It Takes Long-Range Planning to Lick Inflation

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IT TAKES LONG-RANGE PLANNING TO LICK Inflation

by Allan Meltzer

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A striking characteristic of economic policymaking in this
country is our fascination with the ephemeral and our ne-
glect of long-range problems. A lot of passionate com-
mentary, for example, has been devoted to the slowing of the
growth rate of real G.N.P. to 3.8 percent in the third quar-
ter. Yet if the past is any guide, that figure, when finally re-
vised, will turn out to have been in error. The slowdown may
have been much smaller than reported, and quarterly fluc-
tuations in the growth rate are in any case largely beyond
our control. The U.S. economy does not respond like a yo-yo
to every push or pull on the string called economic policy.

At the same time, we seem resigned to enduring over the
long term an unpleasant combination of slow growth, inade-
quate capital investment, and high unemployment. Our af-
flictions are not written in the stars. They can be cured, not
next quarter or next year, but we can reach zero inflation, a bal-
anced budget, high employment, and satisfactory growth rates
within about five years. What is required is that the Pres-
ident adopt an appropriate economic plan and enlist support
for it from Congress and the country. The essential elements
of any such plan are to reduce the growth rate of the money
supply—currency plus demand deposits—by about one per-
centage point a year for the next few years and to cut the bud-
get deficit and the size of government.

The piecemeal approach

It is surprising, given the gravity of our economic prob-
lems, that some sort of plan doesn’t already exist for dealing
with them. It is especially remarkable in light of the fact
that economic planning has become quite a fashionable con-
cept in Washington. Unfortunately, however, many of the
would-be planners begin with the misconception that most of
the instability in the economy results from uncoordinated pri-
ivate activities, which they contend should be planned and di-
rected by government. In fact, government itself has been a
great cause of economic instability. Any national planning ef-
fort should start and end with better planning by govern-
ment of its own activities.

An effective way to reach long-term personal or corporate
objectives is to develop a program that relates current re-
sources to ultimate objectives through a sequence of steps.
Governments do not use anything like this procedure when
choosing economic policies. They act to achieve short-term ob-
jectives with little attention to the longer-term consequences.

Case study of a fallacy

The sequence, and the results, of such short-term tactics
has become quite predictable. During a recession, when men
and machines are idle, the quick remedy is to increase the de-
mand for output through greater government spending,
financed in large part by issuing money. Because the addi-
tional output uses resources that would otherwise remain idle,
it is argued, there is no valid reason for inflation to increase.
A few bottlenecks may cause particular prices to rise, but
these are exceptions, not the expected norm. Inflation is sup-
posed to be a problem only when we near full employment.

Although this reasoning is seductive, as shown by its ap-
peal in many countries during the past three decades, the
facts give it little support. For a while, to be sure, output ex-
pands, and the press hails the "miracle" of economic growth
with low inflation. Then, gradually, prices start to rise. To
keep interest rates from going up, the monetary authorities in-
crease the growth rate of the money supply. After a delay,
the trend rate of inflation increases, and interest rates move
to higher levels. Union and business monopolists, specula-
tors, and other scapegoats are blamed, and selective or
general price controls are introduced to limit the rise in
inflation. When they are found to be ineffective, budgetary and monetary policies shift to check inflation, and the economy tumbles into recession again. Every developed economy has traveled on this merry-go-round in recent years, and most of them are now somewhere in the circuit.

To make matters worse, each spin of the wheel begins from a rate of inflation higher than at the start of the previous cycle. The longest, most widespread inflation in peacetime history is the lasting result of repeated applications of economic stimulus based on the belief that inflation will not increase until the unemployed are back to work. This idea is derived from experience during the Depression of the 1930's, but it is not an entirely accurate conclusion about that decade, and does not come close to describing later experience. Indeed, during the most recent recession, various countries applied the doctrine with quite different degrees of emphasis, and the results amount to a case study in the doctrine's fallacies.

When the quadrupling of oil prices in 1973 disrupted the economies of Japan, Western Europe, and North America and added greatly to the already high rates of inflation, many economists in and out of government urged decisive action to offset the fall in production and employment. Italy, Britain, and France followed this advice. They treated the symptoms of recession and ignored the problem of inflation, firm in the belief that additional stimulus could be offset later before inflation increased. Germany, Switzerland, and the U.S. took a
more balanced approach. Instead of choosing recovery as the main short-term goal of policy, they acted to reduce inflation and expand production, gradually but simultaneously. Instead of increasing the growth rate of money, they steadily reduced money growth to control inflation.

The results are now in, and they vindicate using steady, moderate policies. Although recovery remains incomplete everywhere, those countries that ignored the effects of stimulus on inflation have achieved no greater growth since early 1974 than countries that chose moderate policies. The differences in rates of inflation are dramatic. Inflation remained high, or increased, in Italy, Britain, and France. Average price increases of 10 to 20 percent were the norm in those countries during 1975 and 1976. The experience of the U.S., Germany, and Switzerland is entirely different. By the end of 1976, average rates of inflation in these countries ranged from zero to 5 percent. The experiment suggests that in practice, contrary to the claims of the activists, a policy of gradualism can achieve more by doing less.

**Quitting a good fight**

Unfortunately, the policy of gradually reducing inflation and restoring stability has ended in the U.S. The Federal Reserve has not achieved the reductions in money growth that are a requisite of any long-range anti-inflation policy. Fed Chairman Arthur F. Burns continues to talk about the need for such reductions, and he has got into trouble with the White House for not boosting the money supply fast enough to prevent—or, more accurately, to delay—an upswing in interest rates. But he has exceeded his own money targets; money growth reached a low point in 1975 and then increased in 1976 and again in 1977. The increases during the last two years are now reflected in slowly rising average rates of inflation. Although prices are going up more slowly than in the early months of the year, the average, or trend, rate of inflation has increased. Inflation in 1977 is higher than in 1976. The low point for inflation in this cycle—5.1 percent in 1976—is above 1972, as 1972 was above 1967, and 1967 above 1961.

What lies ahead? Sustained inflation never occurs unless there is excessive money growth, and sustained inflation never ends unless excessive money growth ends. Reported monthly rates of inflation are highly variable and give an inaccurate picture of what is happening. But the trend rate of inflation can be predicted with a fair degree of accuracy. A simple rule of the money thumb works surprisingly well. Compute the average growth rate of M-1—currency and demand deposits—for the previous three years. Use the average as an

*Geoffrey Moss: “The dollars still dazzle us but, when they burst, we are left with a few drops of water.”*
Unfortunately, the policy of gradually reducing inflation has ended in the U.S. Increases in the money supply are now reflected in slowly rising average rates of inflation.

estimate of the trend rate of inflation at the start of the following year. Adjust for any large, special influences on prices as they occur. The many phases of President Nixon's controls, for example, may have increased the error in the prediction for 1972, though not by very much. The error in 1972, as in most other years, was less than 1 percent. The oil-price increase, the sale of wheat to Russia, and other factors specific to 1974 raised prices in that year much more than predicted, and the error persisted through 1975. In 1976, predicted and actual inflation were close together once again.

This rule of thumb summarizes much of what we know about sustained inflation. Money growth usually dominates all other influences determining the trend rate of inflation. The response of inflation to changes in money growth is not instantaneous. It takes about two years, on average, for the rate of inflation to reach a new level, so short-lived bursts of enthusiasm for anti-inflation policy are less useful than steady, maintained reductions in the rate of money growth. Once inflation speeds up, patience and persistence become requisites of a successful policy to lower it again. That's why gradual policies work, and stop-and-go policies fail.

Choices for the future

The best that we can expect from current monetary policy is to hold inflation to a steady rate late in the decade, with prices rising, on average by 5.5 percent or 6 percent a year. Steady inflation is far from certain and will not be reached if the Federal Reserve continues the traditional policy of increasing the rate of money growth during the recovery. Traditional policy produced rising money growth in 1976 and in 1977 as in previous recoveries. If the Fed sticks to the traditional policy, it will let money growth continue to rise; inflation will increase in 1978 and 1979, gradually if the rate of money growth rises gradually, rapidly if the rate of money growth rises rapidly.

Stable prices—an end to inflation—cannot be reached this way. To restore price stability, money growth must fall each year until the trend rate of money growth is near zero. The rule of thumb that predicted the trend rate of inflation in the past implies that we can have stable prices in the early 1980's if the growth rate of money is reduced by about a percentage point each year for the next five or six years. The three-year average rate of money growth will fall gradually and the predicted rate of inflation will follow, as shown in the chart.

The economy does not move like a straight line drawn on a chart. Inflation may well be more variable than the chart suggests. But precision is not the issue. The basic choice is between steady or rising inflation and a return to price stability. At the end of five or six years, individual prices will still fluctuate, with some rising while others fall, but a properly constructed price index will change little or not at all.

Currently, we have no plan at all for stabilizing prices. Monetary policy follows a crooked path, chasing first one short-term objective, then another. Although current procedures require Chairman Burns to announce targets for the growth rate of money four times a year, the Fed has not changed its established method of operation. Interest rates remain the target of monetary policy. Attempts to delay or slow the rise in interest rates during the current expansion differ little from the attempts made in previous expansions and have produced the same general result. Money growth has increased; the trend rate of inflation has increased and will continue to increase. The cyclical pattern of overreaction may be damped, but the pattern has not been broken and will not be broken until we choose stability as a long-term objective, adopt policies consistent with that objective and procedures capable of implementing the policy and reaching the objective. Monetary policy must be used to control money.

In principle, monetary policy can restore price stability even if the government continues to run large deficits. Experience is less encouraging. Budget deficits are financed by selling government bonds. The sales raise interest rates, particularly during periods of recovery and expansion. Rising interest rates bring pressure on the Federal Reserve—from would-be borrowers, Congressmen, and in the most recent case from the White House itself—to halt the upward trend. The pressure need not be intense. The Federal Reserve typically pays close attention to changes in interest rates, so
François Colos: "It's a treadmill; and each time around, the load gets heavier."

later, by contradictory statements about additional spending for pressing needs like housing, health care, day care, urban transportation, or military equipment. Few programs end. Since there is no long-term fiscal plan that limits the size of the budget, there is little incentive to offset budget increases with reductions. The level of spending increases year by year, and frequently the rate of increase exceeds the growth rate of the economy. This process is likely to continue as long as Congress and the Administration can satisfy competing claims for spending by increasing the government's share of G.N.P.

Setting limits

To control the budget, we need a fiscal policy that forces Congress and the Administration to choose between alternative spending programs. In addition, a budget policy to achieve stability should provide information to the public about the taxes they will have to pay and the rate at which taxes can be expected to increase. When the government grows faster than the economy, and taxes increase with inflation, the public can only guess at the size of its future tax burdens.

Congress and the President should begin by agreeing to limit the size of government. The limit would be stated as the percentage of national income that could be taken in taxes when the budget is balanced. In any given year, the ceiling on spending would be arrived at by applying the agreed-upon percentage to the average output of the previous three years.

Once the limit is set, the government will grow on average at the same rate as the economy. If Congress and the President agree that the government should grow faster, or slower, they can announce a growth rate that embodies their objective. Once the size and growth rate of government are set, average tax rates become more certain, and economic stability is enhanced because individuals and firms have more information about the future. The reduction of uncertainty about future after-tax earnings encourages investment, which fosters employment when resources are idle and increases long-term growth and standards of living. And, of course, constant or falling tax rates, rather than higher ones, also promote economic progress.

Fixing the size of government would leave two principal sources of growth in government programs. One is the

it goes into the market without much prodding to buy some of the bonds the Treasury has been selling. The funds it uses to pay for the bonds are an addition to the money supply. This roundabout, indirect process of financing the deficit produces as much inflation as a conscious decision on the part of the Federal Reserve to print money for the Treasury. As long as the process continues, inflation will not end and stability will not return.

The major obstacle to controlling the budget is the absence of a long-term fiscal program to reach this goal. Every Administration announces that balancing the budget is a major objective, but few have achieved the objective in the past forty years. Statements that the budget will be balanced are a ritual, not a program. The statements are followed, sooner or later, by contradictory statements about additional spending for pressing needs like housing, health care, day care, urban transportation, or military equipment. Few programs end. Since there is no long-term fiscal plan that limits the size of the budget, there is little incentive to offset budget increases with reductions. The level of spending increases year by year, and frequently the rate of increase exceeds the growth rate of the economy. This process is likely to continue as long as Congress and the Administration can satisfy competing claims for spending by increasing the government’s share of G.N.P.
increased tax revenues that come with growth of the private economy; the other is the reallocation of spending among existing programs. The former would give the government an incentive to encourage efficient private production. The latter would provide an incentive to eliminate ineffective or outdated programs.

Setting a limit to the size and growth of government would also increase stability by forcing the government to set long-term objectives. If conflicts cannot be resolved by increasing the budget, new programs can be added only gradually and must remain consistent with the long-term fiscal plan. The government would acquire an incentive to project revenues, to plan the timing and amount of additions to spending, and to allocate more efficiently the resources it commands.

Government would also have an increased incentive to limit inflation. Current tax schedules permit government to grow in relative and absolute size by fostering inflation. Tax law treats changes in income resulting from inflation as if they were real increases, so higher prices and wages move taxpayers into higher tax brackets, where a larger fraction of their income is taken by government. Governments also collect an inflationary increment from capital-gains taxes, from sales and excise taxes, and in many other ways. A limit to the relative size of government would limit, though not remove, the incentive to inflate.

Even at moderate rates of inflation, the government gets massive increases in tax revenues without any congressional vote for higher tax rates. The staff of the Congressional Budget Office has calculated tax collections and government spending from 1977 to 1982 on the optimistic assumption that inflation will fall to 4.6 percent in 1979 and remain there for the foreseeable future. Tax revenues attributable solely to inflation increase each year, rising from $24 billion in 1978 to $150 billion in 1982. For the five-year period as a whole, inflation adds $408 billion to the federal government’s revenues, or 16 percent of total tax collections. As a percentage of national output, tax collections rise more than two percentage points by 1982.

The hidden inflation tax

The $408 billion is only part of the revenue that government gains from inflation. Higher prices shrink the purchasing power of everyone’s money, but the government replaces the loss of its own purchasing power by issuing additional money and using the new money to pay wages, interest, and other obligations. During the five years 1977-82, if inflation continues at the rate expected by the Congressional Budget Office, the government will finance more than $100 billion of spending in this way. That $100 billion is not included as tax revenue in the budget and is not included in the share of output taken in taxes. Inflation pays the bill.

A policy of gradually reducing inflation would affect tax collections, the budget deficit, and the size of government. During the transition to stable prices, slower inflation would reduce the growth rate of government spending by curbing the rise in prices and wages paid by government. But slower inflation would reduce the growth of taxes more than the growth of spending, so the deficit would increase for a time.

I have estimated spending and taxes for the years 1977 to 1982 using the lower rates of inflation that would result if money growth were reduced as part of a policy to end inflation in the early Eighties. The projections show that the government budget can be balanced in the early 1980’s. My projections of spending assume that Congress and the Administration maintain existing programs, do not add new programs, and permit spending to rise only as required by rising population, income, and prices. Members of Congress, the Administration, and the Federal Reserve, who all want lower interest rates, would see rates decline to the level of the middle 1960’s. And all of this can be achieved with moderate fiscal and monetary policies.

Sticking to a fiscal diet would be a bracing challenge for Congress and the Administration—and a great change from the pattern that now seems likely. Programs for health care and welfare reform are likely to increase the budget, if not at once, then within the next few years. Energy programs, subsidies to agriculture, to education, and to housing have either risen above projected levels or threaten to do so. Unless there is a major change in the budget process, the size of the government will grow; the budget will not be balanced without more inflation and perhaps not at all; interest rates will rise, not fall. The Federal Reserve, as in the past, will finance part of the budget deficit by increasing the rate of money growth. Inflation will continue and most likely increase. Stability, non-inflationary growth, and full employment will not be achieved.
If the government's spending habits are the first obstacle to the enactment of an anti-inflation program, the fear of recession is the second. With less government spending and a reduction in the growth rate of the money supply, it is argued, the economy will grow more slowly in 1978 and 1979, and the risk of a recession will increase.

This argument may be correct, but as usually stated it misses the point. The risk of recession will also increase under current fiscal and monetary policy. Higher money growth and more stimulus in 1978 and 1979 mean higher inflation in 1980 and beyond. Whenever inflation increases, public concern about inflation rises. Responsive governments shift their emphasis from policies that encourage expansion to policies that reduce inflation. Excessive stimulus is followed by excessive restraint and severe recession. A small recession in 1978 or 1979 is not an inevitable consequence of the program to increase stability and end inflation, but it is a risk that must be compared to the risk of higher inflation and a larger recession if current policies continue.

**A commitment to candor**

A minimum program to increase stability requires the government to make two commitments. The size of government spending and the average rate of monetary growth should be set at the start of each Administration by agreement with the Congress. Annual budgets and rates of monetary growth should be related to the four-year program, so the public can judge the fiscal and monetary policies of the Administration and get a clearer view of the future. In the event of war or catastrophe, the President and Congress can change the limit. The program calls for a commitment by government to candor, not a permanent rule.

The risk of recession is not avoided by piecemeal programs that focus on short-term objectives and ignore their long-term consequences. The economic policies of the past decade have not brought stability, growth, and an end to inflation. Contrary to the many promises of economists and policymakers, stop-and-go policies have brought higher unemployment, more inflation, and more dissatisfaction with government and the private sector. We can do better by doing less. Growth, full employment, a balanced budget, and price stability are compatible, long-run objectives. They can be achieved together in the early Eighties if we move persistently along a path which takes us in that direction.

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**FORTUNE's Jean Held: “The snake, to scale.”**