

RECORD

INFLATION—ILLUSION AND REALITY

An Address By

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The subject of my talk is one you know already quite well--inflation. Permit me to begin by taking a somewhat sweeping view. It is essential for you to know my perspective before I speak to the subject in terms that bear on your work in the years ahead.

The inflation we have experienced unremittingly for three decades is entirely different from the inflation the world knew in the past.

Today it is global. Previously, inflation was highly localized, associated with wars, natural disasters and the like. It was confined to a region of a country, a single nation, or at most to a few countries. Modern inflation pervades nearly every corner of the world.

It is persistent. Previously, inflation rarely lasted more than a few years. Today's inflation is entering its fourth decade with no end in sight. This characteristic of persistence is widely accepted. Like poverty, it is expected to be with us always. People once simply hunkered down until the storm passed. Today much of the global population has never known anything but inflation and most accept it as simply a disagreeable but unavoidable part of life.

Persistent global inflation, widely accepted as such, poses immense danger to everyone. Continuing cost, price and wage increases mean steadily rising price indices, public utility rates, interest rates, money supply, bank credit, and ever higher levels of government expenditures and receipts. Consumers, producers, bankers, politicians, artists, teachers--in short, everyone--come to expect these rising trends to stay, and social, political and economic behavior begins to change radically, and not for the better.

The social and political manifestations of persistent inflation vary markedly from country to country, from community to community, but in every case lead ultimately to widespread discontent, frustration and alienation. A deepening sense that one is running faster and faster only to drop further behind underscores these tensions.

Modern societies show remarkable resiliency, but at the same time, great vulnerability. A break in any link--whether transportation, pricing, water supply, fuels, communications, sanitation, health, and so on--can disrupt an entire society. These breaks have begun to occur all too frequently in recent years in the United States, as anyone living in a major metropolitan area can readily attest.

Repeated disruptions increase popular anger, discontent and alienation. Social and political antagonisms erupt and the tender fabric of social organization is threatened. To understand what we must do, we must first understand how all this came about and why.

The Great Depression of the 1930's altered forever the relationship between government and the governed. To combat the precipitous decline in living standards among the advanced nations, governments assumed an active interventionist role in their economies, a position from which their citizenry does not wish them to withdraw. People no longer allow governments to remain acquiescent in the face of economic downturn.

Meanwhile, a new generation, which since the 1930's has more than tripled world population, has been born in an environment fed by the unrealistic expectations of their parents that government not only could solve all economic problems but could do even more besides. Government would hereafter provide all the health, housing, education, and other services that people want and once provided for themselves.

The world grew economically more interdependent. The sophisticated communications, financial, managerial, and productive channels of world commerce swelled markedly and efficiently in response to the growing demands of populations everywhere. These same transmitting belts of the necessary and bountiful caused with equal facility the deleterious effects of too much demand chasing too little supply.

As a result, we live in a world of infinite demand but finite resources. People, high on unrealizable expectations, demand more of government, which strives to meet these expectations. Huge consumption demands outrunning supply has been the underlying trend for years. The result is persistent, global inflation with expectations of little else. Recessions have repeatedly resulted in temporary gluts, but only temporarily.

The 1930's also saw the introduction of the "New Economics," based largely on the views of John Maynard Keynes, who concentrated on the problems of over-coming world depression with its massive unemployment of men and machinery. He emphasized means to stimulate demand under such conditions. He advocated increased demand to reduce unemployment to acceptable levels. Price rises were encouraged to stimulate business investment. Indeed, in those times, since prices had fallen sharply, price rises were welcomed as signs of coming prosperity! Supply was largely ignored; inflation was far from anyone's mind.

In recent years, many of those who once resisted Keynesian economics now accept it. As one convert said not long ago, "We are all Keynesians now." These techniques, designed to overcome large and prolonged recessions under noninflationary conditions, do work--within the limited context of their design. Today, however, our problems are far more complex and supply is much more important than this approach allows.

For many years, high rates of inflation were considered endemic to such regions as Latin America, but unlikely at all in the advanced countries with their more sophisticated economic techniques. We, in the United States, continued to believe that what had become traditional economic policy made possible an unending consumption binge. We were confident that we could ignore gradually accelerating inflation at home and the larger elements taking shape globally.

Of course, it went awry. Inflation continued to climb despite our confidence, reaching levels considered heretofore totally unacceptable. In the industrial nations, acceptable rates of inflation climbed to 2 or 3 percent in the late sixties, to 7 or 8 percent in the early seventies, and, in some parts of the world, to 11 percent or 20 percent or higher. Only recently, the rate was 16 percent in Australia, 29 percent in Brazil, and 20 percent in the United Kingdom.

Uncertainty overtakes many of us. The young couple is swamped with debt in starting up a household. The college graduate is unable to find a job in his field. The apartment dweller constantly must search for more wages to stay apace of rising rents while services in his building worsen. The pensioner who retired ten years earlier on what he thought was an adequate sum must now qualify for relief rolls. This has become a major problem in Florida in recent years.

Couples with growing children seek a home, only to find that an acceptable one is priced beyond their means. Among the poor, black and white, unemployment ranges from 25 percent to 50 percent in urban areas of the country. Garbage piles up in cities as sanitation workers strike for additional income to

maintain fragile living standards. Pollution increases because governments and industries lack funds to combat it. Health deteriorates because many can no longer afford doctors and dentists, despite medical insurance and welfare.

The small store has difficulty deciding how much merchandise to stock in the face of unpredictable operating costs. The large firm faces bottlenecks and shortages in many areas of production and distribution. The banker wants customers but is hesitant to lock himself into firm commitments on interest rates.

Investors, viewing the confusion all about them, buy diamonds, gold, or real estate, or store funds in supposed safe havens abroad instead of buying equities or bonds that would finance increases in productive capacity. Diamonds and gold provide only temporary relief. We have seen vividly what has happened to real estate. "Safe havens," like Switzerland, don't pay interest on deposits, have high rates of inflation usually, and money placed there diminishes rapidly in purchasing power.

All this and more work mysterious changes in our lives. Our children voice opinions and preferences and act in ways that appear at odds with their upbringing. The family system breaks down in homes where parents cannot afford to educate or properly feed, clothe and house their children. Clergymen ponder the materialism and apparent selfishness of their congregations, despite the upsurge of ethical concern in modern society. The list could go on. But it all adds up to uncertainty, frustration and alienation.

Government efforts in the last two years have generated a decline in the rate of inflation but at the cost of high unemployment. In fact, the view is widely held that the only way to bring inflation under control is through a trade-off against unemployment. Based largely on this approach, the major industrial nations have each launched anti-inflationary programs simultaneously for the first time on record. Yet the effort so far has produced exceedingly high unemployment with only a partial diminution of inflation. Consequently, confidence in private and public institutions deteriorates further.

Surely, your profession senses these difficulties directly and indirectly. The past remains a guide to our future in many ways still, but the more recent past indicates only more uncertainty for our future. In 1971, when I wrote that double-digit inflation was imminent throughout the industrial world, few indeed took the prediction seriously. I do not believe the current effort to combat inflation through increased unemployment will resolve our struggle with inflation, but so much has gone into these approaches that I hope, sincerely, I am wrong.

Currently, the general economic consensus is nothing beyond a general upturn later in the year from the current recessionary malaise. Beyond that, opinion is notable for the lack of it. Rates of inflation have declined, but what about next year and later? Our national economic policy is increasingly reactive, at best short term. We sit astride a stallion running wild and we pull at the reins simply to keep from flying off, knowing only that the charge cannot go on forever before collapse.

Many critical segments of our society must look at least two, three or more years ahead. If interest rates are expected to remain down for a year or two but beyond that, heaven only knows, how can they safely plan further, when the macroeconomic policy they employ is based on macroeconomic policies not even contemplated?

May I try to relate this briefly to your professional concerns? Carefully, and not so carefully, laid corporate and personal financial planning is undermined. What we call "building an estate" is seriously impaired. For retirees, pensions must be supplemented somehow. Savings started early to provide college educations for children ten to fifteen years later prove woefully inadequate when the enrollment year arrives. Life, health, fire, mortgage and myriad

insurance protection plans are seriously diminished in real terms by the time their benefits are needed. How will future health costs be met since many insurers still sold level premium guaranteed-renewable-for-life major medical expense policies during the 1960's and early 1970's?

Is it really feasible to develop insurance planning when the rate of inflation remains unpredictable, as evidenced by its rise from 4 to 12 percent and the drop back to 7.5 percent in the U.S. over the last three years? And how do you build a reasonable premium structure when so many costs influenced by inflation remain unpredictable? What do you advise someone to do for fire insurance for the home or plant when replacement costs are so volatile? Should he take a policy with a built-in increase each year, renegotiate each year on the basis of current inflation, or simply sign a replacement cost-plus-fee policy?

The point is that inflation is likely to persist as long as we apply the limited techniques against it that we are currently employing. The loss in real terms is only one detriment. We also sacrifice efficient allocation of capital, natural and human resources, but most importantly we create confusion, uncertainty and anguish in large segments of our country and the world.

Most attempts to deal with modern inflation fail because it is assumed that individuals, firms and governments will behave as they have done under conditions of previous "temporary" inflations. In the past, raising interest rates on loans during periods of business upswings would have curtailed demand for loans. Today, we cannot be sure of the effect. It may actually increase the demand for loans, after a short period of adjustment to the new conditions. Individuals may believe from past experience that interest rates will simply go higher and it is best to borrow immediately before they do.

It may launch a spiral of borrowing, passing the cost on to the consumer, or stimulate additional borrowing to pay off old debt.

Similarly, higher taxes, particularly during periods of business upturn, may simply induce the consumer to borrow more or use his savings, which become less attractive when inflationary expectations remain high. The rationale is that it is better to use savings now because the desired goods will only cost more in a few months.

Another anti-inflationary device is to hold wages down. But few expect wages really to be held down long enough to ultimately eliminate inflation, so the wage earner maintains consumption by other means--through consumer credit, use of savings, etc. In the last resort, he will call on government to provide, through public expenditures, what he cannot do privately.

What is needed is to end expectations of persistent inflation. Given the general failure to understand this need, essential remedies have been neglected. Those remedies will involve changes in our ways of life, but not so much as the consequences of allowing the inflationary process to continue.

Policymakers and the public alike must recognize that inflation is persistent, global and unrelenting. The campaigns underway in all countries are based on the unemployment trade-off. In almost every case, the effort is to hold prices at some acceptable level. The social cost of unemployment as a means of ending inflation is unbearably high. For these reasons, the anti-inflation campaigns do not even aim to end inflation. We should first decide that the complete elimination of inflation must be our real goal; that this cannot be done quickly and will involve changed emphasis in our priorities.

We must cast off erroneous conceptions. Under current supply and demand conditions, relatively low rates of inflation easily reaccelerate, even in the face of relatively restrictive price, wage, fiscal and monetary policies. Desirable social goals are sacrificed in the process. Persistent inflation is an unrelenting enemy of full employment, the general welfare, and the elimination of poverty and chronic social insecurity. Nations must make zero inflation

their goal.

This is a hard decision, but the alternative societal effects are intolerable. The process can be greatly facilitated by clarifying what each citizen wants for his country--its social priorities, its economic institutions and practices, its political processes. The basic operating assumptions for the management of the economy need to be made explicit and subject to broad agreement.

Typical goals may well include sustained high employment, elimination of poverty, improved quality of life, sharing material improvements, and expansion in the international exchange of goods and services.

We must clarify the role of government in social and economic management, as in attempts to influence consumption patterns through fiscal and monetary policy, the degree of long-term government economic directives and controls, the desirability of increasing savings and investment, and the means for broad public debate on these issues.

The precise content of the program will be grist for the political mill for years to come. We have mounted comparable programs before--the massive commitment to World War II, the rebuilding of Europe and Japan, and the rapid ascent to the moon in the 1960's. The program must be flexible since, inevitably, certain policies will fail, but there should be no doubt about one key element--the program will continue until inflation is buried once and forever.

Our program must attack root causes. We need a carefully selective attack on the scarcities and bottlenecks that hamper the supply of needed goods and services and a carefully selective effort to change the pattern of consumption. Traditional fiscal and monetary policies may well be useful but only if they are chosen in combination with other innovative methods and if they are part of a concerted effort by many other nations.

Tax legislation, interest and credit policies must be used to achieve desired changes in consumption. Simply reducing or increasing consumption is inadequate; the composition of consumption must be changed. Taxes for certain products may be placed much higher and investment incentives for producing them reduced, while the production of more widely used and needed products and services can be strengthened by converse measures. We have done this for years in cases like alcoholic beverages, tobacco and gasoline, and now we see increasing examples for conservation purposes.

Savings must be encouraged by such measures, for example, by making savings deposits interest or earned income that is saved tax free. Imaginative tax and credit policies can help to economize the use of raw materials, to encourage savings, to encourage production of consumption goods in areas of greatest general need that strengthen the anti-inflationary program.

These measures will direct allocation of natural resources among leading national priorities, including urban renewal, medical care and research, housing, defense, education and transportation. They must include the range of private consumption. Decisions about these priorities must be made at the grass roots level to succeed.

Any national program must include provisions for international cooperation in dealing with supply and demand for food, energy, and other resources. If the international aspects are ignored, the national program will be defeated. We must give new responsibilities and support to such existing institutions as the International Monetary Fund, the World Bank Group, the Food and Agricultural Organization, the various regional development banks and other organizations. These institutions take an overview of national conditions and policies and can help importantly to bring about equilibrium between world supply and demand.

Once such programs are widely accepted in many countries, the national programs can proceed with substantial results. Governments will acquire information that will enable policymakers to devise answers and inform the public of

their efforts. Attention can be directed globally to balancing demand and supply with emphasis on the composition of demand and the structure of supply. Scarce resources will be channeled into areas that increase productive capacity--an effort that lies at the heart of a comprehensive anti-inflationary program. Only through increased productive capacity can the desired social welfare and other goals be met.

Let me summarize now what I believe to be the major illusions in our anti-inflationary struggle:

That inflation will gradually subside without major changes in our anti-inflationary efforts.

That inflation can be ended by unemployment.

That rates of inflation are predictable.

That there are defenses against inflation so that it is neither disruptive nor inequitable.

That persistent inflation can be stabilized at some consistent rate.

That wage and price controls can end or stabilize inflation.

That declines in rates of inflation due to cyclical moves mean an end to persistent inflation.

That the glut of many commodities and products means the end of scarcities and bottlenecks.

That lower growth rates can help resolve inflation.

That inflation is caused by public expenditures or government deficits, separately from all other spending.

For those who fear that the effort to end persistent inflation implies an excessive degree of governmental intervention, the answer is that persistent inflation itself makes governmental intervention inevitable. Only when persistent inflation is ended, will it be possible to make a true choice between minimum or maximum governmental intervention. Persistent inflation destroys our political choices, just as it destroys economic and social choices.

The actuarial profession plays a key role in dealing with the uncertainties inevitably facing people and institutions. It is a science devoted to reducing uncertainty. It employs tools of analysis to provide for future contingencies based on historical experience and current trends. It bears the brunt of inflation because inflation increases uncertainty and undermines the reliability of using past experience to measure the money costs of future expenditures, or conversely, the purchasing power of savings. At the same time, people must, and will try to, provide for future contingencies. The dilemma is inescapable. I am sure that you have the ingenuity to erect temporary defenses, but the ultimate viable defense is the end of inflation.