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 irresistable 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.