# Inflation in the world markets[1])

By Edwin H. Spengler.[2])

An appreciable measure of inflation has been witnessed during the past decade; few nations have escaped the effects of the spiral of rapidly rising costs and prices, and the concomitant reduction in the purchasing power of money. Economists and business men agree that this is the world's prime economic problem and that the threat of inflationary pressures will constitute a worldwide challenge for some time to come.

There is less agreement, however, concerning the exact nature of the present inflationary situation, and even less concurrence over the measures that should be adopted to cope with this problem. In part, this arises from the fact that conditions are not identical in every country. In underdeveloped areas, for example, inflation originates largely from the urge to industrialize too rapidly in relation to existing capital resources. Highly industrialized nations, on the other hand, are exposed to conditions of rising prices and costs because increases in productivity (output per man hour) have not kept pace with increases in wages. In the newly developing countries the inflationary patterns are largely of the so-called „classical" variety, involving excessive quantities of money in the hands of buyers and inadequate stocks of commodities that may be bought. This results in the situation of buyers bidding up prices of scarce goods and services. In the older more developed nations the problem becomes more complicated. For example, there may be few, if any, real shortages in basic supplies; in fact, there is often unused capacity in broad sectors of the economy, including manufacturing as well as the extractive industries. Furthermore, the

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money supply is often static or is expanding very slowly, and government expenditures are held well within the limits of current revenues. Yet, the price indexes continue to show a persistent rise.

The above circumstances which, in general, apply to Britain, France, and other major powers, quite accurately describe the experiences of the United States during the last two years. There was some excess capacity in almost every industry; the money supply expanded by less than two per cent. per annum, and the federal budget showed a surplus; but the cost-of-living index reached a new high level. To explain this seeming paradox we must go back to the war years of 1941–1945 when strict price control measures and rationing prevented a runaway inflation in the face of serious shortages in the consumer markets. In the years that followed, as curbs were removed and accumulated savings released, wages and prices rose abruptly. A further boost in prices occurred during the Korean War, partly because of the tendency to stockpile essential materials in anticipation of new shortages, and in part, because of actual scarcities of certain goods and the lack of effective war price controls. Meanwhile, post-war industrial expansion began in earnest, reaching a peak in 1955 when there was a boom in capital goods industries. Backlogs of unfilled orders increased and wholesale prices of basic raw materials and producers' goods continued to rise. These new price levels were later reflected in the consumer markets. Accompanying each increase in the cost of living, organized labor demanded, and received, another round of wage increases which, in turn, formed a cost basis for further price adjustments. This vicious spiral led to an increase in disposable income in the United States of about six per cent per year between mid-1955 and 1957, thus permitting retail prices to go still higher. The nation's total output in 1956 rose by about $ 10 billion, but approximately half of this increase was accounted for by rising prices rather than by larger output of goods and services.

It should be observed that price and wage policies are not entirely determined by the free competitive forces of the market. Big business has demonstrated its ability to push up and maintain prices at higher levels, even if this means that plants must operate at considerably less than full capacity. Similarly, strong labor unions have the power to force up wages faster than the productivity of labor would allow. These administrative rigidities in the economic system help to explain the „cost-push“ inflation that we have been witnessing.

Furthermore, although the money supply itself has been rising only very slowly, the „effective“ money supply (the volume of money out-

standing multiplied by its rate of activity) has increased. Its rate of activity in the United States has risen by no less than 13.6 per cent. In other words, the velocity of turnover of money and credit has expanded perceptibly in recent years. This is equivalent to a substantial increase in the money supply.

Ironically enough, the stimulating effects of an inflationary boom frequently mask the dangers that lie ahead for those who temporarily enjoy its false prosperity. History is replete with examples of inflationary booms and busts. The fact that our current experience is expressed in more subtle terms than the obvious example of an overissue of paper money should not blind us to the severity of this economic disease. As demand expands and output reaches substantially the full employment level, wage and price increases become general. Cost curves rise rapidly and labor unions, spurred on by the rising cost of living and mounting profits, press vigorously for wage adjustments. Bond investors, pensioners and other recipients of fixed income experience the painful effects of a reduced buying power. White collar workers and employees in less highly unionized skills discover that the salary adjustments they have received actually yield less in real income. Owners of small business ventures find that they have lost a considerable proportion of the value of their accumulated savings. The overpricing of stocks introduces a further risk of inflation. Should the stock market liquidate its long forward discount, the effect upon the consumers' propensity to spend may be great enough to bring about a serious recession in business.

In the light of the slump in business that began in the United States in 1957, it may appear somewhat incongruous to talk about the dangers of inflation. The immediate problem is to revive a sagging economy. Measures aimed at halting the economic decline include an easier money policy, greatly increased defense orders, and other forms of higher government spending, and the possibility of a tax cut. Meanwhile, there has been no general decline in prices despite major drops in production and the weakening of the price structure in certain segments of the economy. While it is necessary to take steps to prevent a paralyzing depression, accompanied by widespread unemployment, it is also important to recognize that these remedial measures are potentually inflationary. If not carefully applied and skillfully controlled they could generate another price spiral. This would prolong the upward trend in the United States which has been in evidence since World War II, involving an almost unbroken rise in consumer prices of 44 per cent from 1946 through 1957.

The problem of inflation varies in severity in different parts of the world. In Brazil, for example, the cost-of-living index has advanced at the average rate of 20 per cent during each year for the last five years; Indonesia has experienced a rise of 59 per cent in its living costs since 1953, Britain has had a 16 per cent increase in that time, while West Germany's cost-of-living index rose only 6 per cent during the same period. The devaluation of the French franc in the summer of 1957 was the end result of an internal price and wage inflation which had put the nation in an unfavorable competitive position in the world markets. Although partially successful, this action did not completely balance France's foreign payments, and other steps have since been taken to bring about improved earnings of dollars and other hard currencies, and reduce deficits within the European Payments Union.

Nations dependent upon foreign trade channels are particularly sensitive to the effects of inflation. This is because they can maintain their exports only if production costs are kept at levels that compare favorably with prices quoted by other competitors. If production costs should rise there is danger that foreign importers will seek other sources of supply. This does not necessarily indicate the need for low wages and reduced living standards. The United States is a perfect example of a high-wage economy that competes successfully in the world markets. What is essential is a high level of productivity which will insure low unit costs, despite the existence of a comparatively favorable wage scale. When, however, domestic labor demands higher wages and commodity prices are permitted to rise, without an accompanying increase in productivity per man-hour, exporters have difficulty in maintaining their markets abroad. Despite the external evidence of a booming prosperity on the homefront, such nations soon experience a cumulative trade deficit, a shrinkage of gold and reserves with which to pay for the excess of foreign purchases over sales, and a flight of capital abroad. In desperation, as a final extreme action, a country is sometimes obliged to devalue its currency so as to lower the prices of its products in terms of foreign currencies, and so stimulate an increase in export trade. Other emergency measures may include the raising of taxes and the imposition of new trade controls. If, however, the basic causes of inflationary distress are not removed another series of wage and price boosts will follow and the same cycle of events will be repeated.

What remedies are available to cope with these problems? The classical remedy is resort to a „tight money policy". Normally the aim of a tight money policy is to reduce demand on the theory that inflation

is caused by too much demand for the available supply of goods and services. This involves a system of requiring increased bank reserves against deposits, and of raising interest and discount rates to levels high enough to discourage some borrowing. Policies recently pursued by Britain, France, Denmark, and several other nations in an attempt to apply a brake to the upward movement of prices rest on the assumption that the creation of new money in large quantities is the basic cause of inflation. If any further rise in the price level is to be prevented, it is necessary to restrict the loanable funds of commercial banks. In short, the purpose is to reduce spending and increase savings. Some doubts have been expressed concerning the effectiveness of this remedy. If demand is strong enough, business will be tempted to borrow, even at higher costs, and big business will strive to raise prices still further in an effort to finance expansion out of earnings. Moreover, a greater velocity of turnover of money will reduce the efficiency of credit controls. Meanwhile the government is saddled with increased expense because of rising interest burdens on the public debt.

A second remedy requires the reduction of government expenditures for goods and services and the application of these savings toward debt retirement. This would reduce government bidding for goods in the market and therefore directly remove some of the pressure in the direction of higher prices. A still more rigorous fiscal procedure involves the simultaneous raising of taxes in order to drain off additional buying power, and so deflate prices still more.

The danger of employing government controls of this type is that, if they should really prove successful, their effects may extend too far and too deep – that is, they may become so deflationary that they generate a recession. The curtailment of credit could discourage certain types of investment that might actually increase productivity and decrease costs of production. Higher credit costs may also work to the disadvantage of the small firm and play directly into the hands of big business by lessening the competition that confronts the oligopolies. More significant is the fact that such remedies could easily result in some degree of unemployment, by weeding out certain marginal establishments and by cutting back production based upon new financing. The commitment of political leaders to a policy of full employment makes this an unwise political course to follow.

On the other hand, there are many economists who believe that overall business is still strong and that the above-mentioned measures are inadequate. The arbitrary posting of new high prices by business com-

binations, and the raising of wages by means of „escalator clauses“ and through continued labor union pressures, results in an inevitable „cost-push“ inflation that will not readily be curbed by monetary and fiscal controls. The maintenance of stable buying power of a nation's currency is inconsistent with the maintenance of over-full employment and annual wage increases in excess of productivity.

What is needed is some kind of stimulus to free enterprise and organized labor to become alive to their social responsibilities. Taking a leaf out of the book of Ludwig Erhard of West Germany, other nations, vexed by the weakening effects of inflation, should recognize that the secret of Germany's recovery has been the astonishing energy of its people and the record-breaking production they have achieved, without an accompanying price boom. As a result, real wages of workmen have mounted steadily while Germany's export market has expanded. This has been accomplished without any strict government controls, although the administration frequntly threatened that it might have to resort to the use of price controls and compulsory savings devices to keep the economy in line. Prime emphasis, however, was on the relaxation of controls, the cultivation of a free market, and the granting of tax concessions and subsidies to enterprises that cultivated new export markets or succeeded in reducing unit costs through production economies.

Perhaps, as Gardiner C. Means has suggested, arrangements can be made for a series of agreements between business and labor leaders to develop responsible rules of conduct and to „hold the line“ on prices and wages for a specified priod of time. Prices would become stabilized and wage adjustments would be allowed only where justified by increases in productivity or for the correction of major disparities. Only if such voluntary efforts should fail are some sterner measures of government control called for. We keenly appreciate the value of the free-enterprise system; it generates high levels of production and material well-being. However, if the virulence of inflationary pressure should continue unabated and the stability of the whole economy is endangered, some temporary form of wage and price controls would seem to be in order (no matter how repugnant this may be to a free economy) until the emergency is over, or until the annual increase in labor costs is offset by equal increases in labor productivity. The choice lies clearly between a realistic policy of flexibility in wages and prices, and more inflation. Which shall it be?