

Hand by Brinkley

CONTROLLING INFLATION

Speech by Darryl R. Francis at the 75th Annual Convention, Kentucky Bankers Association, Louisville, Kentucky, September 15, 1969

*Andy proposes an introduction*

In recent months we have heard the repeated suggestions and repeated denials that direct government controls of wages, prices, and credit will be necessary to break the inflationary boom. In testimony before the Senate Finance Committee, Secretary of the Treasury David M. Kennedy said he opposed controls but that procrastination in renewing the tax surcharge would bring on these regulations. <sup>1/</sup>

Secretary of Commerce Maurice Stans concluded from letters and conversations that a growing minority of businessmen are so concerned about the pace of inflation that they would favor controls. <sup>2/</sup>

My contacts with businessmen in recent months, much to my surprise, confirm the Commerce Secretary's observation that many are talking favorably of wage and price controls as a solution to the problems of inflation. This line of thinking is direct and avoids theoretical complications. It assumes that, since inflation is a rise in the general price level, direct controls over wages and prices can stabilize prices and thereby prevent the evils of inflation.

1/ Business Week, July 12, 1969, p. 102.

2/ Business Week, June 7, 1969, p. 49.

*Clay - this is a copy of the original*

*Hidden from*

*control money  
9 - expansion, where there was  
a deficit  
company*

The advocates of bureaucratic control of prices assume that such controls are workable alternatives to less expansive monetary policies as a means of halting inflation. These assumptions are subject to the same type of scrutiny used by Professor Yale Brozen of the University of Chicago in an article entitled "The Untruth of the Obvious".<sup>3/</sup>

*2 generations*  
Despite the widely assumed "obviousness" of the workability of ~~direct controls~~, ~~I contend~~ that:

~~(1)~~ Even under ideal conditions, direct control of wages, prices, and credit are expensive to administer and extremely difficult to enforce,

~~(2)~~ They impair the efficiency of the price system as an allocator of resources and fail to provide an adequate substitute,

~~(3)~~ The arbitrary rationing involved in direct controls is a major infringement on individual liberty and is extremely subject to bureaucratic abuses, ~~and~~

~~(4)~~ Direct controls *at best* are not a solution to inflation but only a partial postponement of price increases in the face of excessive demand.

Some of you will require only a reminder of the problems of administering the Office of Price Administration (OPA) during World War II. During the

3/ Published in, The Freeman, June 1968.

all-out war effort much more favorable conditions *than now* existed for the implementation of direct controls.

In the face of the common enemy virtually all citizens were united and willing to make sacrifices for the successful conclusion of the war. In this emotionally charged atmosphere, broad industry agreements and press releases were sufficient in early 1942 to limit price increases.

By late 1942 specific price schedules were necessary. At this time Price Emergency Regulation No. 2 noted that rents were climbing fast and rent controls were put into effect.<sup>4/</sup> Price Emergency Regulation No. 3 of October 1942 noted that, despite the regulations, wages and farm prices had moved up, forcing continuous amendments and additions to the regulations.

In June 1943, after a hectic 16 months of operating under intense pressure, the OPA was overhauled. The authority for setting prices was passed from the Washington office to the field offices. Numerous advisory committees were appointed, and ration books were issued.

By late 1943 complaints of a black market (selling above OPA price limits) and a shortage of enforcement investigators were noted. The substitution of low-quality goods in the higher quality

4/ U.S., Office of Price Administration, Renewal of the Price Control Act, Congress, House Banking and Currency Committee, Apr. 12, 1944.

price schedules was also apparent. Subsidies to producers became an increasing part of the price control program in the late war years as set prices were insufficient to provide the necessary incentive for production. Commodities subsidized included coal, lead, copper, tin, petroleum, coffee, and farm products.

The number of workers required to operate and enforce this program was staggering. By 1944, 325,000 price control volunteers, in addition to 65,000 paid employees, were being utilized. This was a period when the country was faced with a labor shortage, and most of these people could have worked at productive jobs, thereby adding to total output. In addition to the number of employees required directly by OPA, the program was a burden to all business establishments. For example, the banking system was handling 5 billion ration coupons per month in 1944.

By 1946 people were no longer willing to make wartime sacrifices and much of the wartime price control machinery that limited incomes was by-passed. Breaking the law became extremely profitable. Little respect was shown for a law which banned economic transactions that were permitted and morally acceptable in pre-war years. Similar to conditions during the prohibition era, the number of law-breakers outnumbered the enforcers.

Both for those who had blind faith in the law and for the profit maximizers the choice of action was easy. For many other Americans, the choice of whether or not to live within the law was difficult. Few, however, became disturbed when two or more people got together and made a mutually satisfactory deal.

Most individuals and businesses participated to various degrees in law breaking, including black marketing, gray markets, tie-in-sales, kickbacks, upgrading, etc. For example, those who needed a freezer of beef often went directly to a farmer friend and made the purchase at an agreed price. The packing house and retailer, where OPA prices were enforced, were by-passed. Store shelves were often empty and our efficient channels of processing tended to collapse. Nevertheless, those who had good contacts with producers managed to satisfy most of their demands but at a higher cost through this inefficient means of production and marketing. One OPA official reported that while traveling through Texas he stopped ~~out~~ in a rural area where a farmer was slaughtering a steer for illegal sale. The official asked the farmer if he didn't know that the practice was illegal. The farmer replied, "I reckon we ain't heard about that law out here". Finally, in 1946, after a year of post-war domestic crises which included numerous

strikes, food shortages, and a high rate of inflation, most of the provisions for direct controls were ended.

Rent controls were the last to go, with some lingering on into the 1950's. Owners found it unprofitable to keep rental property in good condition. By the time <sup>most</sup> rent controls were finally removed, <sup>much</sup> most rental property had already become dilapidated. Those World War II rental apartments which continued into the 1950's under controls now comprise our central city slums.

*to the present day*

As an alternative to arbitrary government control, the price system can be looked upon as an automatic and impersonal control mechanism. It allocates resources to various types of production according to demand for individual products, and output is determined according to consumers' willingness to pay for goods and services. Income is allocated to individuals and firms according to their contribution to total output. These allocations are made without personal prejudice and with neutrality with respect to political, religious, or social affiliation. In other words, they are made in a highly objective and democratic manner.

I do not contend that the price system is perfect in all respects. In the existing market, some business and labor groups can exercise greater power than others. This and other flaws, however, are relatively minor compared to problems created

by direct controls. For example, under direct controls, rationing is generally necessary in order to allocate ~~minimum of~~ scarce items, and almost all items are scarce under price controls. Allocations of labor and other resources among industries and firms are determined by arbitrary government rules rather than through freedom of choice ~~of the individual~~. Controls which maintain prices and wages below market levels in any industry offer no inducement for the increase in production necessary to alleviate shortages. Arbitrary wage setting is not likely to provide for payments according to individual productivity; consequently, there is little or no inducement to improve one's skill. Direct government controls, therefore, offer little inducement for the efficient development and use of resources, and contain no automatic mechanism for resource adjustments and the alleviation of shortages or excesses in production. Rather than being an aid to growth and vitality, they lead to economic retardation and reduced welfare.

Equally as important as the economic shortcoming of direct controls is their useless infringement on freedom. Freedom did not come easily to mankind. We tend to take freedom for granted, but in most of the periods since man's

early history he has been forced to bow in both thought and action: to harsh taskmasters. More often than not, his social position, his income, his occupation, and his religion were forced upon him. Some rays of freedom began to be noticed in much of Western Europe about the time that America was discovered. In the late 1600's freedom of thought and action in the Netherlands was well ahead of that in other European countries. Similarly, economic progress was most noteworthy there. ~~During this period~~ <sup>The</sup> streams of Western Europe's ~~persecuted~~ <sup>persecuted</sup> citizens migrated to the American colonies. ~~Most of~~ <sup>these</sup> ~~these~~ <sup>had</sup> migrants had definite ideas about freedom, ~~both economic and political~~ <sup>both economic and political</sup>. They came from areas where the state controlled their economic life and the church controlled their thoughts. Roger Williams led the way toward freedom in the American colonies with a constitution in Rhode Island that provided for relatively little governmental interference with the daily lives of the citizens. Jefferson incorporated much of the 18th Century thinking relative to freedom into the United States Constitution.

John Locke, about 300 years ago, postulated a state in which men were free and equal before the law and before each other. His ideal government was one which represented majority rule rather than an exclusive structure for a king or dictator at the top.

He recognized that most economic problems were self-adjusting. In the economic area, however, we must come forward to Adam Smith's day, about 200 years ago, before a harmonious theory was developed showing how an economy works most efficiently under relatively free conditions. In fact, to the confusion of most people in his day and of our time, Smith showed that most government efforts designed to improve economic activity and welfare actually ~~retard~~ <sup>were retarding</sup> growth. He, along with other great philosophers in later years, pointed to a free and efficient enterprise economy. Added to the freedom to select government officials, this provides by far the greatest freedom from coercion and from want of any system that has so far been devised. Most of these ideas were incorporated into the United States Constitution.

Direct wage and price controls are not compatible with freedom. Instead of workers moving voluntarily from job to job for higher pay, under a direct controls system they must be moved by arbitrary action of government. Under direct controls personal income, living costs, and the very necessities of life are determined arbitrarily by government with an army of enforcers. Such a system contains the ingredients for complete dictatorship at the top and complete subservience at the bottom. It is certainly not compatible with freedom as experienced in America during most of our years since Independence.

In addition to the facts that direct wage and price controls are almost impossible to administer, impair important functions of the price system, and are contrary to our ideals of freedom, they do not provide a solution to inflation. During the period from March 1942 to October 1946, in which direct controls were used, the consumer price index rose ~~6~~<sup>2</sup> per cent ~~per~~ year and there is fairly general agreement that the index understates the actual rate of inflation because of declining quality of products and black market operations. Wages rose at a slightly faster rate than consumer prices during this period. How much prices and wages would have increased without controls is ~~questionable~~. From October 1946, just prior to the removal of controls, until May 1950, prior to the Korean War, prices rose at the rate of 4.0 per cent, or slightly less than during the controlled period, and wages continued up at about the same rate as they did under controls.

*not certain*

*is that  
you  
think  
same*

Even if controls hold back price and wage <sup>for the time being</sup> increases, they do not solve the problem of inflation. If excess demand for goods and services has been created, it continues to exist. Direct controls, like a new paint job over a termite infested house, hide the evidence but do nothing to eliminate the cause of the problem. Unless the basic causes of inflation

are eliminated, direct controls can only postpone the inevitable price increases until some future date.

*might hold back  
creation of  
money*

As suggested in the above discussion of direct controls, the best solution to the problem of inflation is to eliminate the cause. Inflation occurs because the stock of money (demand deposits plus coin and currency in circulation) increases relative to the amount of money that people want to hold, given their level of wealth and income.

Starting from a position of stable prices, if additional money is <sup>created faster than it is demanded</sup> created, people will prefer to spend more, thereby reducing the proportion of their wealth held in the form of money. If the rate of spending rises faster than production of goods and services, prices will rise. Prices will continue up until money incomes and wealth are pushed up to the point at which the public will want to hold the increased stock of money. Money is thus the key to ~~the cause of~~ inflation and appropriate monetary control is the solution to the problem.

The current inflation can be traced to the course of the stock of money. Money grew at an annual rate of 3.0 per cent from 1961 to early 1965. This rate of growth in the stock of money was accompanied by generally stable prices, moderate economic expansion, and a decline in the rate of unemployment.

From the spring of 1965 to the spring of 1966, the stock of money rose ~~6.8~~ per cent and both spending and inflation accelerated. From the spring of 1966 to the close of the year, the stock of money remained stable and the rate of inflation declined. Rapid monetary expansion was resumed in early 1967 and was soon followed by an acceleration of spending and inflation. From January 1967 to December 1968, the stock of money expanded at ~~the rate of 6.8~~ <sup>a 7</sup> per cent <sup>annual rate</sup> and since the second quarter of 1967, the general price index has risen at ~~the rate of~~ <sup>more than a</sup> <sup>annual rate</sup> 4.8 per cent. Since last December the stock of money has risen at a more moderate rate and I look forward to a reduction <sup>in total spending and</sup> in the rate of inflation during the months ahead.

Throughout most of ~~man's~~ economic history, inordinate inflations have been limited because the stock of money was tied to a relatively stable quantity of precious metals. That period in history has largely passed, as precious metals are no longer a restraining influence on money creation. Today, the prevention of inordinate inflations depends upon central banks and treasuries <sup>appropriately</sup> rigidly limiting the stock of money.

In the United States the Federal Reserve System has the responsibility of formulating monetary policy. It is <sup>believed</sup> ~~conceded~~ by most monetary analysts that the System can control the stock of money through its power

*control Federal Reserve credit and*  
 to ~~create and destroy~~ bank reserves and ~~the monetary~~  
~~base (bank reserves plus coin and currency in circu-~~  
~~lation)~~. When the Federal Reserve System buys govern-  
 ment securities, bank reserves are created ~~and the~~  
~~monetary base is enlarged~~. With a larger volume of  
 bank reserves, bank expansion can proceed. As new  
 loans and investments are made, the volume of demand  
 deposits, the major component of our stock of money,  
 rises. Sales of government securities by the Fed  
 reverses the process, reducing the stock of money.

Fiscal deficits are often associated with  
 inflations primarily because of the method used to  
 finance them. If deficits are ~~financed in part~~, as

*is often the case, by <sup>securities</sup> Federal Reserve <sup>by</sup> ~~purchases of~~ <sup>government securities</sup>*  
~~government securities, this is ~~not~~ <sup>found about</sup> ~~not~~~~  
~~creating new money~~. *It is <sup>found about</sup> ~~not~~ <sup>found about</sup> ~~not~~*  
 If the deficit is financed without

the creation of new money, it will probably have little  
 impact on prices. Proceeds from the sale of  
 government securities will be removed from the private  
 spending stream and the rise in government outlays will  
 be offset by reduced spending in the private sector.  
 In nearly every country experiencing a major inflation  
 the cause is the creation of new money to finance  
 government activities. We have no evidence, however,  
 that government deficits which are not monetized  
 will lead to inflations.

~~It is contended~~ <sup>by some</sup> that inflations are caused by "wage push" or "administered price actions". The argument is based on the belief that some wages and prices can be arbitrarily increased because of excessive market power. "Wage push" <sup>or "cost push"</sup> adherents point out that new wage contracts in the steel industry are followed by steel price increases which are in turn followed by automobile price increases. This series of events, however, does not lead to inflation unless excess demand has been created through monetary expansion. If, through excessive bargaining power, wages are pushed too high in these industries, output will decline in the absence of monetary expansion. Resources will then be released to other industries where prices will fall. Average prices for all goods and services will remain about unchanged once resources are again fully employed. Monetary expansion must accompany "wage push" <sup>or "price push"</sup> actions for inflation to occur.

*fraser goes patchy pretty*  
- 15 -

*summary*

In summation, our experience during World War II with direct controls on wages and prices was a futile exercise in the economics of admonition and legal restraint. Both moral suasion and the law were used in attempts to restrain man's age-old propensity to maximize through prices.

*Is there a careful study that says this?*

*obscure*

*WW TP*

Despite the exhortations and legislation, ~~human~~ nature did not change. Most price rigidities set up by the OPA either caused a breakdown in our efficient production and marketing channels or in quality standards. Producers who had products which were in great demand and purchasers who were not satisfied with the rationing process generally found a way to bypass OPA regulations. Disrespect for the law became the normal pattern of life rather than an aberration. Despite the legal and moral restraints and an army of controllers, prices and wages continued to rise at a high rate throughout the war and early postwar years.

If governments were sufficiently strong to set rigid controls on wages and prices, ~~man's~~ freedom would be ~~greatly reduced~~. Labor and other resources would be moved from job to job arbitrarily by the government rather than through wage incentives. Much of the managerial function of entrepreneurs would shift ~~from the individual~~ to the government and the

*(11.1.44. 11.1.44)*

need for ~~higher priced~~ <sup>the best</sup> managerial talent in the private sector would probably disappear. Such controls impair the functions of the market system. They ~~provide~~ <sup>discriminate</sup> no incentive for output increases in areas of rising ~~consumer~~ demand. They are thus conducive to economic retardation rather than progress.

Inflations cannot be controlled through direct controls on wages and prices. Like an anesthetic given in the absence of medication or other treatment, direct controls at the most only put the patient to sleep. His malady remains unabated when he is awakened.

Appropriate monetary policies are the only means that have proved workable throughout history in controlling inflations. When kings and emperors debased their nation's currencies by reducing the precious metal content of money, inflations ensued. Today we debase our currency by excessive ~~paper~~ <sup>credit</sup> money creation. Our means of currency debasement is more sophisticated and less direct than in medieval and ancient ages. Yet, the result is the same - excessive money created relative to production of goods and services lowers its value. The solution requires a rigid ~~limita-~~ <sup>proper</sup> tion on the stock of money.

Control over the stock of money in the United States lies <sup>chiefly</sup> with the Federal Reserve System.

Control can be exercised with greater ease when the Federal Budget is in balance or surplus since the government will not be forced to borrow additional funds in a financial market where credit is restricted by tight monetary policies. Even with ~~irresponsible~~ <sup>stimulative</sup> budgetary policies, ~~caused by war or social needs~~ however, the Federal Reserve System can maintain a moderate rate of growth in the stock of money and control over total demand for goods and services through an appropriate rate of money creation.

Resulting  
from  
military  
or  
social  
expenditures