The New Battle with Inflation

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In recent weeks, President Carter has announced a complicated program to fight inflation and increase confidence in the dollar. Although the program is a smorgasbord of several economic philosophies that go together like caviar and candy bars, it has good prospects of working because it deals with the fundamental causes of inflation: the large budget deficit and the rapid growth of the money supply. It attempts to cut the budget deficit to less than half the 1976 deficit, or by more than $30 billion, partially by reducing the share of the gross national product that goes to the government. It attempts to keep down the growth of the money supply by pushing the discount rate--the interest rate banks have to pay the Fed for short term loans--up one full point to 9 1/2 percent and by increasing reserve requirements on certificates of deposit of $100,000 and over. It also tries to get rid of some of the excessive regulation that adds to inflation. If the government faithfully carries out its promises, the program should succeed.

More important, as long as government policy is systematic and credible, the program is not likely to cause a recession. This contradicts some of our economic sages. Arthur Okun, for instance, claims that to knock just one percentage point off inflation we must sacrifice $200 billion in gross national product. In his opinion, significantly reducing inflation would require a massive recession. Even those who do not share his gloom are concerned that cutting the deficit and slowing the growth of money will lead to a minor recession. No one can guarantee that there won't be a recession, of course--economics just isn't that precise in these matters. But the newly announced policies, if properly implemented, should have lower costs than many of the sages predict and should not significantly increase the probability of having a recession. In fact, the odds are that they will cause only a small reduction in economic activity.

## People's Expectations Make a Difference

This appraisal is more optimistic than many because it is based on some insights that are surprisingly new to the field of macroeconomics. One of these revolutionary new insights is that what people think affects what they do. Thus, an anticipated change of policy can have quite different results from an unanticipated one. Most of the models that economists rely on to predict the results of a change in monetary or fiscal policy assume that the new policy is totally unanticipated. If the government spends more than it budgeted for ten years in a row, everyone is assumed to be completely surprised year after year. If the money supply keeps growing faster than the announced rate, no one catches on quickly enough to make appropriate adjustments. Most economists, if pressed, would concede that people do exist. Some would even admit that people have wills of their own, however inconvenient. But these humanistic values find no home in most mathematical models of the economy. Most forecasts of the impact of a new economic policy are based on the implicit assumption that people can be repeatedly fooled and don't act in their own best interests.

Economics, however, is a study of people's behavior. When people anticipate a policy, their behavior may conflict with what the economic sages and the most popular economic models predict. Suppose that the growth in the money supply is held back by the increased reserve requirements and higher interest rates that were recently announced. Suppose further that this new policy is "unanticipated," either because people didn't expect the new policy or because they don't believe that the government will stick to it. As time goes on, there will be less money available than there would have been under the old policy. Because there is less money, aggregate demand will grow less rapidly. Businesses, in order to keep their customers, do not raise their prices as fast. Wages, though, keep rising at their former pace because workers' contracts--which were written in expectation of greater money growth and greater inflation--cannot be changed. In this way workers become more and more expensive, while the value of the goods they produce doesn't change much. Some workers, in fact, are soon paid more than the value of what they produce, and firms that strive to maximize profits are forced to lay people off and cut back production.

The result of an unanticipated reduction in money growth, then, is that the rate of inflation improves but production and employment suffer. In more technical terms, the aggregate demand curve shifts downward, so that both output and prices are lower than otherwise expected.

If the reduction in money growth is anticipated, though, the picture is much brighter. Suppose now that people expect the newly announced policies to succeed in slowing the growth in money and reducing inflation. At first, this change in expectations makes little difference in the way the policies work. As time goes on, less money becomes available and aggregate demand grows less rapidly. Businesses, trying to keep their customers, do not raise their prices as fast. But this time wages do not rise as fast either, because workers' contracts have been written in expectation of slower money growth and slower inflation. This is the switch. Workers don't become more expensive than what they produce, and firms that strive to maximize profits do not have to lay people off or cut back production.

The result of an anticipated reduction in money growth, then, is that inflation is reduced while real wages, employment, and output are barely affected. In more technical terms, the aggregate supply and aggregate demand curves both shift, yielding lower prices but no big change in output.

The social and economic costs of a new policy could well depend on people's expectations. If everyone expects a new policy to make prices more stable, workers will know that they can maintain their buying power with smaller wage hikes. Businesses will know that if they raise prices too fast, they will no longer be competitive. If an inflation-fighting policy is anticipated, it does not have to disrupt the economy--and it certainly does not have to start a recession.

## Lowering the Costs of a Policy Change

For the effects of a policy to be anticipated, it is not necessary that every American watch the evening news with a pocket calculator and a sheaf of graph paper. All that's necessary is that people avoid making systematic prediction errors when guessing what next year's inflation will be. What probably happens is that they make plenty of prediction errors, but not systematic or repeated ones. They don't make systematic errors because the more often a policy is tried, the better they are able to correct past mistakes. Although they can be fooled the first time a policy is tried, they eventually learn how to use the information they have to make better predictions.

Labor leaders, who are hardly naive about economic matters, avoid systematic errors in predicting inflation by at least two other means. One is to hire forecasters whose job is to avoid such errors. The other is to index their contracts to some measure of prices, so that when the cost of living goes up, pay automatically goes up. This provides no opportunity for error, except the error caused by the time lag between the inflation and the raise in pay. Over 60 percent of all major labor contracts are now indexed. Those that are not indexed are tending to cover shorter periods, so that workers can receive more frequent raises to keep up with rising prices.

Perhaps <u>anticipations</u> is too anthropomorphic a term to cover all the mechanisms that help wages keep pace with inflation. But somehow people form anticipations in such a way that they use the information they have efficiently.

To encourage an efficient use of information--which makes it easier to fight inflation--there are some steps that government must take. They are not difficult or expensive. They do not require any new bureaucracies. They are simple, straightforward steps that government probably should be taking anyway. First, new policies should be announced in advance, so that people can plan accurately for the future. If the policies are inflationary, people will no doubt try to protect their incomes--and a new round of inflation will hit earlier than it might have. But if the policies are anti-inflationary, people will see that they don't have to keep raising prices and wages frantically just to stay even--and the benefits of the policy will come sooner than they otherwise would have.

The second step that the government must take to encourage the right kind of expectations is to stick to its announced policies fastidiously. If it announces that the federal deficit will be cut by some 30 percent, it needs to cut it by 30 percent with no excuses. If its tax revenues are not as high as expected, then its public services must be trimmed. Should it announce policies and fail to carry them out, it will have less credibility and its future announcements will not have the desired effect. Once it announces one or two policies and carefully follows through, however, it will be able to reduce inflation without causing much of a drop in employment or production.

These steps to make government policies better understood and more systematically implemented are necessary mainly because many people do not think government is credible anymore. Unfortunately, their skepticism is often justified. The Federal Open Market Committee, for example, has consistently failed to meet its announced goals for the growth of the monetary aggregates. For the last eight quarters M1, the sum of currency and checking deposits, averaged just under 8 percent--well above the stated target. People could easily expect the government to continue its inflationary policies despite the trumpeting to the contrary.

## Recession: Not Necessary and Not Likely

What this means is this: although a serious anti-inflationary policy is beginning, it is largely unanticipated. The costs will therefore be higher than for any subsequent actions, actions taken after the government has demonstrated that it intends to do what it says. This policy will most likely produce mixed results--the desired lower rate of inflation should be coupled with an uninvited slowdown in output. The slowdown in output should not be as severe as a recession.

Even under the worst conditions, in fact, the costs of the new policy should be minor compared with the benefits, because the government will develop a potent weapon for fighting inflation: increased credibility. As the government gains credibility, it can keep lowering the rate of inflation a little at a time, each time with less impact on output and employment. The more credibility the government has, the easier it will be to bring down inflation without affecting real economic activity, because people's expectations would be working to fight inflation, not to aggravate it. In fact, if the government had enough credibility, it could not just reduce inflation by a few percentage points but eliminate it almost entirely with very little real cost. For the moment, though, it is necessary to build that credibility by cutting the deficit, slowing the growth of the money supply, and reducing the jumble of government regulations as promised. Once this is done, our future decisions will be much more pleasant.

All in all, despite a few objectionable parts like wage and price guidelines, the anti-inflation plan that has been unveiled this fall has a good chance of working. To make it work, however, the government must deliver on its promises better than it has in the past. After all the hoopla, it will be soundly embarassed if it does not deliver. Worse, it will have tremendous difficulty making people believe in the next anti-inflation plan. If the current plan fails because the government does not keep its word, the costs of the next plan--in lost output and employment--will be unnecessarily high, because people's expectations will be working against it. But if the government does attack the fundamental causes of inflation as promised, future battles with inflation will be less costly. Then, even the gloomiest economists will have to whistle a different dirge.