

FOREWORD

On November 28, 1978, the Center for the Study of American Business at Washington University and the Federal Reserve Bank of St. Louis sponsored a conference on "Alternative Policies to Combat Inflation." Designed to examine the full range of public policy approaches to fighting inflation, the conference featured Karl Brunner of the University of Rochester, Beryl Sprinkel of the Harris Trust and Savings Bank, Sidney Weintraub of the University of Pennsylvania and Robert Nathan of Robert R. Nathan Associates, Inc. Over 65 guests -- university, business and Federal Reserve economists -- participated in this third annual jointly sponsored conference.

Additional short presentations were given by Paul Craig Roberts of the Wall Street Journal and Murray Weidenbaum of the Center for the Study of American Business. Discussion papers were presented by Charles Webster of Washington University and Denis Karnosky of the Federal Reserve Bank of St. Louis.

All papers are included in this proceedings volume in their entirety. Summaries of the four major papers are included in this foreword and follow.

"The Commitment to Permanent Inflation"

Karl Brunner of the University of Rochester stated that the waves of inflation that have swept over the U.S. since 1965 have been answered each time, by design or accident, with substantially lowered monetary growth. Each time, however, political pressures or serious

misconceptions deeply embedded in the policy making procedures of the Federal Reserve System produced a reversal in policies. He contended that these reversals ended in every case the gradual decline of inflation and initiated a new surge of prices with a deeper commitment to permanent inflation.

Regarding the President's intentions of reducing the budget deficits, Brunner stated that the President's emphasis on government expenditures is probably highly appropriate with respect to a more productive use of our resources and a correspondingly higher real income. But he viewed it as a peculiarly ineffective and cumbersome approach to curtail inflation.

Brunner was skeptical of the "non-control guidelines" proposed by the President. Political processes exhibit apparently an inherent propensity to respond to inflationary waves with an array of specific political institutions recorded under a shifting set of names (controls, income policy, guidelines, etc.). This disposition, he noted, is particularly remarkable as no evidence would seriously support the contention that incomes policies ever contained inflation in the absence of proper controls over monetary growth. According to Brunner, the experience accumulated with controls from diverse historical conditions overwhelmingly establishes their ineffectiveness as anti-inflationary instruments.

Brunner also criticized the logic of those who advocate a policy of "permanent inflation." In his view, such a policy results in alternating waves of increased inflation and retardation of economic activity expressed by a decline in output and rising unemployment. "An

accommodating inflation policy may thus easily produce two or three recessions, combined with continued inflation, over a ten-year span," he stated.

Brunner disagreed with President Carter that the only alternatives to his anti-inflation program are recession or mandatory and sweeping controls. Brunner stated, "This line is either fraudulent or illusionary... There is indeed only one way to lower inflation and that is to lower monetary growth over a long time." He noted that this instrument of an effective anti-inflationary policy unfortunately induces a temporary recession. But a policy of permanent inflation supplemented with incantations and partially mandatory controls, i.e., guidelines, he maintained, yields the social costs associated with erratic inflation, sluggish output, and higher than normal unemployment. "The promise of permanent inflation at a negligible social cost is a dangerous illusion," Brunner concluded.

"Inflation -- Causes, Cures and Placebos"

Dr. Beryl Sprinkel, Executive Vice President and Economist at Harris Trust and Savings Bank, Chicago, Illinois stated that the solution to breaking the inflation-recession cycle with its ever-increasing peaks and valleys is conceptually simple: conduct our nation's financial affairs in a manner designed to increase total spending in line with the increase in total production. Throughout the post-World War II period, he pointed out, spending increases have persistently exceeded output increases and inflation has become a way of life. Dr. Sprinkel cited three causes of the current rapid rate of monetary growth: 1) the large and growing federal budget deficits (resulting in the national

debt rising from \$31 billion in 1965 to \$148 billion in 1975 to nearly \$322 billion by fiscal 1978); 2) the bias of the political process toward commitment to short run growth; and 3) the attempt by the Federal Reserve to choose a federal funds target consistent with money growth targets (an attempt comparable to trying to shoot a running rabbit by lagging, not leading). Dr. Sprinkel further stated that if appropriate monetary-fiscal policies are pursued, controls are not needed, and that if policies are too expansive, controls will not work.

"TIP For Inflation: Why and How"

One of the foremost proponents of tax-based incomes policy, Dr. Sidney Weintraub of the University of Pennsylvania, presented his arguments for using the government's taxing authority in order to control inflation. Weintraub disagreed with Sprinkel regarding sole reliance on monetary and fiscal policy solutions to inflation, stating that a stable price level and minimal unemployment will elude us if traditional monetary policies or the less efficient fiscal policy are solely relied upon.

Stated in a nutshell, tax-based incomes policy (TIP) is designed to levy an extra corporate penalty income tax on firms that exceed a governmentally determined average rate for wage and salary increases. Labor would be allowed to reap some of the benefits of a superior gain in productivity via what Weintraub termed the TIP-CAP (corrected average productivity) plan. One-third of any productivity increase above the national norm could be paid to the worker in wage increases over and above the governmentally pegged wage rate increase.

Weintraub applauded President Carter for his "better late than never" commitment to subdue inflation, but stated that the program was too bureaucratic for his tastes. "Monitoring prices and costs smacks of price controls," he noted.

"Inflation: Imperfect Markets and Government Policies"

Robert Nathan, Chairman of the Board of Robert R. Nathan Associates, Inc., supported President Carter's inflation proposals "except for the degree of harshness of the monetary restraints." Nathan saw the tight money proposals as increasing the odds of a recession, but doing little to reduce inflation.

He contended that it was unfortunate that the response to the President's program from the press and the financial community focused exclusively on the guidelines for wages and prices. Believing that the guidelines could have a positive impact, Nathan also stated that, equally or more important were the policies and measures announced by the President concerning government spending, taxation, regulations, competition, productivity, and trade policies.

Nathan challenged those who pay "lip service" to free enterprise and competition but practice monopoly and restraints on competition. He concluded, "If we are going to win the war on inflation and preserve the great free enterprise system, we must take seriously the efforts needed to make the market economy function more effectively."

Murray L. Weidenbaum
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THE COMMITMENT TO PERMANENT INFLATION

Karl Brunner

THE DRIFT INTO FINANCIAL MISMANAGEMENT

A period of remarkable economic stability ended in 1965. The United States experienced over twenty years a solid expansion of output and employment, in contrast to the gloomy predictions made at the end of the second world war. Bursts of inflation in 1951-1952 and 1955-57 were successfully contained by comparatively cautious financial policies. This heritage of a determined anti-inflationary policy was reenforced under the Kennedy Administration by an essentially modest and stable course of monetary and fiscal affairs. The price level remained practically constant and interest rates reflected the absence of inflation. The prime rate stayed around 4.5 per cent until the middle of the 1960s.

A new era opened beyond 1965. The United States entered the age of permanent inflation previously confined to the Latin-American scene. Our economy suffered in the last thirteen years four waves of inflation with increasing duration or magnitude (1965/66, 1967/69, 1972/74, 1976/?). On four occasions our monetary authorities (1966, 1969, 1971, 1974) substantially lowered monetary growth by design or accident. On

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each occasion the attempt at an anti-inflationary course in our policy was abandoned. Political pressures or serious misconceptions deeply embedded in the Fed's policy making procedures induced a reversal in policies. These reversals ended in every case the gradual decline of inflation and initiated a new surge of prices with a deeper commitment to permanent inflation. Our policies contributed in this manner to the emergence of a positive association, observed in the average over many years, between rising unemployment and inflation. The consequences of an essentially political failure to maintain an anti-inflationary monetary course over a substantial time horizon were increasingly interpreted as signs of an intractable inflationary process "anchored in our social structure."

At the time the Carter team shaped its policy programs in the fall of 1976 the rate of inflation had drifted to a level of about 4.5 per cent per annum and the dollar held firm on the foreign exchange markets. There appeared a growing chance of sustaining a rising hope that the prevailing course in our financial affairs would produce further reductions of inflation, halt the intermittent fall of the dollar and prevent a new surge of the (nominal) rates of interest on credit markets. But the Carter Administration wasted this opportunity. A persistent acceleration of monetary growth, contrasting (as usual) with the official rhetoric of the Federal Reserve authorities, and large uncertainties bearing on the magnitude of the budget and the deficit lowered the confidence in the U.S. dollar and unleashed new inflationary forces. Until the fall of 1978, the rate of inflation had almost doubled compared to

its lowest level in 1976, and the debacle of the dollar on exchange markets evolved into a political embarrassment. The disarray in the financial affairs of the United States imposed serious burdens on foreign economies and produced pervasive uncertainties about U.S. policies and future U.S. postures. The international repercussions confronted economies with a bitter choice between large real burdens due to adjustments suffered by the export industries or the social costs associated with new waves of inflation produced by persistent and large scale interventions on exchange markets. The financial disarray was also reflected by the stagnation of the stock market. The signs of the Carter Administration's financial mismanagement thus multiplied. They eventually forced the attention of the White House to cope more directly with the persistent threat of inflation. The advisory huddle in the White House eventually produced an "anti-inflation program" announced by the President on October 24, 1978.

PRESIDENT CARTER'S ANTI-INFLATION AND DOLLAR SUPPORT PROGRAMS

This announcement contained four parts with very different significance. It promised first to lower the increase in government expenditures and secondly to reduce the budget deficit. A third strand addresses a variety of measures designed to raise the efficiency of our resource-utilization patterns and to increase the growth rate of labor productivity. These measures are essentially directed to raise the competitive level of the U.S. economy, to lower the extent and magnitude of monopolistic shelters granted by a wide diversity of governmental

arrangements and to remove governmental impositions enforcing an increasingly wasteful use of our resources. The last strand introduces "voluntary" guidelines for wage and price increases. These guidelines are linked with an expectation that Congress will legislate a subsidy to all workers (or employees?) accepting the limit of 7 per cent on their wage increases while suffering a higher rate of price inflation.

The announcement was not really a "non-event." Things did happen, but all the wrong way. The stock market responded with a drop in prices and the dollar slipped on the foreign exchanges. The only markets available to register voter reactions and public appraisals signaled a vote of "no confidence" to the White House. Their behavior revealed in the most unmistakable fashion that the President obtained and accepted bad advice in crucial matters of economic policy. A second huddle assembled hurriedly and produced an additional array of measures designed to "tighten money" and to reverse the drift of the dollar. A substantial increase by 1 percentage point in the discount rate and a supplementary reserve requirement on certificates of deposit, with large denominations impounding about \$3 billion of bank reserves into required reserves, should convey the idea of a determined anti-inflationary shift in domestic monetary policy. These internal actions were reenforced with measures and operations directed to the exchange market. The Swap lines with the German, Japanese and Swiss Central Banks were dramatically extended. The U.S. Treasury envisaged borrowing foreign currency by the sale of special drawing rights. President Carter also announced substantially accelerated sales of gold from the Treasury's stocks and possible issues of U.S. debt instruments

denominated in foreign currency. These "external measures" are designed to provide the foreign currency required for massive intervention on the foreign exchange market.

AN EVALUATION OF THE PROGRAM

The European response to the second White House huddle appeared remarkably positive. It seems generally conceded that the announcement on November 1 reveals, at long last, a major shift in the attitude and financial policy of the U.S. government. The bond market also signaled a positive evaluation. A consensus emerged over the subsequent days that the change in policies was significant enough to produce a recession next year with falling interest rates and a retardation in the momentum of price movements. This evaluation of President Carter's two packages is unfortunately somewhat erroneous and suffers from serious misconceptions about the events and the situation. I will argue that some measures misleadingly convey the impression of an anti-inflationary turn in monetary policy when actually no real evidence supports, so far (December 11), this contention. I will argue furthermore that the external measures exert, without a generally recognized and credible action by the Fed to maintain a lower rate of monetary growth, at most a temporary effect. Lastly, the domestic non-monetary approach to contain inflation is essentially irrelevant with respect to inflation and threatens us, in the absence of monetary control, with expanding controls over prices and wages, lowered welfare and a further loss of freedom.

Among the first lessons of economic analysis looms the recognition that the best intentions of policy programs yield no guarantee for their realization. The most adroit invocations with all the appropriate "McLuhanery" offers us no assurance that the explicitly described public goals are even roughly approximated in reality. Economic policy seems particularly prone to the negative association between intentions and outcome. It may suffice here to note the rhetoric and the facts bearing on the minimum wage legislation or the noteworthy and traditionally negative association between the Federal Reserve's words and actions.¹ The anti-inflation program presented by the President to the American public on October 24 and on November 1 thus deserves some careful examination.

Lowering the Deficit

A persistent reduction in the budget deficit would certainly yield major benefits for our economy. The direct effect on inflation is however a negligible component of these benefits. Neither Keynesian nor monetarist analysis implies any significant impact on the ongoing rates of inflation. The encouragement to capital accumulation in the private sector seems the major gain obtained from a lower deficit. It reduces "crowding out" and shifts, over the longer horizon, the public's portfolio balance towards investments representing productive resources. The higher level of real growth associated with the expanded productive facilities raises over time our welfare but lowers the inflation rate

¹The reader is referred for a detailed documentation of this point to the study jointly prepared in 1964 with Allan H. Meltzer on "Federal Reserve Monetary Policy-Making." The study was published by the Committee on Currency and Banking, U.S. House of Representatives.

by a negligible margin. An indirect effect of smaller deficits mediated by the Federal Reserve's traditional approach in terms of money market conditions may actually be more important with respect to inflation. A smaller deficit lowers pressures on interest rates and dampens political incentives to "monetize" portions of the Treasury's borrowing requirement. This mechanism, linking budget deficits and monetary growth, could inadvertently, without the Fed's deliberate intention and design, produce the crucial condition, i.e., a falling rate of monetary growth, causing a lasting and persistent decline of the rate of inflation. A non-inflationary control over monetary growth appears increasingly improbable as large deficits persist into the future. A reduction in the deficit does not assure, however, the required decline of monetary growth. Immediate and direct attention to monetary growth, so carefully avoided with great circumspection by President Carter, is still the best and most relevant guarantee of a truly anti-inflationary policy. Still, a determined decline in the deficit alleviates at least the political pressures of "accommodating monetization" and lessens the likelihood of rising monetary expansion.

And Budget Expenditures

The President's fiscal proposals foresee, beyond the compression of the deficit, moderation in the rate of increase of government expenditures. We obtain some sense in the matter with an appropriate modification of an old relation between money, expenditures and the value of output. We write for our purposes

$$MV + G = PY$$

where M denotes the money stock, V is the circuit velocity based on private sector expenditures, G expresses government outlay on goods and services in the national income account sense. The right side represents the value of output as a product of price level P and output Y.

Government expenditures are measured as a proportion g of private absorption of total output. We may thus write the approximation

$$\Delta \log M + \Delta \log V + \Delta g - \Delta \log Y = \Delta \log P$$

i.e., over the longer run the rate of inflation, $\Delta \log P$, equals the sum of monetary growth, the velocity trend, the trend in the proportion of government absorption minus normal output growth. A positive value of Δg thus raises the basic rate of inflation beyond the level determined by the rate of increase in private expenditures. A negative Δg on the other hand lowers the prevailing rate of inflation below the level adjusted to the expansion of private expenditures.

Consider, however, some further aspects in this matter. A single percentage point decline of g produces in the average a corresponding decline in $\log P$. But this percentage point decline in g implies a reduction of approximately 4 percentage points in the rate of increase of government expenditures on goods and services below the rate determined by a constant g. In order to produce even a small effect on inflation, a substantial reduction of the government sector's real absorption would be required.

The President's plan foresees (possibly?) a total reduction of g by approximately 2 percentage points distributed over several years. This would lower by itself the average inflation rate at the very most

by 1 percentage point per annum over this time period. But this negative Δg will occur as an essentially temporary event in the hope of confining the government sector's absorption to a lower proportion. Once this desired level of g is achieved Δg centers on zero and the temporary reduction of inflation evaporates. It seems quite unlikely that a negative Δg would prevail for many years. It seems also highly unlikely that any negative Δg would be (numerically) large enough to moderate the inherited inflation by any relevant fraction. The likelihood of a negative Δg could thus be expected under the best circumstances to lower the price level by less than 1 percentage point per annum over a few years. The President's emphasis on government expenditure is indeed most appropriate with respect to a more productive use of our resources and a correspondingly higher real income. But it seems an ineffective and cumbersome approach to curtail inflation.²

The most rapidly expanding component of budgetary expenditures has not been considered thus far. Transfer payments need particular attention. Their explosion affects the normal rate of unemployment; the incentive to work, and to invest in human and non-human capital; and in this manner they influence the average rate of output growth over the longer run. They do not affect per se the rate of monetary growth or the trend in velocity. A revision of the trend in transfer payments may thus importantly shape our longer run social welfare, but we cannot rationally expect from a lower expansion rate of social transfers any

²It may be that the anti-inflationary rhetoric is considered a useful means to overcome the political opposition to "budget tightening."

significant reduction of inflation. Any effect on inflation emerges as a counterpart to the increase in the long term growth of output produced by a revision of the transfer system. The cumulative impact on our general welfare may be substantial, however, even with a vanishing effect on the rate of inflation. This particular combination of events occurs in case the revision of the transfer system essentially induces a once-and-for-all effect on the productive use of our human and non-human resources.

Regulation, Competition and Productivity

The need to remove the many constraints imposed by government on the efficient use of our resources has attracted increasing attention in recent years. A new magazine addressed to the financial world recently argued that government regulation is the dominant cause of inflation in the United States: "The costs that have been imposed on private business, labor and agriculture under the rules of government regulation are a fundamental cause -- conceivably the fundamental cause -- of inflation."³ The President and his adviser also seem to believe that measures designed to raise competitive levels and increase productivity by removing obstructive regulations and wasteful

³Louis Kohlmeier, "New Analysis of Regulation as Fundamental Inflation Cause," Financier, September 19, 1978. The thesis advanced makes little sense. It means that regulations simply raise nominal costs, i.e., prices of inputs, without change in the real cost of production. "Regulation inflation" is then simply a special case of "cost-push inflation." But this is hardly the relevant issue. The range of government activities alluded to actually does raise real costs and this implies a fall in the level and growth rate of normal output. The effect raises the price level in proportion to the fall in the level of normal output and also raises the rate of inflation according to the lower rate of real growth.

impositions effectively lowers inflation. But this approach to cope with our inflationary experiences is again futile. It fails to distinguish between once-and-for-all consequences on the price level and persistent effects on the rate of inflation. It fails moreover to assess adequately the relevant orders of magnitude. A successful removal of obstacles to productivity would probably raise both the level of productivity and the longer run rate of growth in productivity. The level effect permanently lowers the price level relative to any given monetary stock and appears in form of a temporary decline of the inflation rate. The longer run effect lowers on the other hand the prevailing rate of inflation by an amount equal to the increase in the normal growth rate of output. It appears in my judgment highly unlikely that the President's plan would lower inflation via this route by anything even approximating 1 percentage point. But the welfare implications produced by an "opening of the economy" to more efficient production processes exceed by a wide margin the negligible impact on inflation. The once-and-for-all level effect supplemented by the long run effect on productivity growth would raise real income over the years substantially beyond the level otherwise achieved.

The Guidelines

But what about the "non-control" guidelines imposed on price and wage setting of the private sector? Political processes exhibit an inherent propensity to respond to inflationary waves with an array of specific political institutions recorded under a shifting set of names (controls, income policy, guideline, etc.). This disposition is particularly remarkable as no evidence would seriously support the

contention that "income policies" ever exhibited much success measured in terms of the anti-inflationary intentions or rhetoric in the absence of adequate monetary controls. Controls over prices and wages by themselves never moderated the rate of inflation beyond a shorter period without unleashing over time rising social costs and a loss of freedom. The experience accumulated with controls from diverse historical conditions overwhelmingly establishes their ineffectiveness as anti-inflationary instruments and their dangers to our welfare. The impairment of welfare follows from their effect on the use of our resources. The more stringent and "effective," at least in intention, the controls are designed, the greater loom losses in welfare associated with the resulting distortions in resource utilization patterns. Controls systematically obstruct the adjustment of relevant prices and costs to underlying market conditions. This obstruction distorts the pattern of resource utilization away from the optimal usages approached by the operation of open markets.

Stringent controls create moreover socially undesirable short and long run incentives on the supply side. A persistent inability to adjust prices to the realities of the market place fosters implicit rationing schemes. Personal idiosyncracies, personal and political connections, political weight, and the skill to manipulate non-market institutions or non-market relations tend to determine under the circumstances the suppliers rationing behavior. The "controlled" price raises in particular the cost of search and transacting exchanges to the consumer. The resulting arrangements imply a shift from wealth maximizing behavior by business firms (executives) to behavior more

attentive to the executives utility-maximization. This involves a redistribution of wealth from owners and employers to the management level and selected customer groups. This redistribution offers no incentives for productive applications of resources.

This effect is reenforced by repercussions affecting shorter run supply patterns bearing on quantity and quality. The constraints on price adjustments direct attention to costs of production and the nature of the production process. Adjustments are thus concentrated on lowering the quality of the product. There also emerges under the circumstances a strong incentive to invest in political activities designed to influence the political institutions surrounding or representing the control apparatus. Such investments produce at a positive social cost, a positive (expected) private gain but actually yield a vanishing social product. We obtain thus a classic case of negative externalities and "market failures" imposed by policy arrangements. The nature of this externality reflects the loss of welfare associated with a socially wasteful use of resources induced by the political institution. The political reality surrounding the control apparatus increasingly exploits these arrangements for purposes of a politically manipulated redistribution of wealth with little concern or interest for the initial and official purpose of "inflation controls." The social cost of "political investments" tend to be reenforced by pervasive incentives to search for means circumventing the prevailing mode of controls via adjustments in product classifications, production operations or marketing and exchange arrangements. But such adjustments require the investment of valuable resources and impose a social cost. Controls

also lower the incentive to invest and explore new productive opportunities. Evaluations of investment projects involve returns and costs over a larger horizon. The administration of controls unavoidably produces a diffuse uncertainty and a pronounced instability pertaining to the rules of the game confronting the private sector. The assessment of future returns and costs associated with any given project becomes substantially more risky. Business will be increasingly more hesitant under the circumstances to commit resources for projects with longer horizons. The volume of investments enlarging our productive potential thus stagnates and the rate of normal growth declines. We note in summary that the consequences of an anti-inflationary approach based on controls essentially threatens to offset any gains potentially achievable by attempts to raise efficiency and productivity via "deregulation." The reality of controls will suffocate the promise to raise the competitive edge and to improve the use of our resources.⁴

⁴Marxist or socialist intellectuals occasionally claim that inflation reflects the "inherent contradictions and the basic vulnerability" of capitalism. Socialist economies experience either, as in the case of Yugoslavia, a permanent inflation at a rate exceeding the corresponding magnitude in most Western countries, or suffer from all the symptoms of severely repressed inflation. An excellent article in the Neue Zurcher Zeitung from December 9, 1978 summarizes the state prevailing in Eastern Europe with the following points:

- i) There occurs a substantial volume of "forced savings." Price controls imply that portions of the income cannot be used to acquire goods. The marginal price becomes "infinite."
- ii) Large differences between unregulated prices (e.g., on the "peasant markets") and regulated prices
- iii) The pervasive existence of long queues
- iv) Prepayments with long waiting periods for durable goods
- v) A pervasive occurrence of side payments
- vi) Special supplies in special stores for privileged groups

Three aspects associated with the current control program should also be noted in this context. The program was presented as a voluntary exercise in self-restraint addressed to the private sector. This emphasis suffers however under the fraudulent language pervading the political market place.⁵ The legal form and legal basis of the controls is of comparatively minor importance in this context. The relevant conditions confronting the producers in the private sector are reflected by the actual cost of non-compliance. Business firms failing to cooperate and comply may expect "attentive treatment" by a wide range of federal agencies well beyond any procurement offices. It seems most likely under the present circumstances that "voluntary controls" or guidelines really involve substantial cost of non-compliance for large and well-known corporations.⁶ Smaller and particularly non-corporate business or agricultural producers will hardly be seriously troubled by the guidelines. The cost of non-compliance is probably sufficient for most of the large corporations to assure some measure of careful cooperation. For this group in our economy guidelines are for all

⁵A revealing event occurred in early December on some television program. A commentator discussed judiciously and earnestly the difficulties encountered with the enforcement of voluntary controls. At least in terms of "newspeak" we are proceeding well on our Orwellian time schedule.

⁶A useful description of the political mechanism governing the cost of non-compliance can be found in an article published in the Wall Street Journal on November 29, 1978, by Congressman Clarence J. Brown on "The Servility of Business." We note in particular: "The excuse for such pusillanimity (by the business sector) is that the 15 foot shelf of Federal regulations passed by Congress has put a vast arsenal of weapons for punishment in any administration's hand."

practical purposes essentially similar to mandatory controls. It follows therefore that the consequences of controls traced in a previous paragraph would gradually appear with the lapse of time in this range of our economy. But the effect on inflation still remains quite negligible. The inflation, represented by general price movements, continues in accordance with the momentum of private expenditures dominated by the monetary growth produced by our Federal Reserve authorities. Obstructions on price adjustments in the controlled corporate subsector lower the relative prices of this subsector without significantly modifying the general movement. Prices in non-controlled sectors respond with a correspondingly greater speed and magnitude as expenditures shift from the controlled to the non-controlled sector. The current program thus imposes social costs to no avail with respect to our crucial malady.

The subsidy proposal included in the President's program deserves some passing attention. Suppose monetary growth continues to raise the level of inflation substantially beyond 7 per cent per annum. The proposal currently provides about \$9 billion worth of subsidies to employees for every percentage point that the rate of inflation exceeds the benchmark. At a rate of inflation of 9 per cent per annum, government expenditures would rise by roughly \$18 billion. The effect on the budget deficit seems obvious.

The Rationale of Ineffectual Anti-Inflation Policies

The remarkable irrelevance of the President's explicit proposals and argument as an anti-inflation program requires some examination.

The explanation lies probably with a mixture of various beliefs about the nature of the inflation process combined with a specific perception of the White House team concerning the comparative political advantages associated with different policy options.

The President's presentation of the anti-inflation program on television contained a noteworthy imputation of responsibilities. He claimed credit for his Administration having raised the level of employment and lowered the rate of unemployment. The responsibility for inflation was subtly assigned to the private sector. There appeared some acknowledgment that government may contribute to inflation only via purchases, public employee wage settlements, higher taxes, and the Federal Reserves push on interest rates. But the context and tone of the presentation clearly conveyed to the listeners that the private sector dominates the mass of transactions unfolding in the economy, and consequently bears the crucial responsibility for the evolving price-wage patterns. Inflation, in the President's view of the world, forms a social problem essentially caused by the private sector independent of monetary policy and just marginally related to the government's fiscal affairs expressed by the direct impact on output and labor markets. This vision of the inflation problem naturally produces a program assigning some minor significance to the budget, no significance and no attention to monetary policy, with most of the attention expressing the "Moses syndrome," i.e., exhibiting a disposition to wave a stick to make the surrounding world behave according to one's enlightened insights. Controls of one sort or another are the natural consequence

of this vision. The prevalent semi-socialist conceptions cultivated by members of the Carter team on operational levels in various departments influence moreover the direction of controls and their concentration on the "corporate sector" of the economy.⁷ This concentration is reinforced by administrative advantages of the procedure. Lastly, the governing perception explains the ingrained failure to appreciate the real effects of controls occurring in various disguises.

The view from the White House overlaps with the "sociological conception" of inflation extensively used by the intelligentsia (exemplified by the New York Times), cultivated by sociologists, and argued by large groups of economists in Europe and even in the United States. Inflation appears in this vision as the necessary outcome of social factors and processes deeply embedded in the contemporary social structure. Inflation is governed according to this conception by an autonomous social process essentially independent of monetary and fiscal policy.⁸ Lower monetary growth is useless under the circumstances and harmful in terms of our welfare. It lowers employment, raises unemployment and forces output into stagnation without lowering inflation. The

⁷Senator McGovern argued in the late fall of 1978 on television that the Democratic Party should make inflation its own issue. He proposed in particular that mandatory controls be imposed on the "corporate sector." We encounter here a remarkable example of how the political scene favoring "some anti-inflationary" action can be exploited for substantial changes of the "system."

⁸Mr. Kahn seems to advance such a view: "Mr. Kahn sees inflation as a fundamental social problem...." "'Inflation is a symptom and a reflection of a society that is...in a state of dissolution....'" Wall Street Journal, December 11, 1978.

only solution lies in a reform of the social structure associated with a new array of political institutions controlling price and wage setting. Such a view would support the President's guidelines and confirm a policy of mandatory controls, but hardly approve or find relevant the proposals bearing on the budget. Some versions of the "sociological approach," however, seem to offer support for a shot-gun approach to the inflation problem. A diffuse social process with pervasive and uncertain ramifications in all directions may suggest that random combinations of larger and larger programs raise the likelihood of "doing the right thing."⁹

There is a third and distinct view vaguely centered around the Brookings Institution, which also provides an intellectual basis for the President's anti-inflation program. This view recognizes that in the long run monetary growth dominates the average rate of price movements via the momentum of private expenditures. The relevant time horizon seems to involve, according to this view, an extended calendar time reaching probably up to ten years. Within this extended time horizon price levels move for appearances in autonomous fashion. Prices move over the shorter run, so it appears, independently of monetary evolution. General price movements are controlled by an inertial process subject to intermittent explosions. It is fully acknowledged that a lower monetary growth would eventually reduce the prevailing rate of inflation. But the time required is judged to be very long and certainly beyond any

⁹This position seems to describe Robert Nathan's view when he pleaded in the discussion that the President's program should be given a chance.

"realistic political considerations." The responsiveness of inflation to lower monetary growth is not conditioned in this view by the history of inflationary policies and the credibility of anti-inflationary policies. Any attempt to combat inflation with lowered monetary growth produces under the circumstances a serious and persistent loss of output, a fall in employment and a heavy burden of unemployment. An anti-inflationary policy executed via control over monetary growth implies a protracted recession with a heavy loss of welfare. The argument concludes that a wiser course avoids monetary contraction or fiscal restrictions. A policy of permanent inflation supplemented with an array of political institutions shaping, guiding, supervising, "controlling" or "advising" the private sector's price-wage behavior appears therefore more appealing. This recommendation is moreover supported by the claim that the social cost of a policy of permanent inflation is really quite negligible.

A Critique of Some Views of the Inflation Process

The three views summarized in previous paragraphs are fundamentally flawed. The first two conceptions are in conflict with the best established parts of economic analysis. The claim to a total autonomy of price movements independent of monetary growth is substantially disconfirmed by evidence from many different countries or historical episodes, based on data generated under widely different institutional arrangements. We note in particular that upon careful examination most of these views yield no explanation of relative magnitude or direction of inflationary movement. They offer essentially untestable ex post

facto interpretations which fail to satisfy basic requirements of a relevant scientific hypothesis.¹⁰

Attempts to explain inflation in terms of money wages offer some instructive material in this respect. Both wages and prices respond to underlying real and nominal shocks. With real shocks dominated by nominal shocks wages and prices jointly and simultaneously reflect the dominant monetary impulse. Occasional perturbations in real conditions produce, on the other hand, as the French episode of 1968 vividly portrayed, a wedge between price and wage movements. It follows thus that in either case, i.e., in situations accompanied by real shocks, or in states experiencing overwhelming nominal impulses, money wages yield no satisfactory explanation of the inflation phenomenon. The correlation between wages and prices substantially breaks down in the first case. This failure of correlation reveals the causal irrelevance of wages *per se* and reflects the prevailing pressures of nominal impulses on price movements.¹¹ It also reveals that the solid correlation between wages and prices observed in the second case simply results from the

¹⁰The reader will find a more detailed argument in my forthcoming paper "The Political Economy of Inflation: A Critique of the Sociological Approach to Inflation." The fact that many of these ideas and formulations yield no propositions about the very phenomenon under consideration is particularly noteworthy.

¹¹It is occasionally argued that "correlation does not establish causation." Indeed, but it seems overlooked that every causal hypothesis implies the occurrence of specific correlation patterns. The observed absence of such correlation patterns thus disconfirms quite unambiguously the causal hypothesis. The reader is also referred to the Carnegie-Rochester Volume 9 on Public Policy. The chapter on the French inflation is particularly instructive in this context.

simultaneous adjustments of these variables to the driving causal force expressed by the nominal impulse.

Some major observation patterns cannot be reconciled with the sociological approach without adjustments destroying all relevant content. We observe for instance in all countries major surges of accelerating price movements and extended phases of substantial retardations. We also observe large variations in observed inflation across time between countries. Any procedure which reduces this variety, in the absence of real perturbations, to wages or unit labor costs is essentially equivalent to an explanation of inflation in terms of inflation. We are thus offered words with essentially no explanatory power. The sweeping array of "sociological ideas" fares not much better. It fails to cope with the observed patterns for a simple but basic reason: The occurrence and magnitude of inflation is essentially random with respect to any of the social entities ever adduced in this context. Inflationary experiences are on the other hand not randomly associated with the evolution of monetary growth. In particular, no inflation ever emerged without prior monetary acceleration and no inflation was ever curbed without a lower level of monetary growth. We should note in a similar vein that the variations in the rate of inflation across and over time are not randomly related to corresponding differences in monetary evolution.

The third view requires separate examination. It suffers from a faulty perception of the shorter run aspects of the inflation processes and the failure to link the alleged shorter run autonomy of price movements with the longer run conditioning by monetary growth. It fails

lastly with a thoroughly inadequate analysis of the social costs associated with a policy of permanent inflation.

The first two failures follow from an inadequate analysis of the private sector's price and wage setting practices. These practices occur in a social context conditioned by systematic evaluations on the part of economic agents of the policy regime prevailing in the future. It follows that the responsiveness of inflation to variations in monetary growth depends on the length and magnitude of observed inflation, the frequency of aborted anti-inflationary policies and the magnitude or speed of experienced reversals in policy to a renewed inflationary course. The responsiveness of inflation to a lower monetary growth depends thus in general on the inferences made by economic agents pertaining to the prevailing interaction of transitory and permanent real and nominal shocks operating on the economy. This inference is influenced by the observations noted above and other information signalling the nature of a policy regime. This analysis implies that the course of our policies, followed over thirteen years, systematically weakened the responsiveness of inflation to a lower monetary growth. It also accelerated the responsiveness of inflation to rising monetary growth. The increasing appearance of relative shorter run autonomy of price movements with respect to monetary evolution should be recognized as the rational outcome of a policy implicitly committed to permanent inflation expressed by a long run pattern of monetary accelerations, interrupted by intermittent phases of retardation. This argument implies furthermore that the social cost of an effective anti-inflationary policy persistently rises over time with the accrual of

information confirming the commitment to permanent inflation. This social cost is not a constant determined by an autonomous social structure. It is largely the consequence of the policies pursued over a longer horizon. These policies, however, also affect the other side of the ledger. A commitment to permanent inflation also raises over time the social cost of this commitment. Advocates of permanent inflation typically assign comparatively small significance to such costs. We are told that "many Harberger triangles cover a single Okun gap." The social cost caused by permanent inflation is thus attributed purely to the welfare loss associated with smaller real balances.¹² But the welfare loss of a steady and fully anticipated inflation forms just one component of the total loss of an actual state of permanent inflation. The welfare loss derived from lower real balances is supplemented by cost components associated with an erratic and unpredictable pattern of inflationary policies.

An accommodating policy of persistent inflation introduces pervasive incentives into the social system to explore opportunities for accelerating wage and price setting as a means of competitive wealth transfers. A policy of permanent inflation encourages general expectations that the emerging price-wage patterns will be validated in the average. Such explorations in price-wage policies exploit the political

¹²Martin Feldstein recently objected in an unpublished paper that the traditional computation overlooks that the welfare loss should be considered as a stream over time and should be properly discounted. The relevant net discount factor is the time discount minus the rate of real growth. Feldstein thus concludes that the traditional argument severely underestimates the resulting welfare loss of a steady and fully anticipated inflation.

process to produce under appropriate pressures an accommodating stance in financial policies. It follows under the circumstances that a permanent policy of accommodating inflation will experience repeated waves of increased inflation. Every surge in price movements introduces new political opportunities and raises political rewards for the supply of "leadership in the fight against inflation." This pattern has been observed on repeated occasions and all over the world. The resulting shifts in financial policies unleash unavoidable retardations of economic activity expressed by a decline in output and rising unemployment. A policy of permanent inflation produces, therefore, sequences of substantially accelerated price movements interrupted by retardations with declines in output and higher unemployment. An accommodating inflation policy may thus easily produce two or three recessions, combined with continued inflation, over a span of ten to fifteen years. The current value of the costs determined by the future series of recessions forms an important component in the relevant social cost of permanent inflation. This series may already balance the social cost of a determined policy designed to lower monetary growth gradually and predictably over four to five years.¹³

¹³One may object that the comparison is incomplete. Fluctuations in output and unemployment under permanent inflation should be compared with similar fluctuations emerging in the absence of inflation. This is, however, not the relevant comparison. We need to compare the real fluctuations produced by shifting nominal impulses typically associated with the alternative policy regimes. The crucial point emphasized in the text is the comparatively higher variance of monetary growth under a regime of permanent inflation. The almost explicit refusal by the Federal Reserve authorities to consider monetary control or implement appropriate control procedure, combined with the Fed bureaucracy's traditional notions, will most probably produce an erratic course of permanent inflation.

The erratic course of monetary policy characteristically associated with a regime of permanent inflation raises the level of uncertainty in the economy. The penumbra of risk associated at any moment with future returns and costs resulting from longer range projects substantially increases under the circumstances. The basic uncertainty operating on the social system as a result of the real shocks unleashed by nature, including the tastes and propensities of people revealed on the market, are augmented by additional uncertainties attributable to the behavior of specific socio-political institutions centered on the Central Bank. The higher level of risk affects investment and lowers capital accumulation and retards the expansion of productive capacity. This disincentive effect may be reenforced by the expectation of a systematic increase in the marginal effective tax rate produced by permanent inflation.

Another dimension of uncertainty produced by a regime of permanent inflation deserves some attention. Some recent work indicates a positive association between the dispersion of individual prices and the general rate of inflation. But the greater dispersion generated by larger inflation lowers the information level of economic agents and raises the cost of acquiring given information levels about market conditions. Households will find it advisable to invest more time, effort and resources to search and sample their potential opportunities. The larger shifts in relative prices expressed by an increasing price dispersion also induces more social tension and a greater disposition for social conflicts. More rapidly or more widely shifting relative prices involve a quick decay of accumulated information capital and impose

heavier and unexpected adjustments on various social groups. The widening price dispersion means substantial wealth transfers between shifting social groups. The social tensions fostered by this process are not based on systematic transfers between broad groups, e.g., "labor" and "capital." The transfers are almost randomly distributed between many smaller and changing groups. This random impact is particularly prone to encouraging diffuse social unrest and tension.

The permissive regime of permanent inflation may also contribute to raise the average (i.e., normal) rate of unemployment. A pattern of accommodating policies unleashes incentives fostering aggressive wage setting policies. With given expectations about monetary accommodations, aggressive wage settlements become an instrument of shorter run wealth transfers. Organized suppliers are systematically induced to overestimate the most probable degree of accommodation and risk some measure of additional unemployment. The possible wealth transfer still affects a large majority of the organized suppliers and the social cost of the unemployed minority is shifted via the welfare system to the rest of the community.

The social costs resulting from an open inflation do not exhaust the problem. The discussion, presented in a previous section, of the real effects associated with controls over prices and wages circumscribes the nature of the additional costs. These costs emerge in summary as a consequence of the distortions in the utilization of resources, augmented by the effect on the short run supply of output in terms of quality and quantity, reenforced by the allocation of resources of the political process involving a (socially) negative sum game of

redistributive conflicts, and lastly, supplemented by the effect on the longer run growth of output.

The social cost of permanent inflation follows thus from two major facts: first, the observed variability of inflation and monetary growth produced by the nature of the political process, and secondly, the observed disposition of the political process to respond to intermittent accelerations of price movements with controls. These facts appear to be disregarded by the advocates of permanent inflation and the omission explains their casual treatment of the social cost emanating from their policies. It would appear that decades of Keynesian macro-theory clogged the vision with respect to the consequences on the supply side caused by persistent or even intermittent controls. My argument thus tentatively suggests that the comparison of a modest "Harberger triangle" with a yawning Okun gap misses the crucial point. The relevant juxtaposition seems more appropriately between a single Okun gap associated with a determined non-inflationary policy of stable monetary growth on the one side and a multiplicity of Okun gaps augmented with other social costs on the other side.

We should note lastly that in a policy regime governed by a mixture of the three views presented above, policy makers increasingly lock their economies into a pattern of permanent inflation. There emerges an apparent intractability "deeply anchored in a complex social nexus beyond the reach of shallow (or superficial) financial manipulation." But this intractability is not imposed by an autonomous social fate. It is produced by the policy regime and can be broken by a determined and credible return to a well-controlled monetary growth. And

whatever the level to which the social cost of anti-inflationary policies drift as a result of the previous long-time mismanagement, the social cost of permanent inflation probably drifts even higher. But the selective myopia fostered by the incentive system prevailing in the political process, so clearly represented by the Carter team, discounts heavily the future cost accruing from the permanent inflation and concentrates on avoidance of the contemporary short run cost of an effective anti-inflationary policy. This vision influences the "program" offered by the President, a program disregarding monetary policy and offering the appearance of judicious and concerned leadership. Once the unavoidable failure of such a program becomes generally acknowledged on the public scene the President may safely invoke either one of the first two views of the inflation process and accuse the private sector of "social betrayal" or "inadequate cooperation" in the government's attempt to cope with inflation. Mandatory controls supplemented probably with controls over interest rates and bank credit will be imposed under the circumstances and possibly presented at the time as the "moral equivalent of war" (or the "energy crisis"). And so we would gradually sink ever deeper into the Latin-American swamp.

What About the Discount Rate and Reserve Requirements?

Some readers may object and insist that a turn in the trend of monetary policy has been clearly signaled. The discount rate was raised by a whole percentage point and supplementary reserve requirements on certificates of deposit with large denominations were introduced. The change in the discount rate was indeed large by historical standards and the reserve policy action lowers the monetary base (by itself alone) by

about \$3 billion. These measures mean unfortunately very little by themselves. The growth rate in the monetary base could still move in any direction and even accelerate very sharply. Large shifts of Treasury funds from the Federal Reserve Banks to commercial banks or substantial open market purchases could raise the growth of the base in spite of the revised discount rate. They could furthermore easily overwhelm and more than offset the action bearing on reserve requirements. There is no real indication at this time (December 15, 1978) that the Federal Reserve shifted gears to a lower trend in the monetary base. Such a change is not impossible and appropriate evidence may emerge by the end of this year. The lower monetary growth would produce a recession reaching into the year 1980 with initially small effect on inflation. The longer the Fed delays in effective control over monetary growth, the more probably the consequences of the resulting recession threaten to determine the climate of the Presidential election in 1980. The probability of moderating monetary growth thus declines as the winter of 1978/79 progresses. In case the Fed actually reduces monetary growth, however, contrary to all the impressions conveyed by the Carter team, then all the available evidence from history and the nature of the policy institution suggests that policy will be reversed to an inflationary course within three quarters under the increasing pressure of political apprehension fostered by the incipient recession.

The Fed's traditional interpretation of monetary affairs justifies some reservations pertaining to the emergence of any significant action lowering monetary growth. This interpretation was usually geared to the level of short term interest rates. Low interest rates were

always understood to reveal substantially expansionary policies. More expansionary policies were generally indicated by lower rates. The Federal Reserve authorities thus concluded in 1930 that a highly expansionary policy had actually been initiated to counteract the cyclic decline. The same behavior and interpretation persisted over the decades into this year. The Federal Reserve authorities reenforced in the spring and summer of 1978 the media's impression that monetary policy moved on a comparatively restrictive course. The facts were unfortunately just the opposite of the traditional interpretation. During 1930 monetary growth receded and revealed a weakening monetary thrust in a downward sliding economy. A similar pattern occurred in 1960, whereas in the current year, monetary growth accelerated when policy was claimed to have become more restrictive. Our experience demonstrates moreover that monetary accelerations yield a much closer approximation to the monetary thrust exerted on the economy than the level of interest rates. But the Federal Reserve authorities still believe at the moment that they shifted to a cautiously moderated policy in early November. The rapid increase in short term rates in October and early November is, however, quite consistent with even an accelerated monetary thrust expressed by a rising trend in the growth of the monetary base. We note here in passing the consensus appearing among financial analysts. This consensus accepts the Fed's accustomed interpretation and expects therefore that the economy will slide during 1979 into a recession irrespective of monetary evolutions. This perspective is however fundamentally faulty.¹⁴

¹⁴The institutional innovations of the recent past lower substantially the information content of the traditionally measured monetary

The External Measures and the Support of the Dollar

The reservations noted in previous sections with respect to the domestic program announced on October 24 seem well correlated with the "voting responses" on dollar and stock market. This positive correlation does not extend to the range of external measures announced on November 1 and addressed to the support of the dollar on the exchange markets. Whatever the detailed differences in the technical execution of the various measures, they all share a common strand. They are uniformly addressed to modify the relative stock demand for and stock supply of foreign currencies in terms of dollars. The common strand may also be stated as a means to influence the relative stock demand for and stock supply of dollars. This modification of relative demand and supply is executed in order to offset market induced shifts on relative demand (or relative supply) and thus to contain the resulting price movements.

The case of the Swap arrangements may be used to elaborate the point. The monetary base and the money stock expand in Germany whenever the Fed draws on its Swap line at the Bundesbank. The monetary base in the United States remains on the other hand unaffected under the standard procedure. This result offsets the experienced increase in the world demand for D-Mark, and the dollar price of D-Marks is held near

aggregates M_1 and M_2 . The evolution of "overnight-repos" between banks and corporations and the development of NOW accounts or AFT accounts obscures the significance of some published data. The monetary base is, however, not affected by these developments. But rational policy making would require a thorough overhaul of the Fed's concepts and measurement procedures.

the inherited level. The use of an IMF loan would actually reenforce the relative shifts in stock supplies, as the operation per se would simultaneously raise foreign money stocks and lower the U.S. monetary aggregates. Similar patterns hold for selling special drawing rights, gold or the issue of U.S. debt denominated in foreign currency.

The crucial aspect of these operations is their essentially transitory character. They could be accepted as rational procedures under two circumstances. We may suspect that the exchange markets suffered a transitory shock since the fall of 1977, raising for a short period the relative demand for foreign currency (or lowering the relative demand for dollars). One would rationally expect in this case that the pressure on the dollar vanishes in due course. The external measures initiated by the U.S. government express in this case the determination of an official speculator to stabilize the price over the transitory shock. Official counterspeculation is particularly designed under the circumstances to penalize the private speculators producing or magnifying the transitory pressures. An entirely different situation prevails on the other hand in case exchange markets reflect a permanent drift conditioned by underlying nominal or real shocks. The operations executed under the external measures are designed under the circumstances to prevent a further fall in the price of the dollar in the expectation that suitable policies modify the underlying conditions causing the drift. In particular, this would mean that monetary growth and the budget deficit be permanently lowered in the United States, or that other countries (most particularly Germany, Japan and Switzerland) permanently raise their money growth and budget deficits. Such modification in the basic

conditions shaping the "permanent drift" of exchange markets affects the dollar probably with some delays. Market participants would hardly change portfolio commitments without some credible signals bearing on the change in circumstances in the United States or abroad. The external measures offer thus an opportunity to shift the eventual outcome on the dollar market forward in time. The expected change in relevant policy conditions converts the current pressure into a transitory deviation rationally offset by the external measures.

The crucial question bears of course on the nature of the underlying forces shaping the drift in the exchange markets. Unfortunately, we do not possess any firm knowledge in this matter. We have no evidence or relevant information suggesting that we should assign substantial credence only to the assumption of a transitory shock requiring no further adjustments in our financial policies. A rational course should attend under the circumstances of diffuse uncertainty to the control of monetary growth and the budget deficit in the United States. As the winter passes and no relevant signals of the necessary revisions in U.S. financial affairs emerge, the dollar market will reveal a new wave of doubt. This development will raise the domestic political pressure in West Germany, Japan and Switzerland, encouraging the return to the inflationary course imposed by the U.S. government on the world. The dollar may ultimately be "saved" by a concurrent and general policy of inflation and not by the "leadership of November 1."

FINAL REMARKS

In the days following the second package announced on November 1, officials of the Carter Administration assured the public that their anti-inflation program is the "only way." The alternatives are either recession or mandatory and sweeping controls. This line is fraudulent or illusionary. The juxtaposition between "recession or guideline programs" misleads attention. There is indeed only one way to lower inflation and that is to lower monetary growth over a long time. This instrument of an effective anti-inflationary policy unfortunately induces a temporary recession. But a policy of permanent inflation supplemented with incantations and partially mandatory and unpredictable controls (i.e., guidelines) yields the social costs associated with erratic inflation, sluggish output and higher normal unemployment. The promise of permanent inflation at a negligible social cost is a dangerous illusion or an irresponsible fraud committed on the public.

The juxtaposition between voluntary guidelines and mandatory controls also obscures the relevant issues. It obscures the fact that guidelines are in reality selectively applied mandatory controls. Moreover, these guidelines will fail in a context of permanent inflation policies. Such failure leads unavoidably, as a result of the persistent refusal to adjust our financial affairs to the requirements of a non-inflationary course, to sweeping mandatory controls. We should hope that the American public eventually rebels against the persistent irresponsibility of our financial policies which endanger our economic welfare and ultimately our basic freedom.

INFLATION--CAUSE, CURES AND PLACEBOS

Beryl W. Sprinkel

INTRODUCTION

Inflation is a rise in the average price level, inevitably brought on by too much money chasing too few goods. Since most of us prefer stable prices, either for equity or confidence-enhancing reasons, the solution should be obvious. Conduct our nation's financial affairs in a manner designed to increase total spending in line with the increase in total production. Yet, throughout the post-World War II period, spending increases have persistently exceeded output increases, but by varying degrees, and inflation has become a way of life. Each economic expansion has ultimately brought greater inflation, followed by recession and lower inflation rates. But there has been a persistent tendency for each inflation peak to exceed the prior peak, and each inflation trough to exceed its predecessor.

There is no shortage of views concerning why spending increases have exceeded real growth, thereby bringing inflation. They include too much money, too large deficits, slow productivity, excessive wage increases, monopoly in labor and business, too high taxes, currency depreciation, rapacious oil sheiks, high farm supports, higher minimum wages, higher interest rates, higher social security taxes, etc. It is

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unlikely these explanations are equally valid and certainly not all have been rigorously tested.

I want to discuss my views as to why we have serious and accelerating inflation and whether recent policy initiatives will help, and at what potential cost.

The Essence of the Problem

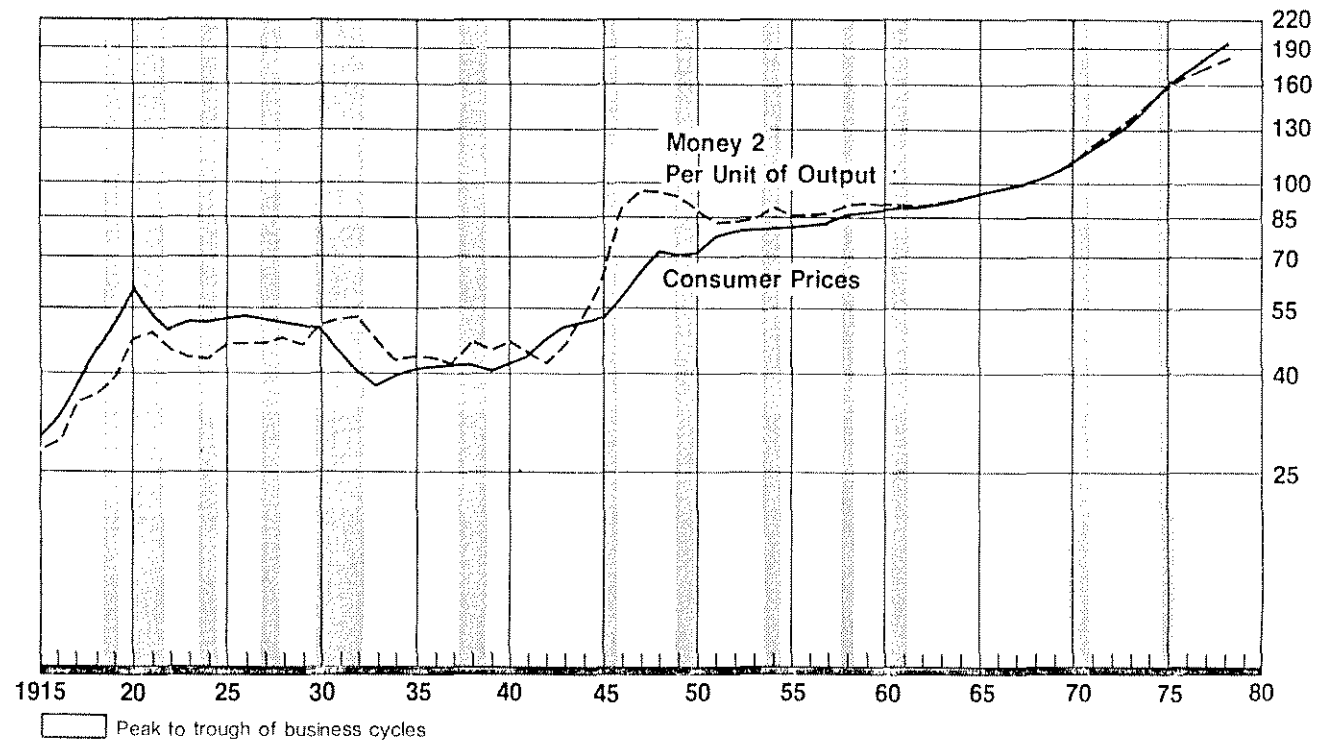
Inflation has been for all known times and all nations a matter of too much money creation. The following chart plots the rate of monetary growth per unit of real output against the rate of rise of inflation for the U.S. from 1915 to now. The correlation isn't perfect, but is very close. There is good reason for the high correlation in the U.S. and for other countries. When more money is created, it inevitably gets spent, and when spending rises faster than real output, inflation ensues.

The reasons for excessive money creation are numerous and have varied from war, to gold discoveries, to excessive spending on domestic programs, to misunderstanding of the lag effects of monetary policy, to support of weak currencies by central banks, to inappropriate operating techniques of central banks.

The Proximate Causes of Present Inflation

In the spring of 1975 the Open Market Committee of the Federal Reserve System accepted, under some pressure from the Congress, the objective of gradually reducing monetary growth until it was commensurate with real growth. That was, and is the correct policy stance. Each subsequent quarter, the Fed has reported to the appropriate Congressional Committee its progress as well as its objectives for the

Money, Real GNP, and Inflation



Taken from: B. Sprinkel and R. Genetski, *Winning With Money*. (Dow Jones-Irwin Inc., Spring, 1977).

coming year. At most quarterly meetings the planned ranges were reduced slightly. Hence, it would appear that stable prices must be just around the corner, if the monetarists are correct. But alas, the actual rate of monetary growth accelerated in 1975, and each subsequent year. Recently, we witnessed the highest rate of monetary growth since World War II, a rate far in excess of professed targets. I will focus on three fundamental forces as the proximate causes of recent excessive monetary growth.

First, large and growing deficits made the job of limiting monetary growth more difficult. Although federal deficits have long been characteristic of the U.S., their size and persistence have expanded. In the decade ending in 1965, the cumulative federal deficit amounted to only \$31 billion. In the next decade the cumulative total was \$148 billion. In 1976-77 alone deficits amounted to \$125 billion, and last fiscal year \$48.8 billion. Deficits must be financed. They may be and have been financed by absorbing savings which cannot then be used for private capital formation. Hence, private capital formation has been relatively weak for over a decade and productivity growth has slowed drastically. Or, they may be financed the politically easy way by creating new money down at the Fed, with the inevitable effect of more subsequent inflation. We've done both and the result is slow growth and high inflation. Deficits are not the boon to mankind that my Keynesian friends allege. Rather, they are the source of massive economic problems.

Second, there are apparently irresistible political temptations to enjoy the short run benefits of accelerating money growth while

ignoring or disbelieving the inevitable inflationary consequence. True, higher monetary growth in the short run brings many goodies. Perhaps interest rates will briefly decline. Certainly spending will go up, incomes will rise, employment will increase, unemployment will decline, profits will spurt, and financial markets may be buoyed. In the inevitable longer run, i.e., one to two years later, inflation will pick up. We are now in the long run, and we are not dead as Keynes once suggested. Until at least recently Carter Administration economists argued that widespread excess capacity would assure positive economic benefits from stimulative policies with only minimal inflationary consequence. Clearly they were wrong. Excess capacity measures are notoriously inexact, and even if they weren't, Keith Carlson demonstrated in the September 1978 Review of the Federal Reserve Bank of St. Louis that a policy of rapid stimulus is likely to bring higher inflation with only very short run benefits to production and employment.

Third, the Federal Reserve System has chosen a technique for implementing aggregate policy objectives that nearly assures a procyclical, not a stabilizing money growth pattern. The attempt to choose a target for the Federal funds rate believed to be consistent with money growth targets nearly assures excessive money growth during expansions, and weak money growth during recessions. The facts are that the Federal Reserve money desk in New York has done an excellent job of achieving Fed funds targets while almost consistently overshooting money targets since 1975. The Fed funds target chosen was too low to be sustained without intervention. Hence, purchase of Treasury securities by the money market desk increased bank reserves and the

monetary base and hence monetary growth accelerated. The Fed funds rate is now about 10% but the gradual escalation began at 4-3/8% in early 1977. As the money supply accelerated, credit demands rose, inflationary expectations increased and the Fed funds rate necessary to dampen money growth soared. The process reminds me of my youth on a farm in Missouri, when I sometimes tried to shoot a running rabbit by lagging, not leading. I sometimes bagged the game accidentally, but I surely expended a lot more valuable ammunition in the meantime! Until monetary execution zeros in on the growth in the monetary base necessary to promote a stabilizing monetary policy, rather than lagging the appropriate Fed funds rate, there is little hope of success.

What About Recent Policy Initiatives?

There exists a plethora of evidence on the effectiveness of wage and price guidelines, standards and controls, either voluntary or mandatory. The returns are all negative. If appropriate monetary-fiscal policies are pursued, controls aren't needed; if policies are too expansive, controls won't work!

The philosophy of wage-price controls is based on the assumption that price changes on particular items cause inflation. This simply isn't true.

Changes in relative prices such as those brought about by a weak currency, monopoly power in labor and business, higher agricultural price supports, higher minimum wages, higher social security taxes, higher oil prices, etc. frequently have a pernicious effect on economic growth, employment and freedom, but do not bring lasting and high

inflation. Only excessive money creation can do that. Factors limiting productivity growth such as government controls and low levels of capital formation reduce real output growth and add to the inflation resulting from any given level of monetary growth, but the contribution is moderate--perhaps one per cent per year. Slow productivity improvement is the major factor limiting improvement in our real living standard, while monetary growth has little effect on long term growth, but is the major force bringing out near double-digit inflation.

It requires no great insight to predict present "voluntary" controls will fail because the self-policing incentives are all wrong. Unless fundamental correctives are applied, mandatory controls will follow. Controls are an attempt to shift blame for inflation from Washington, the source of our difficulties, to blameless labor and business.

The recent massive moves to support the dollar will also fail unless reduced monetary-fiscal stimulus develops. Germany, Switzerland, and Japan expended billions of dollars of resources buying dollars during recent times, to no lasting benefit.

Perhaps policies are tightening. Vetoes of spending bills have been sparse, but apparently stringent efforts to slow spending increases are now underway. Let us hope so. The recent one per cent boost in the discount rate and the \$3 billion rise in required reserves may do the trick, but only if Open Market purchases of securities don't continue to spur growth in the monetary base. The motto of my native state, Missouri, should serve us all well on that score: "Show me!" Careful monitoring of Federal Reserve purchases of securities and

resulting growth in the monetary base and M-2 will yield the answer as to whether recent actions were fundamental or merely another attempt to provide placebos.

If monetary growth is slowed in the months ahead as I expect, I fear our inflationary economy is now highly vulnerable to recession by late 1979. The short run effects of tighter money are adverse to real growth while promising less inflation only after the slowdown begins. The slowdown is worth the cost if massive stimulus is avoided on the other side of the peak. I fervently hope that next time we will have learned from past mistakes, but recent history provides few favorable omens.

What should we have learned from more than a decade's repetition of go-stop economic policies? The one word that best summarizes our enhanced knowledge should be moderation. Rising monetary and fiscal stimulus does not bring lasting real growth benefits, but merely insures accelerating inflation. A continuous moderate trend toward less stimulus would eventually restore price stability with only minor short run restraints on growth. Continuous attempts to follow policies that limit the scope of private economic decision making while enhancing the government sphere of activities, promotes inefficiency and slow growth. Pursuit of placebos such as wage and price restraints promotes inefficiency while yielding no cure for inflation.

Perhaps we have learned our lessons. The recent political campaign emphasized the benefits resulting from reduced government spending, lower deficits and less government regulation. When exposition of the lasting benefits of slower monetary growth is added to our political

lexicon, we will have come full circle. Finally, when political promises are followed by performance, I will then conclude that policies of financial prudence have become good politics.

TIP FOR INFLATION: WHY AND HOW

Sidney Weintraub

Our credibility as a nation has been jeopardized by inflation and aggravated by the accompanying unemployment. Every age faces setbacks to test its resolve for historical evolutionary survival. The 1930s grappled with unemployment, and the not unrelated march of dictators. The 1940s saw the war, peacetime conversion, and the Cold War. Subsequent traumatic episodes, as the Cuban missile crisis, Vietnam, and Watergate can be cited. Energy and inflation, or inflation and energy now appear paramount. Blot out the inflation blight and, barring nuclear war miscalculations, we should again be able to resume the free world leadership that our military might compels and our economic power commends.

My position remains that (except by happenstance) a stable price level and minimal unemployment will elude us on traditional monetary policies, or on the less efficient fiscal policy except in extraordinary circumstances such as the 1930s. At the moment, it would entail some digression to develop this. To those who see monetary policy as ample for the desired price and job stability, and in a relatively noninterventionist framework, I hope my own proposals will be assessed as at least a necessary supplement to monetary policy. I would even go further: on the assumption that an effective and largely nonbureaucratic tax-based incomes policy (TIP) is adopted, I would see no difficulty,

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for the most part, in subscribing to the steady money growth rule foreshadowed in the 100 per cent money of Irving Fisher, or the Simons-Hayek-Robertson discussions of the 1930s, or by modern exponents. The difference between us, as I see it, is whether steady money emissions per annum can perform the stable price feat or whether a TIP-type incomes policy is essential as a prior condition for the real output control mechanics implicit in steady money growth.

I dwell on this because it would be a curious misreading of my position to allege that I deny the potency of money supplies.¹ It has been the efficacy of money control as an inflation instrument that has drawn the criticism, never its potency. It has, too often, been simply too potent, chopping jobs and production rather than subduing the price level. Money retains its majesty in financing output and funding jobs.

Subsequent discussion will strike on literally three planes, with first some general views to establish a position; next, to deal with some slightly more technical issues; and finally, a statement of my own proposals for inflation policy followed by an evaluation of the evolving Carter price level package of October 24.

STAGFLATION: THE IMPOSSIBLE HAS HAPPENED

For perspective, the formidable importance of inflation is sketched so that discrepancies in assessing the issue can emerge sharply.

¹Cf. my Capitalism' Inflation and Unemployment Crisis (Addison-Wesley, 1978), and Keynes, Keynesians, and Monetarists (University of Pennsylvania, 1978) for further elaboration.

Inflation: The Number One Problem

Concurring with the various polls, inflation remains our number one economic problem. It is "the one in many" that mars our economic performance, suppressing actual accomplishments well short of our potential. It impedes full employment; it engenders income inequities and anguish, social unrest and political turbulence; it contributes powerfully to the international dollar decline and raises import prices; it occasions stock market jitters, bearish bond markets, historic high interest rates, and unstable financial markets; it visibly upsets government and private budgets; and it deflects allocational and expenditure decisions from patterns (presumably more rational) ensuing under a more stable price order. The stop-go of minor skirmishes and major failures in combating inflation has repercussions on the housing and construction industry, with multiplier ramifications through the economy.

Subdue inflation and our other national problems should fall into place. Continuing our past stumbles and fumbles leads to a cumulating agenda of unfulfilled objectives, whether envisioned as new ventures for government or as designs to eliminate areas of intervention and alter the scope of the private and public sector.

The Great Intellectual Distraction

Not least, the alarms over inflation and its acceleration constitute a great intellectual distraction. Constantly discussed, new issues are shoved into the background. In the competition for the limited attention span devoted to public issues, a Gresham's law is at work: the familiar diverts reflection from the more novel phenomena. An

undue amount of professional skills, moreover, are preoccupied with the chronic economic ill. Yet despite the concerted focus of intellectual resources, the number of original ideas to arrest the inflation stalemate are conspicuously few.

The Stagflation Ordeal: The Impossible Has Happened

The last decade has witnessed the simultaneous distress of too much inflation and too much unemployment, with the odd couple constituting the stagflation ordeal. The debacle in the United Kingdom has at times been more severe, as output fell amid a chaotic price level surge, giving currency to the slumpflation term. The price of this enrichment of the language was a more total disorientation of the economy.

In the older boom-bust cycles, prices and output rose during the upswing and unemployment rates fell; the reverse pattern marked the recession fallback. Either inflation or higher unemployment rates prevailed. Now, the see-saw has yielded to the buzz-saw: we have simultaneous bad economic tidings. Instead of a single disorder one at a time, we suffer the double trauma. What used to happen in banana republics, or in bizarre comic operas where everything went wrong at once, creating havoc in all directions, has happened to us, and to other affluent, politically mature, and sophisticated economies endowed with all the prescribed sophisticated stabilization techniques.

The "impossible," or "inconceivable," has thus happened. Older economists would have been appalled at the juxtaposition of events. Manifestly, the double-trouble attests to some failure of ideas, and their reenforcement in policy. It is especially perplexing that in an age where economics has become mathematized, fascinated with

econometrics and obsessed with the computer devouring piles of data, the main tangible result is a sequel that previous generations of economists averted, namely, the stagflation malaise. Buried under the enriched technical avalanche, progress in ideas for the smooth functioning of the economy has been impaired.

THE KEYNESIAN-MONETARIST DIALOGUE

Passing reference must be made to the prescriptive versions of the dominant Keynesian and monetarist dialogue filtered over from professional to popular consciousness.

Over the stagflation decade monetarists have generally alleged that central bank policy has been too lax, with the money spill culminating in inflation. They usually advocate annual money increases in the three to five per cent range. In more inadvertent renditions, a steady money pace seems to be the virtue, rather than the two-pronged rule of steadiness at a rate consonant with longer run production growth. The objective remains, to abort inflation on the premise that the steady percentage rule will restore a stable, full employment economy.

Keynesians, with minds riveted on past unemployment episodes and, until a late day, less mindful of the inflation burden and inequities, have usually targeted their money supply recipes on alleviating job distress. Their money supply advocacy has more frequently, over the dour decade, seized on annual money growth rates in the seven to ten per cent zone.

Dialogue has often been at cross-purposes, and misspent; much of the debate has been over whether the glass of water is half empty or half full. Nonetheless, each has called attention to part of the problem, the monetarists to the Keynesian inflation neglect and the Keynesians clinging to implant the dire past unemployment memories.

As a long-time critic of the fashionable brands of Keynesianism, even while not derogating the potency of monetary policy, it is possible to deprecate its efficacy against inflation. Monetary policy scores its hardest direct blows on jobs and production, being particularly destructive to the housing industry when it is severely restrictive. By creating enough unemployment -- as under good Phillips curve doctrine -- it can indirectly slow up the average wage and salary ascent and thus contain the price level. Effectually, by inflicting unemployment distress, it can mitigate the inflation disorder: it supplants the unwanted for the undesirable. For it to win against inflation, there is a precondition, namely, that labor must acquiesce in moderating its wage demands. When labor grows more adamant despite unemployment, insisting on higher pay despite jumping unemployment rates, the double-trouble of stagflation or slumpflation occurs.

The monetary cure against inflation thus partakes of the same dubious policy attributes that Pigou long ago noted for wage cuts as an automatic route to full employment (Lapses from Full Employment); through the "real-balance" effect the ensuing price deflation remedy might be more devastating than the original disease. Pigou might be chided for understating the social, political, and economic plight ensuing from fairly universal bankruptcy.

My conviction thus remains, that over both the near future and the long haul, monetary policy is destined to be inefficient in establishing a stable economy. I offer this as a reluctant conclusion; I would prefer being mistaken, for my analysis suggests that new institutions must be organized to cope with the systemic contradiction. In error, the sole result would be that these skeptical views would be demolished by events and we could go on as before -- a very small price to pay for the maintenance of an orderly and venerable economic system.

The Incomplete Fed

The Fed has been fighting inflation over most of its sixty-four years. The dismal inflation history is a result not of the lack of will on the part of the Fed officials, but of a lack of tools for a direct attack on the price problem without dumping us in the unemployment ditch and, over the last decade, without discernible inflation surcease. The last two chairmen of the system were dedicated and implacable inflation foes, yet both left office with prices over fifty per cent higher than at the start of their incumbency. Even as they reminded us of their zeal and the Fed's eternal vigilance, they would intone the lugubrious price statistics. As in the military communiques, they would always see light at the end of the tunnel crowning their valor, yet always the victory has been beyond reach.

After sixty-four years of retreat, and cumulating distress, we would long ago have altered military strategy and probed whether the weaponry was ample for the task. My conclusion has been that an unaided monetary policy cannot usher in a sidewise price trend, at

least not without a catastrophic cost in unemployment and festering social and political conflict with irreparable damage to the market economy. Where alternatives compatible with the functioning of a market economy are available, in blocking mild reforms, the friends of the relatively free economy who want it to succeed join unwittingly with enemies who prefer that it fail.

Mischievous Phillips Curve Doctrine

Monetarists nonetheless insist that their tight money medicine, pursued long and relentlessly enough, will stop inflation. How long, and how relentlessly, are subjects too often left vague. Too, circumstances under which they might abandon the pressure are seldom revealed; alternatives, if the policy failed to operate on schedule, are not drafted. In the military, there is at least a contingency plan in case the battle goes awry.

More candid espousal of monetarist recipes acknowledge that the policy can spell unemployment. This is good Phillips curve doctrine but it embeds some bad theory and dubious policy, dangerous to the viability of the market system.

There is no need to dwell on the intricacies of Phillips curves, or their wayward patterns of recent years, or the transformation of what was originally hailed as a predictive law into a less edifying post-mortem on why events misbehaved. The case might be made that the Phillips curve lacks even the staying power of the law of demand in consumer markets under the ceteris paribus proviso.

Most dejecting is the advocacy of a policy that aims to replace one dismemberment with another disfiguration, or to supplant the

inflation woes with the unemployment morass. To me it is simply immoral, let alone uneconomic, to recommend unemployment for other people, usually to menace the least adaptable members of our economy with the indignity of a loss of jobs and income. I have said on occasion that advocates of these policies should resign, join the ranks of the unemployed, and become the great inflation fighters. If unemployment is good policy, they should be first to enlist in the battle.

Too, the policy is spurious. It is as if a doctor advises a patient that he can cure him of a coronary ailment by inducing kidney troubles (iatrogenic is the medical word, as Hyman Minsky, Professor of Economics at Washington University, has enlightened us). Most of us would seek a new physician. Medicine aims to eradicate all debilitating ailments, and not to substitute a pernicious malaise for a terminable affliction. In economics, however, we seem less concerned with restoring total health, preferring some impenetrable, often mystic, talk of trade-offs.

The Phillips curve, even when well-behaved, reports relations in labor markets as organized in the past. Not inconceivably, by adopting innovating policies compatible with the market economy, or involving acceptable departures, money wage and salary movements may be moderated to much less inflationary sights without bending too much from the goal of jobs for all who are willing to work at prevailing real wages.

The Destroy-To-Revive Fantasy

Monetary policy, as practiced, entails a curious "destroy-to-revive" fantasy that would stir incredulity in wanderers not steeped in the conventional wisdom.

Every time the economy approaches full employment, we are warned of the danger of inflation ahead and cautioned against the economy "overheating." The sequel involves a tightening of the money screws, and deliberate retardation of the growth rate and job access. Sighting the Promised Land, a bugle call to retreat is sounded.

This is bewildering. Every time we show signs of robust economic health we are coerced into iatrogenic sickness, with the economy dropped into a recession tailspin. After the repressive process runs on for a time, we gather our courage to denounce government for stop-go tactics, and to sound some clarion calls (by Keynesians) for renewing the march to the fuller employment gates. Money policy is eased, to build the economic patient to better health -- not to complete vigor but, for his own good, this is presumed to make him susceptible to later illness. Only the worst symptoms of joblessness are mitigated.

Thus we are perennially trapped below our best performance, and deliberately so condemned. We are compelled to adopt a posture of dedicated underachievement at best, and significant frustration at worst. Systemic masochism earns the more euphemistic name of "fighting inflation."

Despite this "destroy-to-revive" tactic, we have not dislodged the price spiral. (Currently, another tight money venture is in

process). We have, however, sponsored a sputtering economy, rather than a market system riding smoothly at peak efficiency. Monetary policy, despite good intentions, has mired us in an abject outcome compared to an optimal and presumably attainable goal.

THE ASSAULT ON THE LAWS OF ARITHMETIC

Over the last decade especially, we have been engaged in a mad assault on the laws of arithmetic. Average productivity over the longer term has been inching ahead by two to three per cent per annum; money income -- with money wages and salaries comprising the seventy-five per cent bulk of the total -- has been leaping by eight, ten, twelve ... per cent or more. In the United Kingdom and Australia, to name but two countries, the more herculean feat was essayed in 1974 and 1975, with pay increases approaching a twenty-five per cent annual pace. Consternation ensued when prices vaulted in concert.

A Basic Truism

A price level surge is imperative whenever a sharp discrepancy occurs between average income and average productivity. Our inability to apprehend this homely truth is amazing for the results must follow:

(1) $PQ = Y$, where P = average price, Q = aggregate real output,

Y = income

$\therefore P = (Y/Q) = (Y/N)/(Q/N) = (y/A)$, where N = employment,

y = per employee income,

A = average product =

Q/N .

Regardless of what the Fed does, so long as average income² including wages, salaries, profits, rent, depreciation, etc. per employee runs faster than average productivity, the private sector price level is bound to fill the gap.

Futility of Monetary Policy Under Outsized Pay Increases

To make average money wages and salaries stand out more prominently in the price equation, from $PQ = Y - kW_N$, then:

(2) $P = kw/A$, where k = average price markup

(or the reciprocal of the wage share, from $k = PQ/w_N$).

Year-to-year, k is reasonably constant, showing slight downward drift over time. Since about 1950, on the score of the k -factor P should show about twelve per cent lower! P is thus bound up with the flex in unit labor costs (w/A), climbing almost exactly in unison.

Some may characterize this as a "wage-push" theory of inflation. This is a cultivated error: money wages and salaries are simultaneously the chief ingredients of costs, on the supply side of the price equation, and the mainspring of consumer demand, responsible for about eighty-five per cent of consumer purchases. "Cost-push" and "demand-pull," rather than being disparate phenomena, are simultaneous strings in consumer markets emanating from the same money wage phenomena.

Neither in (1) nor (2) are there any separate terms for money, to link money quantities to the price level. Money plays an indirect role

²I generally use Gross Business Product (GBP) for the income concept.

in affecting output and jobs, and thus (as under Phillips curve doctrine) through unemployment levels it can deflect the money wage trend. Tight money, presumably, will rein in the $w(t)$ path over time and thereby work a meliorating price level impact, at least where Phillips curves are well-behaved so that labor militancy does not impair the relations. Tight money, however, by retarding investment, may defer plant modernization and thereby contain the $A(t)$ course. Through this channel tighter money may be (mildly) inflationary.

Instant Billionaires?

The general theory must be correct. Otherwise we could raise average money wage and salary incomes not by two or three per cent per annum for a steady price level, or the eight, ten, twelve per cent figures of recent years, or the egregious twenty-five per cent numbers of the United Kingdom and Australia, but by a thousand or millionfold: why not make everyone an instant billionaire? Why oppose the fulfillment of instant happiness? After all, if money incomes have nothing to do with inflation, and money control by the Fed can inhibit the price level excrescences regardless of wage increases, there should be no objection; there need never be any strikes by people unhappy over their money income lot if price levels are not upset by outsized general pay upheavals.

In concurring that there is a "right," or optimal, pace of average money wage gains, we are assenting to the ubiquity of incomes policy. Too, there is implicit a recognition that money policy, unaided by a supplemental conscious -- or fortuitous -- gearing of w 's and A 's, cannot usher in a flat P -trend.

Productivity and Costly Regulations

The productivity term A stands prominently in the price level equation. Historically, productivity growth was measured at two or three per cent per annum, with three per cent leaning to the high side. The 1970s estimates disclose a shade below two per cent.

Tight money, it was observed, by impeding plant modernization may have had a (mild) inflationary bias. Recent ecological concerns, with pollution and safety drum-beats, have fostered enactment of new regulations and stricter enforcement of old ones. In terms of (1) and (2), insofar as a steel mill has to install scrubbing devices, say, it deflects capital sums from steel-making equipment, indirectly reining A. Likewise, in hiring personnel to clean up the air or to conform to safety rules, the number of employees per ton of steel tends to depress the A-term. Regulatory consequences can thus retard productivity growth rate.

It is easy to oppose sin -- or excessive cost raising, or superfluous productivity-depressing, health and safety regulations. Others will be better informed to cite particulars. Largely, however, their removal contributes a one-shot productivity booster, conceivably with delayed impacts. Big irresistible productivity gains are more likely to follow fresh innovations and technological triumphs.

OTHER INFLATION THEORIES

Many would fault big business for excessive price markups as the decade's inflation source: the available evidence invalidates this view.

Others indict the federal deficit. Yet the last fifty budget years have seen only nine years of surplus, often of piddling size and yet, until the last decade the price level performed reasonably well. In 1933, with a deficit of about fifty-five per cent, the price level actually fell. Deficits are hardly the indomitable inflation-maker despite the popular rhetoric. More detailed analysis would reveal the deficit theory, when undraped, as a crypto-money theory of inflation amenable to a monetary remedy.

Government Debt and Expenditure

Government debt, comprising the residual cumulation of deficits, also gets its share of inflation calumny. Fact: since 1945 private debt has plunged far faster. Until recent years, the big public debt lurch occurred between 1930 and 1945, in a period when the price level behaved "orderly," again by modern standards. Relative to GNP the federal debt has declined sharply over the last generation.

Bombed by Proposition 13, though never really out of season, current onus is directed to government expenditure, especially the federal government though its aggregates are outpaced at the state and local level in recent years. The projected \$500 billions federal outlays for fiscal 1979 would, in 1963 prices, be about \$240 billions. Government outlays under even unaltered programs cost more as a consequence of inflation: when defense hardware prices go up, when civil servant pay climbs to match private sector trends, budget outlays inevitably advance. Relative to GNP, federal absorption of output has not been making greater inroads on the recent aggregates.

Although it braves heresy to say so, if government expenditure "causes" inflation, then other forms of expenditure must also be included, especially insofar as government outlay has not gone up disproportionately. All this, however, presumes that stagflation is a story in excess real demand -- a view which I reject. One would presume, however, that our people would oppose wasteful government outlay in inflation season or out.

More difficult to fathom is the conviction that taxes be chopped with a meat axe while government outlay cuts are evaded, or trimming ordered without assessing military or social consequences. Tax slashes without outlay containment would feed larger deficits, with implications for monetary theories of inflation.

To illustrate the penchant for concentrating on the less significant while the substantial slips away, total employee compensation now amounts to \$1.4 trillion. At compound rates of 10 percent, in just over three years the mere augmentation will overshadow the \$500 billion federal 1979 outlay. At an eight per cent annual escalation, the feat will take under five years. Containment of the wage and salary climb, and thus civil service pay and the price of government procurement, would appear to be the best route to repressing government expenditures.

SOME ASPECTS OF MONETARY THEORY

Emphasis here on the wage-productivity nexus as the price level-maker make remarks on where money fits in obligatory. Discussion inevitably must be brief.³

³Further elaboration appears in my Capitalism's Crisis and Keynes, Keynesians and Monetarists.

Modern quantity theory doctrines link money supplies primarily to money incomes, finding the connection of money supplies to prices and to output variations more perplexing. In the symbols of the old income equation of exchange of $MV = PQ$, implied is:

$$(3) \quad m(\Delta M/M) = (\Delta P/P) + (\Delta Q/Q),$$

$$\text{where } m = [1 + (\Delta V/V)/(\Delta M/M)] = (\Delta Y/Y)/(\Delta M/M)$$

Murkiness -- or indeterminateness -- enshrouds whether money supply changes affect primarily the P's or the Q's, the latter welcomed and the former ordinarily rejected in economic policy. In adumbrating the steady money rule of, say, three per cent annual money increments, there is an implicit proviso that the money swell will sustain the $(\Delta Q/Q)$ increment rather than spill over to generate a ΔP splurge.

From the wage-cost markup equation (WCM) of $P = kw/A$, or from $MV = PA = kWN$, it follows:

$$(4) \quad m(\Delta M/M) = (\Delta k/k) + (\Delta w/w) + (\Delta N/N)$$

If we neglect k in (4), as with $\Delta k = 0$, and if money wage jumps are excessive, and taking \underline{m} (= the money income elasticity at values conjectured in monetarist studies) nearly constant, then a failure of money supplies to balance money wage hikes will have impacts on employment, ΔN . In (4) the potency of money policy for WCM theorizing emerges, with Q and N being hit by the Fed's slingshot, instead of P being brought directly to hand.

From the WCM:

$$(5) \quad (\Delta P/P) = (\Delta k/k) + (\Delta w/w) - (\Delta A/A)$$

By-passing k , P reflects a tug of war between w and A . From (5),

determinateness is imparted to (3) with $(\Delta P/P)$ resolved by the WCM elements and $(\Delta Q/Q)$ a resultant of money supplies.

The Potency of Monetary Policy

Monetary policy thus retains its clout in WCM theory. With reasonable constancy in m , whether money policy is expansive, neutral, or constrictive depends on $m(\Delta M/M) = (\Delta P/P) \begin{matrix} \geq \\ < \end{matrix} (\Delta w/w) - (\Delta A/A)$.

Table 1 indicates the variety of potential economic situations. Whether the economy lands in row 1, 2, or 3 depends, in WCM arguments, on the wage-productivity nexus. Whether column 1, 2, or 3 is our lot rests on monetary policy. Others may elect different names for the circumstances which fill the matrix. To make separate provision for unemployment, a twenty-seven cell, or three dimensional table, testing our facility for devising names, would have to be erected.

TABLE 1

The ΔP and ΔQ Matrix Pursuant to ΔM Action

$\Delta P \backslash \Delta Q$	+	0	-
+	Growthflation	Stagflation	Slumpflation
0	Growth at Constant Prices	Stationary State	Recession
-	Deflationary Growth	Steady State Deflation	Depression

INCOME GEARING: THE TIP PROPOSALS

All economic systems that pay out money incomes, whether a capitalist or a collectivist model, must adopt some method of gearing money incomes to output flows. The market economy has hitherto relied on an indirect tie, namely, the control over money supplies in the thought that the MV aggregate, equal to Y , money income, can thereby be managed. My remarks have assayed the imperfections in the system, or the effect in $Y = kW_N$, on the N variable when Δw has flounced disproportionately; too, when unemployment has grown politically intolerable, the ΔM variations have invariably had to be relaxed.

My thoughts then have gone to ways to gear average money incomes more closely to productivity developments, and in a manner compatible with the enterprise economy. With $P(t)$ reasonably flat over time, monetary policy should then be able to stabilize the Q 's and N 's in the acceptable incomes policy, monetary policy should be able to pursue, more or less, the steady money rule. In this sense monetary and incomes policies can be mutually reinforcing.

Opposition to Price and Wage Controls

Those of us who have preferred market-oriented incomes policy have been concerned with what we contend are modest institutional reforms to protect, to improve, to salvage, to restore, and to perpetuate the market system; the aim is to embed measures to enable it to realize its maximum potential. It is the market system that the policies intend to preserve, rather than to devise grandiose, impractical, and futile plans to supplant it. But the system admits of improvement, notoriously in respect of jobs and inflation.

To dispel any confusion on the matter, mandatory wage and price controls are neither contemplated nor advocated; the quest is for non-interventionist policies. Controls are anathema to the market system: they are bureaucratic, dilatory, harassing, costly to administer and for business to abide; they are apt to be politicized; they induct an army of snoopers and enforcers; they breed a new type of crime engaged in consensual transactions, they thereby erode freedom; they erect a forum for legal histrionics to clog court calendars; they support a retinue of court attendants and jailers; and they outrage vexed citizens.

Nothing advanced here can be remotely interpreted as an espousal of mandatory price and wage controls. My own support for controls would extend only for a brief interlude while measures to be outlined are being legislatively contemplated prior to enactment; for example the Nixon 90 day price and wage freeze in 1971 operated with tolerable effectiveness -- which implies mainly that the economy can stand practically anything for a few months.

The image of Captain Queeg tyrannizing over the theft of a plate of strawberries must not be elevated as the prototype in lieu of private decision making under traditional (or modified techniques) of monetary and fiscal policy, harmoniously meshed with incomes policy in a market system altered in an acceptable evolutionary way to obviate the inflation blight. Private decision making under the corporate income tax is a commonplace, erecting incentives and deterrents to enterprise conduct. Incomes policy can build on this characteristic.

The Wallich-Weintraub TIP

The Wallich-Weintraub TIP (for tax-based incomes policy) is reasonably familiar. Briefly, it is intended to subject firms to an extra corporate penalty income tax if they violate an average money wage and salary norm of, say, five per cent per annum.⁴ The TIP object, however, is not to collect taxes but to deter inflationary money income conduct. Firms could surpass the norm, but at a price; like all good legislation that takes account of special cases, therefore, there is an escape valve for those who cannot conform or who prefer to overshoot the target. The analogy is to a posted speed limit which can be transgressed, subject to a penalty. Obviously, a very steep penalty scale builds an almost absolute prohibition, while a modest rate structure entails a less formidable obstacle. On the progressivity of the penalty schedule, differences of judgment can abound.

As the object is not to collect taxes, the normal corporate income tax rates could be reduced so that the estimated treasury tax-take is held constant, or reduced. Inasmuch as monetary and fiscal policy could work more closely toward full employment under less inflationary pay conduct, on balance it should be possible to lower the corporate tax rates. TIP could not be fairly indicted with eroding internal corporate venture capital.

⁴For a recent statement see my "Proposal for an Anti-Inflation Package," Challenge (Sept. 1978).

TIP could be confined to about the largest one thousand firms, covering about fifty-five per cent of GBP, or the largest two thousand firms responsible, according to available estimates, for about eighty-seven per cent of business output. Legislation could specify firms employing over five hundred, or five thousand employees, etc., or reporting a sales volume of over \$5,000,000, or \$50,000,000, or whatever numbers judgment condones as reasonable and feasible. As about one half dozen extra lines on a corporate income tax form are entailed (involving known information on the wage and salary bill and number of employees), presumably one auditor should be able to examine ten forms per week or about five hundred per annum. For two thousand firms the administrative personnel directly involved would be nominal, and a trifling cost considering the full employment prize at stake, involving \$50 to \$150 billions in lost output in recent years. The tradeoff of administrative outlay as against economy gains is overwhelmingly favorable.

TIP Supplements

Labor bargaining would not be precluded under TIP though settlement terms are bound to be more restrained on the principle that firms would not go far to trespass the norms, and unions could not expect to win huge gains. Blue Collar labor could secure more than, say, five per cent if other employees obtained less than the stipulated average. Bargaining would be centered in a dispute over relative pay scales, rather than all pay moving along synchronously, after minor or longer time lags, so that in the end all run faster and all occupy practically the same position in the pay pack.

To strengthen TIP, at least in its early implementation, for firms that agree to pay, for instances, at least one percentage point over the stipulated norm, several corollary features can be devised. The following are illustrative; others will be able to provide better ideas. For example, some firms may face bankruptcy if their offer is rejected and unions strike. These firms may be candidates for temporary loan guarantees to cover payment of fixed costs; the provisions would have to be hedged to prevent collusion, obviously. Likewise, some NLRB penalties may be levied on unions for rejecting the norm-plus contract. Labor and business specialists may be able to prescribe more workable provisions to forestall gross violations of the TIP objective. Prospective supplementary stiffening of TIP reflects the versatility of the approach.

Widening the TIP Settlement Band

The conclusion that the TIP norm, say, of five per cent, would become the minimum settlement figure, need not follow. For example, firms could be allowed a two percent reduction in the "normal" income tax for settlement, say, at from three to five per cent over the previous year's average pay levels. Some have suggested even widening the band, leading to a perverse conclusion that firms which cut average pay would win a sharp tax break.

Obviously, any provision of this sort would arouse labor's ire for fostering "slave" labor. The intention is to block price ascent, not to foster a price level decline! So, some stop on the lower end of the pay band would be critical, to provide for firms that could not match the average five per cent pay norm, but would still qualify for

tax benefits with a settlement in the three to five per cent range. (All numbers are purely illustrative though they represent reasonable magnitudes.)

TIP-CAP

The illustrative five per cent annual pay increase, on the presumption that productivity trends of three per cent per annum are resumed, would mean an annual price trend in the two per cent range. By recent standards this would be noninflationary indeed. A flat price level would entail about a three per cent norm and, if future productivity improvements because of higher energy costs are more nearly zero, a more stringent incomes policy will be imperative. In the retrogressive economy, average money incomes would have to fall to realize a steady price level.

Economy-wide productivity is the proper guide for establishing the pay norm, rather than firm or plant productivity. In my early writings on TIP, the basic calculation for the penalty tax was a simple pay average.⁵ In my collaboration with Federal Reserve Governor Henry Wallich, a weighted pay average was recommended in order to avert some possible fudging by firms that raised executive pay excessively and then hired many superfluous low paid employees to reduce the average for TIP calculations.

My colleague, Dr. Lawrence Seidman, who has written extensively on the subject, has persuaded me that any wage-padding could only be

⁵The essays are reprinted in Keynes, Keynesians, and Monetarists.

advantageous on a short term look at the matter: after the first year, the firms would be saddled with a too-costly work force for no possible tax benefit or, in making layoffs, they would encounter the same penalty prospects.

Weighting clearly introduces extra complexities and invites endless controversy on the "right" weights. To immunize some pay grants above the norm, and to evade the weighting aspects while encouraging productivity improvements, firms might be permitted to compute a simple productivity average for TIP reporting, and then to correct the value-added figure per employee by any of a variety of price level indexes to eliminate distorting price changes. If the corrected average productivity (CAP) surpassed the economy-wide productivity growth, employees could share in the special gains. For example, if the firm's productivity calculation was nine per cent or six per cent above the economy-wide figure, the average pay increase could be equal to the norm of five per cent, plus one-third of the six per cent productivity bounty, lifting the wage and salary norm in that firm to seven per cent without penalty.⁶

Labor could thus be an immediate beneficiary of superior productivity performance, with a direct stake in improvements. By and large, however, superior productivity improvements should translate into relative price drops. Firm or plant productivity figures cannot be fully allotted to the firm's employees as a bonus without erecting a discriminatory pay scale through the economy, and blocking output

⁶For detailed elaboration, see Capitalism's Crisis.

advances by maintaining costs and prices in sectors of even spectacular productivity triumphs.

TIP can thus be fortified in TIP-CAP, with the extra productivity attachment going some way toward dismantling outmoded feather-bedding restrictions.

CAIP: Government Construction and Procurement

TIP or TIP-CAP, because of the tax aspects, would have to clear tax committees of Congress where it is certain to be misconstrued as a tax measure, and subjected to misdirected debate. Faster progress in income gearing or incomes policy might be made on other lines.

Under the Davis-Bacon Act the government mandates that on government construction, or government assisted construction, prevailing wages must be paid, usually interpreted generously as the highest in the vicinity. Effectively, Davis-Bacon nails a high floor on government-related construction, and inserts a high pay underpinning for the industry. Without general cognizance under Davis-Bacon, and Walsh-Healey which covers minimum wages, the government is effectively imposing an incomes policy; the idea of incomes policy, therefore, is nothing new in our legislative annals.

As matters stand, labor often lobbies with business for construction contracts which mean jobs, and at good pay. After the sums are voted come strikes for still higher pay. It should be possible to limit pay grants, over the life of the contract to an annual increase of five per cent, as well as to cover executive and managerial pay. Pay aggrandizement at government expense and raids on the treasury might be aborted thereby. Penalties could take the form of disallowing

magnanimous pay settlements as costs in computing income tax profits; disallowance of cost overruns in contract negotiations; or closing off bids by offending contractors on other government jobs for a period of years.

The idea could be extended to military procurement and to government purchases generally. Inasmuch as the veritable Who's Who in American enterprise engage in sales to government, CAIP (Contractual Award Incomes Policy) could blanket from twenty-five per cent or so of the business sector, and could do something to suppress the wayward pay explosion.

The Okun Variants of TIP

Arthur Okun, in a more recent variant of the original TIP proposal, has tried to hide the "stick" and dangle a "carrot."⁷ While his proposal has not been spelled in detail, he endeavored to build foremost on a principle of "voluntarism."

Union employees who agreed to a pay increase of about seven per cent per annum would qualify for a tax credit of about \$225 per annum, amounting to about two per cent of a \$12,000 income and enlarging their pay increase to about nine per cent. Firms that abided by the norm would also realize a two percentage point or so corporate tax reward.

It is possible to be dubious of the "voluntarism" feature, except as a tactical debating wedge. Too, the exclusion of nonunionized

⁷Cf. "Innovative Policies to Slow Inflation," Special Issue Brookings Papers on Economic Activity, Number 2, 1978.

employees from a tax benefit would be an inequality. A fairer method would inscribe a three per cent tax credit for all those with employee compensation (or all taxpayers?) of, say, under \$12,000, and two per cent for those above this figure, with a \$200 minimum and \$300 maximum credit.

This feature adopted from Okun could impart real income protection to labor, and make a TIP program more attractive, especially as labor leaders have shown little willingness to analyze the proposal while plunging headlong into advocacy of mandatory price and wage controls.

Nonetheless, the Okun "voluntarism" will not do. Militant labor leaders could aim for fifteen per cent gains while others accepted seven per cent, with the former deriding the latter as "weak" sisters: why accept a \$200 tax credit when maybe this much extra can be grabbed off per month by an exercise of muscle and power?

Likewise, a two percentage point corporate tax cut appears too limited to induce firms to stand against extravagant pay demands. By accepting the Okun tax cut for subscribing to the pay norm (or settling slightly below), and invoking a penalty for transgressing the norm, the effective tax stimuli and deterrent can be widened to make pay excesses more costly.

Government Employees and Anti-Trust

Government employees could be held to an annual five per cent pay increase. For conformable state and local pay behavior, federal grants could be made contingent upon compatible pay norms. To prevent government pay scales from trailing private sector trends, government

pay scales could be corrected every two or three years to ensure reasonable correspondence.

To counter labor protests that prices are not touched, and to avoid debate over the issue, the FTC might be required to report quarterly on trends in profit margins of firms covered by TIP. Where margins rise unduly, data for reasonable review would be on hand. According to the evidence, however, we can be confident that price margins will not be inflationary so long as wages and salaries are reasonably aligned to productivity.

THE CARTER INFLATION MEASURES

The Carter measures of recent days to subdue inflation provoke comment. On October 24, after twenty-two months of incumbency, and thus about eighteen months late, the President announced a program which, in principle, was based on the theory that motivates TIP proposals. Meeting negative reaction in foreign exchange markets and Wall Street impelled the President on November 1 to impose a fairly drastic set of measures typically described as monetary persuasion.

Let's consider the latter first. There was the almost unprecedented full percentage-point tick in the rediscount rate, effectuated by the Federal Reserve. There was also, a two percentage point jump in reserve requirements against certificates of deposit of \$100,000 or more. A foreign exchange stabilization fund of \$30 billion was organized to discourage the frenzied wave of speculative attacks against the dollar, whose prolonged sinking spell brought soaring import prices. A steeper pace of gold sales was put on the agenda.

Shock impacts were uniformly and dramatically unfavorable. The dollar rose instantly in Tokyo, Frankfurt, and Basel. The stock market, in splendid euphoria, rebounded by thirty-five points in the Dow Jones for the largest single day flourish ever.

Assessments are that the tighter money curbs will, over time, rein in the economy and yield a harvest of recessionary tendencies, especially in the housing industry, with multiplier ramifications through the economy. Prediction of a lagged downturn are thus rife. It may be, however, that as the rest of the President's program falls into place, monetary policy can be eased and that a serious fall-back can be evaded. Time, the great hindsight prophet, will reveal the answers.

The President's non-monetary program, disregarding the inevitable born-again homilies opposing government waste to take the edge off political adversaries, contained three main features:

- 1) First, a summons to labor to hold pay demands on new contracts to seven per cent per annum.

- 2) In reciprocity, the President pledged to ask Congress to provide tax "rebates" insofar as price rises exceeded seven per cent. This embeds the Okun "real income insurance" to make the seven per cent norm more palatable to labor. Calculations by the press and economists tended to magnify the possible tax loss though, if the program is successful and prices rise by less than seven per cent, "rebates" will be nil.

The President's description of the rebates was vague. They probably will take the form of tax credits, with rebates only for those

who have overpaid withholding taxes. As noted above, it seems to me that this protection should be universal, and not confined to unions volunteering to abide by the program. Too, it can be interpreted as a gesture to advocates of indexing of income tax rates.

To many, the seven per cent norm is too high. For 1980, a six per cent number is in the wings -- designed more to shave the inflation rate than to stop inflation. The pace reflects a concession to opinion that inflation must wind down "gradually," to avoid damage to expectations from a sharp price deescalation. The United Kingdom has dumped its inflation rate from twenty-five per cent to under ten per cent in short order, with benefit rather than deterioration. Under the gradual time-table, nobody will get hurt, according to exponents, except those who have been basely ravaged already.

3) Business firms are to hold their annual price increases to five and three-quarter per cent per annum, or one-half per cent below the pace of the previous year. Sanctions on firms that fail to comply will consist of denying government procurement to them, or removing import protection, or subsidies, or other forms of penalty as yet unspecified. News releases indicate that the price policies of four hundred of the largest firms are to be monitored.

The denial of procurement is a "stock" lifted from a country-cousin of TIP that Chancellor of the Exchequer, Dennis Healey in the United Kingdom, is readying for parliamentary enactment.

While applauding the President for a "better late than never" commitment to subdue inflation, the present program is too bureaucratic

for my tastes; monitoring prices and costs smacks of price controls. Too, it is likely to engender bureaucratic hassles when for example, the Department of Defense wants essential component purchases and encounters opposition from the price overseers. The air will be filled with "yes, they did; no, they didn't; and what difference does it make." Snarling is likely to create new headline excitement, but not much surcease from the eternal and infernal immersion in minor aspects of the inflation torment.

Future Prospects?

Contemplating the wage contracts already in the pipeline for 1979, the President's men expect a price eruption of six to six and one half per cent, a miniscule improvement after three Carter years. The 1978 figure should come in at above eight per cent so we are supposed to cheer the snail's progress.

The AFL-CIO George Meany has already voiced displeasure at the package, expressing skepticism of its "fairness" to labor. He has, instead, pronounced his support for mandatory price and wage controls. Some business spokesmen express fears over the price ceilings as a prelude to controls. While opposition has not crystallized, enthusiasm for the measures appears underwhelming.

Still, the President has taken a first step on a necessary journey to bring about a mete of rationality into the wage-price shuffles that have plagued us in generating inflation and evoking the tighter money stagflation response. This I find encouraging. Considering the lack of alternatives, we may have to come to some closer kin of TIP, in lieu of the bureaucratic structure that seems to be in motion.

While such events are seldom predictable, the rocky climb may yet be diverted to mandatory controls, postponing a more rational TIP to the longer future.

INFLATION: IMPERFECT MARKETS AND GOVERNMENT POLICIES

Robert R. Nathan

Everybody agrees that inflation is a costly economic disease -- an economic menace. It is like a cancer metastasizing through the economy adversely affecting investment, productivity, our international competitive capabilities, resource allocation, in fact undermining almost every aspect of the American economy.

So far, we have made little progress in overcoming more than a decade of serious inflation. It will not come easily and quickly, but we do not have to trade off other high and important priority goals in the fight against inflation. In the war against inflation, we basically have four alternatives:

One alternative is a deep and enduring recession. To achieve a measurable drop in the consumer price index or in the GNP deflator via this alternative, it will be necessary to resign ourselves to a substantial increase in unemployment over a significant period of years. The chance of significantly reducing the rate of inflation by a mild recession of moderate duration is remote. As a matter of fact, a short and shallow recession might aggravate inflation rather than contribute to its reduction because of lower investment and poor productivity. The

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cost of a deep recession for several years would run into the hundreds of billions of dollars. This does not mean that we can ignore or risk overheating the economy.

A second alternative, which I also find disturbing, is a decision to live with inflation. It is an alternative that encompasses a relaxation of concern over inflation along with attempts to index everything. That notion was the fad not too long ago. There are many businessmen who only a few years ago said that if four or five per cent inflation persisted over a long period of time, the economy would fall apart, that we could not live with it. Now they say, "Well, seven or eight per cent inflation isn't so bad!" It will get worse if we do not seek to make it better. Seeking ways to live with inflation is an unfortunate self-defeating alternative for this country.

The third alternative goes to the other extreme, namely, mandatory controls. As Chairman of the Planning Committee of the War Production Board, I worked closely with the Office of Price Administration, and was impressed with the effectiveness of a mixture of firmness and flexibility. Controls worked quite well, but peacetime is not wartime and mandatory controls would be much more difficult to apply now, especially over an extended period of time. The Phase I freeze in 1971 and Phase II worked fairly well, even though most of those administering Nixon's controls did not really believe in what they were doing. Phases III and IV were largely phony in principle and practice. In any case, controls are generally undesirable and over any given period of time raise very grave problems. They should not be regarded as a priority alternative, though they may be preferable to runaway inflation.

The fourth alternative, which I strongly support, is to attack inflation on a number of fronts. The continuing inflation derives from many forces. My vote goes with the Carter program -- with some exceptions. I strongly support Alfred Kahn because he offers possibilities of achieving reasonably positive results. Kahn is highly intelligent, highly motivated and highly realistic. Given support and reasonable time, his efforts can be fruitful.

What disturbed me most about the responses to the Carter anti-inflation program of October 24 was the tendency of the media and financiers and some academics to celebrate a Mass for the program even before the ink was dry on the press release. It is unfortunate that this program was written off by cynics before there was any possibility of observing or measuring improvement. Those who say in one breath that we must be patient because it is going to take monetary policy or fiscal restraints a year or two or three to slow the pace of inflation are the same ones who are unwilling to wait even a few months to observe the success or failure of the Carter program. The monetarists who say they are for moderation in applying monetary restraints are anything but moderate with respect to supporting or even tolerating other anti-inflation policies and measures.

Of all the Carter programs announced on October 24 and November 1, there are only two parts to which I take exception. One is a commission and the other is an omission. The former has to do with the degree of rise in interest rates. I have grave doubts whether the one per cent increase in the rediscount rate is going to permit us to avoid a recession next year. The recession prospects for 1979 probably moved

up from about 25 or 30 per cent prior to this interest rate move to, perhaps, 50 to 60 per cent thereafter. Having said that, I would happily accept a limited recession in exchange for several percentage points decline in the inflation rate. But there are serious doubts that a mild recession is going to have a sizeable effect on the rate of inflation.

The serious omission in Carter's program was the absence of any policies or programs on energy. If we could reduce our oil imports from \$45 billion dollars or even keep them from rising over the next few years, whether we did it by setting oil import quotas or by becoming serious about relying more on coal, or expanding nuclear energy and intensifying R&D in other areas, this would strengthen the dollar more than anything else. Actually, it will be remarkable if we can avoid big increases in the value of oil imports. I am concerned about the time when we run out of gold to be sold and when we run out of foreign exchange swaps. As long as the dollar is deteriorating, due in considerable degree to huge oil imports, and the trade deficits are not offset by rapidly enlarging industrial exports, the dollar will lose value and this will exacerbate the difficulties of containing inflation. Makeshift adjustments will work only if other more basic corrective programs are undertaken, especially with respect to energy.

Let me comment further on the monetary picture. As we move against inflation, some degree of monetary restraint is essential and desirable. Where I part company with the monetarists, however, is in my conviction that the complexity and the long persistence of inflation require attacks on a wide range of fronts. Cynicism of many

monetarists concerning other programs, whether it be regulation, investment, productivity, trade policy, or tax alternatives, is indeed distressing. If you have a complex issue, it seldom lends itself to a simplistic approach. Support for the Carter anti-inflation program does not mean that monetary restraint should be ignored. But, monetary policy should not be an all-or-nothing proposition as is so often urged by monetarists.

On the subject of monetary restraint, there are grave doubts, looking back at the real growth in the United States over the last year and a half, whether excess demand has actually prevailed and our real growth has been excessive and a major factor in the worsening inflation rate in late 1977 and throughout 1978. There is little evidence of recent demand-pull inflation. There are only isolated indications of supply bottlenecks. Reasonable fiscal and monetary policies are needed to prevent excess demand when that threatens to arise; but exclusive reliance on smothering the economy by the blanket approach makes little sense when the economy is not overheated.

If we have a recession next year, the most serious consequence will not be just unemployment. With all of our unemployment compensation and welfare arrangements and other transfer payments, the impact on the unemployed will be fairly manageable. What is most disturbing is the effect this will have on levels of investment. We need higher levels of investment, we need to improve productivity, we need more modernization, we need more innovation and we need to keep costs low. Yet a recession due to rising interest rates and monetary restraints will almost certainly bring a decline in the ratio of new industrial

and commercial investment to GNP. That would lead to a tragic cost in terms of our international competitive position and our productivity.

One consequence of a recession next year will be an increase in the federal deficit. A recession will cause a drop in revenues relative to what they otherwise would be. As a matter of fact, a large part of the budget deficits we have had in recent years reflects a shortfall in revenues. With a recession, there is not much doubt that the deficit will go up, no matter how tough, mean, and nasty Carter might be in dealing with the appropriation requests of his agencies.

Let me reiterate my previous suggestion that the Carter anti-inflation program ought to be given a fair chance. Most of the criticism to date has been focused on the guidelines, as though they are the whole of the program. I carefully read the President's Message and found many proposals in addition to guidelines. He talked seriously about budget restraints. If he does exercise budget restraints and eliminates some degree of waste and reduces public expenditures without sacrificing essential needs, these will surely provide positive weapons in the war against inflation.

The President spoke very strongly about regulations. He indicated the need not just to eliminate regulations with respect to airlines and trucking, but to pursue environmental and health objectives through economically sound and flexible means, rather than arbitrary standards. He spoke about the need to weigh the costs against the benefits in environmental and health programs. This emphasis on improved regulation should not be tossed aside flippantly as just rhetoric. Those who

attribute some of the inflation to regulation are the very ones who are most skeptical about regulatory curtailment and reform serving as weapons against inflation.

The President also talked about agriculture. We have to be tough about price supports. I would much rather see income supports for family farmers than price supports. Looking back on what has happened to agricultural prices in 1978, it is shocking to remember the tractors rolling on Washington one year ago in the demand for higher farm prices. In 1978, farm prices have been a major inflationary factor.

The President talked about trade policies. He did not elaborate in detail, but up to now the President's policies on protectionism have been, on the whole, constructive. I part company with my business and labor friends on protectionist tendencies which are very strong. The President's program of importing more beef makes a great deal of sense. Too many industries immediately raise prices on their products when competitive import prices rise due to the devaluation of the dollar. Reasonably liberal trade policies are needed to prevent administered prices from going through the roof.

The President said he was against any more income tax reductions. I thought what he was trying to say in a subtle manner was "from here on, let's take a hard look at tax reductions and see that different inflationary impacts of different tax cuts are taken into account." Not every tax reduction has the same effect on inflation. The tax cuts of 1978 did not make too much sense in many respects. The cut in the capital gains tax is much less likely to stimulate new investment than would accelerated depreciation or an extension of the investment tax credit to

structures as well as machinery and equipment. Carter did not develop his tax thoughts fully but the implication was very strong that tax changes designed to increase investment incentives and for having the most impact in lessening the rise in prices should receive priority consideration.

The President went on to discuss competition and productivity. He is committed to developing policies and programs that will improve efficiency and productivity as another step to curtail the rate of inflation.

The price and wage guidelines were stressed by the President, but they certainly are not the whole of his program by any means. Carter is also very much concerned about regulation, trade policy, taxation, investment, agriculture, productivity and other factors influencing inflation.

I have worked closely with labor over the years. I know many of our labor leaders and I do not think all the views of labor are correctly reflected in George Meany's statements. Meany is a strong person. He exercises great influence in the American labor movement, but he does not reflect the views of all his union heads or members. There are a considerable number of labor leaders in the United States who are not antagonistic nor unreceptive to efforts to lower the rates of wage increases as long as success can be achieved in lowering the rates of price increases. Many business leaders have publicly committed their companies to support the guidelines.

Even more controversial than the President's program to combat inflation is the issue of the degree of price competition and the

effectiveness of the market place in our economy. I believe that the market performs a great many very valuable functions, provided it is working reasonably well. If it is not functioning well, then it is essential to concentrate on activities that will help improve its operation rather than go the route of more regulations and more controls and developing other substitutes or alternatives to the market place. Yet, adoption of many of these alternatives can be traced to conclusions, often but not always warranted, that the market is failing to perform as expected. Economists are frequently to blame because they refuse to study the market critically and just assume it works effectively. They ignore the adverse consequences of monopoly or oligopoly or collusion, which not only undermine market forces as much or more than government intervention but actually lead to such intervention.

Many in the business community preach free enterprise and practice monopoly. That is a pretty harsh statement but, unfortunately, it applies in many cases. Many businessmen want competition where they buy goods and services but they seek to exercise market power where the selling takes place. There is now far too much interest in this country in mergers and much too little interest in new investment. Many business people want government regulation when they think regulations are going to protect them, but they are against regulations that might help others. I encounter such attitudes all the time because a large portion of my work and that of my associates is in the regulatory field. Many business executives like to increase prices but very seldom do they engage in price cutting.

In many instances we see larger price increases when demand is less vigorous than when demand is strong. There are cost factors as well as the demand factors, but price competition seems to have weakened. There is a little anecdote that I find amusing. About twenty years ago, when Estes Kefauver was Chairman of the Senate Subcommittee on Monopoly, he had some steel executives testifying before him. He said to one steel executive, "When U.S. Steel raised its price 5.738 per cent, why did you raise your price 5.738 per cent?" The fellow answered, "To be competitive." Laughter practically broke up the session.

We do have very strong tendencies in the direction of administered pricing and rigid costs. Part of our inflation has elements of pricing practices that need to be better understood and corrected. We need to take a hard look at the competitive situation in the market place -- the obstacles and stickiness and rigidities on the downside of prices and costs.

We need another TNEC. In the mid-1930s, Senator Joseph O'Mahoney of Wyoming introduced a resolution in the Senate calling for a Temporary National Economic Committee. It was established and O'Mahoney became Chairman. This Committee worked for about three years and was one of the least politically-motivated committees ever established in Washington. The TNEC undertook a variety of studies of competition and prices in commodities and product markets and costs. It was one of the best jobs ever done on studying the market place. The work was done at a time when there were no computers and when the data base was nowhere near as large as it is now.

We need to understand more fully and more clearly what is happening in our business practices and structures. It is not easy to explain what is happening or has happened in 1978. Even in the competitive agricultural sector, there is real confusion as to how demand/supply situations are manifesting themselves in the pricing area. With the tremendous crops we have had, why have such inflationary price phenomena arisen? We have not had the shocks that we had in 1973-74 with OPEC, although we will get a shock from higher oil prices pretty soon. We have not had the bad agricultural crop failures abroad that we had in 1973-74. We have not had the two sudden devaluations, although we have had steady devaluation. We are suffering an intensification of inflation, which cannot be attributed to the same kind of external shocks we had in 1973-74 and which are confusing. We need to know more if we are going to prescribe better solutions. We urgently need another TNEC.

The inflation problem is not a partisan issue. Carter would be a strange politician if he were not thinking about what inflation is going to do to him politically. If he does not achieve more success in reducing inflation by 1980, and if the value of the dollar continues to deteriorate and if productivity does not rise more rapidly and if our level of investment continues to lag, the electorate will demand changes that may not be rational and orderly. Easy promises and political opportunism can be seriously disruptive at a time when the people are properly demanding an end to inflation and all its horrible impacts.

I do not believe that success will be forthcoming by relying only on monetary and fiscal restraints. Some such restraints are needed as

part of a total program, but we must look to many other areas of policy. Leaders in academic circles and in financial circles should provide constructive leadership. It is going to take some time to show results. Alfred Kahn has my vote and I urge a little patience for his efforts. The true issue concerning inflation is whether we are really serious in seeking to move toward price stability. If we are serious we will support efforts on a broad front and not just seek a trade off between inflation and recession or depression.

RECONCILING MONETARY POLICY AND THE INSTITUTIONAL STRUCTURE

Murray L. Weidenbaum

Most of the critics of the monetarist approach to fighting inflation are on the left, advocating various extensions of government power over private wage and price decisions. My own inclination being to tilt to the right, this critique is aimed from that end of the policy spectrum. Hopefully, it will be taken as a constructive proposal.

Lest I be misunderstood, I am well aware of the power of monetary policy to influence the level of nominal, that is monetary, income or output and I am a strong advocate of its use. As a sometime participant in the policy making process, however, I am also well aware of the very powerful constraints that operate to inhibit monetary policy decision makers. The key constraint, both conceptual and political, I will call the Z factor -- which I define as the portion of the change in nominal output that is price; one minus Z, of course, is the portion of the change in nominal output that is "real." (Why Z? Because it is the last letter of the alphabet and perhaps a last recourse.)

My concern is based on the painful knowledge that, in the early stages of a program of monetary restraint, the Z factor tends to be high. That is, the major initial impact of a slower growth in the

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money supply tends to be lower real output rather than reduced inflation. That relationship should not surprise us. We have learned in specific areas of the economy that short run responses to price and income changes are smaller than long run adjustments. For example, it is now generally agreed that the price elasticity of the demand for energy is much lower in the short run than in the long run.

To be sure, continuation of a policy of monetary restraint -- such as a stable growth of the money supply over a sustained period of time -- will result in a change in expectations and in business and consumer decision making and thus in a subsequent decline in the Z factor.

However, it is in the short run that political forces enter, and for fairly sensible reasons. When the short term effects of monetary restraint lead to a rise in unemployment, a shift in national priorities usually follows, from curbing inflation to reducing joblessness. In general, those political pressures effectively prevent the monetary authorities from continuing the posture of restraint which, if it had been maintained long enough, could have altered expectations, reduced the Z factor, and yielded the results generally desired by society. Indeed, expectations generally are based on the workings of this cycle in political economy.

Incomes policies, of course, attempt to provide an answer to this dilemma. We need to recognize the basic reason that incomes policies -- both voluntary and compulsory, both here and abroad -- have been resorted to. It is hardly because we as a nation like to interfere with private

decision making or that the citizenry is enamored with the success of government intervention. Rather it is that citizens and policy makers have not been satisfied with the apparent results of indirect measures such as monetary and fiscal policy and will support at times a more activist policy stance. But a more satisfying approach than incomes policy experiments, however, may be to change the size of Z , especially in the short run.

As has been amply demonstrated in the recent literature, there is a myriad of government legislation, rules, and expenditures which interfere with competition, raise prices, or restrict the supply of factors and products. These range from government determination of "prevailing" wages to restrictions on the use of transportation facilities to supports of product prices to limitations on imports. But the concern I raise here is not the conventional one of economic freedom and efficiency (which I personally share), but the large welfare costs of these government activities, viewed in terms of the unemployment that results from their interference with the workings of macroeconomic policy.

The changes that I have in mind are in terms of moving toward a more competitive market economy in which labor and product markets would be more price-elastic than is presently the case. There are several routes that can be followed simultaneously in pursuing this objective -- conventional antitrust policy, regulatory reform, and a reduction in the whole range of government subsidies.

In the antitrust area, one specific approach comes to mind -- reducing the various statutory "immunities" from antitrust prosecution. We could do well to lift the exemptions from the competitive norm now

extended to many product markets, such as interstate trucking, milk marketing, maritime activities, etc. Moreover, it may be time to think about the unthinkable -- reducing the broad immunity extended to most labor union activities, which covers so many aspects of product as well as labor markets.

In the area of government regulation, we only need to refer to the expanding literature on the excessive costs of many regulatory activities and the ways to reduce their negative impacts. It is important, moreover, to view these governmentally-imposed impediments in a dynamic sense. In a static world, the one-shot elimination of costly government regulation would have only a one-period effect on the inflation rate. But in the real world of government policy making, we are faced with the phenomenon of a rapidly expanding network of regulatory requirements. Viewed in that light, a regulatory reform effort which is steadily bringing down the costs that would otherwise be imposed on the private sector would yield rising returns over an extended period of time.

The current concern with reducing or at least slowing down the size of government could well focus on the various subsidies embedded in procurement, credit, and expenditure programs -- subsidies which shelter numerous groups from market forces and make more difficult and expensive the access to those products and markets by the rest of the population. The supply of factors and products has been restricted by such government subsidies as production and import quotas and generous government stockpiles of minerals and metals. The opportunities for reducing the Z factor are as exciting as they are numerous.

Of course, these microeconomic structural and institutional changes must be seen as supplements to appropriate monetary and fiscal policy. Indeed, these changes would enhance the effectiveness of these traditional macroeconomic tools.

Overcoming the natural reluctance to cite one's own earlier work, I recall the conclusions of an article in a 1972 issue of the Review of Economics and Statistics in which I wrote that, over the coming decade, this nation may be increasingly resorting to greater controls over wage and price decisions in imperfect factor and product markets, unless we take strong actions to reduce those market imperfections. "...the choice may well be between fostering a greater degree of competition in private markets or relying more heavily on government controls over private decision making." Wistfully and reluctantly, I repeat my earlier conclusion as a forecast for the next decade.

THE GOVERNMENT'S STAKE IN ECONOMIC INSTABILITY

Paul Craig Roberts

I would like to take the opportunity of having the last word to add some perspectives to those that have been discussed today. It may be that what we see as problems in economic stability actually represents maximizing behavior on the part of the government.

From the perspective of social welfare maximization, we see the government doing all the wrong things. But what looks like failures from this perspective may not look like failures to the government itself. It may see successes because, if you think about it, economic instability expands the role of government. Inflation produces revenues for the expansion of government programs. According to the Joint Committee on Taxation, for every one per cent. rise in the price level, the government's revenues go up by 1.6 per cent. So inflation is welcomed by people in government who want to spend more. Private sector unemployment expands constituencies for public service jobs and for public works, and so, what we see as problems may be seen by government policymakers as successes. There is a dichotomy in the economist's behavioral assumption. That is the great failure in the public finance and public choice literature. People in the private sector are assumed to maximize

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their self-interest, while people in the government sector are assumed to maximize the public's interest. The self-interest of government is left out.

We must take into account that the government benefits from economic instability -- not a lot of instability, for if it gets out of hand, those who have power will be displaced by somebody else -- but a certain amount of instability is beneficial to the government. As far as I can tell, the power of Congress depends on handing out things and doing favors. When there is instability, it gives Congress more opportunities to do these things. Everybody is on his knees, "Mr. Chairman, we have got to have an exemption to this," or "I've got to have this special allocation," and "Please do this, that, and the other for us." Doing favors is a source of power and, as I have already mentioned, inflation produces revenues that the government might not be able to get in other ways, while recession expands the market for government unemployment programs. The constituencies cultivated by government grow with economic instability.

Now, why have we had this dichotomy in our behavioral assumption? I don't know. Why don't more people notice it, or why hasn't more been said about it? Maybe Keynesian economic policy veils it because it provides the type of rationale, the type of interpretation, which does veil it. We get in frames of mind where we believe that full employment is caused by demand and inflation is caused by autonomously rising prices.

Monetarists have tried to help Keynesians understand that inflation is a monetary phenomenon, and that the monetization of the deficits that are used to expand demand is related to inflation. I don't know that they have had much success. Proponents of TIP (tax-based income policy) seem to believe that the reason output doesn't expand in proportion to demand, or money, is because business and labor take advantage of the situation to raise prices and wages. Their behavior makes the demand stimulus price-expanding rather than output-expanding. But TIP proponents, along with almost everyone else, ignore the factors which govern the responsiveness of supply to increases in demand. These factors are the relative price of leisure in terms of foregone current income, and the relative price of current consumption in terms of foregone future income -- in short, the after-tax rates of return to work effort and investment. The cheaper leisure and current consumption are in terms of foregone income, that is, the higher the marginal tax rates, the less responsive supply will be to increases in demand.

Over the last decade, the after-tax rates of return have been dropping. The decline in the responsiveness of supply to opportunities to sell is consistent with the situation in which the money supply grows faster than the rate of output.

Monetary expansion relative to output expansion is causing inflation, but other factors are causing once-and-for-all-time increases in the price level. The growth in transfers and entitlements has made it possible for people to consume output without producing it, thus increasing the demand for goods relative to the supply. If government budget deficits increase demand for output, but crowd out private

investment, their effect is to reallocate resources from investment or future production to current consumption, thereby raising the level of prices. In today's environment, small upward shifts in the price level are occurring continuously, and it may be difficult statistically to segregate these from the effect of money creation on inflation rates.

There are other things which are affecting the responsiveness of supply -- for example, federal rules and laws that reduce the value of capital assets by reducing the property rights of the owners. This has an impact on rates of return and has an impact on the amount of investment, no matter what else is going on in terms of monetary and fiscal policy. There are other things going on which may well be raising costs and causing output to fall relative to demand. A good example was pointed out by Dr. Weidenbaum when he spoke about the slowdown effect on research due to the high cost of regulations.

Rather than cite any more examples, I'd just like to say that maybe we should face the possibility that the government is not particularly interested in private sector capital formation because private sector jobs are competitive with public sector jobs. If the labor force is growing relative to the growth of private sector job opportunities, you have an expanding market for public service employment. If productivity is not increasing, the opportunities for real wage increases are not very great, and this increases the constituency for income redistribution. In other words, if you can't get ahead one way, that reduces the opportunity cost to the politicians who are offering you another way to get ahead.

I will conclude with brief remarks on some aspects of TIP. I think we have to take TIP seriously. When I heard that Congressman Mikva, who wants to reduce "tax expenditures," was interested in the carrot version of TIP, I began to wonder if Congress sees TIP in the same light as its advocates. The greatest attraction TIP has to the government is that it shifts the burden of restraining union power to private employers and removes it from the government. It thus reduces the pressure on Congress and the Executive branch to reduce the deficit, because it shifts the blame for inflation from the government to employers who don't stand up to unions. So I think that TIP will be very attractive politically. Generally the outcome of policies and ideas is different from what advocates expect, and there is no real reason why it should be different in this case.

I am not sure how TIP can reduce inflation. My interpretation is that it would raise costs and reduce investment, because it appears to reduce managerial flexibility to respond to profit opportunities. If I understand TIP, managers would be allowed to hire labor at higher wages in order to respond to profit opportunities, but they would have to pay a penalty tax for doing so. In any organization there are people who want to stand pat and people who want to move forward. It seems to me that the TIP penalty would reduce the opportunity costs of standing pat and that there would be fewer new undertakings by firms.

The main direction of my remarks, then, has been to suggest that whether economic instability is a problem or a success depends on one's point of view. Economists have not done their homework on the question

of whose interests are served by public policy. And they have neglected that the responsiveness of output is a function of after-tax rates of return.

COMMENTS ON: "INFLATION -- CAUSES, CURES AND PLACEBOS"

Charles Webster

Dr. Sprinkel's paper raises a number of important issues. He states the obvious when he indicates that, in the long run, there is a very predictable relationship between money and prices. If the rate of growth of the money supply exceeds the real rate of growth of output, inflation will occur. Hence, the money supply should increase at the same rate as the long run rate of growth.

In 1975 the Open Market Committee of the Federal Reserve decided to move towards this policy, and so price stability should have followed. But, according to Dr. Sprinkel, three factors kept the rate of growth of the money supply above the rate of growth of real output. These factors were: 1) the large and growing federal deficits which made the job of limiting monetary growth more difficult; 2) the apparently irresistible political temptation to enjoy the short run benefits of accelerating money growth while ignoring or disbelieving the inevitable inflationary consequences; and 3) the Fed's choice of interest rate targets which were inconsistent with money growth targets. He concludes by criticizing the Carter anti-inflation program, saying that it will work if and only if the rate of monetary growth is reduced from its currently very high levels.

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I, of course, agree that in the long run prices and money move together; however, this does not imply that there is no room for monetary and fiscal policy. Keeping the money supply growing at a constant rate requires offsetting exogenous shocks to the money supply. Keeping it growing at the same rate as real output, on the other hand, requires offsetting monetary shocks -- shocks to the real economy and changes in the real rate of growth of the economy. Hence, even a growth rule requires the manipulation of monetary tools, and the use of some sort of indicators of the growth rate of output and the money supply. But if policy tools can be manipulated for the above-mentioned reasons, subject to substantial uncertainty, why can't the tools be used when the economy needs a bit of stimulation to get back on a full employment path. It is easy to think of times when policy actions have been quite successful (the credit-tightening times of 1966 and 1970) as well as times when more monetary activism would have been quite successful (the great depression).

In terms of fiscal policy, it is easy to build models that show that fiscal policy should play an active role in stabilization policy even when the model is characterized by parameter uncertainty, and total crowding out (however crowding out is defined).

Dr. Sprinkel sees as a primary cause of the current inflation the large and growing federal deficits which have made the job of limiting the growth of the money supply more difficult. While few would disagree with this, agreement with some of the implications he draws from this would be substantially less than unanimous. I know of no Keynesian economists who consider deficits a "boon to mankind." Rather, they see

fiscal policy and its implied surplus or deficit as potential policy tools that can either be used or abused.

The large deficits of the last two years have hardly been the result of Keynesian policy, but instead have resulted from political objectives and the low level of aggregate income -- witness the actual versus full employment deficit. Given the mixture of political and economic purposes that impinge upon the federal budget, it is hardly surprising that a single policy instrument, fiscal policy, did not satisfy any given goal -- in particular monetary stabilization.

A second controversial point Sprinkel makes about deficits is that they have been responsible for the lack of productivity growth by absorbing savings that would otherwise be used for investment. It is obvious that government spending uses resources that could, in times of full employment, be consumed or invested by the private sector. What is not so obvious, however, is whether, when the economy is not at full employment, the resources used by the deficit would in fact be used for private sector investment, or consumption, or for that matter used at all. In fact, in times of less than full employment, higher income will lead to higher savings and investment. In addition it can be argued that in a number of economic downturns the lack of investment spending has led to a lowering of national income, to a lowering of tax revenues, and to an increased deficit. Thus, the lines of causation can run from the lack of investment to the large government deficit, not simply the other way around.

If we are to explain the low rate of growth of productivity due to the low rate of investment, we should look for explanations other

than the large government deficits. I believe there are other much more plausible explanations for the low rate of investment. The most obvious explanation is the substantial under-utilization of resources when the economy is at less than full employment and the lack of confidence in the economy's ability to use all its resources in the future. This seems to me to call for stabilization policy, not argue against it.

Finally, Dr. Sprinkel believes that slower money growth to reduce the rate of inflation is worth the adverse effects of slower growth in output. Whether one agrees with this view or not will very much depend upon the price in terms of output of reducing the inflation rate. In a recent paper, surveying the results from a number of different macro-econometric models, Arthur Okun found that, on average, the models yield a one per cent per year reduction of the inflation rate for about ten per cent loss in the annual GNP. This seems to be a very high price to pay for reducing the rate of inflation a single percentage point. There needs to be an elucidation and tabulation of the real costs of inflation before we jump into a strong anti-inflation policy. What are the costs?

The small anti-inflation yield of contractionary policy explains why the Carter Administration has turned to its current policy. Unwilling to pay the price of harsh monetary and fiscal measures, the President has opted for a program with less adverse impact but also a low probability of success.

COMMENTS ON: "TIP FOR INFLATION: WHY AND HOW"

Denis S. Karnosky

Dr. Weintraub has presented a proposal which emphasizes his concern about the seriousness of the current inflation and the continuing failure of the national authorities to correct the situation. I agree with his emphasis on inflation as an economic problem, and his analysis of resulting economic inefficiencies. However, I am uneasy about some of the analysis which supports his proposal and some of the effects which he foresees as a consequence of adopting his variation of a national incomes policy.

As I understand his position, Dr. Weintraub's recommendation for a tax-based incomes policy is based on two contentions. First, that alternative monetary and fiscal actions either will not work or are very inefficient -- in the sense that they would cause unacceptable losses in output and employment. Second, that if we are going to use something other than the traditional monetary and fiscal actions to fight the inflation, we should adopt a program which does not interfere with the market system.

Considering these premises in turn, there are four aspects of the proposal which are not handled satisfactorily. First, the manner in which the traditional analysis of inflation, as a monetary phenomenon,

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is dismissed is disconcerting. For example, a contention is made in the paper that inflation cannot be successfully combated by monetary actions because both current and prior chairmen of the Board of Governors of the Federal Reserve System have been "dedicated and implacable inflation foes" and yet the inflation has gotten worse. The clear implication here is that the Federal Reserve has actively pursued an anti-inflationary monetary program and failed. When I started in the Bank twelve years ago, one of the first things I learned from Homer Jones (former chairman) was that there is a distinction between monetary policy and monetary actions. I think that Dr. Weintraub fails to make this distinction, misinterpreting the rhetoric of monetary policy, which has been definitely anti-inflationary, and the deeds of monetary actions, which have not. In those rare instances, such as 1969-70, when the Federal Reserve has undertaken restrictive actions, the restriction was very short-lived. The Fed then backed away just as the anti-inflationary effect began to take hold. The economy was run through unnecessary recessions and periods of slow growth, and the monetary stimulus to inflation was then reapplied. The available evidence on leads and lags shows that the expected result from such a start/stop program is stagflation.

The monetary interpretation of inflation cannot be dismissed as irrelevant on the observation that the Federal Reserve has not reduced the inflation rate. The Federal Reserve has not taken any action to reduce the inflation rate. From a monetarist point of view, the key element is not considered by Dr. Weintraub -- a steady fifteen year

acceleration in money growth. Perhaps, before we go on to an alternative proposal, such as TIP, the monetary actions suggested by the prevailing (but certainly not universal) theory of inflation as a monetary phenomenon should be tried.

However, the TIP proposal is also offered as necessary even if we agree that excessive money growth is the culprit in the inflation process. The contention is that monetary restraint is too expensive to employ, in terms of lost output and employment, and a program such as TIP can get to the problem, without this cost. Again, the available evidence seems to argue against this position.

A policy prescription derived from treating inflation as a monetary phenomenon does not necessarily mean that a steady non-inflationary rate of money growth should be achieved immediately. We are not starting with a clean slate. We have a decade of persistently inflationary experience and a large amount of economic behavior which is based on the presumption of continuing inflation. Borrowing Dr. Weintraub's analogy, it is a matter of a doctor advising you that treatment of your ailment is going to incur costs, one of which might be kidney failure. Is it reasonable then to seek other doctors until you find one that assures you that you can be cured at no cost to your kidneys? Are the policy recommendations of this last doctor correct? Not necessarily, but it certainly sounds better.

The other three areas of concern are with the proposal itself. The TIP proposal is based on Dr. Weintraub's well-known and long-standing analysis of the price setting mechanism in the economy -- the mark-up approach to price determination. It is safe to say that there are

few people who would disagree with the contention that there is a functional relationship between unit-labor costs and prices. I certainly would not. I do have difficulty, however, making the transition from that empirical relationship to recommendations for an incomes policy. For example, it is true that over time the mark up of prices over unit-labor costs tends to be stable, with a slight trend. What does that tell us about policy? Does that tell us that if we control unit-labor costs directly, inflation will be controlled directly? Not at all. We are talking about a structural relationship within the economy which relates two endogenous variables to each other, with unit-labor costs on the right, "explaining" prices on the left. Unit-labor costs (in terms of rates of change) consist of the rate of change of money wages minus the rate of change of average product of labor. These too are endogenous variables. What causes wages to change? What causes productivity to change?

It is not enough to say that productivity grows at some "normal" rate over time and that wages will rise by whatever the market power of the labor union determines beyond the increase in productivity, simply because these variables have moved in line in the past. Considering relationships between endogenous variables, especially when they are prices, requires careful attention to the general system and the other factors affecting each. The relationship cannot be considered in isolation, without reference to how it fits into and is affected by the rest of the system. Establishment of an artificial relative price between goods and labor, without considering the other forces working on both prices, can only lead to a serious distortion in the system.

This has been the record in each and every case where direct controls have been applied and where fundamental factors, such as money growth, continue their inflationary path.

Thirdly, the TIP proposal is offered as a means to avoid the inefficiencies typically associated with a "mandatory" incomes policy. I have a great deal of difficulty in making that distinction. TIP seems to me to be a mandatory policy. The situation is much like that of the baseball player years ago who took umbrage at an umpire's call and expressed his emotions by flinging his bat in the air. Reportedly, the umpire very casually said, "Son, if that bat comes down, you're in a lot of trouble." By imposing penalties on market behavior in terms of wage, price, and output determination, the government is mandating behavior. By imposing tax penalties (and subsidies) on individual units who deviate from some average standard, the government is simply forcing the relative price mechanism of the markets to impose penalties on those who violate the government's decrees. It is difficult for me to distinguish between mandatory and voluntary on the basis of who administers the penalties.

Lastly, it has become standard that every proposal for an incomes policy be accompanied by an explicit reassurance that increases in the bureaucracy must and can be avoided. In looking at just some of the general details of the suggested implementation of a TIP policy, the potential for increasing the bureaucracy becomes infinite. Bureaucracies are like noxious gases -- they expand to fill the available space. A new regulation creates new space.