THE POLITICAL ECONOMY OF INFLATION

Fritz Machlup

Excuse me for taking the tea along. My voice is a bit rasping today, so if I had to sing I would call it off. I am so grateful to the Cato Institute for giving me a chance to speak, because I *love* making speeches. This occasion is especially nice not only because I met a lot of old, good friends, but because I have a granddaughter [Laura Hastings] in my presence. She is a graduate student in international relations, and this is the first time that she hears me—well, hears me formally.

I also like to make speeches containing an element of surprise. I will surprise you now, because everyone who has known me would expect me to begin my talk on "The Political Economy of Inflation" by first defining political economy, and then going into the historical and analytical semantics of inflation. I will do neither of the two just to show you that rational expectations are unreasonable.

The Problem of Inflation

With regard to the political economy of inflation, I could easily imagine the following kind of controversy:

> Well, inflation—it's a monetary problem. No, it's a fiscal problem. No, it's a monopoly problem. It's a labor-market problem. It's a sociological problem. It's a distributional problem. It's a psycholog-

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> ical problem. It's a game-theoretic problem. It's a system-theoretic problem. It's an ideological problem. It's a moral problem. It's a political problem.

Well, of course, all of these are right. And, you can now conclude: *It certainly is a problem.* But even to that some people might object: "It is no longer a problem." And I quote: "Now that the back of inflation has been decisively broken, the stage is set for a long period of steady real growth." So the back of inflation has been broken? I think the back has at most been scratched.

Now, here is a question. What do my noble fellow economists think about the backbreaking of inflation? I refer here to one of the wise forecasters, Otto Eckstein, who is an awfully nice fellow—only his forecasts are not very good. He wrote a book on core inflation and said you must distinguish demand inflation, shock inflation, and core inflation.[1] Now, shock inflation and core inflation are both cost-push inflations, but shock inflation has to do with increases in the prices of farm products and fuels, but nothing to do with the prices of labor and capital.

Eckstein measured these different contributions to the inflationary problem for several periods. He found that during the period 1973 to 1979, core inflation contributed 7.1 percent to the average, annual rate of inflation; shock inflation, 1.8 percent; and demand inflation, minus 0.7 percent. Over this same period, the consumer price index rose by an average of 8.5 percent per year.[2]

Eckstein thought that a reduction in the core inflation rate would be a major achievement. However, he thought that it could not be reduced more than 1 percent by 1985, and perhaps 1.3 percent by 1990.[3]

This is how my colleagues the forecasters perform. I do not make any forecasts and am very proud of that. It takes a certain kind of restraint not to make forecasts, and people will believe you are either too honest or a bad economist if you say "I don't know."

Now, I do not know whether Otto Eckstein's econometric methods for distinguishing the different kinds of inflations make any sense. I rather doubt it. I doubt also whether it would take 10 years to reduce core inflation by 1.3 percent. In 10 years we could still have an inflation rate of 8 or 9 percent. He did not say what would happen in that case.

[1]U.S. Congress, Joint Economic Committee, *Tax Policy and Core Inflation*, by Otto Eckstein, Joint Economic Committee Print (Washington, D.C.: Government Printing Office, 1980).

[2]Ibid., p. 2.

[3]Ibid., p. 4.

Stopping Inflation: Gradual or Instantaneous?

This raises the question of choosing between gradually stopping an inflation or instantaneously stopping an inflation. Here I must relate my experience, having been a victim of hyperinflation. When I went to graduate school in economics [in the early 1920s], we had the Austrian inflation going. It was not as severe as in neighboring Germany—we reached a price level only 14 thousand times the prewar price level—but we did have to face the question: Gradual or instantaneous?

Now, it was quite clear: There is no gradual stopping of an inflation. It is like gradually getting rid of a smoking habit or gradually getting rid of a drug addiction. If you stop, it is very unpleasant—withdrawal symptoms are painful—and you say "let's stop the stopping process." In other words, you can make up your mind too often. Hence we agreed at that time—and it looks amazing that in 1921 I was already among those who could agree or not agree, but this is the case—that we had to stop inflation *immediately*.

Incidentally, the same discussion about gradually or instantaneously stopping an inflation, and the same results, occurred in Austria after the Second World War, in 1951. A few years after Austria had a post-war inflation, the decision was again to *stop it immediately*. And in this last case, in 1951, it was like this: In one year the inflation rate was still 30 percent per annum, and in the subsequent year it was zero. Indeed, for several parts of the year there was a negative inflation rate. The results were terribly painful. Unemployment increased by 100 percent, *but only for a year*, and then a nice prosperity developed.[4] So you can see why I am persuaded that a gradual disinflation simply does not work.

Now, this looks like a prediction. It is not. It is a tentative conclusion based on my own personal experience and additional theoretical insights, and I do not swear by it. I may be wrong. Maybe it is possible for some countries to stop inflation gradually, but maybe you have to be Swiss to make it work.

[4]For a more detailed analysis of the inflation and subsequent stabilization that took place in Austria in the early 1950s, see Gottfried Haberler, "Austria's Economic Development after the Two World Wars: A Mirror Picture of the World Economy," in *The Political Economy of Austria*, Sven W. Arndt, ed. (Washington, D.C.: American Enterprise Institute, 1982), pp. 68–69.

According to Haberler, the consumer price index increased by 27 percent in 1950 and 18 percent in 1951, but *declined* by 5.4 percent in 1952. This stabilization process was achieved by significant monetary and fiscal restraint, and by a devaluation of the *schilling*. Although employment decreased by 3 percent in 1952, real economic growth resumed the following year.

The Politics of Inflation

I want to say why I believe it is so unlikely that we will stop the [current] inflation. It is unlikely, especially in our political system, because either you have the inflationists in the administration or you have them in the opposition. If you have them in the opposition, the administration must make concessions and compromises. If it does not, it will be voted out of office and the opposition with its inflationary program will get back in. So I really do not see any solution.

This morning I listened to the honorable congressman from Texas [Ron Paul] and he was very hopeful, very optimistic that we would lick inflation, but, of course, only after the monetary system has completely collapsed. There would then be chaos, and people might be willing to accept a system—probably the gold standard—a system that would no longer permit such an inflation. Well, I really don't know whether I should call that optimism or pessimism.

It is really a terrible pessimism. But you see, the slogans that we hear chiefly from the opposition—in the Republican or in the Democratic party—are designed to sustain the inflationary tendency of the people. It is not only that the newspapers, as we heard yesterday noon [from Tom Bethell], are so inflationist in their attitudes, but that the costs of stopping an inflation are so clearly visible. For example, it is often said that "unemployment is too high a price to stop inflation." Well, that means we do not want to stop the inflation because there is no way of stopping an inflation without experiencing unemployment.

It is of course a malicious trick to say that we want unemployment so that prices go down. No, the idea is that the only cure we have for stopping inflation has unemployment as one of its by-products. But to say then, "unemployment is too high a price to stop inflation," means we shall not stop inflation, and it is too bad that some people do not have the courage to speak in this fashion.

Frédéric Bastiat once wrote: "The state is the great fictitious entity by which everybody seeks to live at the expense of everyone else."[5] Now, whatever plan you have, it always goes back to some creation of new money. If you want more employment, create money. If you want faster growth, create money. If you want more capital, create money, although it is quite clear that money is not capital. If you want lower interest rates, create money, although usually it does not work that way. If you want to help the poor, create money. If you

[5]Frédéric Bastiat, *Selected Essays on Political Economy*, Seymour Cain, trans. George B. de Huszar, ed. (Irvington-on-Hudson, New York: The Foundation for Economic Education, 1964), p. 144.

want to help minorities, create money. If you want more schooling, create money. If you want better health, create money. It is always the same thing, only that everybody thinks someone else will pay for it.

The interesting thing is that the very same people who once acted as if they were nonmonetarists or antimonetarists now stress the use of money more than anyone else. What did the antimonetarists say? "It is not true. Money does not matter. It is other things that matter." But what do they now say? That we have restrained the increase in the money supply too much. So the very same people who say, "we are against the monetarists or against anybody who believes that inflation is a monetary problem," now blame the recession or depression—whatever you want to call it—on the Federal Reserve for having *restrained* the money supply too much. So evidently the antimonetarists seem to believe that money matters a great deal.

Inflation, Wage Rigidity, and Unemployment

But I see very complicated problems quite apart from mere ideology. The point is that the inflexibility of our wage system makes the choice between unemployment and inflation practically inevitable. We know that any kind of change in the economic system, whether it be technological progress, shifts in demands, you name it, leads to a change in the wage rates of different groups. Now, if relative wage rates cannot be changed by lowering the wage rate of anybody, it means that you have to have higher wages year after year. But, you cannot have higher wages year after year without having a constant inflation.

The question then is: Do we want permanent unemployment? Do we have to have year after year an increase in the core inflation or whatever you like to call it? Do we want inevitable inflation? It is a dilemma that I cannot solve and that the people eventually will have to solve for themselves.

Another highly important thing—and it is perhaps related to what Eckstein had in mind with his notion of core inflation—is the expectation of a pay raise. The idea of having an annual pay raise is so clear to everybody, so absolutely necessary, but that idea cannot be carried out without permanent inflation. You see, needless to say, there are annual pay raises—merit raises. As people grow in age, experience, and efficiency they can have wage increases. But that everybody—say all the workers in a particular industry—can get an annual raise of 4, 5, 6, 7 percent is simply not in the picture.

Now, what is a possible annual raise? Very little, if the government makes an increasing claim on the national product. If you speak of an increase in labor productivity of 3 percent—which is highly optimistic if you want to sustain it—and if the government takes away, through its increased governmental tasks, 1 or 2 percent from that productivity gain, what is left? Just an annual raise of 1 percent. There is not enough for a 5 percent, 6 percent, or 8 percent raise for anybody. So this is another great difficulty that will force us to rethink these problems.

Since I spoke of wage increases, let me also mention this: In a recent speech before the American Academy of Arts and Sciences, Robert Solow showed that we know so much more than we did so many years ago. There was Pigou who thought that the elasticity of demand for labor was about 4 or 5, and Solow says, "Oh, now we know it is at best .4 or .5." But that misconceives the entire problem. Most of our unemployment problem is *not* the *average* wage rate. *It is the distribution of wage rates.* This can be very easily explained, and perhaps I should give three different examples that show you what I mean by the distribution of wage rates.

Let us begin with wage rates in a heavily unionized sector of the economy—steel or automobiles. Suppose these strong unions make very high wage demands that are subsequently met. If the industries seek to protect themselves from the effects of these wage increases, you will see one enormous problem. What it means is, of course, that the industries will limit the number of jobs available, and force a large number of people to look for work elsewhere.

Let us take a second important example, one that has to do with relative efficiencies. We all know that in terms of the efficiency of people, measure it by whatever you wish (course grades, piecework, or any kind of handwork), the difference between the average and the least efficient is very great. Now, if wage rates are not permitted to show these differences in relative efficiencies, if minimum wages make it necessary to pay to the least efficient only say 20 percent less than is paid to people of average efficiency, you just keep the less efficient workers out. They are *unemployable*.[6] They could be employed only if the wage differential was commensurate to the efficiency differential. But with our present institutions this is out of the question.

There is a third point, and that has to do with the workers in one

[6]If employers are forced by law to pay low-productivity workers a wage that exceeds the value of their marginal product, these workers will become unemployable. In addition to violating the right of employers to lower their wage offers, the minimum wage legislation attenuates the right of workers to accept employment at a freely-chosen wage rate.

industry holding up the rest of the economy for ransom. Take the subway workers in New York City, for example. By striking they force the city to give them the wage increase they want. This can happen in any kind of utility where the services seem to be absolutely necessary. In such cases, [union] workers can hold up the rest of the economy and take a large part of the national income for themselves at the expense of their brothers, at the expense of the rest of the labor force.

Now, here is a problem. Inflation serves the purpose of taking away from these workers what they have been able to capture in the bargain. In the wage settlement they acquired a 10 percent wage increase at the expense of others. So by inflating you reduce their real income. This problem is very difficult to solve and if there is no solution—and I do not think of governmental wage controls as a solution—it may make perpetual inflation inevitable.[7]

[7]The problem that Professor Machlup is referring to can be stated in more detail. Unexpected inflation erodes the real-wage gains of union workers. They will therefore have an incentive to press for further wage increases at the expense of other workers. These increases, however, will almost certainly be accompanied by excessive monetary expansion in order to avoid (at least temporarily) large-scale unemployment effects. The resulting inflation will lead to a new round of wage negotiations, and if accommodated by the central bank will further accelerate the inflation. Unless effective constraints can be put on the growth of money, and unless labor markets can be made more competitive, the political economy of the above-mentioned process makes "perpetual inflation inevitable."