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Ending the Worldwide Inflation

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Ending the Worldwide Inflation
by Allan H. Meltzer

Reading the program of this conference, I was struck by two facts. We have represented here monetarist, fiscalist, international, European, and Phillips'-curve views, plus some other views, and even overviews. I am grateful to have been spared the oil-energy view, the beef shortage view and other examples that I lump together as the worm's-eye view, or perhaps views, of inflation. The first fact to note is that neither economic theory nor evidence sustain anything like the number of separate and independent views of inflation represented on the program.

More than two hundred years ago economists had learned that prices rise whenever the quantity of nominal money increases relative to real output if money is maintained at the new level. This proposition was tested at the beginning of the 18th century, during the last ten years and on many occasions in between. There is not exact correspondence between the growth of money and the rate of inflation in the 18th century, at present, or in most inflations, that have been studied, so there is room for supplementary explanations. I find the integration of the dominant monetary explanation of inflation with other explanations more appealing than an attempt to pose the issue as a conflict of "views." To me, the notion that there are five or six "views" of the causes of inflation smacks of the politician, or the economist turned politician, who finds a new explanation of inflation each time he changes anti-inflation policy -- about every six months in recent years.

Second, and far more disturbing, is the absence of any paper or discussion on how to end inflation or even on whether to end inflation. We are in the
midst of one of the longest, most widespread, peacetime inflations in history. Do we have nothing to say, or do we wish to say nothing?

I regard my differences with Gottfried Haberler's overview as rather trivial when compared to the problem of ending inflation. Instead of discussing our differences, I plan to use my time to discuss a program to bring inflation to an end.

As I see the problem, the main difficulty is to find a way of reducing the social cost of ending inflation. Previous attempts to end the current inflation, in 1966-67 and in 1969-70, failed because the perceived social costs were higher than those in positions of power were willing to pay. I take this as a fact -- a political and institutional datum that is not going to change soon.

A Program to End Inflation

Past efforts to end the current U.S. inflation failed, I believe, because the rise in interest rates and in unemployment rates induced by a sudden, sharp, unanticipated deceleration of money created pressures on the policymakers that they would not or did not withstand. Looking back to 1966-67, it is hard to believe that so much consternation could be caused by a 5% rate on government bonds, a 6% rate on corporate bonds and an unemployment rate of 3.8%. Yet, these data were the basis for raising the growth rate of money -- currency and demand deposits -- from zero to 7% in one quarter and maintaining a 7% growth rate of money during most of 1967. Since we start with higher interest rates and unemployment rates, and only slightly higher ceiling rates on time and savings deposits, we must not expect
that a policy of ending the current inflation by a sizeable reduction in the
growth rate of money to be adopted, or if adopted to be maintained. A Federal
Reserve capable of producing a 7-1/2% growth rate of money in election year
1968 and an 8-1/2% growth rate of money in election year 1972 is not likely
to opt for zero growth in money in election year 1974. And, I do not
advocate so restrictive a policy.

The policy I propose for discussion is a gradual policy. The main bases
of the policy are two observations based on economic theory and empirical
evidence.

The first observation has been replicated by many economists using a
variety of methods and different bodies of data. A number of studies confirm
the finding that the short-term effect of money on the real output of goods
and services is larger than the long-term effect and larger than the effect
of changes in government spending on taxes that are unaccompanied by
monetary change.

The second observation is less familiar. In recent work, we have
found that changes in the distribution of output between the private and
the public sector have lasting effects on the price level. Prices rise
if the government increases the share of real output or of the labor force
absorbed by government. The rise in prices forces a reduction in private
spending for privately produced goods and services. If the increased share
of real output absorbed by government is financed by issuing bonds to the
public, market interest rates rise. 2/
Our analysis implies that a reduction in the share of government in real expenditure reduces the price level and real output. The reduction of output and prices is a consequence of the release of resources to other productive occupations. The reduction in real output is temporary and, in our analysis, the response of output to a one percent change in government expenditure is considerably smaller than the short-run response of output to a change in money. Many estimates of the short-term effect of changes in government spending on real expenditure support this result. The independent effect of fiscal policy on output has frequently been found to be small, positive, but not zero.

I have made some tentative, preliminary estimates of the effect on the rate of inflation of changes in the relative size of government during the past 100 years. The estimates are based on the compound annual rates of change in prices, money and the relative size of government during non-overlapping five year periods. Increases in the relative size of government appear to have an important and reliable effect on the rate of inflation. Reductions in the share of output absorbed by government can be expected to reduce the rate of inflation.

A policy of gradualism can make use of these findings to reduce the rate of inflation while minimizing the loss of real output and employment during the transition to a lower rate of inflation and to price stability. The policy I propose has four parts. One, government expenditure and government employment should be reduced to achieve an $8 to $10 billion surplus in the current unified budget. Two, the surplus should be used to retire debt held
by the private sector. Three, the rate of monetary expansion should be reduced, gradually but steadily, from the 6% range of the past year to the non-inflationary or less inflationary range of 3 to 4% during the next two to three years. Four, the floating exchange rate system should be maintained without intervention by the Federal Reserve.

By gradually reducing the growth rate of money, we reduce the short-term effect on employment and eliminate the temporary over-response of output and employment to sudden, sharp deceleration of the money stock. Reducing the growth rate of money gradually, while at the same time reducing the stock of debt held by the public not only limits the rise in market interest rates, but gradually reduces interest rates from current levels.

The proposed policy relies on the finding that the first effect of reducing the growth rate of money is not on prices but on output and employment. I rely also on the evidence showing that changes in government expenditure have much smaller effects on output than conventionally assumed.

The fourth part of my proposal recognizes that inflation is a worldwide phenomenon. Countries that wish to reduce inflation at a rate compatible with the proposed policy can tie their currency to ours and maintain fixed exchange rates. Countries that wish to pursue independent monetary and fiscal policies cannot expect to maintain fixed exchange rates, and we should not encourage or help them to do so.

It perhaps goes without saying that I believe the social costs of ending inflation can be made less than the costs of continuing inflation. In part, this judgment reflects a belief that the proposal I advance for discussion reduces the cost of ending inflation. But, it depends, also, on the judgment
that the social costs of continuing inflation are much larger than many economists are willing to recognize. Scientists and social scientists often treat institutions as inconsequential and institutional change as costless, and there is often great benefit from doing so. But policies that require an end to fixed price contracts and the establishment of a floating standard of value and of accounting, impose costs of adjustment that are, I believe, too large to be neglected. The implications of our certainty model with zero cost of information are often useful guides to policy, but I expect this is not true for the case of inflation.

Experience with inflation during the past 8 to 10 years does not suggest that we can choose between price stability and steady, fully anticipated inflation. The costs of fully anticipated inflation may be as low as the certainty models imply. That is of no avail if adjustment to fully anticipated inflation is not a relevant option. Inflation everywhere brings controls on capital, on prices, on wages, and on interest rates. Our choices, worldwide, appear to be between inflation with controls, malallocation of resources, and loss of freedom on one side and the costs of restoring price stability on the other. In such a choice, ending inflation may well be the best option for society.
1/ From 1797 to 1815, the securities portfolio of the Bank of England increased threefold and in the next seven years declined as much as it had risen in the previous fifteen. At the end of the period, as at the beginning, the Bank of England's portfolio was approximately £15 million. Price indexes constructed for the period show that the price level (1790 = 100) rose to 198 in 1814 then fell to 114 in 1822 and 93 in 1830. The measured U.S. rate of inflation has been above 3% each year since 1966. Prices have increased between 30% and 40% since 1966, depending on the measure used, and the money stock -- currency and demand deposits -- increased by 50%.