Ending Inflation: The Next Steps

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The rate of increase of consumer prices in the United States has fallen, gradually, from nearly 14% in mid-1974 to an average rate of about 6% for the past six months. Some further reduction in the average rate of inflation is likely to occur in 1976.

Experience in the rest of the world covers a wide range. Some countries substantially reduced the rate of price increase; in others the rate of increase remained high. During the year 1975, consumer prices rose by more than 20% in Britain, by approximately 10% in France, Italy and Canada, and by 5% or less in Germany and Switzerland.

Why are the rates of price increase in these countries so different? Why is inflation no longer proceeding at high or rising rates everywhere? Why have some countries succeeded in reducing inflation where others have failed?

The answer to these questions is surprisingly simple. Government policies toward inflation have differed. Some countries recognized inflation as mainly a monetary phenomenon, the result of too much money in circulation, and took effective action to control inflation. The countries that now have the lowest rates of inflation -- Switzerland, Germany and the United States -- are the same countries that changed their approach to monetary control. Each of the countries has, in its own way, chosen a
target rate of increase in money. Each has managed to keep the growth rate of money close to the announced target.

Where the rate of growth of money has been reduced, the rate of inflation has been reduced. Where monetary growth has been kept at a high rate, the rate of inflation has remained high or has increased.

Britain is an outstanding example. During the past year most countries experienced less inflation, but Britain experienced more. British consumer prices rose by 16% in 1974 and by more than 20% in 1975. Even Italy, with its severe political, social and economic problems, was able to slow inflation, to reduce the rate of increase in consumer prices from 1974 to 1975. But Britain did not.

Economists differ about why inflation starts and about how inflation can be reduced and ended. For decades influential British economists argued that it was unnecessary to control the rate of monetary expansion. Some argued that the way to end inflation was to stimulate the economy by government policies that create jobs and output. By increasing output they hoped to lower prices or the rate of inflation. Contrary to experience everywhere they sought to end inflation by stimulating the economy.

The result was predictable, and both the predictions and the results are part of British history. Inflation increased. An economically weak Britain became weaker.

Programs similar to those that failed in Britain are advocated and at times adopted here. We followed the British into stop and go policies -- policies to stimulate the economy today and take care of the inflation tomorrow. We achieved more inflation and currently have more unemployment.
We followed the British and other Europeans in attempting to control inflation by using government intervention in wage and price disputes. Inflation did not stop, it increased.

The policies of the past year and the results they achieved are a means of discriminating between the differing opinions about the causes of inflation and the means of ending inflation. Some prominent economists urged rates of monetary expansion in 1975 as high as 16%, and a rate of monetary growth of 10% in 1976. They argued that with unemployment high strong stimulus would reduce unemployment and reduce inflation.

If we had adopted very expansive policies we, like the British, would have experienced rising inflation in 1975 and 1976. Instead of a falling rate of inflation, we would now have a rising rate of inflation.

The marked difference in countries' experience with inflation during 1975 and 1976 is not a unique event. Recent experience is only a repeat of the experience of the late forties with a change in the roles chosen by the governments of particular countries. Then, and now the countries that promptly reduced the rate of monetary growth ended inflation promptly. Countries that experimented with controls on prices and wages, with restrictions on credit or that engaged in fine tuning of taxes and government spending continued to experience inflation.

No sustained inflation has ever been ended until the growth rate of money has been reduced. Inflations at the end of World War II, after the Korean War, and in other times and places were ended by controlling money. The experiences of the past two years is in this respect consistent with the past.
Policies for the Future

What of the future? Barring some new shock like the oil price increase, a crop failure, or a war we can expect the economy to approach full employment in about two years if government policies are less erratic in the future than in the past. We cannot expect, however, to reach full employment without inflation. In this respect, as in so many others, government promises and performance differ.

Ending inflation means bringing the average rate of price change, properly measured, to zero. We are fighting inflation. Inflation has been reduced, but we will not end inflation unless we change some government policies and continue others.

I believe we can end inflation in the next few years. To do so, we must adhere to four principles of economic policy.

First, we must continue the present international monetary arrangement known as the fluctuating exchange rate system. Under the fluctuating rate system, we rely on the market and not on governments to determine the current exchange value of our currency. The exchange value of the dollar fluctuates, rising with increases in the demand for dollars and falling when we speed up the printing press and increase the supply of dollars. The fluctuating exchange rate protects us against inflationary (or deflationary) economic policies abroad. If foreign governments adopt policies more inflationary than ours, and many foreign governments have, the fluctuating dollar helps us to avoid inflation. We are freer to pursue stable prices.
Second, we must reduce the growth rate of government. A high growth rate of government transfers spending from private to public hands, and reduces efficiency. Growth of public employment transfers skilled labor from more productive to less productive activities and slows the growth of the economy. Government regulation absorbs skilled personnel in countless wrangles with the bureaucracy, increases uncertainty and deters investment. But, the principal effect of a growing public sector on inflation is not from the loss of efficiency and growth. A rising government budget creates strong pressure to finance the government by printing money. Our current inflation began when we tried to finance war and social programs in the middle sixties without raising taxes. Despite a four hundred percent increase in the federal budget, in little more than a decade, costs of social programs continue to increase and the problem of financing the budget without increasing taxes remains a force for inflation.

Third, we must continue to reduce the growth rate of money gradually. Between 1973 and 1976, the rate of monetary growth has been lowered from 9% to about 5%. This reduction is the most important force working to reduce present and future inflation. During the next two or three years, the rate of monetary expansion must be brought, gradually, to about three per cent. Once we fully adjust to the lower rate of growth in money, the economy will be at full employment without inflation.

Fourth, we must avoid price and wage controls and government interference in price and wage decisions.