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# PRICE STABILITY AND ECONOMIC GROWTH

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This will be a rather "miscellaneous" talk on the vast subject assigned to me and will deal largely with matters that are obvious. My excuse for presuming to talk about the obvious is that the obvious is not the same as the familiar. Some things become obvious only upon reflection. Therefore, taking stock periodically serves to remind us of the obvious and to clarify notions only vaguely held.

## PRICE STABILITY

Let us begin with some reflections on the subject of price stability. Everybody seems to be against inflation as they are against sin, but seldom do people try to analyze why they really ought to be.

### Why Inflation Is Harmful

I should like to review briefly several important reasons for opposing inflation.

1. Inflation harms those whose incomes do not rise proportionately with the general price level. During a general price rise, all prices and incomes do not move in unison; those whose incomes lag behind suffer most.

2. Inflation tends to injure low-income groups somewhat more than the upper income or even the middle income groups. Theoretically this should not necessarily be so, but it works that way because lower income groups cannot, or do not know how to, protect themselves as do people at higher income levels. For example, in several public opinion polls, people have been asked how they think they can best protect themselves against inflation. A surprisingly large number reply that the best way is to invest in government bonds. This view may make the Secretary of the Treasury happy, but it does not make good sense as a hedge against inflation. Answers of this sort come much more frequently from low-income respondents than from those at higher income levels, who are generally more sophisticated financially. Another common answer from those with low incomes is that protection can be provided by saving more and by getting out of debt, where-

as higher income groups are much more likely to say the opposite—"buy now, pay later; go into debt if you can."

3. Inflation results in unfulfilled implied promises. I am not moralizing; I refer simply to the economic inefficiency caused by inflation. When people lose confidence in the value of money, they change their savings habits and refrain from making the kinds of commitments—insurance policies, purchase of fixed money claims, and the like—upon which our organized economic life depends.

4. Inflation has harmful effects on business decision making. A rubber measure of value destroys the integrity of the monetary unit for accounting purposes and creates maladjustments in the use of our resources. Under inflation some businesses think they are making money when they are losing money and dissipating their capital. Inflation also diverts an excessive amount of resources to speculation. Speculation is not bad in itself, but inflation causes excesses and overcommitments, which in turn create economic disturbances and lower efficiency.

5. Inflation creates a balance of payments problem by reducing our exports and stimulating our imports. Needless to say, the resulting serious financial difficulties and adjustment problems impair our economic efficiency and growth.

### **The Meaning of Price Stability**

So we are all against inflation. We want and need a stable dollar. But what is a stable dollar? What exactly do we mean by reasonable price stability? Clearly we do not want each individual price to stay fixed, for prices perform an important function. High prices indicate that more of certain things are wanted or are hard to get. Low prices indicate that the things to which they are attached are in surplus or have a low priority. Individual prices not only convey information about relative needs and scarcities, they also serve as a strong force in compelling people to do what they should do in the social interest. The efficient operation of the economy depends on the flexibility of individual prices.

Price control has an intuitive appeal for many people—they like the idea that if you do not want prices to rise you can pass a law to prevent it. Of course, such a procedure is self-defeating. When we have price controls, prices no longer mean what they meant when we wanted to stabilize them. Under price control, amounts of goods and services wanted are no longer available at the stated prices; and furtive auxiliary considerations enter many transactions. The fact that a number stays constant does not

achieve stability of individual prices, nor of the average level of prices. The average will be based on fictitious prices.

The notion of price stability is further complicated by the fact that not only does it refer to an average of all prices, but it refers to this average only "on the average." That is to say, we do not want the average to remain the same day in and day out, month after month. Mild ups and downs are normal and to be expected. What we want is the average to average out at a fairly constant level over a period of time. With this double form of averaging necessary even to define the concept of price stability, no wonder it remains so illusive for the public to grasp.

### **Historical Price Patterns**

People often talk as though a mild or extreme inflation has been going on ever since the Pilgrims landed and that more is inevitable. What has been the history of prices in the United States? We have data on wholesale prices as far back as 1720 and on retail prices as far back as 1800. To be sure, some of the data are not very accurate or reliable, but over the sweep of history they give us a pretty good picture of the price record.

If we plot these average prices on a chart, we find the predominant impression is one of stability. Over the whole period from 1720 to 1960 wholesale prices have gone up, on the average, about one-half of one percent each year. The second striking aspect about such a chart is the tremendous peaks scattered along the long-term trend. People not accustomed to reading charts will often be impressed by these great peaks without noticing the basic trends.

Every such peak in American history, every large rise in the average level of prices, has been associated with war and the immediate aftermath of war. After each war, however, within ten to twenty years, prices have dropped again, at least briefly, to their prewar level. The only exception has been the period since World War II. A comparison of the peacetime years with wartime years shows that in peacetime years prices have declined about one-half percent per year—speaking very roughly, of course.

Another characteristic of the long-term record is that during periods of as much as thirty years prices have moved gradually and cumulatively up or down. From 1865 to 1897, for example, the index of consumer prices declined by nearly one-half and the index of wholesale prices by nearly two-thirds—a generation of creeping (and sometimes galloping) deflation.

Finally, if we look at the record still more carefully, we find

smaller movements associated with business cycles. Typically, in a period of economic expansion, the price level is stable after the trough and during roughly the first half of the upswing; but toward the peak, prices begin to go up, and they continue to rise after the peak level of economic activity has been reached and even after a downturn is in progress. Later, as a recession develops, prices stabilize; and if the recession is long enough or deep enough, prices may fall. Typically, only a severe recession can break down the price level; in a mild recession the level only stabilizes for a time.

### **Recent Price Patterns**

I stress these characteristics of our long-term price history patterns which are similar to those recorded by other countries for two reasons: (1) Our recent experience, at a first superficial glance, seems somewhat different from the normal pattern; and (2) we are badgered today with many special explanations for our recent price history which seem to me to be either specious or amateurish or both.

Consider first our postwar experience. As recorded by our price indexes, prices have doubled in the past twenty years. After the second World War and after the Korean War, they showed no sign of coming down as they did previously. They evidently are not going to come down. If they did, the result would be disastrous. Historically, some sharp deflations and some severe depressions were required to bring prices down. The recessions we have had since the second World War have all been very mild—extremely mild by historical standards. In these postwar recessions, price behavior has been entirely typical. Our success in coping with recessions has given us an inflation problem which we did not have before. By controlling recessions, we have strengthened the normal tendency for price increases to become cumulative. This simply means that our improved ability to control recessions has made it much more important for us to control general upward price movements during periods of business expansion. As we become more proficient in dealing with the major problems of recession, we become much more alert to the serious, though smaller and related problem: price level stability. This is as it should be, but we should not be misled about the magnitude of the problem.

Though I believe we face the danger of persistent upward price pressures in the future, this does not mean that I place much stock in the new and special explanations of the recent

past. What has happened since World War II can be explained in the same terms that explain the price history of the past two hundred years. One distinction between an amateur and a professional in the field of economics, or in any scientific endeavor, is that the amateur always thinks up *ad hoc* explanations for everything that has happened, while the professional looks for the pervasiveness of basic forces and first tests the validity of proven generalizations.

In public discussion *ad hoc* explanations naturally have popular appeal. Two of them received sufficient attention to merit examination here. According to one widespread belief, a basic change in the structure of the economy is creating new rigidities in wages or in prices which exert persistent upward pressures. According to other views, inflation results from a change in national economic policy occasioned by the Employment Act of 1946. Let us take a moment to look at each of these explanations.

On the question of new rigidities, some people argue that inflation is largely caused by unions which have prevented lowering of wages and have pushed wages (and costs) up excessively by monopolistic power. The other variant is that businesses with monopolistic power have "administered" prices generally upward.

Whatever may be wrong with unions, and that may be a great deal, I think it is a bad mistake to blame everything that goes wrong with the economy on unions. One quarter of the labor force is unionized. Wages have gone up more in many nonunion occupations than in strongly unionized occupations. Of course, unions have brought blame upon themselves by their sales campaigns and internal politics. But the impact of the unions on general wage levels has been greatly exaggerated. One labor expert has summed up the results of the recent studies something like this: About a quarter of union members have had their particular wages raised substantially, perhaps 15 percent above what they would have gotten without their unions; half of the union workers may enjoy wages 5 to 10 percent above what they otherwise would have gotten; and about a quarter of union workers belong to organizations that have not had any appreciable effect on their wages.

The fact that unions have had some, albeit overrated, impact on the structures of wages among different groups of workers does not mean that they have pushed up the average level of wages and costs for the economy as a whole. Indeed, what has happened to wages on the average would have happened in any inflationary situation and can be explained without recourse to witch-hunting.

With respect to business monopoly—or business concentration to use a more neutral term—three separate studies in recent years, using different concepts and criteria, all come to the conclusion that concentration of business power has not been increasing during the twentieth century and may be decreasing. Therefore, administered pricing does not seem to be a likely “new” inflationary force in the economy. Besides, despite popular misunderstanding that it could be, no systematic analysis has been adduced to show how or why.

Let us turn now to the other alleged explanation: the Employment Act of 1946 and the policies used to implement it. Here there is a grain of truth—not as to cause but as to effect. As I indicated before, to the extent we are successful in eliminating major depressions, we are confronted with a problem of cumulative price rises during expansions. Surely, no one would say, “Let’s go back to some serious depressions in order to deflate the price level!” The moral of this story is that, with or without the Employment Act, we simply have to make comparable progress on the inflation control front. The situation is similar to that in other fields. In medicine as we reduce infant mortality almost to zero, we turn our main attention to cancer or heart disease. As we eliminate smallpox, the common cold becomes a subject of greater attention. As we solve the inflation problem, we can be sure that other problems that now have lower priority will become increasingly urgent.

### **Compatibility of Price Stability and Other Goals**

Some people feel strongly that the Employment Act raises a serious issue of conflicting goals—that price stability, high employment, and economic growth cannot be achieved simultaneously. I do not believe that a major conflict exists. The compatibility of these goals depends largely upon how we set them and the means by which we pursue them. Historically the record shows no conflict between price stability and economic growth. As I have pointed out, a reasonably stable dollar is necessary for rational decision making and orderly economic progress. Price level stability, properly conceived, implements rather than hinders growth.

As with price stability, “full employment” is not a simple concept, and it means different things to different people. But no one seriously holds that it means 100 percent of the work force at work. Some people put an acceptable level of unemployment at 3, 6, or 2.94 percent. My feeling is that no percentage which in-

cludes me and my friends is acceptable. But whatever level we settle for, it will vary from time to time, and it will not mean what the public at large seems to think when they hear the word "unemployment." This term conjures up visions of the 1930's with its massive unemployment—visions of children at home with no food, no shoes, no fuel for the furnace, and what not! While we still have some unemployment that causes severe economic hardship, this type of unemployment has been vastly reduced since the war.

A detailed study by the Bureau of Labor Statistics for 1956-57 (prosperous years) showed that about 20 percent of our unemployment was of a seasonal character, in construction particularly. About 20 percent consisted of new entrants into the labor force, young people and others who had not previously been employed (these people would not even be counted among the unemployed in most other countries). About 10 to 15 percent consisted of people who were voluntarily changing jobs. In other words, about half of the unemployed were not really hardship cases. During a recession a much larger proportion of those unemployed would be lay-offs and heads of families who cannot remain long out of work without their families suffering privation. The duration of unemployment would also increase. But with improved unemployment compensation systems, much of the sting can be and is removed from this form of unemployment. If we can keep our recessions mild and short, we shall certainly have achieved a reasonable full employment goal. Such hardship as may remain, and some is unavoidable, can be alleviated by welfare measures.

### **ECONOMIC GROWTH**

Now let us turn to the current debate about economic growth and try to identify the real issues. Many arguments in vogue for and about economic growth do not hold water. Unfortunately, when anyone exposes false or unsound arguments, he is often accused of saying that growth is not important. Of course, growth is important; it is and always has been a basic characteristic of American life. High as our level of living is compared with that of other lands, we still count on a doubling of the material standard of living every generation or so. But expanding opportunities and improvement in the quality of life, rather than quantity are the important features of growth.

#### **Limitations of Measures of Economic Growth**

Economic growth can be and is measured by various yard-

sticks, none of which is satisfactory. Some people focus attention on Gross National Product or its rate of increase. Others more properly take account of the increasing population and use per capita GNP as a growth indicator. Both measures have disadvantages, however. GNP data are crude, vague, and difficult to compare over time. Therefore, some people concentrate on industrial production, a less broad measure, but more accurate in its limited area. A common tendency is to shift from what we want to know to what we can find out.

The big drawback with all three measures is that they leave out the really important quality aspects of growth, such as leisure, for example. One of the most striking changes of the past forty years or so has been the great increase in leisure, coupled with a great reduction in brutal physical toil. To the extent people demand leisure instead of additional goods and services, they hold down the numbers that purport to measure improvement in economic well-being.

One way to get around the welfare problem is to measure changes in output per man hour. This, too, has limitations because it does not tell us how many people are working or how national output is distributed. From an efficiency standpoint we might want to use a measure of output per unit of labor and capital combined.

Still a sixth measure frequently used is disposable income per capita after taxes. Of course, this is not a really satisfactory measure, because a lot of tax spending brings direct and indirect benefits to the consumer, and disposable income, therefore, understates growth. This measure does have the advantage, however, of excluding national defense and other items for protecting welfare rather than improving it.

Let me emphasize, further, that all quantitative growth measures suffer from some technical disadvantages as well as their inherent conceptual limitations. First, the basic data are crude and subject to wide margins of error. Second, valuation presents serious problems when we form aggregates such as GNP. How horses and apples are combined depends on how many apples we think are equal to one horse—or vice versa if we have a golden apple. This problem is not so critical when the values used are determined by voluntary exchange, that is, where prices reflect people's willingness to buy and sell. In the government sector, however, which now constitutes 20 to 25 percent of the economy,

we have no price tags, only cost tags. Output is measured by inputs and the two may not be of equal value.

The valuation problem becomes extreme when we try to compare our country with other countries. For example, with some justification, albeit slight, we can say that Russian GNP is somewhere between one quarter and one half of ours—depending on whether we use ruble prices or dollar prices as a common denominator. Anyone who says it is 40 percent is simply splitting the difference, and usually he splits the difference between two and four rather than between a quarter and a half which gives a different result—the difference between an arithmetic and harmonic mean. In any case, splitting the difference yields essentially meaningless results as a measure of comparative values produced.

Another difficulty is the tricks of averages. An average can go down while every individual component is going up, if weights shift in a certain way. When people shift from areas where productivity is increasing rapidly to fields where productivity cannot increase so fast, the average output may be pulled down. For other shifts the converse may be true. It is like the old example of the employer who cut everyone's wages 10 percent and afterwards the average wage was higher because he fired all the low paid workers; he reweighted the average.

Finally, we have the treacheries of timing. To measure growth at least two points in time must be used. Unless beginning and ending dates are chosen very carefully, the error introduced will be great enough to make the measurements meaningless. Business cycles create a wavy pattern. The only really good measure is from peak to peak of the cycles—preferable over two or more cycles. Trough to trough measures are not good because troughs are too erratic. Of course, measurements from trough to peak or peak to trough yield nonsensical results. And obviously we have to steer clear of abnormal peaks such as occur during wartime.

During the postwar period we have had only three peaks—1948, 1953, and 1957. Since the middle peak was the Korean boom, it is not good for measuring purposes. This means literally that we have only one valid time segment for measuring postwar growth—from 1948 to 1957. Of course, this is quite frustrating for people who want to make partisan comparison of economic performance under different political administrations. Some people pick their dates to get the particular results they want, or I should say they pick their party and then pick their dates. By doing so they show

that the rate of growth was twice as high under President Eisenhower as under President Truman or the converse. But we should never confuse party loyalty with empirical fact.

### **What the Record Shows About Our Growth**

Since we have had a lot of talk about our growth rate slowing down, perhaps we should take a detached look at the short-term and the long-term record. Besides bearing in mind the limitations I have previously mentioned, we should also remember that a percentage rate is a foolish parameter for measuring growth. No farmer measures the growth of his corn, no parent the growth of his children, by a percentage rate.

In spite of these difficulties, how does the record look?

1. GNP grew at an average annual compound rate of 2.9 percent from 1909 to 1957. During the period from 1948 to 1957 it grew at 3.8 percent per year. If we take non-overlapping periods the difference would be even greater.

2. Per capita GNP shows much the same story. The long-term rate has been 1.5 percent per year; the postwar rate has been 2.0 percent.

3. Data on industrial production go back to 1919. From 1919 to 1957 the average annual rate of increase was 3.7 percent, whereas in the postwar period (1948-57), it was 4.4 percent.

4. Output per man hour has grown over the long term since about 1880, at 2 percent per year. Since World War II (1948-57) it has gone up 3.1 percent per year—about 50 percent higher than the long term.

5. Output per unit of labor and capital combined shows a long-run growth rate of about 1.7 percent per year. Our postwar rate has been 2.2 percent.

6. Disposal per capita real income increased at an annual rate of 1.6 percent from 1929 to 1958. This rate was pushed down by the depression and pushed up by the war. But the postwar annual rate, even with very high personal taxes, has been 1.9 percent.

In short, the evidence seems to indicate that our growth has been accelerating not slowing down in recent years. Detailed research now underway will help to clarify the record, and help us to understand the growth process better, but the evidence

shows no deceleration. The evidence available, however, does show two things clearly: (1) rates of growth seem to follow a pattern of long waves; and (2) economic growth is not accelerated by a rising price level as some people hold; the empirical record does not show any correlation between the rate of growth and changes in the price level.

### **Policies to Promote Growth**

Let me conclude with some observation on policies to promote growth.

Basically, the many recipes for growth being embraced these days seem to fall into two general categories: (1) measures which would try to force a rate of growth upon the economy by greater government regulation, higher government spending, and inflationary finance; and (2) measures which would create a favorable environment for private thrift, creativity, innovation, and capital formation.

The first approach I think of as a sort of architectural or engineering approach because it calls for detailed central planning and government intervention in order to try to build the economy according to a preconceived plan. The second approach, which may be called a biological or agricultural approach, holds that growth in a free society must be cultivated and nourished. The key to meaningful growth, in my judgment, lies in this latter approach. The question is not whether government should play an important role. In either case it must. The crucial question is what kind of role. The following seem to be essential policies for cultivating growth.

1. Orderly government is very important. We tend to overlook this factor in this country because by and large we have it. On the other hand, lack of it here and there retards progress. For example, depressed areas are due to a wide variety of causes; no blanket diagnosis or blanket treatment can be applied. But in some cases at least, disorderly government is a basic or complicating cause. In situations where violence is possible and occurs, where the courts are not equitable and prompt in the enforcement of justice, and where on the whole a thoroughly bad climate exists, people who have options do not stay. And investors do not invest or they disinvest as opportunity arises.

2. Equality of opportunity is exceedingly important. Unless everybody has a genuine opportunity to make the most of his own capacities, we will not come anywhere near attaining a

maximum rate or an optimum rate of economic growth. A great deal of the change which occurred at the end of the eighteenth century and many of the great accomplishments that followed came from increased individual incentives, enlarged individual capacities, and new opportunities. In the aggregate these previously nonexistent forces gave tremendous impetus to economic growth.

(I should mention that almost all of the things I am listing here are probably desirable whether they promote economic growth or not. The basic reason for promoting equality of opportunity, for example, is a moral one, but I am just pointing out here a good practical reason also: it promotes economic growth.)

3. Stability of employment and income is needed to promote economic growth. It enables people to make plans and to calculate risks, to make investments in training, equipment, and plants, and to do it without the added uncertainties of the general business cycle.

4. Stability of the price level is important for the many reasons I set forth at the beginning of this talk—mainly, in connection with growth because of the salutary effects it has on economic efficiency.

5. The general tax structure has vastly greater effect on economic growth than is generally realized. People think of it almost exclusively in terms of getting the most feathers with the least squawking, or the ability to pay, or equity. Economic growth should also be an important consideration in reforming our tax system, if we are really serious about accelerating growth.

6. Maintaining competition is another growth imperative. Competition ties in closely with promoting equality of opportunity. Competition keeps the economy efficient, and leaves the way open for people with ideas to undertake new, bold, and prosperous activities.

7. International trade is also important. Sometimes we can get more output indirectly by producing more than we need of something and trading for something else we need or want. As a result we end up with more of both goods than if we try to produce them both at home. In addition, international trade helps police or enforce competition.

8. One of the cheapest ways to promote growth would be for the government to stop blocking growth. The government has

literally hundreds of programs which retard economic growth. Economic growth always requires some change and adjustment, which at times causes real hardship here and there. The government should alleviate hardship. But characteristically, instead of diagnosing the situation to find means of facilitating change and adjustment, the government subsidizes the people who are adversely affected, and this tends to maintain the *status quo*. As a result, over the course of time, say twenty years, a minor problem may assume such overwhelming proportions that nobody can see a solution—or a solution which would be politically possible.

9. Public investment is another policy for economic growth which I would emphasize. A large number of public works, particularly at the local level, but also at the national level, contribute directly and indirectly to growth. We can mention here, rivers, harbors, the airways, and the like.

10. I would like to emphasize in addition research and education.

For all of these things, let me point out, criteria other than “we think it is a good thing” can be applied. The fact that somebody thinks something is good, of course, is no proof that it is good, that it would be worth its cost, and still less, that the government should do it. General principles can be applied, however, to determine whether the government ought to do it or not. If an activity yields benefits that cannot be captured entirely by the person who conducts it, then public support in such cases may be in the general interest. In addition, the theory of welfare economics has developed semi-objective, or at least analytical, criteria for deciding whether an activity should be placed in private or in government hands.