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Renewing Growth and Slowing Inflation

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by Allan H. Meltzer

For the past two years I have used this space to discuss inflation, one of our continuing long-term social and economic problems. Two years ago I tried to distinguish between the effects of inflation and the real gains that investors receive in a growing economy. Last year, I discussed the timing of inflationary gains and losses and pointed out that large wage increases for unionized workers usually come near the end of a period of rising inflation. Now that workers and management are signing contracts calling for relatively large wage increases, it is useful to stress again that the wage increases are not the start of a new round of inflation but one of the late stages of the inflation that started in 1965.

Because inflation and attempts to control inflation have had such a dominant effect on stock and bond prices during the last few years, many investors now ask how these large swings in bond and stock prices can be avoided. There are a great many myths about inflation, just as there are about most other social processes. Speculators, workers, businessmen, housewives, farmers, middle-men, grocers, wholesalers, at one time or another practically everyone of these groups gets blamed for inflation. In his televised address to the nation on inflation last year, President Nixon made one of the most candid statements about the causes of inflation ever made by a leading government official. He didn't blame any of the groups I just named. Instead, he placed the blame exactly where it belongs, on expansionist government policies.
How It Started

The current inflation started in 1964-65, when the government maintained expansive policies at too high a level for too long a time. These policies continued in 1965 and beyond, despite the clear signs that inflation had started. The policies became even more expansionist early in 1966. Then, after a brief pause, marked by a sudden sharp contraction during the winter of 1967, the government resumed its inflationary policies in 1967 and continued them in 1968. Some of those who were responsible for the policies of that period were so confident of their ability to control inflation by increasing taxes that they were willing to continue inflationary policies until 1969. By that time, we had spent more than four years building up the notion that inflation was going to continue and become a way of life.

Now, two years after the start of an anti-inflationary program, we are beginning to see a slower rate of price increase that signifies the start of a period of slower inflation. If the government maintains its commitment to reduce inflation, we can expect the rate of inflation to drop gradually during 1971.

You have probably asked yourself, "Why did those responsible for the government's economic policies in the late 1960's allow the inflation to build up for four or five years without taking effective and consistent action to prevent it?" There is, of course, no single answer to that question. But, we can gain some understanding of their reasons by looking at the kinds of policies they advocated then and the kinds of policies they pursued.
The policies came to be known as "fine tuning." The essence of fine tuning was, and is, that the responsible officials can make frequent, rapid adjustments to offset the undesirable consequences of past policies or private decisions. When the problem is rising unemployment the government provides a highly expansive policy—a combination of deficits, tax cuts and monetary expansion to eliminate the unemployment. Knowing that one likely side effect of a more expansive policy is a later inflation, the proponents reason, "when that problem occurs, we will shift to a slightly less expansive policy." When inflation increased, they tried to combine tax increases and interest rate increases to maintain employment and slow inflation. Furthermore, they believed that they could reduce inflation by talking to businessmen and union leaders, by twisting arms, by threatening various groups and cajoling others, by bringing public attention to bear on the people who raise prices or wages.

One of the main effects of the policy of fine tuning, of the threats, of the cajoling and all the rest, was to increase, for a time, the uncertainty about the outcome of inflationary policies that the government pursued. The end result, as we now know, was failure not only in the U.S., but in other countries that have tried to stop inflation by exhortation, guideposts, guidelines, or incomes policies. The policies not only did not work, there is little evidence that they had any important effect. The rate of inflation was not noticeably different from the rate that would have prevailed had the government not pursued any of these policies.
I do not want to dwell on the errors of the past few years or the details of policy. The government has taken steps in the past two years to restore stability to the economy by reducing inflation. Effective policies to slow the rate of inflation are now working their way through the system. With persistence by those responsible for carrying out these policies, the rate of inflation will decline gradually in 1971 and beyond. Equally important, if we persistently continue to avoid expansive policies, we will also avoid a new outburst of inflation in the next few months.

Why It Started

Most inflations in the United States have occurred during and after wars. This is not an accident. The government runs large deficits to pay for the war, sells bonds to finance the deficit and in the mistaken belief that it can prevent interest rates from rising, prints money to buy up the bonds. One government agency responsible for controlling the amount of money we have available to spend, the Federal Reserve, buys up the government bonds issued by the U. S. Treasury to pay for the government's purchases. When we clear away the complexity of this transaction, we find that the government has financed its budget deficit by putting money into circulation. The expanding amount of money starts the inflationary process.

Wartime inflation is the standard type of inflation in this country. Most of the inflations that we have had have occurred during wartime because the government has financed its budget deficit in the way I just described. It is precisely because the budget deficits are clear and obvious indications of imbalance in the government's operations, and the monetary operations occur through a complex series of transactions, that laymen and businessmen generally believe that it is the government's budget deficit that causes inflation.
There is a grain of truth to this position. The use of resources for war and government budget deficits is, in principle, inflationary. But wartime deficits have not been the main cause of inflation, either in the United States or in most of the other countries that we have examined. The main cause of inflation is the Federal Reserve's actions that increase the amount of money in circulation.

Latin American experience shows that governments do not require wars to produce inflation. A few years ago Brazil maintained rates of inflation of 20 to 30% per month. The famous German inflation of the 1920's had nothing to do with wartime expenditures. The country was disarmed in the aftermath of World War I, and rearmament had not yet started. Likewise, our current inflation is not wholly or even mostly a direct consequence of expenditures for the Vietnam War. Other parts of the government budget, expenditures at home for social programs, have been rising more rapidly.

There are many examples of peacetime inflation in other countries that help to establish that wartime expenditures are not a pre-requisite for inflation. Other examples show that we can get inflation if the amount of money in circulation expands even if the government's budget remains close to balance. There is, however, no example on record of serious inflation that has not been preceded or accompanied by a sizeable increase in the growth rate of the amount of money in circulation, nor are there examples of inflations brought to an end without a slowing in the rate of monetary expansion.
What Are the Consequences for the Mutual Fund Investor?

The economy is in the process of slowly completing the adjustment to the less inflationary policies of the past two years. The euphoria that dominated the securities markets in 1967 and 1968 is for the time being far behind us. The doubts and uncertainties and fears that dominated the market in late 1969 and much of 1970 are beginning to recede into the background also. Ahead we see that, if the government continues to pursue less inflationary policies, the economy will slowly begin to move forward and get back on its old growth track.

What are the consequences for the coming years? For the Mutual Fund investor who bought and held his shares in a well-managed fund, the long-run consequences are not severe. The economy will gradually return to its growth track, and the stock market will resume its long-term historic upward movement reflecting the underlying productivity of investment in American corporations. Dividends, profits, share prices of well-managed companies will resume their upward movement. Memories of the enormous swings in the financial markets during 1969 and 1970 will fade, gradually, as new events, unforeseen and often unforeseeable, compete for attention in the newspapers, in the financial pages, and in the background.

The speculator, the amateur who enthusiastically extrapolated the trends of 1967 and 1968 into 1969 or 1970 has had a more difficult time. If there is a lesson in that experience, it is the same lesson that we have had so many times in the past.