Book Review: Curing Chronic Inflation and Microeconomic Effects of Monetary Policy

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After more than a decade of relatively high inflation, economists remain uncertain and divided about the social cost of non-indexed inflation, the costs of lowering inflation and the benefits of price stability. Both of the books under review take as unchallengeable truth that any monetary and fiscal program to lower inflation involves very high costs in unemployment and lost output. Both consider, and at places advocate, new types of government policies to manage or influence the economy. Both ignore or dismiss all of the work on rational expectations bearing on the costs ending inflation.

These general similarities aside, the books are very different. *Curing Chronic Inflation* is the report of a conference on new policies to control inflation held at Brookings in April 1978. Most of the discussion is about tax-based incomes policies, so-called TIP plans. Professor Miller favors indicative planning of the French type, rather than the less formal Japanese type, to achieve a 2 to 3 per cent unemployment rate, reduced inflation, and improvement in distributional equity. (Professor Miller is unwilling to tell us what is an "improvement" or even what is "distributional equity.") He does tell us that (1) monetary restraint causes inflation and also causes unemployment; (2) that (p. 160) since 1969, the U.S. has not experienced demand pull inflation except possibly during part of 1973, and that (3) there is (p. 5) "Obvious starvation of the needs of the public sector in the United States."

The last two chapters of Miller's book, by Alasdair Lonie, dispense with Miller's polemics against economics, economists and something called
"free market ideology." Lonie describes some of the events accompanying high interest rates, inflation and "stop-go" anti-inflation policies in the U.K.'s business and housing sectors. Lonie's standard is monetary stability of either the Friedman (money growth) or Keynesian (interest rate) variety. The U.K. fails on either standard; Lonie then tries to show that public policy caused "imbalances" and "illiquidity."

It is a pity that we do not have Professor Lonie's comment on alternative policies. While I read Curing Chronic Inflation, the newspapers reported daily on the strikes in Britain as the government tried to hold a five per cent wage guideline against the workers' demands for wage increases of twenty per cent or more. Would a tax on firms or a payment to workers prevent the strikes, or settle them? It seems unlikely, not only in my opinion but in the revealed opinion of Prime Minister Callaghan. The Prime Minister has resorted -- can we believe it -- to the most classical of all anti-inflation policies, a rise in Bank rate, to signal that his government does not intend to let the growth of the money stock be determined in the labor market.

The Brookings Conference did not produce many new ideas. Robert Crandall's paper is the only paper that is not about TIP. Crandall discusses the effect of government regulations and restrictions on efficiency and the price level and attempts to measure some of the costs imposed by current restrictions and standards. The paper is an interesting attempt to quantify some of these effects but, as the author is usually careful to point out, eliminating the restrictions or standards lowers the price level once-and-for-all.
There is no lasting effect on inflation -- defined as the maintained rate of price change. Crandall also analyzes various tax adjustments, such as the substitution of income taxes for the state sales tax, the replacement of the 1978 minimum wage with employment incentives and the substitution of general revenue financing for recent increases in the social security tax. His discussion is marred by the failure to take account of the effects of income taxes on labor supply and the more general failure to consider the incidence of the taxes removed and the taxes imposed.

Crandall avoids the vulgar error of recommending deregulation or efficiency gains to reduce inflation. However, he lists (Table 12) the rates of price change that could be avoided if certain regulations are removed. Suppose that his estimates are correct, that all his proposals are adopted and have their full effect on the price level promptly. The annual rate of price change would fall to about zero. What happens to employment and the maintained rate of price change?

The rational expectation answer is that if market participants believed that monetary policy had changed -- or had not changed -- the rate of inflation would reflect that information. Relative prices would be affected by deregulation and to the extent that the excess burden of regulation falls on employment, equilibrium (or natural) employment would change. But the maintained rate of price change would be dominated by the actual and anticipated rates of change of monetary and fiscal variables. And, if there is uncertainty about the durability of the government's commitment to non-inflationary policies, the rates of price and wage change would not adjust
fully to the reduced rates of monetary and fiscal expansion. Unemployment would remain above the new "natural" rate until participants in labor, output, securities and money markets decide whether the change in monetary and fiscal policy is permanent or transitory.

The idea that inflation is mainly a "cost-push" or "wage-wage" process is inconsistent with much of the current research in macro-economics. The cost push view is so well accepted by many of the participants at the Conference, however, that it is not discussed thoroughly. One consequence is that there is no analysis of steps to reduce the cost of slowing inflation by adopting policies that affect demand.

A policy of announcing paths for monetary and fiscal variables, and policies to increase the credibility of the announced paths, would more fully reflect current research in macro-economics. A policy of this kind has not been tried, to my knowledge, so it is "new" and, therefore, within the scope of the conference. It is unfortunate that the organizers did not consider any institutional or procedural changes to reduce the costs of achieving and maintaining stable, non-inflationary rates of change in the stocks of financial assets. Neglect of supplements or alternatives to TIP is surprising in view of Arthur Okun's belief that "recession will slow inflation but only at the absurd cost in production of $200 billion per point." (p. 284)

The source of this extraordinary estimate -- nearly 2 trillion (nominal) dollars of lost output to restore price stability -- is George Perry's latest estimate of the trade-off between unemployment and the rate of wage change. In view of the subject matter of the conference, one expects taxes, tax rates
or after-tax wages to enter the equation, but they do not. Unemployment compensation does not affect the trade-off. Perhaps these omissions and the neglect of anticipations explain why Perry's predictions of the rate of wage change are generally too low.¹

Perry offers no test of TIP and no evidence that TIP works. He conjectures that TIP shifts the Phillips curve by lowering the rate of wage change. This, in turn, reduces the rate of price change, and a lower rate of price and/or wage change lowers the demand for wage increases without causing unemployment. There is no mention of the possibility that a temporary tax on wages can induce workers to alter the distribution of time between labor and leisure or that firms facing lower after-tax profits would reallocate production. Nowhere in the volume is there consideration of intertemporal reallocation of production in response to workers and employer anticipations of the real returns in different periods. The nearest Perry comes to a discussion of anticipations is a non-informative comparison of union contracts to see whether anticipations are "forward looking" or "backward looking." Two striking features of the comparison are the absence of attempts (1) to separate one-time shocks to the price level from changes in the maintained rate of change and (2) to formulate a hypothesis about anticipations. Perry dismisses the omission succinctly: "If inflation responds weakly to actual unemployment, why should expected inflation respond so strongly to expected unemployment?" (p.51)

The aggregate Phillips curve says nothing about the effect of TIP applied to a few large firms. For the years 1959-76, Perry estimates Phillips curves

¹ Only 9 of the 72 reported errors for various equations in Table 6 are overestimates and 6 of the 9 overestimates are in 1976, a year in which there is substantial reduction in the rate of wage change. In his comment on Perry's paper Martin Neil Baily points out that his version of Perry's preferred equation makes a cumulative error of 16% for 1971-77.
for about two dozen industries. There is very little evidence of a reliable relation. The standard errors of estimate are often 40% of the average rate of wage change.

The estimated trade-off from the old fashioned Phillips curve is the only basis for the estimate that it takes $2 trillion of nominal output loss, and more than twenty years, to bring inflation from 10% to zero. Perry never mentions experience in Germany, Switzerland and Japan, where inflation was brought to relatively low levels in three to four years without recession or the experience in Britain and Italy where inflation was brought from 25% to about 10% in two to three years. In 1975 and 1976, inflation in the United States was reduced to about 5% while output rose. Perry's wage-wage inflation equation has relatively large errors in both years.

Neither Perry, nor the other authors, ask whether the loss in output is permanent or temporary. There is no discussion of the different effects of penalty and reward TIP plans on the government budget and, thus, on anticipations of monetary and fiscal policy. Apparently, the changes from fixed to fluctuating exchange rates had no effect worth mentioning on the processes generating anticipated or actual rates of price change. Previous Brookings conferences have discussed, at length, the effect of import prices on domestic prices during the sample period used to estimate the trade-off, but this volume ignores the topic.

Lawrence Seidman argues that TIP succeeds only if it is accompanied by reductions in monetary and fiscal stimulus. This view is repeated by others. One should expect, therefore, to find an estimate of the marginal contribution TIP can make as part of a comprehensive program. No estimate of this kind is attempted. The closest we come is a hypothetical example, constructed by Seidman, which concludes that the parameters "are not known
and at best can only be imperfectly estimated." Seidman is optimistic, however. His simulation shows that inflation is reduced from 6% to 1% in 4 years while the unemployment rate is reduced from 6.0 to 4.6%.

Seidman favors a permanent TIP. In his hypothetical example, the "natural" rate of unemployment eventually falls to 4%. His calculation assumes that velocity is a constant unaffected by the anticipated or actual rate of inflation and that the ratio of prices to unit labor costs is constant also. Later in the volume, Rees presents data denying constancy of the mark-up.

By using the quantity equation as a spending relation, we can find the implications of Seidman's simulation for spending. Seidman's assumption of constant velocity implies that the rate of growth of real income (and expenditure) rises above the "normal" long-term rate when money growth falls and remains above normal growth during the seven year adjustment of money and money wages to a non-inflationary path. There is no recession. It is, of course, sub-optimal to let the economy reach equilibrium. Accelerated deflation would be better, since on Seidman's assumptions, income and spending would grow faster than normal.

Seidman's empirical wage equation differs substantially from Perry's. Seidman makes the rate of wage change depend on the lagged rate of change, on the deviation from trend of profit per unit of equity, and he tries several measures of the unemployment rate. The unemployment rate has relatively low statistical significance and not much effect. The profit measure implies that an effective way to lower the rate of wage change is to increase equity or reduce reported profits. Taxes do not affect wages except by changing after-tax profits. In view of the focus of the conference, one might have expected some comparison of the effects of unemployment and
anticipated inflation on the rates of change of disposable and earned income (wages) or some attempt to distinguish between the effects of temporary and permanent tax cuts on the rate of change of wages.

Seidman recognizes that if workers accept a tax cut in exchange for a reduction in their wage rate, they lower the base on which future wage increases are built. If the tax cut just compensates for the reduction in wages, TIP causes a permanent loss in wage level. To avoid the loss the reduction in taxes must be permanent or, if temporary, it must be large enough to compensate for the lower wage base in later years.

Seidman's paper contains useful information about the differences between penalty and reward TIPs. His attempts to combine micro and macro analyses are in the right direction, although the conclusions he reaches are flawed by the failure to adjust for responses to a permanent TIP. These include the effect of taxes on investment and productivity growth, on the government budget and on incentives to work or remain idle.

Larry Dildine and Emil Sunley present a thorough and informative discussion of many of the administrative difficulties that can be anticipated under the various TIP plans that have been proposed. Dildine and Sunley believe that the problems are less severe if TIP is applied only to wage payments made by large firms. In their judgment, any TIP for prices involves administrative costs much larger than anticipated benefits.

Joseph Pechman suggested that Dildine and Sunley's excellent summary understates the costs of administration. Like many others at the conference, he offered the opinion that a TIP for wages, but not prices, is impractical. Pechman (and others) noted that the costs of TIP include uncertainty about the rules and the resources used in litigation to resolve disputes. Several
of the participants used the high costs of administering an excess profits tax to indicate the costs that would be incurred.

Albert Rees's paper is mainly concerned with the reasons unions and firms oppose TIPs. From his experience with labor unions and cost-of-living councils, he draws some conclusions about what "unions" like and dislike and adds new items to the list of administrative problems. He, too, accepts the wage-push theory but rejects the constant mark-up. This makes the theory incomplete or empty.

Rees believes that guidelines and TIP programs are inferior to controls as a means of restraining wages and prices. One reason, according to Rees, is that controls are more effective than guidelines in preventing strikes. He cites the experience with controls in 1972 and 1973 but makes no mention of the real wage anticipations of employers and employees or differences between these anticipations and the real wages implied by guideposts or controls. Rees's judgment is not entirely consistent with data on strikes. Even under the conditions of World War II, workers went on strike to achieve larger wage increases than wage controls permitted. Seven percent of the workers were involved in strikes in 1943 and 1944. This is a much larger percentage than in most years of the 1950's. The fact that the strikes did not last long is not very informative given the size of the real wage increases workers received. Contrary to Rees, limited experience with controls and guidelines in the U.K. and the U.S. suggests that workers are willing to strike if they anticipate sufficient gain.

A symposium featuring Gardner Ackley, Alan S. Greenspan and Franco Modigliani, with comments by Okun and Henry Wallich, repeats many of the points made earlier. Ackley favors selective incomes policies but finds TIP too cumbersome. He believes that Congress, not the President, should
set price and wage standards applicable to a few firms. Greenspan opposes TIP because of its costs and because he believes that the likely failure will lead to controls administered by the bureaucracy created to enforce TIP. Modigliani remarks that TIP is less appealing than he believed, but he offers his own plan for a TIP limited to 2000 firms and supplemented by an excess profits tax. Two bureaucracies must be better than one.

The participants failed to agree on most of the details. As Abba Lerner said, "The discussion at this conference has convinced me that the objections to the various TIPs are much more serious than I had supposed..." (p. 255) Lerner also offered his own scheme. He would have the government set the national average rate of wage increase equal to the growth of average product, say 3% a year. The government would issue permits that allow the labor force to be hired at the stated rate of wage increase. The permits would be negotiable, so firms could buy or sell permits and raise individual wages in response to market forces. As Lerner points out, the permits are negotiable ration coupons that permit holders to increase wages by a fixed number of dollars. Firms that wish to grant large wage increases bid for permits from other firms. Lerner does not fully explain how wages paid by governments would be determined.

The proposal lowers the anticipated average rate of wage increase and removes the heritage of past inflation. Once the proposal is in force, there should be no discrepancy between the anticipated and actual rate of wage increase, and if the permitted average rate of wage increase is equal to the average rate of productivity growth, one condition for price stability is established. Lerner's proposal, however, would delay
labor market adjustment since a firm would choose to sell permits and let workers quit rather than fire workers and surrender permits to the government. Further, it is not clear what Lerner proposes to do about deferred compensation, fringe benefits and all the other issues about the measurement of wages raised elsewhere in the volume.

Lerner believes his proposal is a less costly means of lowering inflation than a law requiring the growth rate of money to be held within one or two percentage points of the non-inflationary rate of monetary growth. Reductions in aggregate spending, he believes lower inflation only by causing "catastrophic depression and severe unemployment." (p. 257) For Lerner, and others, unemployment is entirely waste. There is a "flaw" in the price system. The rate of change of money wages does not respond to changes in demand.

The idea that there is a flaw in the price system is a recurrent theme in the volume and more generally in the literature on guideposts and controls. Slow adjustment of money wages, or their rate of change, is used as evidence of the flaw.

An alternative interpretation of gradual or slow wage adjustment suggests that the workers' inference problem has been neglected and that it is the Keynesian interpretation that is flawed. Suppose workers in cyclical industries anticipate spells of lay off but are uncertain about the timing and duration of particular spells. Suppose, further, that governments are expected to increase spending whenever measured unemployment rates increase. Under these conditions workers have incentives to delay money wage reductions and to remain idle, at least for a time, if they believe that the change in the demand for their services is temporary. Cutting wages promptly in response
to every change in demand is not a rational response to a layoff that is regarded as temporary.

If workers in cyclical industries anticipate brief, recurring spells of unemployment, but are uncertain about timing and duration, slow adjustment of money wages in response to unemployment is not evidence of a flaw in the price system. *Curing Chronic Inflation* never considers economic issues of this kind and, therefore, fails to make a defensible economic argument for TIP. No evidence of the effectiveness of tax incentives, penalty taxes or guideposts is offered, and there is no attempt to compare the costs and effectiveness of anti-inflation policies in countries that have used or avoided guidelines, controls or some type of social contract.

Readers who believe that the proponents of TIP do not have a well designed plan, that all TIP plans are difficult to administer and that their effect on wages and prices is arbitrary, capricious and inequitable will find supporting evidence in this volume. Although the editors, and several participants, conclude that, despite the costs, some TIP should be tried, readers will be less certain.

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