THE COMMITMENT TO PERMANENT INFLATION

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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

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[1]The 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 <u>indirect</u> 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.

<u>And Budget Expenditures</u>

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

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[2] It 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

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[3]Louis 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]

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[4]Marxist 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

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[5]A 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 proceding well on our Orwellian time schedule.

[6]A 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 <u>general</u> 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 <u>relative</u> prices of this subsector without significantly modifying the <u>general</u> 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 <u>minor</u> significance to the budget, <u>no</u> significance and <u>no</u> attention to monetary policy, with <u>most</u> 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 reenforced 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

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[7]Senator 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."

[8]Mr. 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 <u>eventually</u> reduce the prevailing rate of inflation. But the time required is judged to be <u>very</u> long and certainly <u>beyond</u> any

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[9]This 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 protrayed, 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

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[10]The 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.

[11]It 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 <u>not</u> 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 <u>weakened</u> the responsiveness of inflation to a <u>lower</u> monetary growth. It also <u>accelerated</u> the responsiveness of inflation to <u>rising</u> 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

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[12]Martin 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]

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[13]One 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]

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[14]The 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

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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 <u>expectation</u> 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) <u>permanently raise</u> 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 <u>expected</u> change in relevant policy conditions converts the <u>current</u> pressure into a <u>transitory</u> 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 <u>not</u> 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.