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Inflationary Changes

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INFLATIONARY CHANGES
by Allan H. Meltzer

Most economists looking ahead to 1970 expect the rate of inflation to slow as the effects of government's anti-inflation policies begin to show up in the prices of the goods and services each of us buys and sells. Inflation is defined as a sustained rise in some broad based index of prices, so the effects of the policies designed to slow the current inflation will not become apparent until the indexes show a slower rate of increase. In the less inflationary environment for 1970 that I and others envision, many prices will continue to rise but, on the average, the rise will be smaller than in 1969.

If all prices rose and fell together, one of the most important effects of inflation would not occur. One of the ways most of us are affected by inflation is that the prices of the goods and services we buy and sell do not change at the same time or by the same percentage. Some prices are more sensitive to market pressures, including inflationary pressures, and adjust upward and downward quickly; others adjust very slowly. Differences in the speed with which particular prices adjust to inflation help to explain why there are inflationary gains and losses and why some prices continue to rise long after the rate of inflation, measured by the price index, has slowed. Because some prices will rise more in 1970 than in 1969 while others fall and widespread misunderstanding is engendered by the differences, this year is a good time to consider why some prices will continue to rise at a high rate in 1970.
Leaders and Laggers

To concentrate on the reason for differences in the speed with which changes in the rate of inflation affect particular prices, we have to separate the price changes attributable to inflation from those that have little or nothing to do with inflation. Changes in tastes, the introduction of competing products, improvements in production techniques or quality of product, increases in sales taxes, and similar features of economic life affect the prices we pay for particular goods and services. Such changes may cause small movements in the indexes used to measure prices but do not produce the sustained rise characteristic of inflation.

To understand why some prices lead the inflationary increase while others lag behind, we can compare the way in which inflation affects the prices of two different types of goods or services. One type is characterized by the prices producers pay for raw materials such as copper, zinc or lead, the other by rents paid by residents of apartment houses. Raw materials prices generally adjust most rapidly to changes -- up or down -- in the rate of inflation. These prices are determined daily and even hourly by the actions of skilled traders who decide how much to buy or sell based on their judgment of present and future market conditions. Even the anticipation of increases or decreases in the sales volume of the products that use certain raw materials, such as might be caused by changes in the rate of inflation, is reflected quickly in the market prices of the raw materials that are bought and sold in well organized markets.
The rents paid by the tenants in an apartment house adjust to inflation more slowly. Many of the rentals are covered by leases that run for one, two or more years. Once a lease is signed, the rent on the apartment — the price the tenant pays to use the space — is fixed. Of course, the landlord may try to estimate the future rate of inflation, but unless he is very far sighted and the tenant is very agreeable, he is not likely to set a price that protects him against an unanticipated inflation. The landlord or property owner loses if he underestimates the future rate of inflation and gains if he is able to get his tenants to agree to pay rents that overestimate the inflation. As leases expire and are gradually renewed, rents reach levels that more accurately reflect the prevailing rate of inflation.

By comparing the speed of adjustment for prices set by long-term contract and prices determined in well-organized markets, we see why some prices lead the rate of inflation while others lag behind. Wages and salaries are the prices paid for the use of labor services. Many of the factors that slow the adjustment of rents and the prices of other goods and services that are set by contract apply to the prices of labor services.

Wages and Inflation

When the rate of inflation slows, the prices of goods and services that have been slowest to adjust upward continue to rise. As contracts are reopened, new agreements are made at prices that reflect the average rate of inflation of the past few years. Since many labor union contracts expire in 1970, we can expect labor unions to ask for above average increases when collective bargaining starts.
That the process I have described is generally misunderstood is clear from the fact that the attempt to raise wages in the late stages of inflation is often called "cost push inflation." The very phrase suggests that independent action by labor unions causes a renewed outburst of inflation that pushes up market prices. Instead of interpreting wage increases as a delayed adjustment by unions to the inflation that has been underway for some time, the "cost push" view regards them as the start of a new burst of inflation.

Inflation is not the only reason for wage and salary changes, and all wage and salary increases are not the result of inflation. In a growing economy, wages and salaries can increase without inflation because productivity -- output per man hour -- increases. When wage increases just match productivity gains, the economy produces more output and workers receive higher incomes while the labor cost of producing a unit of output remains unchanged. By looking at what happens to unit costs of production and comparing prices to the labor cost of producing a unit of output, we can glimpse how wages, prices and productivity changed during the past decade.

The chart shows the ratio of prices to unit labor costs of production from early 1959 to mid-1969. 1959 was the last year of the inflation of the 1950's. Prices had risen on the average more than unit costs of production from 1957 to 1959, but in the late stages of inflation this trend was reversed, and the line shown on the chart falls. During the next few years of non-inflationary growth, the three factors -- wages, prices and productivity -- changed at about the same rate. The line shown in the chart remained within a narrow range.
The much faster rate of inflation that started in 1964 and has continued with only a slight pause up to the present is shown by two very different movements on the chart. At the start of the inflation, prices rose much more than unit labor costs of production. Spending increases, financed by inflationary government policies, pushed prices up. Unionized workers and salaried employees on long-term contracts found that the cost of the goods and services they buy rose much more than they anticipated when they agreed to their wage and salary contracts. As the time for contract renewals approached, they took steps to protect themselves against inflation and to recover their lost purchasing power.

The first stage of the current inflation ended early in 1966 when the line shown on the chart reaches a peak. After mid-1966 wage increases outran both productivity gains and price increases. Unit labor costs of production rose faster than productivity and prices, as workers tried to recapture their losses. Prices continued to rise for the next few years, but did not rise as much as wages. Despite productivity increases, unit labor costs of production rose bringing the ratio shown in the chart back to the 1957-1959 average.

Past experience suggests that as inflation slows, unit labor costs will rise for a time at a faster rate than prices. It is a mistake to interpret the resulting wage increases as the start of a renewed inflation, as is often suggested by the name "cost push." Wage increases, just as much as the price movements that generally precede and accompany them, are mainly a delayed effect of a common cause -- the inflationary government policies of the past few years.
Ratio of Prices to Unit Labor Costs in Manufacturing, 1959-1969
Base 100, 1957-59

Sources: Department of Commerce, Department of Labor, and Board of Governors, Federal Reserve System