Dealing with Inflation: Policy Alternatives

F. Thomas Juster
Director, Institute for Social Research
Professor of Economics
The University of Michigan

Major Economic Policy Issues

The three major issues facing economic policy during the next several years are controlling the inflation rate, increasing real growth rates via improving productivity performance, and finding ways to reduce dependence on imported oil.

These problems are obviously interrelated, but less so than many suppose. For example, it is entirely possible to adopt policies which will control the inflation rate while doing nothing for stimulating rates of real growth and improving productivity; conversely, it is possible to adopt policies which will improve real income growth and productivity, while having very little impact on inflation rates. In particular, I suggest that the oft-repeated notion that improving productivity will take care of the inflation problem is simply wrong: in the short run, policies designed to improve productivity (such as increased investment) may even exacerbate the inflation problem, and even in the long run, the inflation benefits are a modest by-product of a better productivity performance. And getting better control over the volume of imported oil will have its chief beneficial effect on preventing price shocks of the sort that adversely impact the overall inflation rate, with some possibility that reduced oil imports would strengthen the dollar in foreign exchange markets and thus lessen or even reverse the inflationary pressures resulting from adverse movements in the terms of trade against the U.S.

Inflation Policies

To formulate policies designed to deal with inflation, one has to understand the roots of the present inflation. I share the opinion of those who hold that the present inflation has little to do with excess demand—the conventional cliche of too much money chasing too few goods, thus driving up prices. Rather, our present inflation is largely a consequence of the momentum of past increases in cost being passed on into prices, and the nearly universal expectation held by decision-makers that inflation will continue inexorably into the future. Employers do not sign wage contracts calling for increases between seven and 10 percent because they are afraid that employees would otherwise move to different jobs. Rather, they sign such contracts because everyone else is signing such contracts, and because they are confident that such increases can be passed along via higher prices.

There are basically only four possible "solutions" to the inflation problem: one is to leave it alone on the assumption that nothing can really be done about it; the second is to bring down the inflation rate gradually, by means of moderately tight macroeconomic policies (monetary and fiscal), maintained over a long period of time; a third is to break the cycle of momentum and expectation rapidly by initiating drastic macro policies; and the fourth is some variety of controls, either voluntary or involuntary.

The principal risk of the first policy—ignoring inflation because doing anything about it is too costly—is simply the potential damage to economic and political institutions that might be associated with a policy that allowed the price level to double every six or seven years. Worse still, it is arguable that aiming at letting the inflation rate persist at double-digit rates will inexorably lead to escalation, and we will find the price level doubling every three or four years instead of every six or seven, then every other year instead of every three or four, etc. While I do not think that is inevitable, there is enough risk in it so that it appears to be an unappetizing alternative, possibly the worst of the four.

Gradualism obviously has much to recommend it, and has been the policy of every administration and congress over the last decade. Unfortunately, the evidence suggests that it does not work. The basic problem with the policy of gradual reduction of the inflation rate—from 10 to nine to eight over several years—is that the immediate impact of any conventional macro-policy designed to decelerate inflation rates is not on inflation at all, but on real output growth. It is only after real output growth has been adversely affected that price inflation begins to be impacted by fiscal and monetary constraints. Thus the initial results of restrictive fiscal and monetary policy is that we get a recession, with virtually no impact on prices. Eventually, prices will begin to decline unless we are so unlucky as to run into adverse shock of one kind or another—oil, food prices, etc.

To both the public and political decision-makers, the policy of gradualism thus appears to provide almost no immediate benefit, and to entail noticeable costs. As a result, people get disenchanted with it. If the U.S. were a very patient society, with a strong tradition of tolerance for error and with long-term economic planning mechanisms that were immune to short-term reverses, gradualism might work. But this is not a very patient country, either in terms of popular reactions or political ones; hence I have almost no confidence that gradualism will actually be successful.

While the problem of gradualism is that it makes progress on the inflation side too slowly to generate continued support for it, the problem with the third policy option—severe economic constraints—is that we are not quite sure now far the policy will have to be carried to make it work. There is little doubt that sufficiently severe monetary and fiscal constraints would in fact reduce the inflation rate down to any desired level. But no one can predict with confidence how far unemployment rates would have to be pushed, and how much real output would

Note: This article is adapted from testimony given before the House Budget Committee.

have to decline, before inflation rates are pushed down to a tolerable level. Some would argue that the mere threat of maintaining a severe constraint policy until inflation rates come down will insure that inflation rates will in fact come down rapidly at relatively modest costs in terms of foregone real output and economic hardship. That case, made by many distinguished economists of conservative persuasion, is by no means implausible. The problem is that no one can guarantee that such a policy would not produce an economic disaster, and that risk seems unacceptable.

Wage and Price Controls

If leaving inflation alone is intolerable, gradualism won't work, and tough constraints imply unacceptable risks, we are left with some kind of controls policy as the best of a bad lot of policy alternatives. Critics will hasten to point out that controls have never worked; that they treat symptoms and not causes; that they will merely suppress inflation for awhile before eventuating in a new explosion of price increases when they can no longer be maintained; and that they are inequitable, impossible to administer, and create pernicious evasion incentives which distort production decisions.

Those arguments need to be taken seriously, and some of them are clearly correct: controls have not generally worked well in the U.S. during past periods when they have been used; they are inequitable; they do create pernicious incentives to evade; and they are difficult if not impossible to administer. Still, they are worth discussing as a serious instrument of economic policy under the present set of circumstances, where nothing else seems to have much prospect, by itself, of reducing inflation rates at reasonable cost and with reasonable risks.

This is not the place for an extended discussion of the issue, but I will simply note some characteristics of controls which seem to me often overlooked in recent public discussion:

- If the basic inflation problem is not excess demand but momentum from past price increases and expectational phenomena, controls do treat root causes and not symptoms: one way to impact momentum and change expectations is simply to freeze prices and wages, since momentum and expectational forces are impacted by interrupting the historic inflation path.
- Control in this country has usually been put on when the economy is strong and there is the threat of excess demand. Under those circumstances, incentives to evade are powerful. But controls put in place during a period when the economy is weak create less strong incentives to evade. The lesson is that a precondition for successful implementation of controls is that sluggish demand conditions must be maintained whenever controls are in effect.
- While it is true that controls are inequitable,since they freeze prices and wages in various stages of catch-up relative to other prices and wages, inflation is also inequitable. It is far from clear that controls are more inequitable than inflation.
- Incentives to evade controls are not only a function of the underlying strength of demand, but also a function of whether people generally visualize that there is a crisis that needs to be dealt with or whether they see the world in "business as usual" terms. Controls can only work if the community is psychologically prepared to adopt a crisis strategy because they perceive that a crisis is at hand. Perhaps that time is now, perhaps not.
- Anyone who has administered price controls can testify to the impossibility of achieving equity, the extremely high cost of administrative decision-making, and the potential for strangulation by red tape of various sorts. A possible solution is to have legally enforceable controls with no bureaucratic apparatus to administer them, relying on normal sources of statistical information to uncover evasion and on public acceptance to insure compliance. While that can only work for a limited period of time, controls designed to stop momentum and cut into expectations should be viewed as temporary anyway.

Preconditions for Successful Controls Policy

The principal point of this analysis is not that controls are clearly the policy of choice in the present environment, but rather that controls are a possible policy, and they should be seriously considered. More importantly, certain preconditions are essential for any controls policy to have a reasonable prospect of success. These preconditions are that: controls can only be put in place effectively when the economy is weak on the demand side, and they must be removed while the economy is still weak; it must be recognized that controls are inequitable, and their justification is simply that they are no more inequitable than alternative policies; controls will not be successful if any substantial number of prices and wages are exempted as a consequence of perceived inequity, since there is literally no price or wage adjustment for which a plausible equity case cannot be made; and controls are most likely to be effective when implemented in conjunction with conventional policies designed to modify or reverse cost-increasing pressures (payroll taxes, agricultural price supports, import quotas, etc.)