ANTI-INFLATIONARY POLICIES: ALTERNATIVE APPROACHES

Dennis J. Weidenaar
Professor of Economics, Purdue University

My instructions in preparing this presentation were simple, — in stark contrast to the complexity of my topic, namely, address the topic of inflation by dealing with policies that combine aspects of the various approaches to inflation. My presentation will provide a menu of alternative approaches to resolving the issue of inflation in hopes that you would be able to select a la carte that combination of policies that would satisfy your value posture or at least provide fodder for discussion.

Rather than use sterile economic terminology to identify the array of alternative solutions and combinations of policies that have been suggested in recent years, I will enhance their argumentative quantities by anthropomorphizing them as follows. The set of characters that I will use to represent a combination of views would do any Hollywood casting director proud. Can you imagine a stage graced by Milton Friedman, John Kenneth Galbraith, Barry Bosworth, George Meany, Lloyd Bentsen, and Arthur Okun? Milton Friedman, of course, represents the monetarist view. Barry Bosworth represents the administration view—somewhat. Senator Lloyd Bentsen represents the Joint Economic Committee. Arthur Okun represents to some extent the neo-Keynesian-Brookings view. George Meany represents organized labor. And John Kenneth Galbraith represents - John Kenneth Galbraith.

Rather than plunge directly into the six different approaches I have selected, I would like to take a few moments to present an overview or theoretical framework for the policy combinations that will follow. The first framework is traditional and provides four causal explanations for inflation. The second is newer and more pragmatic.

Theoretical Framework

The first framework is familiar to you all, incorporating the Monetarist, Keynesian, Wage-Push, and Mark-Up views.

The Monetarist view is founded on Quantity Theory of Money. It states that if there is full employment, the price level is exclusively determined by the size of the money supply, and increases in the money supply produce proportional increases in the price level. If there is unemployment, increases in the quantity of money will still cause prices to rise, with a decrease in unemployment occurring if the rising prices resulted in a fall in real wages.

The proposed solution that accompanies this interpretation is that a decrease in the money supply will raise the rate of interest, thereby reducing expenditures and easing pressures on resources. For the long run, the monetarists assert the need for monetary authorities to adopt a target rate of increase in the money supply roughly in line with the planned rate of growth of output. If pursued, price stability will eventually ensue.

The Keynesian view identifies inflation as a condition resulting from excessive expenditure relative to the available supply of goods at current prices. Hence, prices must rise for the goods market to clear. In the inflationary process, fiscal policy is more significant, both as a cause and control, than monetary policy. Money will respond to the needs of trade. If the money supply increases but does not influence spending, prices will not rise; if the money supply contracts, the velocity of circulation of the reduced money supply will rise to counteract it. As a remedy, reducing the money supply, if affective at all, will not slow the rate of change of prices. Instead, it will cause unemployment.

Hence, the Keynesians believe that an incomes policy can help to reduce inflationary expectations, while the decrease in expenditures is accomplished to eliminate the "inflationary gap." They regard wage-price policy as a necessary weapon in the deceleration of inflation and a far less costly method of inflation control than via prolonged deep unemployment which they contend is necessary in today's society to bring about and maintain price stability.

The Wage-Push view approach stems from the belief that labor unions have power within the market process. This power reflects itself in a persistent tendency for money wage rates to increase faster than worker productivity. These wage increases spill over from the union sectors to the non-union sectors as employers respond to threats of organization.

The Mark-Up theory states that inflation is caused by firms with market power taking advantage of their monopolistic status to increase profits.

The second framework is attributable to Otto Eckstein. It is reported in the U.S. Congress Joint Economic Committee's **1979 Midyear Review of the Economy**.

That report notes that the expansionary demand policies and exogenous price shocks of the past decade resulted in a rising core rate of inflation that has shown surprising resiliency even during periods of recession and high excess capacity. It asserts that the major source of reductions in the core rate of the 1980s will be improvement in productivity. As an analytical framework, the report espouses Otto Eckstein's interpretation that the rate of inflation can be disaggregated during any period into three components: the demand rate of inflation, the shock rate, and the core rate.

Within this framework, the causes of inflation include: government monetary and fiscal policies which determine the demand rate; exogenous factors, such as changes in OPEC petroleum prices or increases in payroll taxes, which contribute to the shock rate; and inflationary expectations which determine the core or underlying rate of inflation by affecting unit labor costs.

Alternative Policies

I will now turn to a series of different policy combination suggestions. Each of these can be pegged in the framework cited earlier —but in most cases, each approach is predicated on a perspective with a unique twist. Consequently, I will introduce each approach with some background comments.

Arthur Okun.

Arthur Okun has been an articulate spokesman on policy issues since his role in the Johnson administration. Okun asserts that the chronic inflation of the 1970s is a new and different phenomenon that cannot be diagnosed correctly with old theories or treated, effectively with old prescriptions. Furthermore, left untreated, the chronic inflation will worsen.

An efficient anti-inflationary program must be multi-faceted and diversified, including fiscal and monetary discipline to keep excess demand in check, coordinated federal initiative to reduce private costs, and constructive measures to obtain price-wage restraint.

His line of analysis begins by examining the excess demand in the mid-sixties which he identifies as a clear cut case of "too much money chasing too few goods." The federal budget is identified as the engine of inflation during this period and monetary restraint did not offset it. In time, the demand inflation was transformed into a system of cost-oriented prices and equity-oriented wages, and we now must operate in this environment.

What is this new milieu like? First, the sector of the U.S. economy in which products are traded in organized auction markets (markets in which prices vary from day to day to keep supply and demand in

balance) is small and shrinking. In contrast, the economy is dominated by forces that operate in terms of cost-oriented prices and equity-oriented wages. This means prices are set by sellers who wish to maintain a market share. Prices are set to exceed costs by a percentage markup that displays only minor variations over the business cycle. The key to wage decisions in union and non-union areas is the common long run interest of skilled workers and employees.

Thus, during recession, non-union firms with laid off workers find it worthwhile to raise wages of workers to protect long term relationships. In areas where there is little stake in lasting relationships, wages respond more to the level of employment. The basic test of equity is whether the pay of workers is raised in line with the wage increases of other workers in similar situations. This pattern introduces momentum and creates a pattern of wage increases.

This new milieu is not the product of evil-minded persons—but is a set of efficient arrangements for a complex interdependent economy where all benefit from lasting relationships. The arrangements influence on wages and prices is such that when total spending rises, the increase is a bonus in output and employment with little relief from inflation. In time people adapt to the inflation in ways that make it more tenacious.

Okun's approach assumes that a reduction in inflation can be accomplished only gradually and it can be accomplished efficiently only through combined use of several tools. Consider first fiscal-monetary restraint. There are some downside risks on output and employment, and we must recognize the effects of overdoses of fiscal and monetary restraint. For example, in 1974-75, the federal budget was nearly balanced and the growth of money was held to 4.5%. This policy had little beneficial impact on inflation, while the bad effect on employment, production and capital formation was enormous.

Second, consider federal cost-reducing initiatives. Federal policies have important impacts on costs and prices in many sectors. It does this when it: imposes cost-raising taxes, such as excises on products or payroll taxes on employees; imposes regulations affecting safety, health, and environment; pursues equity objectives by setting floors on prices; dairy and sugar programs, minimum wage; affects output by acreage controls, restrictions on timber cutting, oil leasing, and imposes import restrictions. Even though each has a small effect and often goes unnoticed, the costs mount up and individual cost-reducing attempts are frequently rejected. Instead, we should cut employer payroll taxes, use grant formulas to encourage states and cities to lower price and cost-raising taxes, and reform regulation to reduce the cost burdens.

Finally, consider price-wage restraint. Policy should support the administration price-wage standards by focusing a spotlight on

flagrant violators and using sanctions concerning government contracts and developing a tax-based incomes policy that could reward compliance and penalize non-compliance with the guidelines. This approach relies on the market and allows people to make free choices, although it would add to the burden of the tax system.

Barry Bosworth.

A number of basic changes have occurred in the U.S. economy that are reflected in the Bosworth approach to inflation. First, it is still true that in the long run, the economic system in the product markets is highly efficient and competitive. But, the time involved in reaction to changes in supply and demand has lengthened so that a moderation in price increases in response to a reduction of demand takes a lot longer than formerly.

Second, the proportion of the economy today that is not operated for profit has increased. For example, government employs 18 percent of the economy's workers and government regulated industries comprise 35 percent of the economy. This means that 35-40 percent of employees work in industries that are not operating either to minimize costs or maximize profits.

Third, government has entered the field of social regulation in a major way. Attempts to achieve national goals through other than budgetary expenditures have increased. The cost shows up not in higher taxes or government expenditures, but in increased costs of doing business and in making the system more rigid. These are gradual changes. In the short run, we now have a rigid system and it has been hit with many shocks in the 70's.

What are the appropriate policies? Aggregate demand restraint is an obvious policy to deal with the economic system. It is clear that if the Fed did not increase the money supply, forced interest rates to rise, let home building decline, and let investment and demand fall off, then at some level of unemployment and excess capacity, prices and wages would stop rising. Historical experience, however, suggests that the social cost would be too high. The data show that one million people must be unemployed for two years to take one percent off the inflation rate. Fiscal policy operates in a similarly costly fashion.

Fear of unemployment is no longer an adequate restraint on wage increases and fear of lost sales won't restrain prices. Controls are short-term solutions and we have a long-term problem.

Bosworth prefers to focus on government and the industrial core of the private sector in grappling with the problem of inflation. First, we must face the fact that the government itself has become a major source of inflationary pressures, especially in the last decade. This is partly because of the instability of its fiscal and monetary policies on aggregate demand. But this is not the fundamental problem.

Through its direct actions such as taxes and regulatory actions in the social arena, government has introduced a new element that adds considerably to the inflation rate—even though it may be justifiable from a benefit standpoint. For example: the increased social security tax, the minimum wage increase, and unemployment insurance tax increases. These three items added 3/4 of a percentage point to the inflation rate. Another 3/4 percent is added by environment and health and safety regulations.

When prices rise, people want a wage increase in compensation. But people are not willing to pay for these improvements through the price mechanism. The government also has a special interest legislation problem. A group can make a very strong case for why it deserves government help—whether trade restrictions, price supports, or whatever. The industrial core sector of the economy also has generated difficulties. There are problems in the concentrated industries and the regulated ones. It shows up in industry-wide bargaining, e.g., why should steel companies resist union demands. If they argue to a reasonable request, every other company will grant the same increase and all costs rise proportionately. The rate of wage increases can't be moderated without dealing with the split between very large increases in the major unions of the industrial core and those of the rest of the economy.

Lloyd Bentsen.

The Joint Economic Committee (Staff) viewpoint resembles Bosworth and Okun with an added feature—concern for the supply side. This is not unexpected, since this may be an easier approach politically.

The first policy recommendation is demand restriction. The growth in the money supply should not exceed the Federal Reserve Board's target ranges. The goal should be a gradual reduction in the money supply growth rate. Also, reliance on monetary and fiscal policy as the sole weapon against inflation is inappropriate today, because demand restriction does not address supply-related inflation and exacts intolerable costs in terms of lost output and high unemployment.

The JEC report also supports the trend toward a reduced share of federal outlays in GNP. If aggregate demand pressures continue to mount, additional restraint should come through fiscal, not monetary, policy. Fiscal policy should then be the leading demand restriction weapon. If the real GNP growth rate falls below administration projections, easier monetary policy and/or a tax cut should be used.

The second policy approach is voluntary wage and price guidelines. Voluntary wage and price guidelines can be an effective policy for winding down persistent long-term inflation when they are part of an overall anti-inflation program that includes fiscal and monetary

restraint and other anti-inflation policies. Inflationary expectations have become firmly entrenched. The psychology of the wage-price spiral must be broken to control inflation. This is the rationale for voluntary wage and price standards.

Supply stimulation is a major JEC policy goal. All government regulations should accomplish the statutory objectives in the most cost effective manner. When alternatives exist, each of which clearly would achieve a particular regulatory goal, the least costly way should be adopted. The senate rule requiring all legislation to be accompanied by a regulatory impact analysis should be enforced. Congress and the executive should develop the methodology necessary to make a regulatory budget a reality.

Government regulations affecting health, safety, and the environment have contributed significantly to the overall well-being of the vast majority of Americans. But there can be little doubt that the rapid growth of regulation has been a substantial contributor to our current inflation. With the rapid growth of the new regulatory agencies (OSHA, EPA, etc.), the federal budget no longer conveys a complete picture of the government's economic impact. The annual budget now understates the proportion of the nation's resources used for public purposes.

Finally, productivity — the Administration and Congress should develop proposals to stimulate productivity growth. Policies should be introduced to raise real business fixed investment to 12 percent of real GNP. Tax and other incentives should be considered to promote industrial research and development. Federal policies should be supported that encourage the establishment in industry of joint labor-management committees to identify opportunities for productivity gains and the improvement of worker morale.

John Kenneth Galbraith

The Galbraithan solution is a Comprehensive Incomes and Price Policy (CIPP). It asserts that an uncontrolled struggle for more income brings inflation that defeats most of the efforts to control it and that the traditional means of control—monetary and fiscal policy—either do not work or work by hurting the least affluent, least employable, those with least control over their prices and income. The solution accepts that the burden of restraint must be distributed fairly.

The strategy for solution begins with consultation coordinated by the government to exact agreements from principal groups to hold their demands to affordable increases in income. Wages must be kept to what can be afforded without forcing prices up; large corporations must not take advantage of pay restraint while allowing unavoidable cost increases to be passed along; profits must be kept in line with past experiences; there must be restraint on minimum

wages, pay of civil servants, farm support prices, pensions, transportation costs and other publicly controlled incomes and prices; and understanding must be achieved by government led negotiation and consultation—but government must retain power to enforce the result.

This goes beyond ordinary control of wages and prices. It extends in principle to all who have achieved a measure of control over their incomes—since escape from the control of the market necessitates the CIPP. The restraints involved are: trade union claims are limited to increased productivity on average; large corporations must respect this wage restraint and not increase prices; profits may rise, but only from more sales or above average efficiency or productivity. This program is not radical according to Galbraith since public restraints simply replace private price fixing of the corporation. Some price fluctuations are inevitable—farm products, small industries, service enterprises, self-employed. Here the market still works, though imperfectly.

Taxation is an important part of CIPP. It reaches incomes untouched by wage, salary and price restraint,—e.g., lawyers, doctors, and other professionals. A stiff inheritance tax also will serve equity, "Instead of just praising the work ethic, the children of the affluent also practice it."

Since the largest part of savings today is by corporations, CIPP will not have a deleterious effect on savings and capital formation. To insure this, profits would be in line with past experiences. Private saving in the form of social insurance and pension funds will not be affected. Where the market works we should not interfere. Do not touch the prices of the millions of small firms, self-employed, farmers, except as minimums set by the government.

In conclusion, Galbraith believes that CIPP must be introduced since the alternative remedies are worse than the disease, at least for the poor. We now restrain prices and wages by slack in the economy —by low demand, idle capacity, high unemployment. CIPP direct restraints would replace unemployment as the basic policy against inflation.

George Meany

The anti-inflation policy prescription of organized labor has three parts with the basic approach being a comprehensive mandatory controls program. This program must cover *all* prices and *all* forms of income—profits, dividends, rents, interest rates, executive compensation, and professional fees.

The rationale for this approach is two-fold. It could deal with immediate economic pressures, and it could break the existing inflationary psychology. Politically it would not be unpopular. According to labor, polls show that the majority of Americans favor

controls. Furthermore, a Gallup-Chamber of Commerce survey released in December 1978 revealed that over three-fourths of a cross-section of 1,000 business executives anticipate some form of mandatory controls by 1980.

Specific aspects of the program include:

- The controls program should be administered on an industry basis with special attention to those industries where bottlenecks and inflation pressures are most severe, namely, food, energy, housing, medical care, and financial markets.
- The program should provide a mechanism for future decontrol action on specific parts of the economy on an industry-by-industry basis.
- Price and wage controls and determination should involve consumer, worker, producer, and government representatives.

Accompanying the basic controls program should be policies to stimulate economic expansion so that the effect will be to hold down prices during economic growth rather than simply contributions to shortages.

Finally, in addition to the broad comprehensive controls program and the stimulative economic policies, the AFL-CIO calls for specific, targeted programs. These would focus on that major portion of the inflation that has been concentrated in food, fuel, health, housing, and interest rates. These specific policies are listed below.

The nation's agricultural policy must encourage maximum production to redress the lack of balance between domestic food supplies and the demand for American farm products at home and abroad. Specific tools are the establishment of adequate stockpile reserves of agricultural goods against erratic price and supply fluctuations and the establishment of effective export controls on agricultural products and other raw materials in short supply during inflationary shortages. More specifically:

- The Secretary of Agriculture should postpone export of any food products when the domestic price rises by 10% or more.
- A National Grain Board should protect U.S. interests in foreign markets for agricultural products and provide price and supply stability in domestic U.S. markets.
- Bargaining with communist and centralized economies must be on a government-to-government basis to protect the American people.
- Government must regulate commodity speculators.

In the short run, rationing and allocaton of gasoline and other fuels are necessary. For the long run, the nation needs a broad comprehensive program of energy conservation, development of new supplies, and anti-monopolistic action against the big oil companies.

Enactment of a universal and comprehensive national health insurance program is needed.

The President and the Federal Reserve Board should adopt selective credit regulations and allocate credit to protect the housing industry. Congress and the administration should increase the supply of low and moderate-income housing.

The President should authorize the Federal Reserve Board to allocate credit at reasonable interest rates and reduce its discount rate.

An excess profits tax will dampen the normal corporate drive to raise prices to raise profits.

Milton Friedman.

The monetarist approach has been summarized earlier and I repeat it here. The monetarist view is founded on Quantity Theory of Money. It states that if there is full employment, the price level is exclusively determined by the size of the money supply. Increases in the money supply produce equiproportionate increases in the level. If there is unemployment, increases in the quantity of money will still cause prices to rise. A decrease in unemployment occurs if rising prices result in a fall in real wages.

The proposed solution is that a decrease in the money supply will raise the rate of interest, thereby curbing expenditures and easing pressures on resources. For the long run, the monetarists assert the need for monetary authorities to adopt a target rate of increase in the money supply roughly in line with the planned rate of growth of output. Price stability will eventually ensue.

Conclusion

What combination of policies is appropriate. This brief survey of six approaches to reducing inflation suggests the following:

With the exception of Friedman, all of the policy proposals are highly eclectic.

a. Monetary and fiscal restraint are important but certainly are not adequate *alone* to deal with the inflation of the sixties.

Further use of monetary and fiscal policies should be gradual, definite, and consistent.

b. Much closer scrutiny of the government's role in raising prices must be exercised.

c. Active steps must be taken to increase productivity—this is the JEC's major stance and it reflects the political realities of being less painful.

d. Price and wage controls are to be avoided.

What is encouraging is the broad range of agreement. What is discouraging is that we've heard it all before!

CONTROLLING INFLATION

Impacts and Implications