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INFLATION: HOW TO LOOK AT IT

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This paper is addressed to economists, and especially to extension economists. My objective is to consider how to address the topic of inflation. In no sense do I aspire to set forth the one correct analysis or definitive interpretation.

Definition of Inflation

Inflation is an abstraction conveying the observation that prices of goods and services show a pronounced and general tendency to rise. Inflation is that and nothing more.

In a moment I will admit that inflation is now taken to encompass much more than price trends. But first let me warn against pitfalls in the definition. It would be easy to convert inflation into a positive force. To be sure, the experience of inflation generates certain psychological attitudes that become motivational. But the statement heard often, "The price of such and such went up because of inflation," can be correct only in the special circumstance of indexing, as of union wage rates or target prices for grains and cotton. In all other respects to say that a price rose "because of inflation" is indolent, wrong, and even deceptive. The price of a commodity goes up or down because of specific forces brought to bear on that commodity.

Another trap economists fall into is to define inflation prejudicially — that is, in language that biases analytical interpretation. A favorite phrase is, "Inflation is too much money chasing too few goods." Surely the monetary school promoted this canard. The phrase suggests that monetary authorities pull the strings of the economic universe and do so badly. This vastly overstates monetary influences.

A second popular line about inflation is that too many claims are being made on the economy. In a sense that is correct. One question

is why the contemporary economy, running under-capacity, cannot or does not meet those claims. But the phrase becomes a foil for berating the claims one dislikes, such as those of organized labor, or civil servants, or highly paid executives. Seldom does one include his own claims among those that inflate.

Clichés that pass for wisdom may be the worst of all obstacles to economic education.

Citizens' Interpretation

Most people, I believe, wrap around the single word "inflation" the whole retinue of their concerns and disappointments. Preeminent is lagging employment and productivity. Alongside that are individual frustrations as dollar incomes go up but living standards do not.

In the popular view inflation represents what is capsuled in the crude coinage, stagflation. In other words, in the public mind inflation has become proxy for the many uncertainties and apprehensions that bother people.

More than Economics

It is unfortunate, I believe, that U.S. economists stand so much in the English tradition of economics, which tends to be mechanistic. The economy is not a machine. It has a physical resource component, but it operates through the interplay of warm blooded human beings. These in turn mix and confuse their logical thought processes with their emotional drives. There is something disturbing and even pathetic about the prevailing state of mind today.

Daniel Yankelovich, my favorite taker of the public pulse, observes that inflation grips the public as "no other issue has . . . since World War II." He adds, "The closest contenders are the cold war fears of the early 1950s and perhaps the last years of the Vietnam war." Reminding that inflation is more than an economic phenomenon, Yankelovich warns that it "would be a great mistake to address the problem of inflation in economic terms."

What are those other terms? Yankelovich is not clear, but he may concur that Americans have developed a "psychology of entitlement." He believes "the nation's expectations must be changed."

How Good a Tradition?

In yet another sense I believe economists' analytical equipment to be inadequate. U.S. economic theory is still in the tradition of Marshall. That great man was preoccupied with partial equilibria. Those of use who were adult during the depression of the 1930s remember how futilely economists of that day, relying on partial-equilibrium concepts, tried to account for what was going on.

After all, did not Say's Law mean that production and consumption could not long be out of kilter? After a few depression years when even some economists were producing nothing and consuming little, the positive answer of John Maynard Keynes was listened to.

During the post-World-War-II expansion Keynesianism became a cult. I never joined it, because I was too troubled by the neglect of price level considerations, and also because of my countryman's doubt about fine tuning an economy by simple fiscal and monetary manipulation.

Most prophets eventually are stoned, and Keynes is no exception. It is now popular to chastise his memory, as though somehow his intellectual legacy is the cause of our troubles. It is just as wrong to vilify Keynes now as it was to eulogize him earlier. Keynes almost certainly would oppose some of the policies carried out in his name.

At this point I confess the only dogma I allow myself. It is to reject all slick, single-theme explanations for the present morass. It follows that I am even more impatient with nostrum prescriptions. The atmosphere invites sophistry and charlatanism and we see a lot of both. They must be avoided.

Production versus Consumption

In the last two issues of its *Economic Report of the President*, the Council of Economic Advisers rediscovered the economics of productivity. It was high time!

Throughout my professional career the U.S. has been ambivalently obsessed with the techniques of production and the economics of consumption. Enormous expenditures have gone into the training of people, and into research and development. The object is high technical capacity for production — that is, to be able to convert our abundant physical resources into goods and services. On the other hand, ever since the depression we have worried about purchasing power, about making sure consumers have the financial capacity to draw human and physical resources into the production process. If enough buying power could be expressed, we have said, the production side of the economy would respond.

Our faith is now being strained. Even the Council of Economic Advisers has joined the ranks of those who doubt that our economy is still so fluid that it responds quickly to the demands made on it. Worse, many fear that adding to consumptive demand only lifts prices higher and speeds inflation.

Resources, Performance, and Institutions

I am something of an institutionalist. I do not believe that economic forces find determinate expression irrespective of how the system is organized. Surely it is not necessary to debate this point.

Most economists concede that both the nature of the resource base (human and physical) and the form of economic organization are involved in the economic situation today.

Resource economics is getting a new play, and deservedly so. But resources are looked at differently now. In a summary word, during the yeasty pioneer years of our nationhood natural resources were available for the taking. No reservation price could be placed on them. The economics of natural resources was the economics of their extraction and delivery. As we became more clever in extracting and delivering, we enjoyed their stable or even decreasing supply price. Scarcely more than 10 years ago I could pump gasoline into my car's tank at 24.9 cents a gallon, almost half of which was tax!

Developments during the 1970s have shocked economists and non-economists alike. The decade promises to go down as one of the most dramatic in history. Physical resources began to become scarce, and they did so through two changes in conditions of their availability. One, their extraction and delivery became more difficult and costly, especially in older supplying countries.

Secondly, OPEC has taught the world how to apply a reservation price. It did so on oil. Other countries have tried to do the same with other minerals. Some persons say we should apply the principle to wheat exports.

So we have the interesting and perplexing scene whereby OPEC offers a price shelter to U.S. oil producers, yet billions of barrels of U.S. oil are taken from the ground at a cost of \$3 a barrel. Of course, the upper limit to extraction cost will occur when it takes a barrel of oil power to get a barrel of crude.

Resources divide into physical and human. The latter have drawn a new and non-gratifying accusation, namely, that the Puritan work ethic has left us. Yankelovich touches on this. He alleges that productivity has slipped more than data show, as published data do not "take into account such factors as poor product quality, pilferage, bad service, low morale, not caring, and the costs of layers on layers of managerial and supervisory controls" Low motivation is revealed by surveys showing that only one fourth of Americans now view "their work as a prime source of personal fulfillment." Not long ago, half did so.

It seems to me that events of our day are forcing economists to look again at the make-up of the business world. Only individual prices rise; and so we direct attention to why the price of steel rises, and bread, and physicians' fees, and cost of hammering nails into a new house. When we do so we reconsider once again the time-honored questions of the competitive structure of the U.S. economy.

It helps to separate the part of the economy that "administers"

pre-announced prices of goods and services from the part that arrives at prices by auction. Among other differences, auctioned prices are capable of two-way movement, whereas administered prices seldom go down, as even so conservative an economist as Arthur Burns declares. It is hard to avoid inflation if some prices never go down!

Prices of farm commodities other than fluid milk and a few others are auction-set. Farmers like to declare how they are victimized. In some inflationary experiences they are correct, but in others they are not, as I will observe later. But it is noteworthy that farmers pay administered prices and sell for auction-made prices, as a rule.

The Mystique of Money

When I first studied economics (1931) professors praised the statesmanship of Senator Carter Glass in setting up the Federal Reserve System. Never again would the U.S. economy be brought to a halt by financial crises such as the one of 1907, we were assured. Never again would the economy be squeezed by a shortage of money, and certainly not one manipulated by J. Pierpont Morgan.

The object of the system was to make sure that the monetary mechanism would not frustrate the needs of business and thereby stifle the economy.

During what is known as the Keynesian era, though Keynes would likely disavow much of it, the doctrine was held that monetary authorities could somehow wield both micro and macro influences. They could serve businesses, and they could at the same time keep the economy on a nearly even keel.

So it is that during 1979 we have seen the Fed, in an effort to play the macro role, try to reestablish a shortage of funds to the business world. It would replicate in miniature the kind of crises the system was set up to prevent. To be sure, an interest rate scarcely equal to the rate of inflation is not really high. Both businesses and citizens ingeniously devise play money to frustrate monetary authorities. They use private credit and land contract sales and all sorts of accommodations to substitute for M_1 and M_2 . Nonetheless, in principle the Federal Reserve authorities attempted to create an artificial shortage of money that is an interesting throwback to tight money periods of the 19th and early 20th centuries.

There is a basic inconsistency in the Federal Reserve System's being charged with both serving the financial needs of business and regulating the economy. Often, the two objectives are in conflict. Dire consequences could follow if the Fed were highly effective in its macro-stabilizing efforts. I am skeptical as to how effective the agency actually is. I believe I am joined in skepticism by Arthur Burns, former chairman of the Federal Reserve Board.

Inflation, Futurity, and Fixed Assets

I come now to the most entangling part of my topic. Inflation of course relates to price trend over time. It says nothing about whether individual prices are too high or too low.

Manifestly, inflation takes on such dramatic meaning because various prices do not go up in unison. Certain patterns of leads and lags are familiar. Inflation helps debtors at the expense of creditors. It hurts all persons on fixed or nearly fixed incomes and is devastating to retired persons whose annuities are not indexed. It induces a scramble for all parties to try to keep their prices or incomes at least in line with trends, and differing results are visible and meaningful.

Organized versus unorganized labor, big versus small businesses, oligopolized versus non-oligopolized businesses, industries such as steel with politically derived peril-point import protection versus those that are exposed naked: the list is long.

The various leads and lags amount to redistribution of income. Sometimes it redistributes from spending for consumption into private or public investment. Developing countries have deliberately used fiscally-induced inflation to generate savings from the wage-earning population for development purposes. They can do so because wage rates are sticky; for a time, purchasing power can be sapped from wage workers.

On occasion our fiscal policies have had a similar effect. Indeed, one of the reasons for the clamor for a balanced federal budget is taxpayers' belief that they are being taxed surreptitiously by fiscally-induced inflation. In my judgment they are essentially mistaken; their protest is more strategic than sound.

Our present inflation is not primarily fiscally induced. Our country is not resorting to massive borrowing to fund any huge public works or even welfare programs. Paradoxically, if inflation is forcing a diversion from consumption into investment it is doing so via tax deductions, a sort of publicly sponsored private investment.

Much more obvious nowadays is the opposite tendency: many people prefer to spend instead of invest.

The heart of the relationship between inflation and investment is that all investment is a promise to return not only the investment dollars but a bonus. Implicitly, the promise is to return dollars of equal purchasing power. Put in "real" terms, we expect the investment to be genuinely productive, that is, to yield more goods and services than were committed in the investment. If it were not so, investment would add nothing to gross productivity.

The point I lead to is trenchant: unless an investment is productive in a "real" sense, it is implicitly inflationary. This holds true

irrespective of whether the investment is public or private. If that outcome is not realized — if investment is not that productive — we end up paying off in cheaper dollars.

This is exactly what has been happening. During our inflation, investors invest and then are paid off in dollars of reduced buying power. They complain, and they say they are discouraged from further investment. In one sense they are correct; in another, they complain too much.

The positive side is that inflation is a bonanza to investors because assets appreciate in value. Even routine turnover of inventory yields inflationary profits. The result is a big unearned return. And then, taxation of capital gains at less than personal earned income adds to asset value inflation.

On the other hand, inflation hurts businesses as they are forced to pay higher prices to replace equipment. Moreover, conventional ways of calculating depreciation allowances add to the problem.

Much is said about inadequacy of the present rate of investment. Our productivity has always rested on high investment, has it not? Therefore, slowed investment dooms us to reduced output. Such is the allegation, read daily in the business press and heard in economics classrooms.

Perhaps investment is the culprit, and perhaps not. To be sure, rampant inflation invites spending in the here-and-now instead of saving for an uncertain future, as I noted above. It is one of the evils of inflation and is damaging. Equally true, though, is that this is a rational response, and all supporters of *laissez faire* doctrine should raise no question.

Critics worried about slowed investment point an accusing finger at the federal government whose tax policy, it is said, is discouraging. In view of all the write-offs it is hard to be convinced. Furthermore, according to classical economic theory, not tax policy but perceived opportunities are what entice funds into investment.

If the economy is in fact entering a stage of reduced productivity, investors are making rational judgments. They should not be faulted. No one should be surprised when the stock market refuses to go off on a tear. The market may be more accurate than the pundits. And if slowed output be our destiny, tax and fiscal gimmickry will not readily set things right.

Another angle to the situation is worth a note. Hyman Minsky says that as physical resources become scarcer the economy must adjust to less use of heavy capital equipment and toward a more labor intensive productive process. This is a powerful idea; and without defending it further I ask that it not be disregarded.

Almost a separate issue is the surge of investment in fixed assets. Distrusting future productivity, investors turn from stock shares with their intangible claims to almost anything tangible and durable. Enthusiasm extends from antique dolls to good farmland. Even European and Japanese investors are getting into the U.S. land-buying act. Investment in fixed assets such as land has the piercing macroeconomic consequence that it cannot add one iota to national productivity. It amounts only to a transfer payment, a change of ownership. And tax policy to encourage this kind of "investment" is not only futile, but actually fuels further inflation.

In summary, I suppose I am impressed by the sensitive relationship between inflation and investment yet skeptical about much that passes as conventional wisdom and enters policy. I believe we should be cautious in making judgments about this aspect of inflation.

Inflation and Agriculture

At this point I turn to the familiar terms, demand-pull and cost-push inflation. They help explain how inflation bears on agriculture. Demand-pull inflation bears differently than cost-push, and the administered price sector of agriculture responds differently than the auction-priced part. As a rule, demand-pull inflation is likely to bring a quick bubble in prices of auction-priced farm products. It will have a much less, and much slower, effect on administered prices such as those of fluid milk.

During a cost-push inflation, prices of wheat, corn, and cotton may be slow to go up, but prices farmers pay for fuel and fertilizer will increase. The resulting cost-price squeeze leads to calls for higher support or target prices and, often for credit on favorable terms.

Inflation's greater impact by far is on the value of agriculture's fixed assets, mainly land. During the 1970s the price of farmland has moved skyward. Asset appreciation has been twice net farm income and even when deflated, capital gains have equalled (deflated) farm income. Land price inflation amounts to a redistribution of wealth between generations: the gain to the older generation becomes a cost to the new (except to the select few heirs who pay little estate tax).

It encourages investment in land purely for speculative purposes, without regard for maximizing productivity, and on balance it has a negative effect on productivity. It lures non-farmers into the farmland market and if continued will pry landholding apart from operatorship.

Because various origins of inflation bring different effects on various parts of agriculture, agriculture's stake in inflation control is by no means uniform. Debt-ridden young farmers subject to a price-cost squeeze have grounds for complaint. Their grasping at the American Agriculture Movement is logical if probably futile. On the

other hand, Bruce Gardner was dead right when he observed that landholders' greatest risk in the present inflation is that it will be checked.

I continue to believe, though, that farmers' primary concern with inflation is in their role as citizens, not as a special interest group.

International Aspects

This paper is essentially oriented to the U.S. situation. Nonetheless, inflation is not some plague that has selectively been visited on the errant United States. It envelops the industrial world. It is vicious in many poor countries. Because inflation rates differ among countries — West Germany is celebrated for its good record — a study of comparative experiences and policies could doubtless be instructive. And the international monetary mechanism redistributes inflationary pressures in unfathomable fashion.

A Summary Word

I have offered a number of ways to look at inflation, each of which I believe to be useful and relevant but none itself sufficient or even entirely satisfactory. I conclude with a few highly personal judgments.

First, I believe inflation to be so much a part of our mind-set that significant correction will prove excruciatingly difficult. Yankelovich is still my favorite commentator. U.S. citizens simply refuse to believe that there is anything basically wrong with our economy — nothing that some omniscient genius cannot correct by turning the right valve or pressing the proper button.

Second, in my bones I distrust a corrective policy of forcing idleness of plant and people. I see red when I read financial writers' glee that the economy is being pressed into a corrective slowdown. My reaction is to wish that they themselves might be counted among the victims; their counsel might change. The policy is appropriate to an overheated economy but ours today is sluggish, not overactive. The first flaw in forced contraction is its ineffectualness; the second is its inhumanity; the third is the risk of civil strife.

Third, projections that the inflationary rate will itself "stabilize" at somewhere around 8 or 10 percent, and need only be adjusted to, are unsupportable. We have no guidelines to tell us what lies ahead. Inflation has a way of picking up speed. Yet it also saps the buying power of so much of the population that it could ignite economic collapse.

My fourth comment is much more substantial and contains my deepest worry. It ties to the most vulnerable aspect of inflation, namely, its relation to investment. All investment, whether equity or loan, amounts to a promise to pay in the future. An incisive feature of a faltering economy is that those promises cannot be kept.

There are two routes to correction. One is the catharsis of depression wherein the promises are reneged on; the other is inflation in which the payoff is sustained nominally but in depreciated terms. What worries me is that the sum-total of promises to pay is so astronomically large. It is large within the economy, a perilous plight. Our obligations abroad are mounting.

Few economists are as apprehensive as I about the rising debt owed oil exporting countries, notably Saudi Arabia. A substantial part of Treasury bills is bought by Arabians. For my part, I would rather let the exchange value of the dollar depreciate still more than incur great international debt.

Cartelized prices of fossil fuels, led by OPEC's oil, surely are one of the powerful ingredients of our present inflation, and they account for our growing international obligations. Can recent trends continue without forcing a confrontation between oil exporters and major importers? But a confrontation can be successful only if U.S. consumers are willing to forego imports, at least temporarily. Idle threats are futile; we must be willing to play the hard game. I doubt we are prepared to do so.

Fifth, I have argued for years that the competitive structure of the economy is drifting into a form that fits few if any models, and that the relationship of government to business is slowly conforming. For lack of a better word I call it syndicalism. Major industries are becoming oligopolized entities that gradually acquire distinctive patterns of business practice. Government influences those patterns through regulatory commissions. Currently, an attempt is being made to introduce inflationary restraints into industrial codes. I suggest that new thinking about the nature of competition and industrial organization lies ahead for the more imaginative economists.

As my sixth and final point I offer a world view that I have been expressing more and more often. Without seeking to be melodramatic, it seems to me the United States and the entire Western World are going through a watershed period. Four or five centuries ago the West's scientific and cultural revolution, accompanied by territorial expansion and spurred by technical miracles, exploded into material comfort and emancipated the human spirit.

It was a grand achievement. A denouement may be upon us. Population is beginning once again to press on resources. Land is scarce. The environment is under stress. Although no doomsday is in prospect a tapering off of earlier progress is likely and it is traumatic to a generation that self-promised Utopia.

The problems of accepting and accommodating a less bountiful outlook without revoking our cherished concepts of participatory democracy and distributional justice epitomize the indistinct hopes and fears with which we surround the word, inflation.

CONTROLLING INFLATION

Alternative Approaches

