PART II
REPORT OF SUBCOMMITTEE ON INFLATION

In considering the problem of public policy education this committee first considered the people with whom the work was to be done. It was decided that the most important group would be farm people or farm leaders - who came for a special meeting on policy; another important group was farm and nonfarm groups who request a speech on a policy problem as part of an annual meeting, dinner meeting, or other activity.

The committee attempted to illustrate both subject matter and techniques for these two types of meetings. These techniques may be equally well applied with other groups. To aid the extension specialist or county agent to do this job some background material and suggested readings were also prepared by members of the subcommittee.

J. Carroll Bottum, Purdue University, Chairman
G. Alvin Carpenter, Utah State College
Dale E. Hathaway, Extension Service, USDA
D. B. Varner, Michigan State College

AGENDA

TIME ALLOTTED	
30 minutes	Calling All Doctors - D. B. Varner
30 minutes	Discussion
15 minutes	Background material for extension specialists and county agents - Dale E. Hathaway
90 minutes	Inflation Control and Greater Price Stability - J. Carroll Bottum
45 minutes	Break up into small discussion groups of 7 to 12 people to consider subject matter and methods
45 minutes	General discussion

CALLING ALL DOCTORS

(A 30 Minute Talk Suitable for Presentation to Such Groups as Service Clubs, Farm Banquets, and Annual Meetings of Farm Organizations)

Presented by D. B. Varner

A few weeks ago, my young son checked in at the breakfast table with a rather high temperature and an assortment of aches and pains. My wife and I -- thinking, of course, that these were part of the all-inclusive symptoms of polio, immediately rushed him to our pediatrician. After the usual hour and 15 minute wait in the doctor's office, he proceeded to conduct his examination. I was intensely interested in the procedure he followed. The first move made by the doctor was to check for symptoms. He took our son's temperature and found it to be 103 degrees. He then inquired about any other pains or peculiar behavior. Following the routine ear, eye, nose, and throat inspection, the doctor announced to us in a very reassuring voice that this was only a recurrence of an old trouble with which our son had been bothered -- simply a case of inflamed tonsils. He then proceeded to explain to us in a very fatherly professional manner (at the rate of about $48 per hour) the causes for this trouble. He went further. He said that it appeared to him that unless corrective action were taken in the near future there was a danger of lasting damage. It was pointed out to us that we were faced with several alternatives in choosing the course of action that we should follow.

On the one hand we could simply ignore the trouble and hope that nature would correct the condition. As a second alternative, we could give our son an aspirin tablet each three or four hours which would tend to reduce the temperature, eliminate the headache, and in all probability, within a matter of a few days, remove the symptoms. He pointed out, however, that we were going to have to face up to the third alternative - that of surgery - sooner or later. This alternative, he explained carefully, was the only one that would give lasting relief.

As I observed the performance of this doctor of medicine, I became all the more aware of the similarity which exists between a doctor and the treatment of an individual patient and an economist in his treatment of a collective patient. This analogy is not, of course, a perfect one. As a matter of fact, it breaks down on at least two distinct counts. In the first place doctors are rewarded for their services in large quantities of legal tender, while economists as a rule receive a subsistence wage plus varying amounts of prestige. The other sharp difference is that when a doctor of medicine makes a faulty diagnosis and a wrong prescription the patient sometimes dies. The evidence is destroyed. No such luck for the economist. If he prescribes in error, and finds his counsel accepted, his mistake lives on to haunt him.

Nevertheless, the similarity is real. Today economists have been called in to diagnose a patient and to prescribe the proper treatment. Our patient in this case is a very large and important body -- it is the economy of the United States of America. The patient at the present time is experiencing considerable pain, quite a few headaches, and a recurring fever. There is little doubt that it is in need of some sort of economic attention. Let us all, for the moment, don the white robes of the doctor and see what can be done for our patient -- certainly none of us are willing to permit this condition to become so aggravated that a fatal illness develops.

You will recall that the doctor of medicine followed five rather distinct steps in handling his patient. First, he checked symptoms and then made the diagnosis. Having diagnosed the illness, he outlined the causes for the trouble and stressed the dangers inherent in permitting the disease to persist. Finally, he prescribed the alternative courses of action that were available to us. Let us follow this same procedure with our patient.

I. THE SYMPTOMS

The most obvious symptom which confronts us as we examine our patient is the very sharp increase in prices since June 1950. We discover that the index of wholesale prices has risen 17 percent in one year. The cost of living has gone up by 10 percent during this same period. These are definite symptoms that there is a lack of adjustment somewhere in the system. We look again for symptoms and find that certain types of goods are becoming scarce - production does not respond normally to the rise in prices. We discover that as a result of this, the government is stepping in and making allocations of some of these scarce materials. There is some talk of rationing of certain commodities today, although this has not yet come into being on the consumer level.

A third very noticeable symptom in this patient is a general nervous condition. This is, of course, no surprise to us since such a condition normally accompanies the first two symptoms. This nervousness is evident at many points. Businessmen are quite shaky about the behavior of consumers, labor, and the government. Labor has great fear that the cost-of-living index will not move up rapidly enough and therefore it will become necessary to find a new basis for increased wage demands. The government itself has difficulty in controlling the actions of all its organs. The administrative branch makes vigorous appeals to Congress for greater power to control the price level but finds Congress actually weakening existing control measures.

II. THE DIAGNOSIS

Having reviewed these obvious symptoms of our patient, we are ready for the second step in our procedure - that of making a diagnosis. Certainly in this case the diagnosis is not difficult - this is simply a recurrence of that disease common to a capitalistic economy - inflation.

Doctors of medicine and doctors of economics alike have the common fault of using terms not generally understood by the patient. Perhaps we should try to spell out exactly what we mean by the term "inflation." Economists are generally agreed that inflation is that condition which exists when consumers are able and willing to spend more money than there are goods to be bought at existing prices. The inevitable result is a rise in prices.

While we recognize that this disease is not normally fatal in itself, it is very painful. There have been cases in history where it went untreated for such long periods that major and very serious operations became necessary. Surely it is a disease which deserves the very careful attention of our most competent doctors of economics.

III. THE CAUSES

Let us turn then to the third phase of this process - that of explaining the causes for this inflationary condition now bothering our patient. We defined inflation in terms of a lack of balance between money to be spent and goods to be bought. Simplified still further, we can explain inflation in the terms of the "sidewalk" economist - through the interaction of the forces of supply and demand. What we have actually said is that the demand for goods has exceeded the supply of goods at existing prices. Then the cause of inflation must be found in a situation of short supply and/or excessive demand. We shall look at each of these forces in turn.

There is little evidence that the blame for our inflationary ills can be placed at the door-step of supply. Our industrial production has increased by 11.5 percent during the past year; agricultural output in 1950 was far above average and indications for this crop year point to the second largest total production in our history; productivity per worker has increased and total employment is approaching an all-time high. The supply side of the picture looks good - we must look elsewhere for the source of our difficulty.

Demand is unquestionably the culprit in this case Not only has demand matched our increased supply, but has sprinted well beyond. To get a better view of this demand phenomenon, let's trace the developments since June 1950. As a background to this, however, we should appreciate the fact that even before Korea we were enjoying a very high level of prosperity - total employment was high, wage levels were near an all-time record, personal incomes and expenditures were at or near the highest points in history. Then came Korea. Several developments - some occurring simultaneously - fed the already smoldering fires of an inflationary demand spiral. Let us recount these briefly.

A. **Anticipatory Buying Surge.** The American consuming public, remembering the shortages of World War II, immediately plunged into the market in a mad scramble for many goods. This demand, financed from current incomes, savings, and consumer credit, actually threw the switch on the inflationary spiral.

B. **Private Domestic Investment.** Hand-in-hand with the magnified consumer demand went a surge of optimism on the part of businessmen and investors. Gross private domestic investment jumped from an annual rate of $44 billion in the first half of 1950 to $61.8 billion in the first half of 1951. This is money being spent - an addition to the income stream - potential new demand.

C. **Expanded Credit.** Supporting both the consumer buying spree of 1950 and the great expansion of private investment was a widely expanded credit base. Between June 1, 1950 and December 31, 1950, consumer credit outstanding increased by 14 percent. While this has decreased somewhat since the first part of 1951 it still is 9 percent above the pre-Korea level. New credit went beyond the consumer level. Total loans from all banks increased by 23 percent between June 1950 and June 1951. It must be borne in mind always that new credit means new money to be added to the demand side. As a matter of fact, a bank loan contributes far more to the inflationary pressures than the mere quantity loaned. If the money loaned is kept in use it can add six or seven times its total to the demand stream.

D. **Defense Orders.** Immediately following the Korean outbreak our Defense Department began a program of semi-mobilization. The personnel of the military establishment was expanded by more than 100 percent. The production of military material became a matter of first importance. Financial and military aid to our allies became essential. To move out on all fronts in this limited mobilization has made it necessary for the Department of Defense to spend $55 billion since June of 1950. This is approximately $35 billion more than had been anticipated before the North Korean attack. This is big money - money that surely finds its way into the reservior of demand that brings relentless pressure against the existing supply.

This will give us at least a broad picture of what has happened to total demand during the past year. It has simply overpowered supply. Inflation has been the inevitable result.

IV. THE DANGERS

Just as the doctor of medicine explains to the interested parties what the consequences of an illness may be if not properly treated, we as economists must point out to our patient some of the more serious dangers of an uncontrolled inflation.

Perhaps the most serious damage done by inflation is the distortion of values. Prices in general rise, but not all prices rise alike. Nor do all incomes and wealth necessarily move up the dollar scale together. For example, dollars used to buy defense bonds in the early 1940's have now depreciated to the point where the net proceeds of a bond at maturity are worth only about 75 percent of the original investment. Lifetime savings invested in insurance policies now return only a fraction of the purchasing power anticipated. On the other hand, farm land, urban real estate, and many common stocks have returned rich rewards to the investor. Not only have values been thus distorted, but a general feeling of uneasiness prevails about investments in the future.

Inflation always penalizes fixed-income groups - clerical forces, white-collar workers, pensioners, annuity holders. Their incomes have habitually lagged behind the rises in costs during an inflation, and this one has been no exception.

Defense costs - and this is of prime importance to all of us today - skyrocket even more than other costs if the military has to bid in the open market for scarce resources. A spokesman for the Department of Defense recently stated that money appropriated last fall for defense purposes would now buy only 70 percent of the quantity estimated at the time the appropriation was made. This means that an ever increasing quantity of dollars must be appropriated to meet the defense requirements, and this in turn means either more taxes or a higher public debt, or both.

An uncontrolled inflation could conceivably, carried to its ultimate conclusion, result in a complete breakdown in our monetary system. If prices should continue to rise, but at an accelerated rate, holders of money would try to get "out of money and into goods." This could develop into a panic with a resultant flight of capital from our country into foreign holdings. Economic chaos would surely result. Let us be very clear on this point - there is absolutely no evidence available today to indicate that such a condition is developing or will develop in the United States. On the contrary, such a development is highly unlikely. Nevertheless, this is a possibility that we must not ignore when enumerating the dangers of an unbridled inflation.

V. THE ALTERNATIVE PRESCRIPTIONS

We can now focus our attention on that all-important last step - the spelling out of alternative prescriptions. Again we find ourselves in much the same position as the doctor of medicine. We can suggest the possible alternatives and can point out the probable consequences of each, yet we have no way of forcing our patient to follow our recommendations. There appear to be three approaches to treating this disease and each has its advocates. We shall list them and mention some of the strong and weak points associated with each.

A. **Do Nothing.** There are some who contend that the only proper way to handle this disease is to let it alone. This group contends that our system is automatic in its functioning and that higher prices will reflect the message to the producer to produce more. By following this procedure we would eliminate all administrative costs and the inconvenience of other schemes and would insure the continued operation of a free market.

Opponents of this proposal argue that there are two major defects in such a scheme. In the first place, if prices were permitted to move freely through the inflationary cycle, many inequities would be created between different income groups. The second argument against this suggestion is that if prices continue to move upward and production continues to respond, a point of full employment of all resources is soon reached. Beyond this point higher prices serve only to add to "paper" profits and contribute to a wage-price battle.

B. **Indirect Controls.** Much has been written and spoken by economists who favor attacking inflation through this scheme of indirect controls. Specifically, the steps usually recommended are:

1. Increase federal taxes, principally through use of progressive income taxes.
2. Curtail and control the supply of money.
3. Use of consumer credit controls.
4. Reduce the volume of government loans and guarantee of loans.
5. Reduce public works activities to a minimum.

Many advantages are claimed for this system. In the first place, it is designed to attack the disease at its source - i.e., reduce the pressure on the demand side by siphoning away available purchasing power. This is in contrast to other proposals which attack the symptoms and not the disease. Secondly, this plan would not interfere with the normal automatic operations of the market. Lastly, such a scheme would be relatively inexpensive from the standpoint of administrative costs and would be more palatable to the public than one involving more direct intervention on the part of the government.

Critics of this suggestion for the most part admire the esthetic beauty of the program but challenge its ability to move effectively and rapidly in controlling inflation. Moreover, a real danger is inherent in this proposal - that the controls might be applied so vigorously that a "depression psychology" would overtake the economy and unemployment would follow. Such a psychology, once underway, is admittedly difficult to reverse. One further criticism of this plan is that a system of equitable and administratively feasible taxation is indeed difficult to devise, to say nothing of the political acceptability of such a plan.

C. **A Combination of Direct and Indirect Controls.** This prescription would call for the moderate application of a system of indirect controls, but for immediate results would supplement this with a system of direct price and wage controls and government allocation of scarce materials.

Proponents of this approach claim that the direct controls achieve immediate results while waiting for the slower indirect control program to become effective. It is further contended that the price ceilings serve to equalize the sacrifices necessitated by the defense program in that prices of scarce commodities are held within the reach of the low income groups. Otherwise, the wealthy would be able to outbid the poor and gross inequities would result. One further advantage claimed for this approach is that it makes it possible for the defense establishment to procure necessary goods at reasonable prices.

Opposition to any system of direct controls has been vigorous from many economists. It is held by these dissenters that (1) we are not in full war and therefore the patriotic motive necessary to permit controls to operate is almost wholly lacking; (2) if this "semi-hot" war should last for 10 years or longer - as is often predicted - the American public would rebel at the thought of a long period of "regimentation"; (3) the function of our price system, i.e., to guide production and ration goods would be rendered largely ineffective through the establishment of arbitrary price and wage ceilings; and (4) such a direct control plan does not attack the true source of the trouble at all, but rather directs its attention toward the symptoms. It would, at best, but suppress an inflation.

These are the three major alternative prescriptions which are available for our patient to follow. The decision as to which is chosen must be made by the patient through whatever reasoning process there is in existence.

We must concern ourselves about these processes of reasoning in this economy of the United States. Decisions as to which route we will follow in combating this No. 1 domestic enemy must be made by an enlightened public. Legislation enacted by our Congress should and must reflect the will of the people if it is to be lasting and effective. A prerequisite to such sound and lasting legislation is, therefore, a better understanding on the part of the citizens of the fundamental issues involved.

It is toward this goal that I have directed my remarks.

BACKGROUND MATERIAL FOR PUBLIC POLICY EDUCATION ON THE PROBLEM OF INFLATION

Prepared by Dale E. Hathaway

This discussion attempts to cover briefly some of the background material that should be helpful to those who wish to do public policy education on the subject of inflation. It discusses:

1. What is inflation?
2. What causes it?
3. What are the effects of inflation?
4. When does inflation become dangerous?
5. Possible alternative methods of controlling inflation.
6. The present situation.
7. The meaning of mobilization.