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MONETARY-FISCAL POLICIES AND INFLATION

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The Employment Act of 1946 placed responsibility for maintaining economic stability upon the federal government. An avowed objective of responsible agencies now is to promote economic stability, growth, and a stable price level. This objective is currently being implemented through monetary-fiscal techniques.

Monetary policies are concerned with those decisions and actions of the Federal Reserve System which affect the cost and availability of money and, hence, the stock of money. The techniques available to our monetary authorities include: (1) open market purchases and sales of United States Treasury bills, (2) changes in the rediscount rate, and (3) changes in reserve requirements.

Fiscal policies are concerned with those decisions and actions of Congress and the administration which affect government revenues, government expenditures, and management of the federal debt.

COST OF LIVING IS THE MEASURE

Stabilization tools are now directed toward the objective of eliminating inflationary pressures. By inflation I mean a rise in the general price level or "cost of living." Changes in the "cost of living" in the above sense should be distinguished from changes in the "standard of living." A rise in prices, or the "cost of living," means that more dollars are required than previously to buy the same bundle of goods. On the other hand, a rise in the "standard of living" means that more goods and services are being consumed. Hence, it is unfair to compare total living expenses between two points in time and allege that the increase is due to inflation, or higher "cost of living," when actually a goodly portion arises from the higher "standard of living."

Unfortunately, the long-term history of our economy is characterized not only by a rise in living standards but also by inflation. In recent years a substantial portion of increased family expenditures is due to a higher "standard of living" rather than solely a higher "cost of living."

During the past five and a half years the "cost of living," or consumer price index, has risen by an average of about 1 percent per year, while the wholesale price level has risen by an average of about .5 percent per year.

Why then so much current concern over the problem of inflation? The answer, of course, lies in the fact that most of the increase in prices has been concentrated in the last year and a half. Therefore, the attention of our monetary-fiscal authorities is focused upon the objective of controlling inflation while maintaining high levels of employment and growth.

I would like to consider briefly: (1) the historical trend in prices and the basic factors affecting those prices, (2) the specific causes of current inflationary forces, (3) what is being done to stop the inflation, and (4) the chances for success.

LONG-TERM LOOK

During the past fifty years, the United States economy has suffered an inflation averaging 2.7 percent per year, as indicated in Figure 1.

Price increases were not continuous but were concentrated around periods of war financing. What was the basic cause of the price increases? The data presented in Figure 1 strongly suggest that inflation stemmed from too much spending relative to the production achieved by our economy. During this period, spending increases averaged 5.8 percent per year, while output increases averaged only 3.1 percent. Hence, spending increased almost twice as fast as production.

Why did spending rise so rapidly? Both theoretical and empirical evidence suggests that over the long pull spending increases are determined largely by growth in the money supply. During the period under consideration, monetary growth averaged 5.9 percent per year, almost identical to the average spending increase of 5.8 percent. Therefore, both monetary and spending growth was nearly double the increase in production of goods and services. The inevitable result was an inflation averaging 2.7 percent per year.

Since the United States economy continues to grow, due both to greater productive efficiency as well as increased labor and capital facilities, a goal of stable prices implies that over the long term the money supply and spending should rise but no more than output increases.

Therefore, limiting growth in the money supply and spending is essential in any attempt to prevent inflation. The Federal Reserve System is in a strategic position to accomplish just that. Money in our modern economy consists largely of bank deposits. The volume of bank deposits is determined primarily by the reserves which the banking system holds. The Federal Reserve System has the power to regulate the volume and cost of these reserves. Therefore, it has the power to effect changes in the stock of money.

For many years after the formation of the Federal Reserve System in 1913, this power was not fully appreciated. Even after the effects of Federal Reserve operations were understood, monetary policy was frequently focused upon objectives other than maintaining economic stability and growth without inflation. Not until 1951, following the accord between the Federal Reserve and United States Treasury, were monetary powers exercised with the objective of "promoting monetary and credit conditions that would foster sustained economic growth together with stability in the value of the dollar."

CAUSES OF CURRENT INFLATION

As in the past, the current inflation difficulty appears to stem from too much spending relative to the capacity of the economy to increase output. Some observers contend that the present inflation is unique in that costs are pushing prices rather than demand pulling prices.

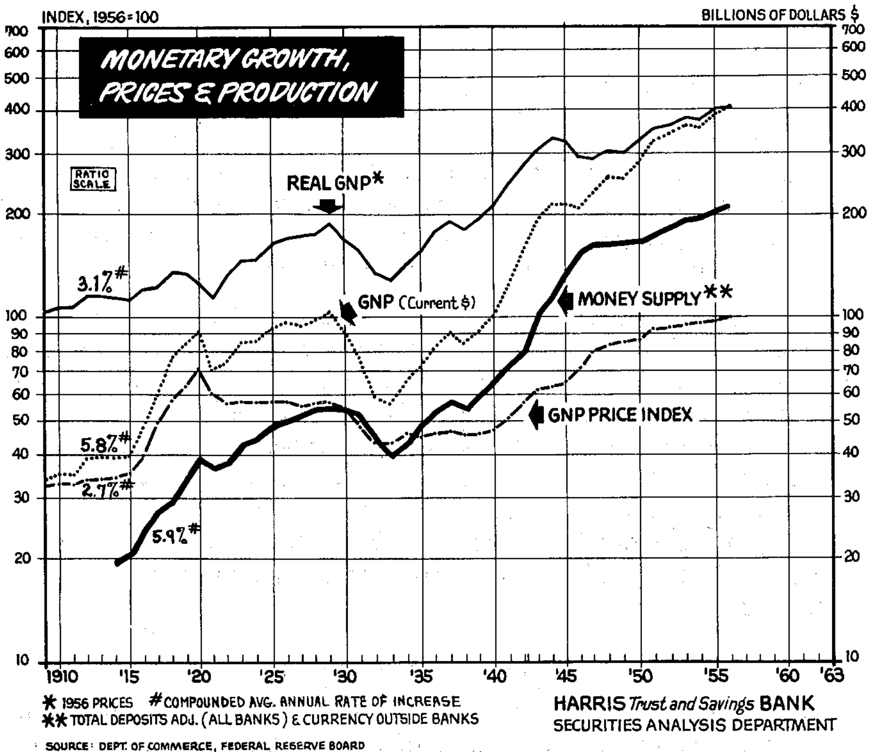

Figure 1

No doubt higher costs have increased incentive for businessmen to raise prices in many lines, but this condition is always characteristic of periods of inflation. However, unless final demand is sufficient to

absorb output at higher prices, either unemployment will rise or prices will decline. Since neither of these conditions has characterized the past year and a half, we still appear to be faced with too much spending. During the past two years spending on finally produced goods and services has risen 12 percent. As was true during our long-term history, this increase in spending is nearly twice too fast.

Who accounted for the spending increase? Consumers increased their outlays 11 percent, business investment rose 8 percent, while combined federal, state, and local government spending increased 14 percent. Focusing on business investment, we find that outlays on producers' durables rose 36 percent during this period, about the same as the 37 percent increase in plant and equipment outlays. The major strain placed upon the economy during the past two years appears to have stemmed from a private investment boom. At the same time, government spending was up substantially, and consumers continued to spend liberally.

In the long run, increased plant and equipment spending raises the capacity of the economy to produce, thereby encouraging growth and providing some protection against higher prices. However, in the short run, sharp increases in such outlays create inflationary pressures unless consumers and/or government are willing to use fewer productive resources. In other words, if savings had increased as rapidly as investment during the past two years, the increased spending for capital formation could conceivably have taken place without inflation.

Actually, personal savings were up nearly 25 percent during the period, but this was insufficient to finance the investment boom without some inflation. Also, higher federal, state, and local outlays added to the problem. Therefore, I believe the basic cause of the recent price rise was the attempt by business and government to expand spending more rapidly than the economy could accommodate with the savings available. Among the forces accounting for the investment spurt were: (1) accelerated depreciation, (2) perhaps too easy money during 1955, and (3) higher wage rates which encourage capital substitution for labor.

WHAT IS BEING DONE

If the preceding analysis of the cause of the current inflation is correct, the solution to the riddle of price stability lies in restraining investment or stimulating saving or some combination thereof. The effects of monetary policy through changes in the cost and availability of money influence primarily the private sector of the economy. Fiscal policy has direct effects on the federal sector and indirect effects upon the private portion of the system.

Some contend that restricting monetary growth will have no effect upon spending as velocity or turnover of money will merely increase, and spending will continue on its merry way. The long-term evidence reflected in Figure 2, suggests that this is true in the very short run, but that continued restraint on monetary growth soon affects total spending and aggregate business activity. The liquidity of the economy is

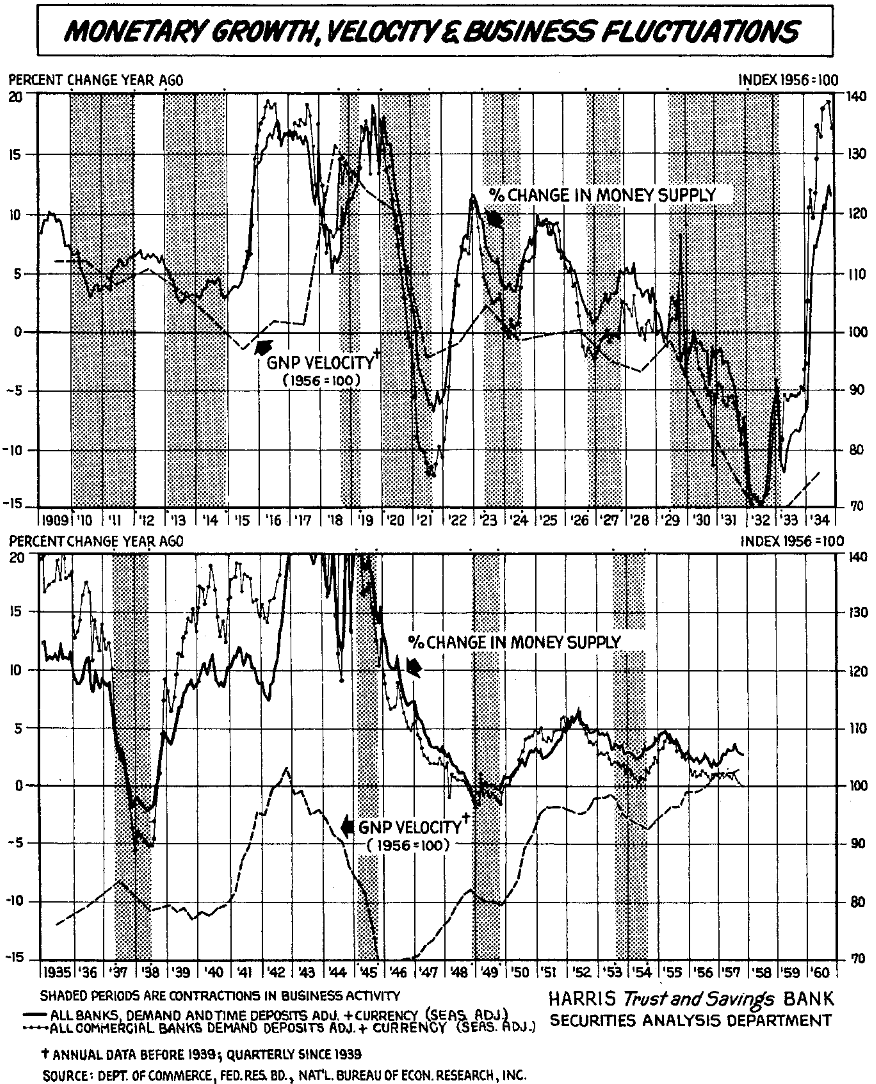

Figure 2

now quite low as a result of monetary restraint during the past two years. As indicated in Figure 2, the turnover of money spent on gross national product has remained about the same for the past six months.

Figure 2 also suggests that even though a restriction in monetary growth can restrain a spending rise, there is danger that such action will be followed by a business downturn. In many past periods when reduction in monetary growth was sharp, these periods were followed by business recession or depression. However, since the adoption of flexible money in 1951, changes in the rate of monetary growth have been quite modest and, in general, in the proper direction.

The rate of monetary growth has declined rather continuously, but moderately, for the past two years as a result of the restrictive monetary policy. Despite all the public concern over "tight money," the economy is still enjoying some growth in money supply.

In addition to the effects of action in the monetary sphere, the recent economy drive in Congress and the administration may bear fruit in coming months. The bulk of the planned reduction in federal outlays is concentrated on defense spending, where some projects have been cancelled, while delivery dates for others have been postponed. Although Congress reduced appropriations by about 5 billion dollars, any reduction of actual spending in the next year must stem from action by the administration.

The objective of the administration now appears to be to reduce defense spending by an annual rate of about 4 billion dollars to an annual rate of 38 billion dollars by the end of the year. In the first half of next year, a further reduction of 4 billion dollars is sought.

Secretary of the Treasury Anderson recently gave renewed strength to budget cutting activities by avoiding a request to Congress to raise the 275 billion dollar debt limit. Outstanding debt subject to the legal limit is now in excess of 273.5 billion dollars.

Since revenues in coming months are seasonally low, careful spending control will be essential if an increase in the debt limit is to be avoided. If the administration succeeds in its objective of cutting spending in coming months, this source of inflationary pressures will disappear.

CHANCES OF SUCCESS

The long-term record suggests that substantial inflation can be prevented, provided war is avoided. Wars are typically financed largely by the creation of new money due to the unwillingness of Congress to raise taxes sufficiently to cover outlays.

Fortunately, attention is now focused on the basic cause of inflation rather than upon the symptoms of inflation. Proper monetary-fiscal action is now being taken and evidence indicates that these actions are beginning to take effect.

Total wholesale prices have risen less since the turn of the year, while wholesale prices of industrial products have been quite stable, as indicated in Figure 3. The cost of living, however, continues upward due largely to higher food prices. This index tends to be a sluggish indicator rising after wholesale prices start upward and continuing upward after wholesale prices stabilize.

Wholesale prices started their upward climb at about mid-year 1955, and the cost of living remained stable for another nine months. In recent months several basic raw material prices have declined sharply. Retail prices now appear to have about absorbed the pressures previously exerted by rising wholesale prices, and wholesale prices are not getting new pressures from rising raw material prices.

Furthermore, the investment boom appears to be topping out. Increased capacity in many lines, accompanied by lower profit margins, is dampening the incentive to expand. Also, money is becoming more expensive, and the reduced availability of money is even more significant. Finally, savings continue to move upward.

The timing of the prospective balance between investment and savings is impossible to predict, but the desired adjustments definitely are occurring. The economy is now tending toward stability rather than either runaway inflation or deflation. Unfortunately, the free enterprise system does not have automatic forces which tend toward full employment and stable prices. Rather our economic history suggests a tendency to oscillate widely in the absence of corrective action. Monetary-fiscal policies properly executed will not bring the millennium, but they can do much to foster business stability and growth.

Even assuming that monetary-fiscal policies succeed in decreasing oscillations of the economy, many important economic problems will remain. Among these problems are: (1) the ever present necessity of preventing monopoly in both industry and labor and (2) the discouraging task of eliminating surpluses in agriculture.

When the price system is allowed to function, surpluses will be automatically dissipated through lower prices which discourage production and encourage consumption. However, in areas such as agriculture, where government price fixing and subsidies interfere with such adjustments, imbalances may persist for protracted periods of time.

Proper monetary-fiscal policies through their effect upon aggregate demand can contribute much to achieving over-all price stability

and preventing depression characterized by apparent surpluses in many lines. However, these policies do not solve the problem of overexpansion of particular industries relative to the total economy.

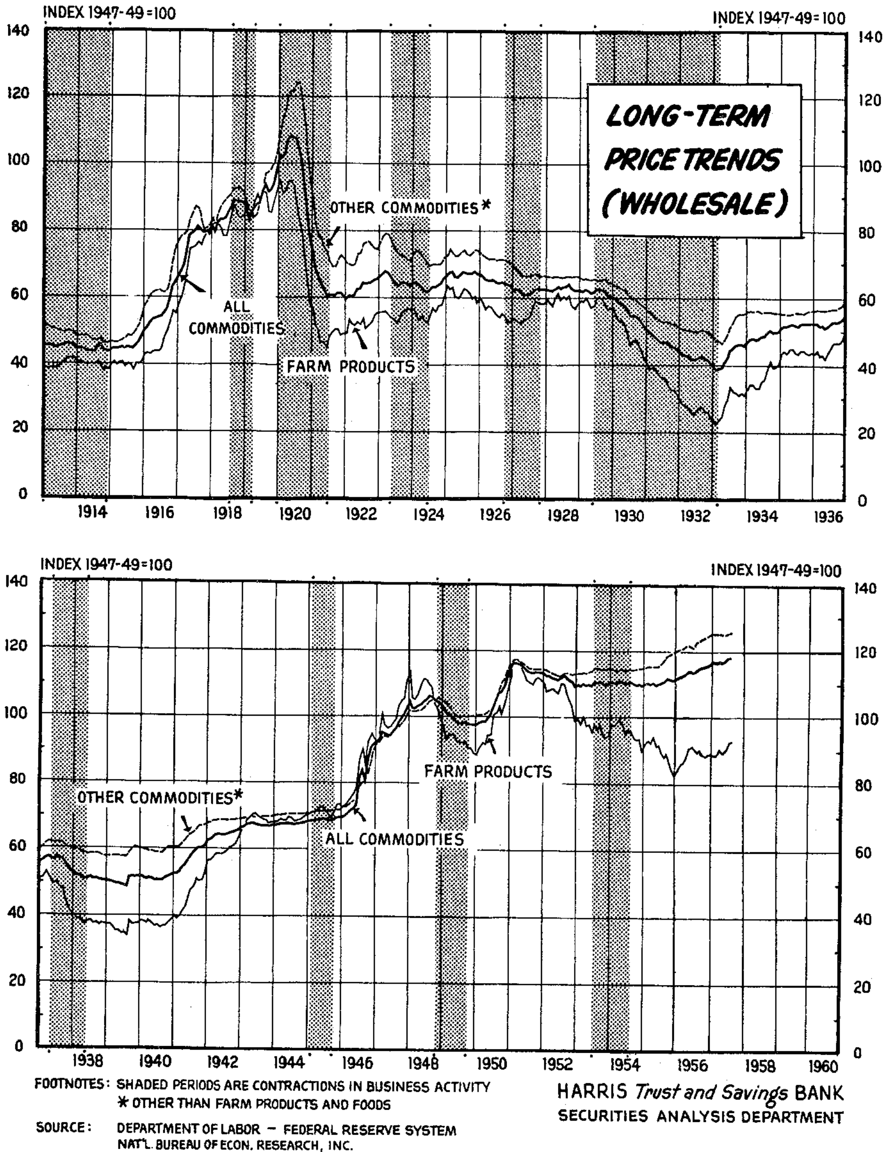

Figure 3

It is hoped that an understanding of some of the strengths and limitations of monetary-fiscal policies will contribute to widespread acceptance and support.

Periods of tight money, such as the present, inevitably create dissatisfaction on the part of those demanding funds. This is, of course, due to the fact that some potential borrowers are denied funds and, hence, the ability to purchase resources. Others must pay higher interest costs. Yet if all demands for money were satisfied so that everyone could spend as desired, total spending would increase sharply and inflation would become rampant.

The policy of easy money at a time of full employment and rising demands was tried during the war and in the early postwar period, with inevitable inflationary consequences. Contrary to the impatient outcries of a vocal minority, current policies are having the desired effect of curtailing the spending rise and, hence, inflationary pressures. So far critics have not succeeded in forcing a premature easing of policies before an investment-savings balance is attained.

As the economy approaches equilibrium, policy makers must be careful to avoid retaining a restrictive policy past the time when it serves a useful purpose. Given the present low liquidity, a severe drop in monetary growth could well initiate a downturn in the economy. The record since 1951 suggests there is good reason for believing the transition will be successful.