INFLATION--CAUSE, CURES AND PLACEBOS

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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

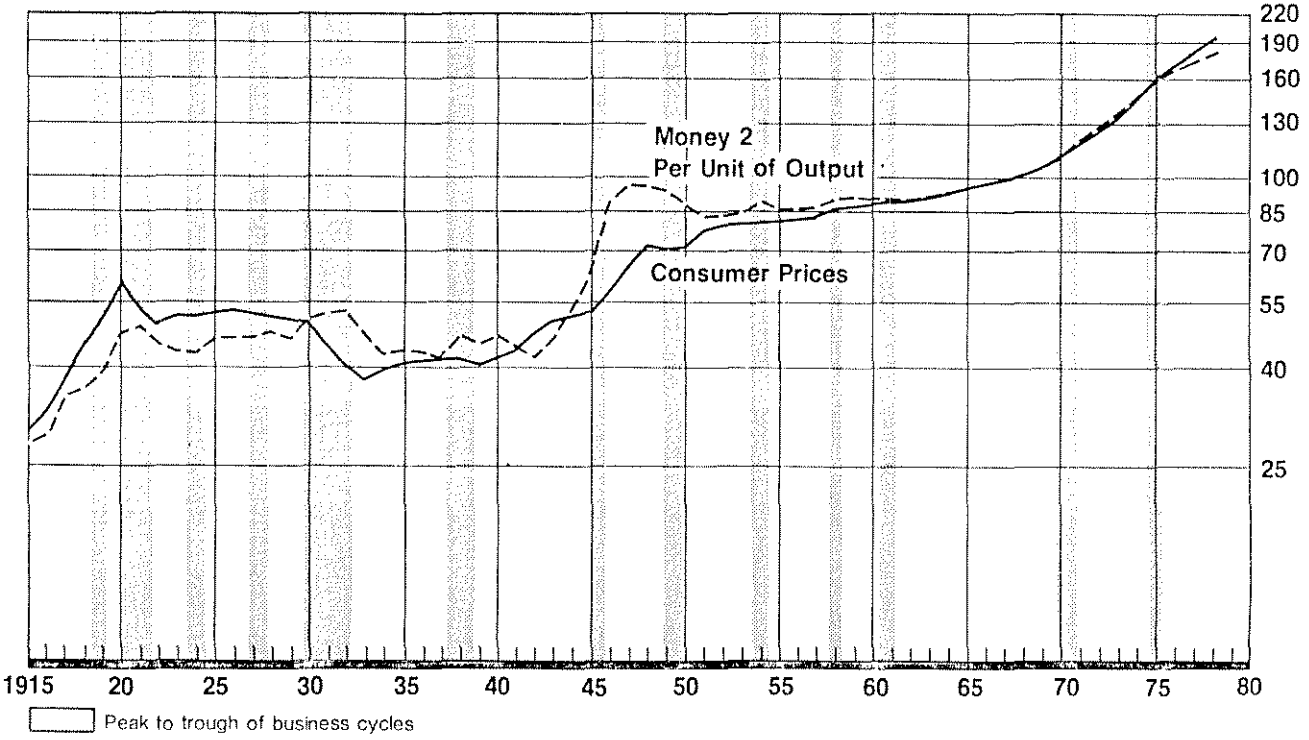
Inflation has been for all known times and all nations a matter of too much money creation. The following chart plots the rate of monetary growth per unit of real output against the rate of rise of inflation for the U.S. from 1915 to now. The correlation isn't perfect, but is very close. There is good 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 sparce, 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.