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INFLATION and The New Economics

by Alvin H. Hansen

Now that inflation has become the nation's chief economic preoccupation, we tend to forget all the problems associated with the price stability of the early 1960s.

President Johnson with Treasury Secretary Henry Fowler and Federal Reserve Board Chairman William McChesney Martin.

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be free to state his personal views before Congressional committees.

Let us hope that a sane view of this controversy will prevail. Let us hope that we shall not again see such a display of arrogance as we witnessed in December, 1965, when the Fed defied the Administration and raised the discount rate.

Some commentators have tried to defend the Board's action on the ground that it was, in this case, right. I am unable to follow this argument. Witness the near crisis created by the interest rate war and the unholy scramble for deposits.

The issue here, however, is not a question of who was right. The point at issue transcends by far any specific incident. Surely an elected democratic government must be held responsible for its management of the economy. Every Administration, whether Republican or Democratic, must have command of all the instruments of control so that it can carry out its program.

One practical procedure might be to institutionalize the so-called quadriad consisting of the Chairman of the Council of Economic Advisers, the Secretary of the Treasury, the Director of the Budget and the Chairman of the Federal Reserve Board. Here differences of opinion, as represented by all the relevant agencies, can be thrashed out.

Vital decisions by majority vote of the quadriad would be reported to the President, and if approved by him should command the united support of all the agencies concerned. No more would be demanded of a Board member than is now demanded of every Cabinet officer. Whenever a Governor of the Federal Reserve System felt that he could no longer go along with the overall governmental policy, it would be his duty to resign.

I should like to add a word about the relation of monetary to fiscal policy. We have been moving, in recent years, in a dangerous direction. Not only have we allowed the Fed to become increasingly independent, we have also tended to expect from monetary policy far more than it is capable of producing. In the past, our monetary authorities were content to make a modest contribution to stabilization policy. Not so in recent years.

In my view—I am aware that not all adherents of the New Economics would fully agree—monetary policy should always be relegated to the position of serving as a handmaiden to fiscal policy. In this capacity it can play an enormously important role. Money *is* important. No government can pursue an effectively expansionist fiscal policy without having at its beck and call the vast monetary powers of a central bank. Nor can it pursue an orderly program of fiscal restraint unless the central bank plays its supporting role in carrying out tax, expenditure and debt-management policies.

From the growth standpoint, I should hope that we can develop long-range government expenditure programs based on social priorities. These long-range projections could play an important stabilizing role with respect to planned private investment outlays. The long-run interest rate should be kept low to help stimulate growth. As for countercyclical policy, I should strongly favor primary reliance on tax policy. When we use fiscal policy, we know what we are doing. We can calculate fairly accurately the impact of tax and expenditure changes. Sharp changes in the rate of interest leave us groping in the dark, as the recent Federal Reserve fiasco illustrates.

Consumer price increases of the magnitude experienced by the high-pressure economies of Western Europe admittedly present equity problems in a society operating generally with fixed money contracts. Since all advanced countries prefer full employment, despite its attendant inflationary consequences, it would seem that the next order of business in the free world is to devise and build institutional arrangements to alleviate the inequities flowing from creeping inflation.

James Tobin emphasized this point in a recent book: "It is a major defect of our financial structure that inflation hedges are not available for the majority of the population. American inventiveness and ingenuity have been sadly lacking in this area. The government could issue bonds with purchasing power guarantees and life insurance companies could offer 'variable' annuities to protect beneficiaries against inflation." Paul Samuelson reaches a similar conclusion in his recent two-volume *Collected Scientific Papers*.

We have, of course, already made some starts in this direction. Some 2.5 million workers are protected by so-called cost-of-living escalator contracts. Private universities have learned to live and prosper in a period of creeping inflation. Social Security benefits have been raised periodically, but always with a lag. Inflation-proof arrangements need not necessarily exert an upward push on costs. Escalator wage contracts prevent *immediate* wage demands based on anticipated cost-of-living increases.

Such arrangements redistribute rather than add to aggregate income. By and large, they take income from the inflation-advantaged group and give it to the inflation-disadvantaged group. But these measures are not inflationary per se. And they will become increasingly necessary in a high-pressure, full-employment economy.

Living, as the whole Western world does, in an age of creeping inflation, the impact of this fact upon expectations becomes obviously a crucial matter. As I have already noted, there appears to be no evidence in advanced countries that creeping inflation necessarily leads to runaway inflation. How can one account for this fact?

In a perfectly fluid free market we should expect a rapid escalation of any inflationary movement. But the price system, fortunately, is not perfectly fluid. If it were, any movement away from equilibrium would rapidly cumulate. Not only is the system far from being fluid, it is in fact a network of contracts, partly legal and partly behavioristic. Inertia plays a big role. Any movement away from equilibrium makes headway against a sticky mass. The result,

(continued on page 41)

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Inflation

(continued from page 6)

fortunately, is a lagged adjustment to change.

What implications do these considerations have for the commonly held view that cost-of-living escalator clauses in collective bargaining contracts tend to accelerate creeping inflation? In my opinion, this view is a mistaken one.

Take the recent abortive contract (the one turned down by the membership) between the airlines and the machinists union. Aware of the continuous, though moderate, upward trend of consumer prices throughout the past 18 years, the union demanded a cost-of-living escalator clause. The airlines stood firm against this. The union, fearful that a consumer price rise of, say, 2.5 per cent or more, might largely nullify any intended increase in real wages, demanded, and was granted, still higher wages as compensation for surrendering the escalator clause. The revised (and finally accepted) contract was far more generous than the first. It provided both higher wage rates *and* an escalator clause, and crashed right through the Administration's wage guideposts. Thus, with or without the escalator clause, the expectation of creeping inflation affected the proposed settlement.

Higher wages, paid in *anticipation* of price increases, come immediately into play, and so at once operate to intensify inflationary pressures. *Future* wage increases, paid in accordance with an escalator clause, come *after* consumer prices have risen. Escalation validates a price increase that has already taken place, but is not the *cause* of the price increase that has already occurred.

The lag is highly important. Stability in a market economy is largely a function of lagged adjustments. At all events, there is no escape from the perfectly reasonable demand of workers that the Consumer Price Index must somehow be taken account of in wage contracts. It makes more sense to make the adjustment *after* the event than to force the issue before the event.

Clearly, the modern inflation problem presents many conflicting and often irreconcilable factors. What then? Should we abandon the wage-price guideposts? I think not. We do need a thorough overhaul of the statistical foundations upon which the guideposts rest, and we need to clarify our concepts, and our goals, with respect to price stability. But as broad-gauge directives, the guideposts do point to basic relationships which cannot be ignored. The guideposts should be perfected, not abandoned.

Improved guideposts, Presidential authority to raise or lower taxes within specified limits and, finally, monetary policy working in tandem with fiscal policy, could give us full employment *and* "reasonable price stability." In the meantime, let us not blame our inflationary pressures on the New Economics. ■

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