The Current Inflation as an Anomaly

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Transform first 2 paragraphs into a 1 page intro into the inflationary expansionary impact / the devaluation

In science, anomalies are observations which do not fit into the accepted theory. If the anomalies are deemed significant, then the validity or relevancy of the accepted theory is brought into question and an effort to develop some alternative or modified theory is indicated. The history of the progress of scientific knowledge can be written as a process in which the development of new theory is the response to anomalies.

The current inflation is an economic anomaly -- i.e., it cannot be readily explained without modifying the current accepted theories. It suggests that we should take a fresh look at how we interpret and try to forecast economic events.

In particular the behavior of the economy over the past two years suggests that greater attention must be paid to the particular impacts of overall changes and of policies. It is the particular impacts of the devaluations that have been so disruptive to the American economy -- and a devaluation in and of itself is a particular impact.

THE INADEQUACY OF THE STANDARD THEORIES.

Two theories -- usually labeled the Monetarist and the Standard Keynesian doctrines -- have been slugging it out for acceptance as the "best" explanation of how the American economy works and as the "correct" guide to economic policy. Neither theory adequately explains the current inflation. The monetarists look to the money supply as the prime determinant of what happens. Even though the money supply has been growing at a fair clip, the growth has <u>not</u> been great enough to explain what has happened. The standard Keynesians or the fiscalists look to the fiscal posture (surpluses or deficits in the Federal Budget) as the prime determinant. The budget deficits have been decreasing rapidly, and the fiscal posture has quickly moved toward constraint even as inflation has accelerated.

Furthermore, neither theory can adequately explain the special characteristic of the current inflation, which is the runaway prices of basic commodities. Both the scope and the character of the current inflation call for explanation. Both theories tend to slight the importance of the details as to what is happening -- how the money supply changes, or the details of the fiscal posture are regarded of secondary importance. In taking a fresh look at the inflation, we will note how the particular impacts are important and how effective policy must be designed to take special characteristics of the going processes into account

MASSIVE DEVALUATION AND FINANCIAL FRAGILITY

A starting point in our search for an alternative or modified theory is to inquire whether anything of sufficient magnitude and with the correct sectoral thrust occurred recently which was either absent or of minor proportions earlier in the post World War II epoch.

There are two sets of developments of the recent past which are not given much weight in either the monetarist or the fiscalist models and which may account for the size and special dimensions of the current inflation, and which may explain why the policies adopted to date to constrain inflation have not been successful. One development is the huge devaluation of the dollar as against the currencies of most of the other rich countries that has occurred since August 1971. The second is the evidence of financial fragility, as exemplified by the credit crunch of 1966 and the liquidity squeeze (Penn-Central crisis) of 1969-70.

In this paper the major emphasis will be upon exploring the effects of the devaluations that have taken place over the past two years. The major significance of the now evident fragility of the financial structure is that it has transformed the Federal Reserve System into a reacting (or defensive) rather than an initiating (or dynamic) policy agency when economic developments indicate that policy should try to constrain the economy. Whereas the Federal Reserve can act boldly and independently when the economic policy problem is to induce an expansion, the Federal Reserve once it recognizes that the financial system is fragile can only act with caution and constraint when the policy problem is to bring about a slowdown of the economy. In the now ruling financial situation the Federal Reserve on the whole behaves to accommodate the financing needs that arise from expansionary or inflationary pressures.

Thus the major and initiating factor which has to be integrated into our explanation of the present inflation is the huge change in the exchange rate of the dollar that has occurred since August 1971.

THE SCOPE OF THE DEVALUATIONS.

The devaluation of the dollar with respect to the German Mark, the Japanese Yen and other major currencies since August of 1971 has been huge. This devaluation has taken place in three stages: the first stage led to an establishment of new parities in January 1972, the second stage was the formal devaluation of February 1973, and the third stage encompasses the floating of the dollar since February 1973. As the attached table shows, strong currencies of Western Europe and Japan have appreciated by some 35% to well nigh 50% against the dollar over this two year period.

Exchange Rates: Cents per unit of Foreign Currency

Country	July 1971	Mar 72	Feb 73	July 73	Sept 17 73
Germany	28.728	31.545	33.273	42.821	41.53
Japan	.27980	.33054	.36041	.37801	.3770
Netherlands	28.097	31.384	33.119	38.700	39.32
Switzerland	24.423	25.974	25.326	35.428	33.30

% Appreciation with respect to the dollar since July 1971

Germany		1.098	1.158	1.491	1.446
Japan		1.181	1.288	1.351	1.347
Netherlands		1.117	1.179	1.377	1.347
Switzerland		1.064	1.201	1.451	1.363

Source: Federal Reserve Bulletins for all except the quotation for September 17, 1973. That quotation is from the Wall Street Journal.

Of the currencies listed in the table, the German Mark has appreciated the most. The 45% appreciation of the German Mark is broken down as follows: some 10% in the initial revaluation of 1972, a further 6% appreciation in February 1973 and a further 30% (against the original base) appreciation during the float until the end of July 1973. Since July 1973 there has been a slight (5%) improvement in the value of the dollar. As this is being written, the dollar is once again under pressure.

These appreciations of the strong currencies have not been small. The cumulative changes in the exchange rates are larger than those that have taken place over equivalent time spans in the post war period when, for example, the par value of the Pound and the Franc were changed.

Also note that the largest part of the devaluations with respect to the European currencies have taken place since the floating of currencies; for the Japanese Yen the official devaluations constitute the major part of the total change in exchange rates.

THE SIGNIFICANCE OF THE DEVALUATION

The dollar devaluations have had two effects. The effect that has been emphasized in the discussion is that the relative prices of goods produced in the United States has fallen whereas the relative prices of the goods produced in the appreciating countries has risen: i.e., the price of a Volkswagen has risen relative to that of a Pinto in the United States, in Germany, and in third countries. This change in relative prices means that a substitution of United States goods for German and, say, Japanese goods will take place.

Another effect that has not been emphasized, and which is of perhaps greater importance, is that the large scale devaluations of the dollar translates into a large increase in the dollar value of both the national income and personal incomes for the appreciating countries. The 45% appreciation of the German Mark over a two year period means that the dollar value of the National Income of Germany increased by 45% above and beyond the increase in the German National Income that has taken place because of internal economic growth. Similar increases have taken place in the dollar value of the National Income of Japan and the other appreciating countries. A sharp increase in money income, no matter how it is brought about, leads to a sharp increase in money demand for a broad spectrum of goods and services. A lowering of the prices of particular commodities leads to a substitution of the lower priced commodities for the higher priced commodities.

To put it quite generally, the dollar devaluations of the past two years, when translated into income increases in the appreciating countries, increased the demand for many products. For many items the devaluation meant that the quantity demanded at the ruling prices exceeded the quantity available. This was particularly true for those items whose world prices were denominated in dollars, and whose world demand was dominated by American demand. Given the predevaluation incomes of the appreciating countries, the huge increase in the dollar equivalent of their incomes has led to disproportionate increases in the demand for an improved diet (protein foods) and fuels. Thus, with a short lag, large price pressures due to the devaluation affected the markets for meat, feed grains, and oil. Furthermore, as most basic commodity prices were denominated in dollars, they suddenly became relatively cheap to the appreciating countries. This led to excess demand and rising prices in these commodity market.

Thus, the devaluations of 1971-73 in and of themselves triggered rising prices in many commodity markets.

THE IMPOVERIZATION OF THE UNITED STATES

The huge increase in the dollar value of the national and personal incomes of the appreciating affluent countries means that the United States has become relatively impoverished: the United States is now not as rich as compared to these other countries as it was in 1971. This change in the relative dollar incomes has taken place in a world in which most of the rich countries were at or close to full employment. Thus there was not much unused capacity available to expand production -- this is especially true for the basic commodities. The relative impoverization of the United States, in the context of the ruling full employment world, means that some absolute declines have to take place in some components of the United States Gross National Product, i.e., in absolute terms the United States is now poorer.

The devaluations only tell us that the United States is now poorer, they do not pinpoint which dimensions of final output the decline in the real National Income of the United States will take place, nor do they select whose real income will fall. Impoverization means that some combination of United States consumption, investment, and government taking needs to fall.

Initially, the devaluations mean that excess demand develops over a wide range of markets; that is, the quantity demanded at the ruling dollar prices became greater than the quantity supplied. The market reaction to excess demand in a world where supplies cannot adjust because of full employment and capacity limitations takes the form of rising prices. The current inflation is the result of the way in which the market mechanism is trying to affect the required impoverization. The inflation is the process by which the market tries to select where the reductions in real standards will take place and who will suffer a decline in real income.

THE INEFFICIENCY OF THE MARKET AND POLITICAL RESPONSE

A broad generalized inflation is an inefficient way to affect and distribute a decline in United States real income. This is so both because of the way in which the market mechanism operates and because of the political response to the rising prices. It would be more efficient to use policy measures to help ~~the~~ market processes select the sectors and the incomes that will be cut back. But before that can happen, the political leadership needs to recognize that the course of events over the past several years has in fact impoverished the United States. As yet there is no recognition of this phenomenon. The political leadership still emphasizes how rich and powerful the country is. It is difficult to believe that apt policies can follow from false perceptions. Pollyannas never solve hard problems.

One reason the market's inflationary reaction is inefficient is that many of the demand and price increases that take place are immediately transformed into increases in dollar incomes. Thus the higher dollar prices of agricultural products implies higher farm incomes, the higher farm income increases the demand for agricultural machinery, and this in turn leads to increased wages and profits incomes for the affected workers and firms. Thus the excess demands which are due to the devaluation leads to income increases which in turn lead to further increases in demand: inflation generates further inflationary pressures.

Furthermore, where higher prices do tend to squeeze out demand, the government and private organizations tend to intervene to protect the affected. Thus, social security payments, government employment pay scales, and military pay (and retirement) all respond to rising prices by increasing money payouts. Trade unions not only have inflation clauses in their contracts, but also base wage demands on prices. Government contractors, who can pass wage increases on to the government, do not resist wage increases.

The interest rate mechanism is one way in which the market mechanism tries to squeeze demand out of the economy during an inflationary period. An inflation, which means that financing needs are increased will tend to raise interest rates. High and rising interest rates in the context of

United States institutions tend to have a disproportionate effect upon housing production. However housing, because of political pressures, is a bit of a sacred cow. Thus, the administration and the Congress intervene and try to insulate housing demand from the effects of rising interest rates.

What we therefore have is an inflationary process that is presumably a mechanism to decrease real demand, and a combination of market and political processes that tend to offset the effects of the inflation by feeding additional money demand into the system. All in all, this picture indicates that inflationary pressure will continue, although they may be somewhat abated, and that small adjustments in monetary and fiscal policy will be inefficient in halting this process.

NEAR TERM IMPLICATIONS

It is likely that the full impact upon demand of the rise in the incomes of the appreciating countries has not as yet been felt in product markets. In particular, as the food and energy consumption standards of these countries complete their adjustment to their newfound affluence, further price increases will take place.

As a result of the changes induced by devaluations, we can expect United States households to spend a significantly higher proportion of their family budget on food and energy than hitherto. As households are locked into housing and energy consumption patterns, and as the habits of discretionary spending will erode slowly, we can expect the household savings ratio to be low. Thus, in the near future we expect households to act as overall stimulus to the economy.

The strong foreign demand for agricultural output, together with the continuing demand from American households, implies that there will be a strong prosperity in agriculture. This will spill over to the industries that provide agricultural implements and services. The spillover will be so strong that demand will press upon the productive capacity of these agriculture related industries and induce capacity increasing investments.

Because of the above it is difficult to envisage a marked slowdown in the economy during 1974. Consumer durable and nondurable expenditures, plus expenditures on new housing, might well go down. However, inflationary expectations should make consumers willing to go into debt, ~~with~~ in the ~~expectation~~ belief that they will pay off their debt in depreciated dollars. Much depends upon whether the lenders' terms will be allowed to fully reflect the anticipated inflation and whether lenders react to the increased drain of food, etc. upon the budget by decreasing the amount of debt that any take home income can support.

Thus, it seems as if the economy might be on an inflationary treadmill in which ever-rising prices are necessary to enforce the decline in real standards that the devaluations have imposed. With the processes now operating, the particular real standard that is reduced at any moment of time is in part the result of a lottery: it depends upon where in the cycle of increases in money income and prices the economy happens to be. Such an inflationary treadmill, with its rotating declines in real income, will tend to erode the improvement in relative prices that the devaluations have brought about and therefore decrease the favorable effect that the devaluations have had upon our balance of payments. Inasmuch as an undervalued currency is inflationary and an overvalued currency is deflationary, if the float has resulted in a relatively undervalued dollar, the ensuing inflationary process may very well lead to further devaluations -- market processes can worsen rather than improve the situation. We can call this prospect an open ended inflation.

LONGER TERMS IMPLICATIONS: THE NATURE OF APT POLICY

All in all, the prospect of open ended inflation accompanied by further devaluations is not appetizing. The open inflation will lead to domestic disarray.

Our experience since August of 1971 with the reactions to economic difficulties of the current crop of political leaders does not indicate that a wise course will be chosen and sustained.

No apt policy intervention will be forthcoming before the political leadership faces the fact of our impoverization and is willing to make the hard decisions with respect to tax, spending, and income maintenance programs that could get the country off of the open-inflation treadmill. The float since early in 1973 can be interpreted as a gigantic evasion of such political responsibility. If, after the second devaluation, the administration had embarked upon a program designed to protect the newly-established value of the dollar, it would have had to revise its policies to cut expenditures on military bases abroad, it would have reduced defense spending, it would have proposed tax increases, and it might very well have undertaken measures to cut our use of fuel and energy. However, the float enabled this cowardly administration to evade its responsibility -- but the result of this evasion is the prospect of open inflation. The measures that need to be taken to halt the inflation and to prevent further devaluations are very much the measures that would have been taken if the Administration had undertaken to defend the dollar in February 1973.

It is clear from our experience since 1971 that whereas in a world with general widespread unemployment a lower rather than a higher exchange rate may be favorable for a country, in a world where each trading partner achieves a close approximation to full employment a higher rather than a lower exchange rate is favorable. Thus the thrust of longer run economic policies might well be designed to first undo the devaluation due to the float and then perhaps to achieve subsequent appreciations of the dollar. But in order to achieve this, our domestic policies will need to change.

One issue that needs to be faced is the prospective impact upon our balance of payments of the huge forecast dependence upon foreign oil. The forecast oil requirements generate a huge "nut" that our exports will have to finance. The prospect is not good that our exports will make this "nut" even at the present exchange rates, particularly given the way in which the lowering of our exchange rate induces domestic inflation. The price of doing nothing about our oil and energy consumption is a continuing worsening in our terms of trade and further impoverization. Inasmuch as the coal resources of the United States provide ample sources of substitute for all except gasoline, the major need is to constrain the growth of gasoline needs --which in turn implies positive policies to change the nature of the American automobile and to undo some of our dependence upon the automobile.

Policy measures that would substitute for inflation and would perhaps be effective in offsetting the impoverization due to the devaluation might well include:

a) reductions in military spending

b) efforts to compact our urban complexes

c) decreased subsidy to and emphasis upon construction

In addition, many of our policies with respect to income maintenance, labor force participation, and job security were adopted during the great depression when the ability of government actions to sustain a close approximation to full employment was rightly questioned. The past twenty-five years have demonstrated that policy can maintain a close approximation to full employment and thus many wasteful practices can now be eliminated. Such a fuller and more efficient use of our capabilities can offset the impoverization that the devaluations imply.

As far as economic analysis is concerned, the evidence from this inflation indicates that simple minded models, which argue that the behavior of the economy depends upon the behavior of one or a few variables, are not valid. In particular, any view of the economy which does not give large weight to international economic variables when these variables change significantly will mislead both forecasts and policy. Furthermore, we should learn that an analysis or a point of view which did well in the past will not necessarily hold true in the future.