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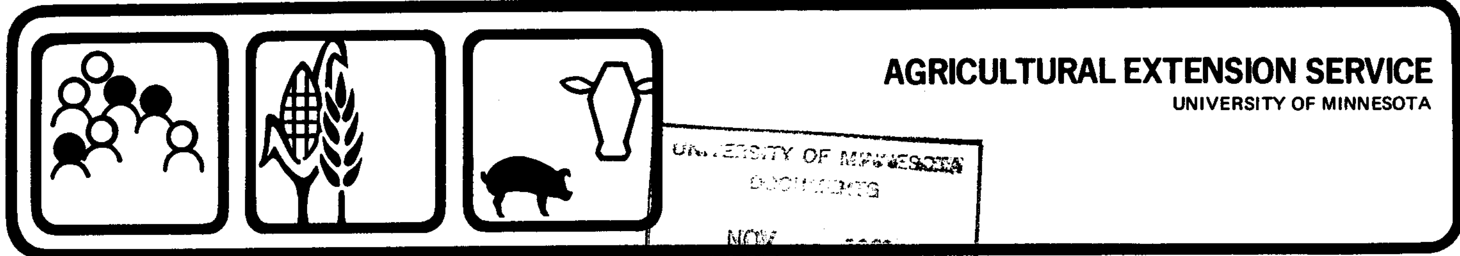

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Inflation-Causes and Cures

Inflation is defined in *Webster's Third New International Dictionary* (1971) as "an increase in the volume of money and credit relative to available goods resulting in a substantial and continuing rise in the price level."

Inflation is a rise in the **general** price level. An index is needed to measure **average** changes in the prices of all goods and services because during any one period some prices may be declining while others are increasing. The Consumer Price Index (CPI) is the best known index. It reflects price changes for a **specific bundle** of goods and services. However, in reality, the bundle never stays constant from one period to the next. When beef supplies are short, the relative price of beef increases—but consumers buy less of it.

Since the CPI does not consider adjustments in purchase patterns, it sometimes overstates the actual increase in the cost of living. A measure that adjusts for changes in the amounts of different goods and services purchased (Gross National Product Deflator) showed an average inflation rate of 6.27 percent per year during the seventies versus the 7.11 percent indicated by the CPI.*

Causes

The inflation rate is largely determined by the excess of the growth rate of money (plus any growth in the velocity, or turnover rate, of its use) over the rate of increase of the production of goods and services. Thus, if in one year the money supply increases 15 percent while velocity is constant and the supply of goods and services increases only 3 percent, a measurable inflation rate of about 12 percent will generally follow.

The Federal Reserve Board is an independent banking agency that has control over the rate of increase in the supply of money in the United States. Why, then, doesn't it slow the rate of increase in money creation to more nearly match the rate of growth in real goods and services? Because it is not easy to do this when most forces in the economy and most political pressures via the U.S. Congress and prior executive branches have been pushing for increases.

The origin of the recent escalating inflation cycle in the United States is generally traced back to the mid sixties when we tried to fight a war on poverty at the same time as the war in Vietnam without increasing taxes.

Rapid growth in federal spending—when not covered by equal growth in taxes—creates pressures for increases in the money supply. The treasury must secure funds to cover deficit spending. If the Federal Reserve Board does not increase the supply of money when the treasury needs it, some of the credit needs of the private industry get squeezed out—causing a credit crunch like we saw in the spring of 1980. When credit is short and interest rates increase, Congress and many special interest groups—including farm groups—ask for an increase in the money supply as they did in 1980 and again in 1981.

Unfortunately, when the Federal Reserve Board accommodates such pressures and again increases the money supply, the expectation of the business community is that the inflation rate will increase again in coming months. (Investors and businessmen are generally well aware of the lagged relationship between the growth in the money supply and changes in the inflation rate.) This change in expectations causes a decline in bond prices—that is, higher interest rates must be paid on new bond issues in order to entice investors to buy them. Thus, excessive growth in the money supply (easy money) leads to greater inflation, which tends to be followed by **higher**—not lower—interest rates, contrary to what many believe.

The higher interest rates in turn discourage business investments in long-term capital improvements, reducing future economic growth. Long-term bond issues are delayed with the hope that periods of lower inflation and interest rates are coming. Sometimes this means an increase in short-term credit needs, putting additional pressure on the banking system that pushes up short-term interest rates.

Fuel shortages caused by the OPEC cartel are often cited as a factor in the escalating inflation rates of the seventies. The impact of this could have been minimized had the U.S. government and the Federal Reserve System not provided the increases in money supplies to cover these increased costs. The only way that a shortage (and a subsequent high price) in **one** commodity can significantly push the average of **all** prices up is through increases in the money supply. If the monetary authorities refuse to yield to political pressures to increase the money supply, the prices of some other commodities will decline. This would have **negative short-term effects** on the economy, but **positive long-term effects.**

This theoretical expectation was validated by the economic results realized by European countries that responded differently to higher OPEC prices. The seven European countries that succumbed to pressures to increase money supplies when OPEC sharply increased oil prices were able to dampen the short-term negative effects on economic growth, but they have subsequently paid for such behavior with higher inflation rates and lower capital formation rates that will hinder their longer term economic growth. In contrast, five European countries (Belgium, Germany, Netherlands, Austria, and Switzerland)

*Prentice, Paul T. and Lyle P. Shertz, ***Inflation: A Food and Agricultural Perspective,*** USDA, Agricultural Economic Report No. 463, February 1981.

that practiced tighter monetary policies accepted a greater initial economic slowdown but have since shown more growth and less inflation. (Their average inflation rate was only 3.8 percent in 1978-79 versus 9.5 percent for the other group.)

Another cause of increased inflation are government program benefits that are linked directly to the inflation rate through some index such as the CPI and that are overindexed. For example, for 1979, social security benefits were increased approximately 20 percent more than the cost of living actually increased, according to the implicit GNP deflator. Another example is that when dairy price supports were held at 80 percent of parity from 1977 through 1980, net earnings per cow increased much more rapidly than the inflation rate. This brought about an increase in milk supplies and necessitated government purchases of $1.3 billion of milk products during 1980—thereby increasing the budget deficit.

Finally, consumers have been encouraged to spend more and save less. They have observed during the past two decades that Ben Franklin's motto "a penny saved is a penny earned" no longer applies. Rather, it often appears more prudent to buy today before the price goes higher tomorrow. This natural urge in an inflationary economy, of course, only adds more fuel to the inflationary fires by increasing the demand for the goods and services that are available.

Unfortunately, it also decreases the rate of savings. And, a low rate of savings means a low rate of investment in more efficient means of production. A slower rate of capital investment and lower expenditures for research and development slows the rate of economic growth. This, in turn, increases the rate of inflation over what it would have been. For instance, in the earlier example we used a growth rate of 3 percent and a money supply increase of 15 percent to determine a 12 percent inflation rate—if the growth rate drops to 2 percent the inflation difference increases to 13 percent.

Cures

The Federal Reserve Board—with the encouragement of the Reagan administration—has embarked upon a policy of slowly decreasing its annual increment to the supply of money. Continued adherence to this objective will be essential to bringing down inflation rates and, ultimately, interest rates. The question is whether or not voters, their congressmen, and the administration will allow this policy to be followed. If short-term economic problems such as increased business failures and greater unemployment occur, will the complaints of the many special interest groups become strong enough to stop or reverse this policy?

To facilitate a reduction in future inflation rates will require many of the following:

- A change in people's expectations regarding inflation.
- Increasing the incentives for savings and business investments. (This will likely be done through reducing taxes on savings and allowing a more rapid write-off of business investments.)
- Increasing incentives to work (this can be done by reducing marginal income tax rates and changing the rules regarding loss of government payments from many social programs as earnings increase).
- Breaking the indexing spiral that drives up returns from some social programs—such as social security and food stamps—more rapidly than living costs are actually escalating.
- Cease bail-outs of large business firms that go bankrupt (including banks and thrift institutions).
- Move away from protectionist trade policies.
- Continue and accelerate moves toward deregulation that will encourage more competition in all sectors of the economy.
- Finally, as suggested previously, to refrain from putting political pressure upon the Federal Reserve Board to increase the rate of growth in the money supply to help stimulate the economy every time there is a short-term business downturn.

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