Proposed Solutions to Inflation — Effective and Ineffective

Speech by DARRYL R. FRANCIS, President, Federal Reserve Bank of St. Louis, at the University of Mississippi School of Banking, Oxford, Mississippi, June 13, 1971

I AM GLAD to have this opportunity to speak to Mississippi bankers about some vital issues relating to inflation and price stabilization. The numerous proposals advanced in the past year to stabilize prices indicate the wide concern of this nation for the inflation problem. Some persons view the continuing rise in prices and the large wage increases negotiated in some sectors as evidence that monetary and fiscal actions have been ineffective. They suggest that other measures must be applied to stem the tide of rising wages and prices. Such proposals include Governmental admonishment, wage and price guidelines, and mandatory wage, price, and credit controls.

The Committee for Economic Development (CED), a proponent of voluntary wage and price controls, in a recent discussion of measures for controlling inflation stated, ". . . while appropriately stabilizing fiscal and monetary policies are clearly essential for the containment of inflation, it seems doubtful that these policies *alone* can fully succeed in reconciling price stability and high employment."[1] The CED further stated, ". . . that the United States should include voluntary wage-price policies among its tools for reconciling price stability and high employment."[2] I find, however, that in May 1946, near the end of that period of mandatory controls, the CED issued a statement which represents a different view. At that time it concluded, ". . . prices cannot be centrally controlled for any sustained period without inefficiency, inequity, breakdown of respect for law, and most important, serious danger to our personal and political freedoms."[3] "The government has a responsibility to supplement and supplant price control by anti-inflation measures which do not restrict the full and free operation of the American productive system. In the traditional governmental functions of taxation, public expenditure, and monetary control we can find the necessary tools."[4]

I prefer the Committee's 1946 statement made while experiencing the impact of direct government controls on wages and prices. It then recognized that the mandatory controls interfered with the profit incentive and led to a breakdown of respect for law. I see no reason why voluntary controls will engender greater respect for law or governmental authority than mandatory controls.

It is my view that the general stabilization measures will work if applied with patience. Neither official admonishments, voluntary controls, nor direct controls are workable; they are useless as substitutes for or long-run supplements to less expansive monetary actions. The elimination of inflation requires great patience; with ideal monetary policies it takes longer than most of the public realizes.

Direct Controls Not Workable in United States . . .

Our most extensive experience with "jawboning," "moral suasion," and direct controls on wages and prices was during World War II and a short period following the war. Beginning in early 1941, the forerunner to the Office of Price Administration (OPA) issued schedules setting maximum rents and prices on other "critical" items.[5] Although these schedules were issued on the basis of dubious legal authority, this deficiency was remedied in early 1942 following the United States declaration of war. Retail prices of

[1]Committee for Economic Development, Research and Policy Committee, *Further Weapons Against Inflation, Measures to Supplement General Fiscal and Monetary Policies* (New York, November 1970), p. 12.

[2]*Ibid.*, p. 22.

[3]Committee for Economic Development, Research Committee, *The End of Price Control — How and When?* (New York, May 1946), p. 4.

[4]*Ibid.*, p. 10.

[5]U.S. Office of Price Administration, *Chronology of the Office of Price Administration, January 1941 - November 1946*, prepared by Lawrence E. Tilley under the direction of Harvey C. Mansfield, Chief, Policy Analysis Branch (Washington, D.C.: Government Printing Office, November 30, 1946).

most items were frozen at the March 1942 level, and mandatory price controls remained in effect for most items until October 1946.[6] However, as a result of excessive monetary growth, demand for goods and services grew rapidly.

During the initial period of jawboning and price schedules (January 1941 to March 1942), the stock of money rose at a 16 per cent annual rate and the consumer price index at a 12 per cent annual rate.[7] While mandatory controls were in effect (March 1942 to October 1946), the stock of money rose at an 18 per cent rate and consumer prices at a 6 per cent rate. Such data, however, tend to underestimate the real increase in prices since they exclude numerous black market transactions and deterioration of quality.

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

By the end of the war most Americans had become disenchanted with rationing, price controls, empty grocery shelves, and queuing up for purchases. After a year of postwar domestic crises, including numerous strikes and food shortages combined with a high rate of inflation, direct controls were largely ended. During the three years following the termination of controls on most items in October 1946, money rose at less than a one per cent rate, and consumer prices increased at a 4 per cent rate.

We have no way of knowing how much inflation would have occurred during World War II had free market conditions prevailed, nor how stable prices would have been following the war had controls continued. Generally accepted economic theory does tell us something about such controls. If prices or wages are arbitrarily set above equilibrium levels, sales will decline and fewer workers will be employed. On the other hand, if wages and prices are set below equilibrium levels, consumers will want to purchase more goods and services than are available, and output must be rationed.

. . . Nor in Western Europe

The foreign experience with direct controls has been no more favorable than our own. A study for the President's Council of Economic Advisers of the experience with controls in Western Europe following World War II reports, "Holders of public office . . . have sought . . . to avoid the excessive exercise of private power, not by eliminating the source of such power but by preventing its full exploitation. This is the essence of what has come to be known as incomes policy."[8] It was concluded that none of the methods used were very effective, and public disillusionment was reflected in the decline or abandonment of such controls in most of these nations by the end of the last decade.

Typical of the experience with direct controls in Western Europe is that of the Netherlands where these methods received their most determined and innovative support.[9] The Dutch Government passed a labor relations act in 1945 which provided mediators with stringent powers to control labor markets and wages. With the Socialists in power the incomes policy in the early postwar period was quite effective, but the honeymoon did not last long. The guidelines kept all wages below equilibrium rates as intended. In 1951, with a balance of trade deficit and a high rate of inflation, real wages actually fell. Labor shortages developed, and considerable pressure built up for additional labor resources, especially in the high profit industries. The willingness of employers to grant wage increases in excess of the legal limits began to undermine the guidelines. Black market wages were common, and prosecutions, fines, and even jail sentences followed.

When union leadership agreed to a wage increase of only 3 per cent in 1955, members began to criticize their leaders for supporting the guidelines, an unusual action in the Netherlands. As a result, the wage negotiating agency failed to function, and the government was forced to grant higher wages through arbitration. In 1957, with wages rising 8 to 9 per cent per year and a balance-of-payments crisis developing, the union leadership again accepted a policy of extreme re-

[6] *Ibid.*

[7] Money stock data through 1946 from Milton Friedman and Anna Jacobson Schwartz, *A Monetary History of the United States 1867 - 1960* (Princeton: Princeton University Press, 1963), Appendix A, Table A-1; 1947-71 from Board of Governors of the Federal Reserve System. Consumer price data from U.S. Department of Labor.

[8] Lloyd Ulman, University of California, Berkeley, and Robert J. Flanagan, University of Chicago, "Wage Restraint: A Study of Incomes Policies in Western Europe" (unpublished study made possible by grant from Council of Economic Advisers, 1971), p. i.

[9] *Ibid.*, Chapter 1.

straint. This time, however, the leadership could not carry the members with them. The new policy required that all wage increases in excess of 3 per cent come out of profits, but it failed as both wages and prices soared above guideline rates, and the balance of payments worsened.

The Labor government was replaced in 1959 by a more conservative government which espoused greater freedom in wage determination. More flexible limits on wage settlements and increased use of collective bargaining were permitted at the industry level. This policy achieved more government regulation but failed to control wages and prices. A 1961 law limited wage increases to increases in productivity. It acknowledged no role for interoccupational wage differences, however, and ran into difficulty almost immediately.

A new wage policy, based on the Central Planning Bureau's econometric model, was adopted in 1963. The model was no more competent to establish wages than the mediators. It implied a wage increase of 1.2 per cent, but this was arbitrarily raised to 2.7 per cent. Pressure for higher wages developed within the unions, and employers, short of help at the established scale, openly announced plans to pay more. As a result, wages and salaries rose 13 per cent in 1963, 15 per cent in 1964, and 11 per cent in 1965. No agreements were reached in 1966 and 1967, and by the autumn of 1967, all factions of labor refused to participate in the policy any longer.

In response to these challenges, the Government decided in 1969 to introduce more stringent legislation which gave it formal authority to freeze wages after consultation with the Social and Economic Council and the Foundation of Labor. The measure, finally passed in 1970, was strongly opposed by the unions, and they withdrew from the Social and Economic Council and from central bargaining. The minister in charge was warned that Parliament had given him nothing but a "paper sword."

Thus, the Sixties witnessed the collapse of an ambitious attempt by the Netherlands Government to supervise a private incomes policy, and the Seventies revealed the failure of a policy based on compulsion. The formal incomes policies adopted in the United Kingdom and Denmark have likewise been less than successful, and the more limited attempts to administer wages or prices in France, West Germany, and Italy have generally failed. Yet, the incomes policy's popularity in principle has thus far proved almost as durable as the problem which it was designed to solve.

Stable Prices Not Inconsistent with Current Economic Structure

Despite the failures of direct controls in other countries, the arguments for their use in the United States continue. Such arguments are generally based on the belief that a large portion of the labor and commodity markets is comprised of noncompetitive elements and that prices of goods and services sold in such markets are not sensitive to a reduction in demand. Most analysts admit that demand for goods and services can be increased by public policies. Nevertheless, some contend that after periods of excessive demand, the noncompetitive elements in labor and business can continue to push prices upward despite less expansive monetary policies.

It is my view that in the absence of excessive demand average prices cannot be pushed up significantly, even by noncompetitive elements. The price lag relative to declining demand probably reflects imperfect information in forming price expectations rather than monopolistic power. Current wage settlements are being made on the basis of recent price trends rather than on conditions likely to prevail during the period covered by the agreements.

When the rate of monetary growth is reduced, consumers and business firms find themselves with less money than anticipated. They reduce their rate of spending in an attempt to maintain cash balances. Some producers will find themselves with excessive inventories. They may first attempt to cut costs by reducing hours worked or overtime. Then, if the price incentive is not sufficient to maintain current output at current wage rates, producers will lay off workers or reduce their work force through attrition until output clears the market at a profitable price. Most workers who are unemployed because of excessive wage settlements will eventually find acceptable jobs. Thus, the restricted output and increased prices in specific sectors resulting from noncompetitive elements are partially offset by increased output and lower prices elsewhere.

Economy Still Subject to Competitive Forces

Even if large unions and business firms could induce price changes, we have no evidence that they have greater power than during the period 1953 to 1961 when the postwar inflation was slowed to a one per cent rate, as measured by the consumer price index. Let me quickly add that I do not condone monopolistic power, either in the hands of unions or of businesses. It has without doubt caused misallocation of resources and higher levels of unemployment, but we have no evidence that such power has been an important factor contributing to the current inflation. For example, following the high rate of inflation during World War II and the Korean War, the rate of inflation was reduced from 1953 to 1961 with a slower rate of monetary growth. The stock of money during this period rose only 1.4 per cent per year and prices only 2 per cent as measured by the GNP price deflator, or only 1 per cent as measured by the wholesale and consumer price indices. This slower rate of inflation was achieved despite the fact that a larger per cent of the labor force was unionized than is the case today. The share of nonagricultural workers in unions declined from 34 to 28 per cent and the total labor force in unions from 25 to 23 per cent during the period 1953-68.[10] Such data suggest that the noncompetitive elements in the labor market have not increased.

We likewise have no evidence of an increase in monopoly power in commodity markets since the mid-1950's. The fifty largest manufacturing firms had 23 per cent of value added in 1954, 25 per cent in 1963, and 25 per cent in 1966.[11] Shipments accounted for by the largest four firms in each of twenty-two selected industries showed little change in concentration from 1947 to 1966. The share of the largest four firms increased in half the industries and declined in the other half. Furthermore, any tendency toward domestic concentration has been more than offset by the rising competition from manufacturing firms abroad.

In addition, if greater competition is desired, there are actions which the government can appropriately take within a free market framework to improve both labor and commodity markets. I suggest further relaxation of tariffs and other import controls. The resulting increase in worldwide competition would tend to stabilize prices for all goods and services traded in international markets. The removal of archaic building codes would aid the construction industry.

Action should also be taken to reduce restrictions on entry into unions. Relatively higher pay scales for trainees after attaining moderate skills might be helpful in attracting more labor into some sectors. Where bottlenecks to entry are retained through union action, I suggest the application of anti-trust legislation. Minimum wage laws which restrict the employment of students, the unskilled, and the handicapped should be repealed. An incomes policy that includes only these actions will not only improve the functioning of the labor and product markets but will also enhance output of goods and services for the entire community.

Excessive Money Growth: Cause of Inflation

In contrast to the view that imperfect labor and commodity markets are an important cause of inflation is my belief that an excessive rate of monetary growth is the chief culprit. All substantial and prolonged general price increases throughout history have been associated with a rapid increase in the stock of money per capita. Following successive debasements, the precious metal content of the Roman coin had been reduced until it was almost worthless in the early 300's. Prices had increased four to eight times their former level. Through price and wage edicts, an incomes policy was established which quickly failed because people began to make most payments, including taxes, with commodities or other nonmoney assets.[12]

A similar debasement followed by a rapid rise in prices occurred in England under Henry VIII in the early 1500's.[13] Landowners who had long-term crop-share leases maintained their living conditions of prior years. Many, however, had long-term fixed payment leases, and their real rental returns were reduced while their tenants received a windfall.

A hyper-inflation in Germany following World War I can be traced to monetary growth. From July 1922 to June 1923, the quantity of money rose 86-fold, and the cost of living (food) rose 137-fold. By June 1923, German money was worth less than one per cent its value a year earlier.[14]

Our experience with excessive money growth and inflation has been consistent with the experience elsewhere. Many of you are doubtless familiar with the excessive money creation and the consequent inflation in the Confederate States during the Civil War. By January 1864 the stock of currency in circulation had increased about elevenfold, and prices had increased faster as a result of declining output of goods and

[10]U.S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States*, 1970. For a further discussion of this point see Alfred L. Malabre, Jr., "Troubled Unions," *Wall Street Journal*, June 25, 1971.

[11]*Statistical Abstract*, 1970.

[12]Paul-Louis, *Ancient Rome at Work* (New York: Alfred A. Knopf, 1927), pp. 313-315.

[13]William Cunningham, *The Growth of English Industry and Commerce During the Early and Middle Ages*, 5th ed. (Cambridge: At the University Press, 1910-27), p. 543.

[14]Constantino Bresciani-Turroni, *The Economics of Inflation; A Study of Currency Depreciation in Post-War Germany 1914-1923*, translated by Millicent E. Sayers (New York: Barnes & Noble, Inc., 1937), p. 35.

services.[15] One contemporary reporter observed, "Before the war I went to market with the money in my pocket and brought back my purchases in a basket; now I take the money in the basket and bring the things home in my pocket."[16]

Our more recent inflations, although on a much smaller scale than these hyper-inflations, can be traced to the same causal forces. For example, from 1915 to 1920 the stock of money rose at the annual rate of 14 per cent and wholesale prices 17 per cent. From 1938 to 1948 the stock of money rose at a 14 per cent rate and wholesale prices at a 7 per cent rate, despite the sharp increase of resource utilization during the period.[17] In the recent inflation from 1965 to 1970 the stock of money grew at a 5 per cent rate, wholesale prices at a 3 per cent rate, and the general price index at a 4 per cent rate. The leveling off or a prolonged decline in the stock of money likewise is associated with a leveling off or decline in prices. For example, in 1920 and early 1921 both the stock of money and prices declined, a pattern which was repeated in the period 1929-33.[18] The decline in the stock of money in this latter period was sufficiently prolonged and intense to cause a major depression.

Slower Money Growth the Solution

The solution to inflation is the elimination of its cause. Actions were taken in early 1969 to slow the rate of money growth. The stock of money rose only about 3 per cent during the year, down from an 8 per cent rate in the previous two years. In response to slower money growth, spending on goods and services began to moderate late in the year. Such spending rose at a 4 per cent annual rate from the third quarter of 1969 to the end of 1970, following an 8 per cent rate of advance in the previous five quarters. Consistent with past experience, however, the momentum of the inflation continued following the reduced rate of spending growth.

By mid-1970 the rate of inflation began to decline. Since last June consumer prices have risen at the annual rate of 4 per cent, compared with a 6 per cent rate in the previous year. While the rate of inflation was slowing, the nation was paying for the previous excesses. Unemployment was rising, and real product was down. The immediate impact of a change in monetary growth was on spending and output, but there was a lagged effect on prices.

Early last year monetary policies were relaxed as a consequence of the decline in output and higher unemployment. During the year the stock of money rose 5 per cent, but the recovery of spending and production may have been delayed a few months by the automobile strike last fall. Early this year the growth rate of money again accelerated. In the last three months it has risen at a 13 per cent annual rate – the highest rate of any three-month period since 1950. Recovery is now underway. Retail sales have risen markedly, housing starts have increased, and industrial production is up. Again an early impact of monetary growth on economic activity is observed, while prices are affected only in the longer run.

Expectations Have Exceeded Possibilities

The relatively long lag between monetary actions and their impact on prices has probably been the major disappointment with the progress made in slowing the rate of inflation to date. Most people fail to recognize the length of time required for monetary actions to have a significant impact on average prices. Monetary restraint first induces a slower rate of growth in cash balances relative to money demand. Individuals and firms reduce their rate of spending in an attempt to build up cash balances to desired levels. This reduction in spending growth reduces nominal GNP growth and the growth rate of overall demand for goods and services. Expectations based on past trends in prices and wages, however, continue to provide inflationary momentum until offset by basic supply and demand conditions. The lag between appropriate monetary actions and the achievement of relatively stable prices may thus be expected to extend over a period of three or four years, following a prolonged and relatively high rate of monetary expansion, as in 1967 and 1968.

The slowdown is aggravated by imperfect functioning of labor markets as reflected by a relatively high unemployment rate. In addition to higher unemployment in the civilian sector, unemployment has been aggravated by a sharp decrease in some types of defense expenditures. Aircraft manufacturers on the West Coast have made sharp cutbacks.

In some occupations unemployment was further increased by the sufficiently strong bargaining power of unions. Excessive wage rate settlements relative to supply and demand conditions tend to reduce the number employed.

[15]Margaret G. Myers, *A Financial History of the United States* (New York: Columbia University Press, 1970), p. 169.

[16]Harold Underwood Faulkner, *American Economic History*, 7th ed. (New York: Harper, 1954), p. 357.

[17]Friedman and Schwartz, *Monetary History;* Board of Governors; Department of Labor.

[18]Friedman and Schwartz, *Monetary History*, Chart 62.

It takes time for the laid-off workers and the new entrants into the labor market to find jobs. Time is also required for business firms to adjust to a change in demand. During this adjustment period the nation's resources are underutilized, and production of goods and services is well below potential levels. This is the price we pay for reducing inflation. It is a cost which we must accept, and it cannot be legislated into nonexistence through the provision for nonworkable controls on our economic system.

Conclusion

In summation, direct controls on wages and prices have been tried both here and abroad and found unworkable. They may suppress the rate of inflation for a short period under favorable conditions, but the inflationary pressures soon build up, and the controls are usually abandoned. Furthermore, all attempts to control inflation by such methods have led to a reduction in economic efficiency and a breakdown of respect for the law.

The argument that inflation can no longer be moderated by monetary actions is not valid. Non-competitive elements in the labor and commodity markets were probably stronger in the early 1950's, when a similar inflation was slowed.

Excessive money growth is the cause of inflation, and a slower rate of money growth is the solution to the problem. Money has an early impact on spending and production, but a longer period is required to slow an inflation. The length of this period has been misjudged by many people who have concluded on the basis of recent experience that monetary actions are ineffective. If we exercise the patience to wait for the economy to adjust to a slower rate of demand growth and maintain appropriate monetary policies, I am sure that we can again stabilize prices at a relatively low rate of unemployment.

Stabilization can be attained at higher levels of employment and output if we adopt policies to eliminate sharp changes in the rate of monetary growth and reduce barriers to a more rapid adjustment to market forces. The stop-and-go method of monetary actions in recent years tends to reduce both output and employment.

Expectations of future price trends must be changed before reduced demand growth can have a major impact on prices. This changed outlook, first evident about mid-1970, has caused the momentum of the current inflation to slacken. I am vitally concerned, however, about the rapid rate of money growth in recent months. There is great danger of rekindling the flames of inflation.

Furthermore, if we attempt to halt the inflation through direct controls, I fear that we will not exercise the necessary monetary restraint and will lose much of the gain achieved from the slower rate of money growth in 1969. In addition, such controls will mean further losses of freedom for individual action which has through the years provided us with the world's most efficient economy.