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Defence Without Inflation

Aaron Director

THE promptness with which both the United States and Canada dismantled the wartime control system of prices and allocations after the last war could have been interpreted as evidence of the greater attachment to the competitive order than that which prevails in other parts of the world. And the outstanding success with which the market brought about the tremendous reallocation of resources from war time to peace time uses in both countries should have justified this attachment. The only comparable experience is that of Western Germany after the recent monetary reform. Those inclined to this interpretation received quite a jolt when in the United States

the whole apparatus of price and allocation controls was promptly instituted when it became evident that once again a substantial amount of resources had to be transferred to military objectives. This shows how tenuous is the faith in free markets in one of its strongholds. It is one thing to be persuaded that the market system is a good system when there are no serious economic problems to be resolved. This persuasion is now widely held in socialist circles. It is quite another thing to be persuaded that the virtues of the market system lie in its appropriateness to solve economic problems—such as bringing about an orderly shift of resources from an existing to a new use.

There is an additional and immediately more relevant interpretation of the prompt resort to price and allocation controls. A decade of inflation has restored the sensitiveness of the community toward this phenomenon. And a prior decade of depression has led to a method of analysis which, when crudely applied to the problem of inflation, is misleading. For it has led to the view that the way to prevent government and private individuals and firms from trying to buy more than is available is to operate on them directly. But since it is also recognised that denying goods and services to those who want to buy more of them at current prices will not keep prices from rising, the obvious solution is to suppress the potential price increases. This is surely a mistaken position; once attention is directed to the monetary mechanism thru which attempts to buy more than is available work themselves out, it becomes apparent that we have a powerful instrument for checking such attempts. It should also become apparent that this instrument is to be preferred.

II

WHY do we expect inflation to appear when it becomes apparent that government will have to spend a lot more than it has been spending for military purposes? One answer is of course that this is what has taken place in past periods. But why has it taken place in past periods? We should not and will not be surprised to find that the new government expenditures were in part at least net additions to aggregate expenditures. When government spent an additional dollar it did not at the same time see to it that private individuals were taxed an additional dollar so that aggregate expenditures would not be stimulated. In the present context the right standard for fiscal policy is to prevent government expenditures from enlarging total expenditures. And this is the reason why one ingredient of correct policy is to have an approximately balanced budget. This much would be conceded by all. But it is clearly not enough.

The inflation can take place when government does not directly contribute to it through its expenditure and revenue operations. The inflation which took place in the early part of 1950 is of this type. If individuals and firms expect prices to rise they will try to increase their expenditures. But they can do it only if they have monetary means with which to do so. To some extent they can do so if they try to reduce their holdings of cash, i.e., through an increased rate of use of existing money. But the more usual procedure is by getting hold of new money. And this is precisely what happened during the period in question. As individuals and firms tried to accumulate goods, the banking system provided them with the necessary monetary means.

WE can have no quarrel with the commercial banks which are, after all, profit making institutions. But these banks cannot provide additional means of payment unless they have or can obtain the required reserves. The provision of such reserves is in the hands of the central monetary authority. It is precisely because the monetary authority provided the required reserves that the commercial banks were able to provide the means of payment. There can be no doubt that the monetary authority had power to prevent the increase in the means of payment.

Two qualifications are likely to be raised. Granting that the monetary authority could have prevented the increase in the supply of money, there is still the possibility noted above, that inflation can take place because of the increase in the rate of use of existing money. And this is particularly emphasized nowadays because of the large volume of liquid assets outstanding. But the monetary authority is not limited to preventing an increase in the supply of money. It can bring about almost any degree of contraction in the existing supply and thus offset somewhere in the system the increased purchases due to an increase in the rate of use of money. By selling enough securities it can force the banks to reduce their deposits.

The other qualification stems from the current fashion of emphasizing increases in costs as the mechanism of inflation. Prices, it is said, rise not because of increased expenditures, but because the owners of resources—especially workers through their trade unions—demand higher rates of remuneration. Without denying that this may happen, it is largely a mistaken view of the process of inflation and of the role of trade unions in periods like the present. It is in response to “expansion” that trade unions demand and get wage increases. And if they didn’t, this would only mean that the results of higher prices would remain elsewhere—say in profits. And the consequent effect would be largely the same, although the larger profits would be spent on different things than the higher wages. Even if it be granted that large groups of workers do in fact get wage increases prior to price increases, this need not result in inflation, since the monetary authority can offset this effect also. Objection to monetary policy in this case must therefore turn on its undesirability rather than on its inability to prevent inflation. The implication being that monetary policy would in this circumstance lead to unemployment. At this point the criticism might also be made against reliance on monetary policy in the general case as well, so that there is nothing peculiar to the new approach.

III

WHAT has been said so far points to the responsibility of the Federal Reserve System for the inflation we have had, and for any further inflation which comes in the near future. But this seems odd. Surely the monetary authorities also wish to prevent inflation. But it is not odd at all when we recall that our monetary authority has not been given the definite objective of stabilizing the level of prices. In the United States as in other countries, it has discretionary powers to do this along with other vague objectives. Experience should teach us

that discretionary authorities are often hesitant and consequently unreliable. They want to prevent inflation but they also fear the real or imagined other consequences of doing so. But there is a more *relevant* explanation for the period in question. While the Reserve authorities have had adequate powers to prevent inflation they have not been free to use such powers, and they have not been free to do so because the world over the fetish of low interests has taken strong hold.

Now it is not surprising that treasuries should wish to minimize the cost of borrowing. But they must take into account the cost of doing so. That they are somewhat mindful of this cost is obvious. The cost of borrowing can be reduced to zero by issuing non-interest bearing debt, i.e., money. If this is not done, it must be because of the inflation which would result. But this is precisely what the policy of maintaining low interest rates has implied. The lack of freedom on the part of the Reserve system to carry out its monetary responsibilities stems from the policy of trying to maintain low rates. As banks or individuals endeavour to sell some of their government securities, the prices of these securities would fall—their yield would rise. If this is to be prevented, the Reserve authorities must stand ready to buy them and prevent the price decline. And when they do so, they provide the banking system with the reserves necessary for an expansion in the supply of money. We shall not be free of this limitation on monetary policy until the legislature makes it clear that the goal of monetary policy is to stabilize the general level of prices, and the interest rate on government securities must accommodate itself to this goal.

RESISTANCE to a “free” interest rate comes from those who fear the consequences of freeing a rate which has been artificially kept down for a number of years, and from those who visualize a period in the future when low interest rates will be necessary to combat deflation and depression. The latter is easily

disposed of. It is not the low rate of interest of the present period which will be significant when the period of deflation arrives. That period will require a rate lower than the one which prevails prior to the deflation. When deflation takes place a reduction in the rate of interest on government securities will be consistent with the stabilization objective of monetary policy just as an increase in the rate is now consistent with this objective.

Nor is the fear of the consequences of freeing the rate more significant. It is nothing more than the fear of any necessary price change. There is no way of indicating what a "free" rate would be. The consequences of a higher rate should not be exaggerated. Holders of government securities who can wait until the securities mature need not suffer any capital losses. In any event the rate will not be higher than necessary to prevent inflation. And what can be the benefit to the community of maintaining the price of government securities only to see the real value—the purchasing power—of the capital sum steadily decline? Those, therefore, who continue to favor the policy of maintaining low interest rates must at the same time point to some better means of preventing inflation than monetary policy, or must accept inflation.

IV

BEFORE discussing these other means of preventing inflation, some observation is in point about the so-called undesirable consequences of using monetary policy. Among those who would agree with the position outlined above that the Reserve authorities have had adequate powers to prevent inflation some would add that the consequences of using such powers are unacceptable. One of the consequences—the rise in interest rates—has already been noted. Upon examination the others turn into the fear that any attempt to prevent a rise in prices by monetary means will result in unemployment. Enterprises will respond to monetary pressures by overdoing the necessary

contraction. The difficulty of estimating the effect of a given amount of monetary pressure is not insignificant and raises some problems about long run monetary policy. But the fear of unemployment cannot be taken seriously at a time when a substantial volume of resources have to be transferred to production of military supplies. The release of resources—unemployment—might very well expedite the rate at which the military objective is attained. Finally reference should be made to the fact that non-monetary methods are not altogether free of the possible consequence of some unemployment. The decision to cut the materials available to a given civilian industry by a specified amount is not as free of error as some would have us believe. There may indeed be some merit in the complaints that allocations are depriving some industries of materials with consequent unemployment of other resources before other industries are ready to use these materials.

V

MONETARY policy as an appropriate instrument for preventing inflation would be more widely accepted were it not for the failure to realize that there is in fact no alternative policy. Price control to keep prices below the level which would prevail in a free market suppresses inflation but does not remove it. If monetary expansion is permitted, as evident when it becomes necessary to keep prices down by law, the price increase will appear when the law is repealed. This is why there is some truth in the observation that price control stabilizes the idea of the cost of living and not the cost of living. And this is why prices rose after the last war when price control was removed.

Price control can make only a minor contribution to keeping down monetary expansion. This contribution it makes by keeping down the government deficit which might be larger because procurement officers may tend to be careless and pay more than is necessary in a free market. Price control is not only a very poor

substitute for monetary policy to prevent inflation but also undesirable. Relative price changes have a useful function to perform, especially in times like the present when we are forced to change the relative importance of the goods and services which make up the community's output. Relative price changes indicate which goods should be economized more, which goods should be substituted for others, and they exert pressure to effect such economies and such substitution. Centralized decisions are but a poor substitute for the market which utilizes the knowledge and experiences of all participants in the market. Price stabilization by law, requires an elaborate system of rationing to allocate the available supplies which are smaller than the amounts people are willing to buy at the fixed prices. If the market method of rationing is suspended some alternative method must be provided unless we are content with some such standard as the early bird should get the worm, or friends are more deserving than strangers. Any alternative method is costly in terms of resources, and its

ethical advantage is no more obvious in times like the present than in more ordinary periods.

FINALLY, a brief observation about the place of allocations and priorities. If markets were fully competitive, the government could obtain all of its additional requirements by entering the markets in competition with other claimants. Monetary policy can keep general prices stable. Some prices would rise and choke off the demands made by other claimants. But where markets are not competitive prices may not rise. The allocation is then made by the supplier. He may favor his existing customers. The government may find it difficult to meet its requirements. Since it cannot outbid the rival claimants, it must use its coercive authority to get its share of the output. Beyond this limited scope for direct control of allocations, the case for it, as a substitute for, or supplement to, monetary policy is no stronger than the case for direct price control.

Production in Lieu of Cash

Money does not pay for anything, never has and never will. It is an economic axiom as old as the hills that goods and services can be paid for only by goods and services; but . . . years ago this axiom vanished from everyone's reckoning and has never reappeared. No one has seemed in the least aware that everything which is paid for must be paid for out of production, for there is no other source of payment.

ALBERT JAY KNOCK