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Prices and Incomes—The Way out of Inflation?

By Dr Karlheinz Kleps, Berne *

In almost all industrialised countries of the West the rates of inflation have risen considerably if we compare the averages of recent years. This can be seen in a particularly clear and striking way when rises in consumer prices are compared over the periods 1954-61 and 1962-66.

Rates of Increase of Consumer Prices in 12 OECD Countries between 1954-61 and 1962-66

Country	Average 1954-61	1962	1963	1964	1965	1966 *	Average 1962-66
France	4.1	5.0	5.2	3.9	2.7	2.8	3.9
Sweden	3.1	4.0	3.0	4.0	6.0	6.7	4.7
Britain	2.9	4.4	2.2	3.6	5.4	4.1	3.9
Norway	2.7	5.0	3.0	6.0	5.0	3.3	4.5
Holland	2.6	2.0	4.0	6.0	6.0	6.9	5.0
Austria	2.4	4.0	3.0	4.0	6.0	2.3	3.9
Italy	2.1	4.8	7.9	6.8	5.5	2.6	5.5
Fed. Republic of Germany	1.8	3.1	3.1	2.6	3.8	3.7	3.3
USA	1.4	1.1	1.3	1.4	1.7	2.6	1.6
Belgium	1.3	1.4	2.2	4.4	4.4	4.4	3.4
Canada	1.3	1.2	1.8	1.9	2.6	3.6	2.2
Switzerland	1.2	4.4	3.6	3.4	3.9	4.9	4.0

* Provisional figures for January-September 1966.

Sources: for 1954-61 OECD: Policies for Price Stability, Paris 1962, p. 12; for 1962-66 OECD: Main Economic Indicators, Paris, November 1966.

Since the use of conventional economic instruments was often unable to achieve the aim envisaged, new methods of countering inflation are being sought on all sides. Increasing interest is being shown in the connections between productivity, income and prices in a full-employment economy.

Considered in a general way, the national level of prices rises as soon as the effective total economic demand exceeds the supply of goods and services, the extent of such imbalance being expressed in the size of the inflation rate. Balance can be restored either by an increase in supply and/or a reduction in demand.

In a full-employment economy the opportunities to increase supply are very limited. In the short term, in particular, there is scarcely any opportunity to solve the problem of inflation in this way. Thus greater hopes are placed upon measures to reduce demand.

Since the effective total economic demand must be considered as a variable dependent upon income and since—once the inflation process has commenced—this is determined primarily by price development, the view has spread that the problem of inflation can

be solved, or at least reduced to manageable dimensions, by means of a central prices and incomes policy aimed at bringing increases in demand into line with growth in productivity.

At a first glance, this view (the principle of which is by no means new), expressed in different ways, seems quite correct.¹ But a closer look at experience gained meanwhile in those countries which have experimented with a productivity-orientated State influence upon the structure of prices and incomes raises certain doubts. Such doubts are mainly in connection with the indicative value of productivity progress as an indicator, the efficiency of trade cycle policy, the side-effects of growth and structural policies and—not least—with the consequences upon control policy of a State prices and incomes policy as a means of countering inflation in a market economy.

The Problem of Indicators

The ex post calculation of productivity rates still causes considerable difficulty and the final results often give rise to violent arguments. But we do not need to go into this aspect here. More important is the fact that State prices and incomes policies attempt to base themselves upon productivity estimates which, e.g. determined by the duration of tariff agreements or national plans, are made for periods of one year or more.

As such estimates are necessarily based upon numerous hypotheses, they can never be more than relatively valid bases of prognostication. On the degree of reliability of these it depends, in the first place and to a very considerable extent, whether or not the proposed balance in the future development of supply and demand can be achieved by corresponding measures in the field of prices and incomes policies. With a logical prices and incomes policy, any over-estimation of ex ante productivity rates leads to greater inflation and, vice versa, any under-estimation to deflation.

If the Government is content to predict merely the average productivity of the total economy and to announce this as an indicator, a further question then

* Like the earlier paper by this author on "Economic Planning in Theory and Practice—The Experience of Western European Countries" (INTERECONOMICS, No. 10, 1966, p. 18-23), this contribution is also based mainly upon the conclusions to which Dr Kleps came in his recently published study on "Long-term Economic Policy in Western Europe", Freiburg im Breisgau, 1966.

¹ The only new aspect is the transition from a State policy on wages to an incomes policy covering all types of income. As early as May 1944 the British Government, with regard to its future prices and wages policy, stated inter alia: "Increases in the general level of wage rates must be related to increased productivity . . ." And elsewhere it goes on: "If the general level of wage rates rises, and there is a corresponding increase in prices of goods for civilian consumption, the individual wage earner will be no better off." (For more details, see Ministry of Reconstruction: Employment Policy. (Cmd. 6527), London 1944, paras. 50 and 52.

arises about what concrete prices and incomes decisions can use this type of average macro-economic indicator as a guide. For instance, to take wage negotiations in the mining industry, the printing trade or in certain service industries, where there are considerable variations in productivity development, this question almost answers itself: in actual individual cases the forecast value of the predicted average rates of growth is extremely small.

The forecast of detailed growth rates of productivity cannot be considered a solution to the indicator problem, if only because the degree of reliability of such prognostications falls as the breakdown becomes more detailed.

However, the failure of attempts to date to solve the problem of inflation by adopting State prices and incomes policies is only in part due to the in any case highly problematical and therefore always controversial validity of forecasts as indicators.

The Efficiency of Trade Cycle Policy

In general, it is possible to differentiate between an indirect and a direct State incomes and prices policy. Both methods have already been given practical tests, but no satisfactory results have yet been achieved.

In case of an indirect policy the Government limits itself to publishing the predicted average rates of productivity—which assume the character of instruments—whilst attempting to convince the numerous decision-makers in the field of prices and incomes policy of the necessity to conduct themselves in line with such productivity. The Government refrains from any significant intervention in prices and incomes policy.

When this variant of "moral persuasion" is adopted, the anticipated success can only occur if the following conditions are also fulfilled: first, inflationary impulses deriving from foreign trade have to be eliminated; secondly, rises in expenditure by all State authorities must be brought into line with productivity rate; finally, all prices and incomes policy decision-makers in the private sector must be willing and able to limit their exploitation of market opportunities open to them in accordance with the degree of productivity increase.

Quite apart from the limited and always controversial validity of predicted average productivity rates, it is an illusion to hope to fulfil such fundamental conditions on a voluntary basis in an economic society with differing interests. On the other hand, it seems more correct to assume that in low productivity sectors (for instance, mining and agriculture) attempts are made, for prestige reasons, to obtain increases in income at least equal to, or even in excess of, average productivity rates. For example, one cannot help wondering what trade union leader—contrary to his function and his mandate—would be able and willing to convince the members of his union that their wage increase should be below the average.

Considered from this point of view, the average rates of productivity published by the Government may even be an additional incentive to inflation, for it is hardly to be expected that excessive wage increases in low-productivity sectors will be balanced by voluntary wage restriction in high-productivity sectors. This is certainly not the case when a further unavoidable rise in prices is expected in the relevant *ex ante* period and is predicted at the same time as the productivity rates.

The hope that the economy will voluntarily conform with directives announced by the State has hitherto, and without exception, never been fulfilled, either in the private or the public sector. Even explicit statements of intent (for instance, by the British Government, the unions and trade associations on 16th December, 1964) to base themselves on productivity and to exercise price discipline have remained ineffective due to the interplay of interests and of political forces and also because of the tendency of any market economy to follow its own laws and impulses.

Meanwhile, this experience has caused certain countries to adopt direct, rather than indirect, prices and incomes policies.

Amongst the numerous phenomena caused by direct State prices and incomes policy are the establishment and constant expansion of State control authorities, progressively more detailed productivity forecasts, detailed admissibility studies of proposed prices and incomes increases, restrictions upon the auto-financing of private investment, credit controls, selective tax and financial incentives for investment, increasingly greater interference in the autonomy of trades' unions and employers' associations concerning rates and, finally, directives freezing prices and wages. For several reasons, however,—if freezes upon prices and wages are left out of account—the results of such measures have hitherto remained unsatisfactory.

First—as has been seen very clearly in Britain—even the announcement of direct intervention on prices and income structure resulted in a wave of price increases and demands for income increases. Since entrepreneurs and unions both endeavour to exploit in good time whatever chances the market offers before State measures take effect, precisely the contrary happens in the initial stages of a prices and incomes policy to what it is supposed to achieve, i.e. inflation becomes more acute.

Secondly, similar considerations on the part of entrepreneurs mean that price reductions are unlikely to be made voluntarily because State intervention is to be anticipated when such prices are due to be raised again. Thus a considerable element of competition and economic impetus is largely excluded by a State prices and incomes policy. Not only wages but prices, too, are obstinate about falling.

Thirdly, the more active the Government is in limiting increases in prices and incomes, the stronger become the overt and covert resistances in the economy. As well as uncontrollable prices (mainly in the service

sector), hidden earnings and tax avoidance, there are "black" wages and firms which grant illegal social payments. Market dynamics, so to speak, go underground.

Even these few aspects show that the chances of solving the problem of inflation by direct manipulation of prices and incomes are extremely slight. It is only possible to achieve modest, partial results by these means, in particular when a Government decides to freeze prices and incomes and at the same time is able to maintain economic growth by means of suitable tax and financial incentives to encourage investment. However, one cannot help wondering what price will have to be paid, in the long term, for the relative monetary stability thus achieved.

Consequences of Growth and Structural Policies

Prices and incomes increases restricted equally by sectors mean smaller profit expectations for entrepreneurs and higher risks in introducing new products. This leads to a lower rate of private investment activity and a hardening of the production structure, above all in the consumption sector of the economy, where a direct prices and incomes policy has more effect than upon the production and distribution sectors. A further effect is a fall in economic growth, which becomes more acute when employee incentives are simultaneously curtailed.

Thus the problem of inflation is rendered more acute by the supply sector, so that further interventions are required in the formation of prices and incomes. A development is initiated which either leads, when unemployment is on the increase, from a recession, via stagnation, to deflation, or terminates in a system where the Government succeeds in balancing the recession in private investment activity by public investment. Hitherto experience has shown that the chances of solving the problem in this way are extremely slight, if only because of the limited opportunities for deficit spending. The main thing is that it is almost impossible to achieve structural modifications or new combinations of production factors by such means.

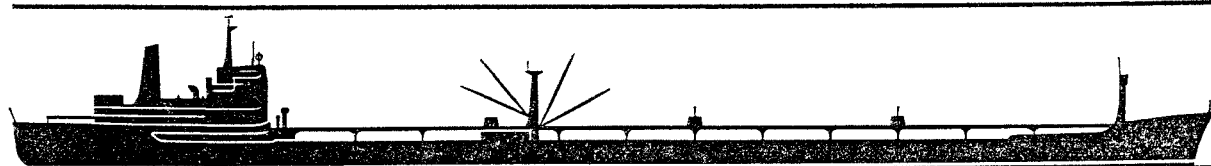
Problems of Control Policy

Whereas the widespread assumption that inflationary problems can be solved by means of State prices and incomes policies seems to be false and the effects of such attempts upon the growth and structure of the economy give rise to further anxiety, there are also considerable reservations to be reported about control policy.

Due to the progressive intensification of State intervention and control, the guiding function of the formation of free market prices is being excluded from ever increasing sectors of the economy and the speed with which the market economy system is able to adapt to changed circumstances is considerably reduced. To an increasing degree, the State is responsible for development deficiencies and this leads to further intervention. But at the same time this means that tensions and conflicts between the unions and employers' associations, on the one hand, and the State, on the other, become more acute, and because of this growing intolerance and radicalisation a situation is reached where democracy itself is seriously endangered.

The high rates of inflation which have persisted for years in almost every industrialised country in the West have been described as the expression of our impatience.² This is certainly correct, but it is only a partial evaluation of the problem. For inflation is not only a consequence of the excessive demands made from all sides upon the national product, but also the result of a preserving economic policy, whereby the market economy process of adaptation and, consequently, economic growth have been more or less inhibited for years. Instead of speeding up this hardening process by interfering in the formation of prices and incomes, the economic policy of the State should really be directed at constantly improving the adaptability of the market economy system. This is the only means by which the problem of inflation can be satisfactorily solved.

² See Günter Schmolders: Die schleichende Inflation—ein Ausdruck unserer Ungeduld. (Creeping Inflation—an Expression of our Impatience.) In: Schleichende Inflation? Information, Vol. 12; published by M. N. Metz, Cologne and Berlin 1965, p. 129.



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