoiding serious distortions and spreading the burdens of adjustment in a socially tolerable way.

The major defect in the "gradualist's" approach is its weak "business as usual" appeal for public support while the institutionalizing of inflation as a part of the program of amelioration further undercuts the case for urgency and adequacy of action. Once the evident injustices of inflation, or at least the politically evident injustices, have been more or less neutralized, the public zeal to deal with the causes of inflation abates. And the longer inflation continues, the stronger grows the case for additional ameliorative measures. Cost-of-living adjustments become universal and applicable not only to salary and wage earners but also to annuitants, time depositors in financial institutions and bond holders. The adjustments become more frequent or anticipatory of future escalation; they are increasingly a matter of wage contract negotiation or political pressure, not objective fact finding. To a greater and greater degree, economic life and practices reflect the assumption of continued inflation.

The experience of Argentina, Brazil and Chile over a long period of time, to which could be added that of many other countries, clearly indicates that if we fail to avert inflation or to cure it, we, too, will have to fall back on methods of living with it. Some of these methods can be implemented by individual decision--others, as I have been saying, become institutionalized by cooperative effort or by Government action.

Some individuals are less concerned with inflation because they are in a position to arrange longer range investments and obligations so as largely to neutralize inflationary risks. Such countermeasures involve a larger concentration of investment in equities along with larger and longer term debts, the proportions being indicated by a personal judgment of the probability and severity of the inflationary threat. However, a large proportion of our citizens have limited opportunities for "inflation-proofing" their long-term assets or debt positions. Most insurance and retirement contracts are heavily exposed and non-home owners are especially disadvantaged.

While our economy has experienced serious inflation in wartime we, as a nation, have taken no more than limited or interim steps in peace time to institutionalize changes in the CPI, for example. Thus, in some industries and communities there are some wage and salary adjustments tied to increases beyond a certain threshold in the CPI. There are also sporadic adjustments in Social Security and Government employee retirement benefits, reflecting both increases in the price level and in the scale of living. In all, these measures do not yet add up to acknowledging that a continuing inflation requires modifications in our retirement systems, saving instruments, or financial institutions. Our public policy is still implicitly and explicitly committed to averting inflation or to holding it within a tolerance which we judge may reflect the upward bias in the CPI. This judgment is reinforced by the stability of the WPI in most years of the post-World War II period.

Since inflation is easier to ward off than to cure or live with, there is a considerable premium on early detection, on being foresighted and knowing when inflationary forces are brewing. Unfortunately, there is no reliable early warning system. In some sectors of the economy, where expectations are highly volatile, cries of "inflation" can be heard at almost anytime but such cries are often not based on fact.

Our intuitive reactions to changing prices are usually not very perceptive; too often they are conditioned by changes in income status, geographical and social environment, or to a general rise in the standard of living which may amount to as much as 3.5 to 4.0 per cent per year. Perhaps the most obscuring factor is the overlooking of "quality" changes in goods and services. As consumers, we often term "inflationary" higher prices than we have previously known for certain items. But, in fact, although certain of these items have the same name, they do not have the same utility we associate with the earlier lower price. In reality, of course, we do not want the fabrics of the Thirties, the transportation modes of the Twenties, or the pre-supermarket food era, nor pre-miracle-drug medical care.

The official price indexes are the best early indicators of inflation forces but they, too, have short-comings. The GNP deflator and the Consumer Price Index have well-known upward biases. The latter has risen continuously since 1955 at an average annual rate of about 1.8 per cent; but some of this rise is due to a change in the products and services measured rather than a rise in prices. The Wholesale Price Index is notoriously sluggish in registering early firming or softening of prices even though it still provides the most useful basic data available for a careful analysis of the breadth and persistency of price trends. The behavior of the industrial commodity and manufactured goods components of the WPI are particularly significant for this purpose. These components indicate that our main bout with inflation in the post-World War II period was in 1950 and early 1951. Lesser, but more sustained rises occurred in 1955-56 and in 1965-66. Since the middle of this year industrial commodities have been rising at about a 3 per cent annual rate.

Some observers believe that inflation or deflation can be predicted from prior changes in the rate of growth in the money supply. While this theory is plausible enough to attract quite a following it is not the type that can be easily dismissed or endorsed.

As a general proposition, increases in money or, in more general terms, in liquidity, are likely eventually to lead to increased demands for goods and services. If the economy cannot readily expand to accommodate such an increase in demands because resources are already fully, or nearly fully, employed we should expect evidences of inflation to begin to appear.

The difficulty with using changes in the money supply or liquidity, as an early indicator of inflation, lies in the inability to predict with consistency and accuracy the course of the economy from changes in the money supply alone. How much money or liquidity is appropriate to a particular economic environment depends on a host of factors: stocks of wealth, expected income flows, possible shifts in spending propensities, interest rates and Government fiscal policies to mention some of the most important.

Given traditional central bank operating procedures, the dominant factor accounting for period-to-period changes in the money supply or its rate of growth is often the change in the transaction and buffering money needs of individuals, corporations and governments that accompany changes in economic activity. There is no reason to attribute to money supply changes reflecting changes in such needs any significant positive or negative influence on decisions to spend or not to spend, or to defer or accelerate some previous investment or spending decision. Changes in the money supply to accommodate transaction needs are "caused" by the forces emanating from the tempo of the economy and from decisions made prior to the recorded changes in the money supply. In other words, changes in money are, more often than not, a function of changes in the economy, rather than the other way around, as some would have it.

It is possible that changes in money stock to accommodate transaction needs complement a different and more economically significant type of change in money supply or mirror, in some complicated pattern, such a change. If this were the case, money supply changes might be a useful proxy variable but it is neither a likely nor very apparent probability.

While some monetary students profess to see in every country, and at every state of economic development, an underlying pattern of money causation of economic behavior, this possibility seems less and less likely as alternatives to money as sources of liquidity proliferate and as money itself becomes less and less desirable in this respect.

Since money statistics are not disaggregated by type of owner nor segregated so that stocks held for transaction needs can be distinguished from those held to satisfy liquidity or other needs, users of money statistics perforce lump all money holdings together thus masking the statistical evidence we have available for regarding changes in money supply as a significant economic variable. However, it is possible to achieve some disaggregation of money holdings pertinent to estimating transaction and liquidity uses.

For example, regardless of what might have been true in some past periods, it is impossible to believe that coins, today, perform any liquidity function. Coins are no longer treasure or precious metal but purely tokens of a metallic alloy best suited to circulation requirements. Piggy bank hoards, bureau drawers with Kennedy half dollars and collectors' "standards" have less than a nominal effect on over-all coin demand--they certainly have no liquidity effect.

Nor can one attribute much, if any, liquidity significance to changes in the public's demand for paper currency. With confidence in the banking system restored, few but the zany, those wary of the Internal Revenue, and foreigners abroad, have any desire to use currency to fill or drain a liquidity pool. None of these incentives to hoard currency are of the type to generate or dissipate spending proclivities--in short, changes in the demand for currency and coin are a passive response to non-economic factors, to technological changes in money settlement methods, or to changes in the tempo of economic activity.

The statistics on coin and currency in circulation bear this out. They show that coin has been the most rapidly growing segment of the money supply throughout the current decade. This is mainly because of the vastly expanded requirements for meter and vending machine operations and accompanying pools of inactive coin. Since 1963, coin stock has had an average annual growth rate in excess of 12 per cent.

At the end of 1966, coin outstanding was almost 100 per cent above the 1959 level; the comparable increases for small bills ($1, $2, $5, $10) was 24 per cent, for $20's and $50's, 35 per cent, and for large bills ($100 and over), 42 per cent. In the same interval GNP rose 55 per cent, personal consumption expenditures 50 per cent and personal consumption expenditures on nondurable goods 41 per cent.

The inferences to be drawn from these relationships are almost entirely related to transaction developments. The exceptionally large increase in coin is to accommodate metering and vending machines. The slower rise in lower denomination currency reflects an increase in the average size of currency transactions, and the greater rise in largest denominations suggests the possibility of some foreign, or concealment use, of $100 denominations. The slower growth in the total for all currency denominations relative to GNP or personal consumption expenditures certainly does not reflect more efficient paper money use, as in the case of demand deposits, but a steady shift toward the substitution of convenience credit and checks for cash.

Coin and currency growth in the decade thus far amounts to 33 per cent of the total change in the money supply. Obviously, this ratio is highly variable on a period-to-period basis mainly because of the nature of changes in privately-held demand deposits. However, if the calendar year is taken as the period, and 1960 is omitted, the proportions from 1961 to 1966 are 16, 50, 34, 27, 28 and 56.

The disaggregation of demand deposits to identify the size and change in private balances for transaction uses involves more hypothesis and inference than is needed to evaluate the transaction role of the coin and currency component of the money supply. This deficiency we are working to remedy in the near future by resumption of our efforts to trace more accurately and frequently the changes in major categories of the ownership of bank deposits. Using information presently available it can be noted that demand deposits of State and local governments, for example, are inappropriately included in conventional money supply definitions because they are not segregated in daily, weekly or monthly banking statistics. But these holdings--largely transaction conditioned--are not inconsiderable. Call report data indicate that such balances are about 10 per cent of the demand deposit component of the money supply.

Demand deposit balances of the Federal Government are excluded from most money supply definitions; but the frequent rapid shifts from private to Government accounts around tax and financing settlement dates, followed by the buildup in private accounts as Government balances are drawn down, often dominate short-run changes in the money supply. On some occasions they seem to have more than a transaction significance.

The most useful detail on demand deposit balances would enable the analyst to distinguish among a few major ownership- and account-size groups. We know, for example, that large corporations manage their demand balances more efficiently than most individuals, and that unneeded balances for transaction purposes are promptly invested in market instruments or time deposits. In fact, the size of the typical corporate balance is based on anticipated transaction needs including whatever balance requirements are imposed by banks for services rendered or future access to bank credit.

This behavior of corporate balances is reflected in the New York City banking statistics which are dominated by corporate financial transaction. As is well known, demand deposit balances in New York have changed little in recent years--rising only 12 per cent since 1960 and through 1966. Much of that change probably came as a result of the stiffening of compensating balance arrangements, either in observance or enforcement. But this modest rise in deposits has been adequate to accommodate a 125 per cent rise in debits because of the increased efficiency in money management and changing settlement technology. These factors are evident in the nearly 100 per cent rise in turnover.

The behavior of balances outside of money centers, where corporate balances do not dominate trends in deposit growth, comes closer to reflecting the average individual depositor's attitude toward his demand deposit balance and the closeness with which he manages it.

Increases in deposit balances in over 200 of these cities averaged 24 per cent which, supplemented by a rise in turnover of 44 per cent, accommodated the 80 per cent rise in debits. This transaction increase compares to a GNP rise of 55 per cent in the same period.

The inferences to be drawn from these proxy measures of corporate and individual deposit behavior suggest quite clearly that demand deposits in the United States today are heavily oriented toward transaction needs. This is especially true of corporate holdings. Liquidity objectives increasingly can be met with profit and adequate availability by the use of time deposits in banks and savings and loan associations, and by investment in money market instruments.

The conventionally defined money supply thus is losing its liquidity significance. While it may still incorporate changing elements of great significance for appraising economic trends the odds are that any such elements are less and less likely to be discernible. Rather, the more significant developments in banks' and other depositories' assets or liabilities appear to be taking place in the shifting flows and terms for near monies and the direct participation of individuals and corporations in money market instruments.

To return to our problem of a short recognition lag, the answer to the question, is inflation coming, is never likely to be settled by some single economic barometer such as change in the money supply growth. As of now, the public, Congress and, to some degree, economists are divided in evaluating the inflationary implications of the current economic environment and the projections of future economic activity. This typical division of view is the characteristic factor that gives inflationary pressures a head start and lessens the possibility of warding them off with a minimum of disruptive consequences.

Even if a public consensus could somehow be reached at an early stage that inflation was coming, the prescription for a public action would still be controversial, as it is now. Changes in public spending, taxing, in credit conditions, or direct restraints on the private economy would be debated as they are now along with the proposition that there is no need for any action.

We have been very fortunate in the current situation that financial institutions and consumers have been following conservative lending and spending policies and that the ultimate objective of monetary restraint--the postponement of some credit-financed spending--has been achieved to a significant degree without vigorous Federal Reserve intervention. In fact, developments in the capital markets have been productive of restraint comparable, so far as nominal long-term rates and postponement of corporate and municipal flotations are concerned, beyond that experienced in 1966. Up to this point the consumer saving rate has been holding at or near 7 per cent but this fact may become less reassuring insofar as restraint on inflation is concerned as the rise in disposable income spurts in the months ahead unless the rate of saving rises also. And on the basis of historical precedent this is not likely.

With very few exceptions the managements of financial institutions have been sufficiently concerned about future depository flows to have added rate and other inducements to attract time deposits while avoiding terms which might become disequilibrating. These steps have produced large flows of funds and, in the main, have done so without unduly enlarging institutional exposure to disintermediation even though the market rates for many maturities of market instruments have become highly competitive.

On another front lenders generally are observing more caution in future commitments to their loan customers. They are doing so because of a conservative appraisal of the uncertainties with respect to their own sources of funds, and just recently because of uncertainties growing out of the British devaluation.

Despite the assist from financial institutions and consumers, the source of inflationary pressure today--the disproportionate deficit in the Federal Government's budget--will soon have to be eliminated in one way or another. This is the easiest way of dealing with inflation and the longer we delay curative measures the more drastic the subsequent alternatives become, for, if we will not avoid inflation nor cure it, we will be forced in the end, and to our great disadvantage, to live with it and institutionalize remedies for its injustices as best we can.