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INVESTMENT POLICY

Inflated Fears

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Inflation is Never a Big Problem Unless We Want It

- Inflation is an aberration that occurs when the government pursues a systematic policy in favor of rising prices.
- From time to time, the Federal government has followed inflationary or deflationary policies:
  - Inflation has been used as a primary method of financing wars.
  - In the late 19th century, prices were deflated to pre-Civil War levels.
  - After World War II, the U.S., haunted by the Great Depression, systematically pursued inflationary policies. Moreover, so-called "fair trade" laws, industry regulation and strong labor unions gave the economy an inflationary bias.
- In contrast to the 1960s and 1970s, inflationary policies have little support today because:
  - War, historically the most common source of inflation, is not a visible threat.
  - In contrast to their parents, baby boomers grew up in an era when inflation—not deflation—was the chief economic problem.
  - Inflation is not backed by labor unions or by politicians who believe that higher inflation will reduce unemployment and help the poor.
  - Investors, an influential group composing more than half of all voters, oppose inflation, which clobbered stock prices in the 1970s.
- Today inflation also lacks a strong economic foundation because of:
  - More intense foreign competition.
  - Strong productivity growth.
  - The info economy is driven by excess, with many products available for free on the Web.
  - The Internet makes it possible to collect and compare prices instantly.
  - The Federal government is running surprisingly large surpluses—not deficits, as in the 1970s.
  - Deregulation continues in such areas as telephony and electric power.
  - Wall Street's boom is financing new capacity.

Although Friday's employment report assuaged some of the recent inflation fears, investors should look beyond the market's manic swings in sentiment driven by the latest economic statistic and consider the underlying question: Is there substantial risk that inflation will accelerate over the next few years? Such an increase would be unambiguously bearish for stocks. When inflation averaged 9.3% in the second half of the 1970s, the P/E multiple of the S&P 500 averaged just 9x, versus 26x today.

Inflation is not a "natural disaster" that strikes economies randomly, like a drought or a tornado. Inflation is an aberration that occurs when the government pursues a systematic policy in favor of rising prices.

Fortunately, there is no reason to believe that a return to the high inflation of the 1970s is likely. Inflation is not a "natural disaster" that strikes economies randomly, like a drought or a tornado. A review of U.S. financial history demonstrates that fairly stable prices are the norm, and that inflation is an aberration that occurs when the government pursues a systematic policy in favor of rising prices. Most inflationary episodes have occurred during wars. However, inflation also gradually infected the economy in the three decades after World War II when Americans, striving to avoid a replay of the deflationary catastrophe of the1930s, consistently favored a rising level of prices.

Today, in contrast to the 1960s and 1970s, there is essentially no public support for a pro-inflation policy. On the contrary, a progressive decline in inflation for two decades has raised living standards for virtually every segment of the population, from affluent investors to welfare mothers who are leaving the dole for jobs in the private sector. Therefore, Mr. Greenspan has the full backing of politicians and voters as he does what it takes to keep the inflation genie in the bottle. And this should not be too difficult, because the economy is far less inflation-prone than in the 1970s.

Pursuing Inflationary Policies During War

Prior to the mid-twentieth century, nearly every bout of severe inflation in the U.S. was associated with, and caused by, a war—notably the Seven Years War (aka the French and Indian War), the Revolutionary War, the War of 1812, the Civil War, World Wars I and II, and the Korean War (Charts 1, 2). During wars, everyday goods such as food, clothing and housing rise in price because output is severely constrained as workers join the army, factories are converted to producing war material, and economic activity is impeded by the war itself (which disrupts shipping lanes, closes harbors, etc.). Furthermore, while the economy's productive capacity is reduced, total demand for goods rapidly increases as a war machine is built.

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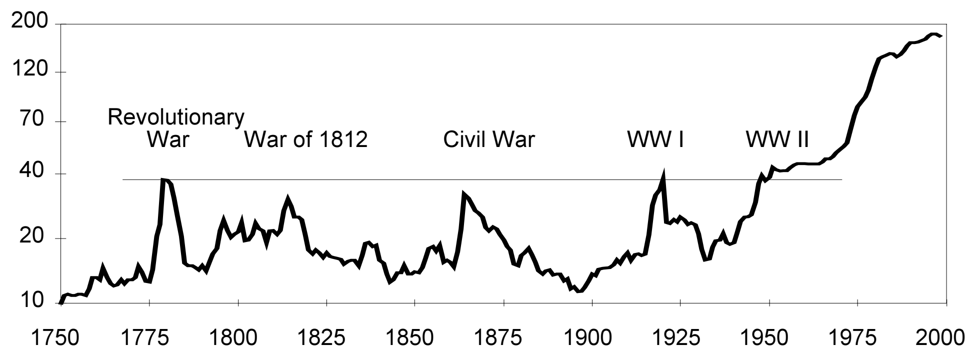
While the shift of an economy to a wartime footing boosts inflation, government policy invariably does as well. To finance a war, a government has four main options:

- *Get subsidies from foreign nations.* During the Revolution, America received financial aid from France, which was seeking to avenge its loss of control of North America to Britain in the Seven Years War. (France got the revenge it was looking for, but also huge debts that helped trigger the French Revolution a few years later.)
- *Raise taxes.* This is fiscally prudent but hard to do when citizens are already making immense sacrifices.
- *Borrow.* A popular method that passes on the cost of the war to future generations.

- *Print money*. The easiest method but also highly inflationary. Because it transfers buying power from the public that takes a depreciating currency to the government that issued it, this method resembles a tax in some respects—albeit a silent, nonexplicit tax.

A comparison of the American Revolution and the Civil War shows how governments varied their choices among this menu of options, depending on economic and political circumstances.

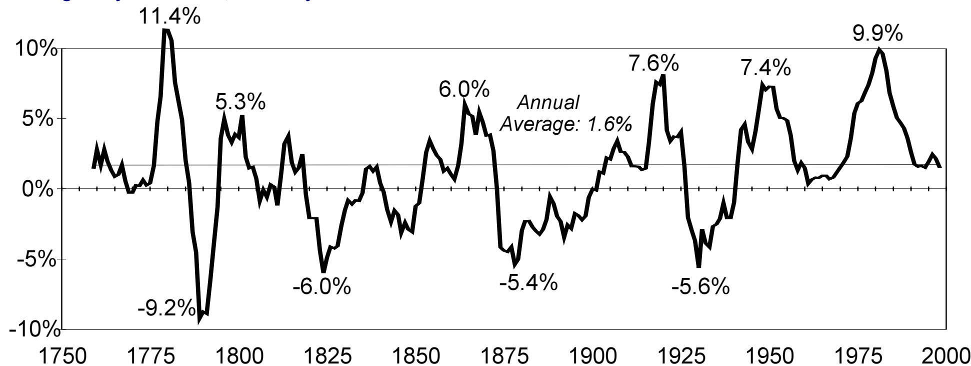
Chart 1: Wholesale Prices in the U.S., 1750-1999



Source: Historical Statistics of the United States: Colonial Times to 1970 (Part 1).

Chart 2: Wholesale Price Inflation in the U.S., 1750-1999

Rolling ten-year CAGR, annually



Source: Historical Statistics of the United States: Colonial Times to 1970 (Part 1).

The American Revolution: Founding a Nation on Hyper-Inflation

As noted, America received some subsidies from Britain's sworn enemy, France. However, the embryonic nation's credit rating was too poor to borrow much from Dutch and French bankers. And only about 6% of the cost of the Revolutionary War was financed with taxes, which were politically difficult to levy. The Revolution's whole purpose was to prevent a distant political power—the British Parliament—from imposing taxes, so it is not surprising that state governments also did not grant the Continental Congress the power to tax. Meanwhile, state governments were not inclined to tax their citizens heavily, in part because the economy was ravaged by the war. The United States was occupied by a hostile power and suffered not only widespread destruction of property but civil disorder and—thanks to the British navy's

control of the high seas—cessation of its best mode of transport, the coastal trade. Goods had to be moved overland with wagons and teams of horses, which were slow and consumed vast quantities of scarce grain.

During the Revolutionary War the Continental dollar lost 99% of its value.

With its power to borrow or to tax severely curtailed, the Continental Congress had no choice but to finance the war by issuing paper money. It started to do so a full year before the signing of the Declaration of Independence, and by 1779, had issued more than $225 million, with additional sums issued by state governments. With a rapidly expanding quantity of money chasing a supply of goods that was being restricted by the impact of the war, the buying power of a Continental dollar declined by 99%.

Because Congress was buying real goods with increasingly worthless paper, this inflation transferred wealth from the private to the public sector and severely reduced living standards, particularly for urban workers who had to buy food. Conveniently for the politicians in Congress, many Americans blamed this inflation not on the government that issued the money, but on speculators and merchants who seemed to be responsible for skyrocketing prices. One patriot accused businessmen of "basking in the sunshine of monopoly, forestalling and extortion and withal pampering their vile natures in ease, superfluities and luxury." Eventually Congress redeemed Continentals at a penny on the dollar.

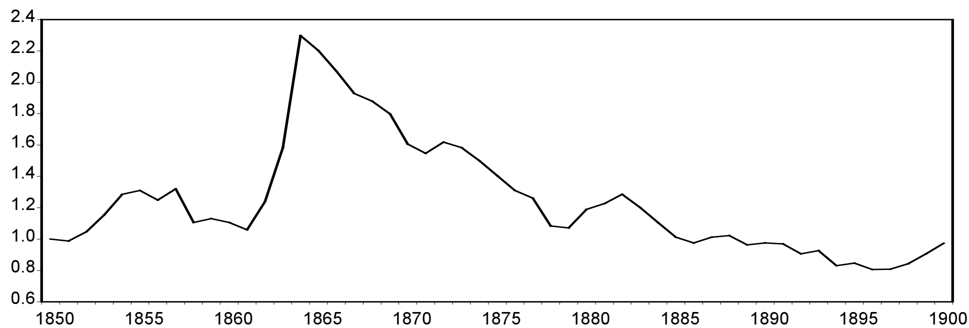
The Civil War: Prices Double

The Civil War period did not experience the hyperinflation of the Revolution, but still experienced an annual inflation rate of 20%.

By 1861, both the U.S. economy and the Federal government were much stronger than during the Revolution. Therefore, a far higher percentage of the war's cost was financed with taxes—20%, versus 6% for the Revolution. Again unlike the Revolution, a significant part of the war was financed with the issuance of government bonds, particularly by the Philadelphia-based investment banker Jay Cooke, the first American financier to mass-market bonds to the public. Nevertheless, the cost of the Civil War was so huge that the Lincoln Administration, like the Continental Congress in the 1770s, also had to issue pure fiat money, known as greenbacks. As a result, the price level of the U.S. more than doubled between 1861 and 1865 (Chart 3). This was not the hyperinflation of the Revolution, but still an annual inflation rate of 20%.

Chart 3: Wholesale Price Index, 1850-1900

Indexed to 1850=1



Source: Historical Statistics of the United States: Colonial Times to 1970 (Part 1).

Pursuing an Anti-Inflation Policy in the Late 19th Century

The government pursued deflationary policies after the Civil War, shrinking the money supply by using the Federal budget surplus to buy in greenbacks. By 1879, prices had returned to pre-Civil War levels.

At the end of the Civil War, the price level was about double its prewar level, and the greenbacks issued by the Federal government were not convertible into specie (gold and silver). However, just as inflation is usually an explicit or implicit government policy, so is deflation. Adhering to the economic orthodoxy of the time, the Federal government pursued deflationary policies. From 1865 to 1868, Uncle Sam shrank the money supply by using the Federal budget surplus to buy in greenbacks. Even after this policy of currency shrinkage ended in 1868, the money supply grew very slowly at a time when the economy was growing rapidly; consequently, prices continued to fall. By 1879, prices had returned to pre-Civil War levels, and they continued to fall until the mid-1890s, when new gold discoveries in several parts of the world (including Alaska, Colorado and South Africa) began to expand the global money supply and price level (Charts 1, 3).

As we have discussed elsewhere (see "Benign Deflation," February 22, 1998), the price deflation of the late 19th century was *not* inconsistent with prosperity. On the contrary, this was a period of rapid technological innovation, strong economic growth and rising living standards. To some significant extent, deflation encouraged technological innovation because businessmen, facing relentless pricing pressure, were compelled to find new ways of cutting costs. However, certain elements of the American population—particularly western mining interests and farmers with mortgages—considered deflation anything but benign. With the price of agricultural commodities falling while the principal and interest payments on the farmer's mortgage were not, over time, it required more and more bushels of wheat to make a mortgage payment. Of course, the farmer's loss was the banker's gain; the eastern financial interests who backed the Republican Party considered deflationary "sound money" policies the bedrock of national prosperity. The overriding economic issue of the last third of the 19th century was between the eastern "sound money" interests and the western inflationists who advocated "the free and unlimited coinage of silver" to raise the price level.

The secular deflation of the late 19th century differed from the secular inflation of the post-World War II period in one critical respect. In the former instance, Americans were sharply and bitterly divided as to whether deflation was a wise policy. By contrast, after World War II, pretty much everybody thought that a little inflation was a good thing. In both instances, the nation made a policy choice about deflation/inflation.

The Great Depression . . .

Whereas the deflation of the late 19th century was either good or bad, depending upon where you were situated in the U.S. economy, the deflation of the 1930s was a catastrophe for everybody, from the richest Wall Street speculator to the proverbial shoeshine boy who was passing him stock tips in the great bull market of the 1920s. A still-inexperienced Federal Reserve permitted the stock market crash of 1929 to lead to a collapse of the banking system and a 30% contraction of the money supply. The disastrous results were skillfully outlined by historian John Brooks:

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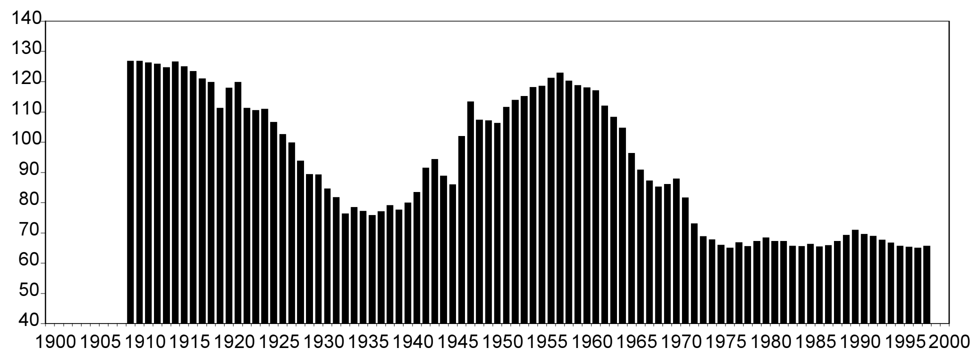
> "In early 1932 unemployment was above ten million and heading for twelve million, or not quite a quarter of the civilian labor force; industrial production nationally was down to half its 1929 rate; industrial stocks listed on the stock exchange were worth about one-fifth of their 1929 peaks; foreign withdrawals of U.S. gold were running at a rate of $100 million a week; and more than a billion dollars worth of currency and coin, much of it gold, was being hoarded by terrified Americans—in sum, a nation in the throes of economic disaster."

That was the good news. The bad news was that no one in power had a clue as to how to end the depression. In 1932, President Hoover raised taxes in order to balance the Federal budget and revive business confidence. In the campaign of 1932, Franklin Roosevelt promised to do the same thing if he became president. After he took office in 1933, FDR's decisive leadership style and implementation of New Deal programs did much to restore national confidence, but only the military build-up for World War II put the nation back on the road to full employment.

This was a scary time. Even Joseph Kennedy, one of the leading Wall Street operators of the 1920s (and father of President John Kennedy), later wrote, "I am not ashamed to record that in those days I felt and said I would be willing to part with half of what I had if I could be sure of keeping, under law and order, the other half." The typical American who reached adulthood in the late 1920s or the 1930s had his or her career and personal plans turned upside down by the Great Depression of the 1930s. So profound was its impact that fertility was extremely low in the 1930s (Chart 4).

Chart 4: Fertility Rate, 1909-1998

Births per thousand women aged 15-44 years old



Source: U.S. National Center for Health Statistics.

. . . Produces a Structural Bias in Favor of Inflation

Americans took away from the trauma of the 1930s a single, overriding lesson: Deflation = Disaster.

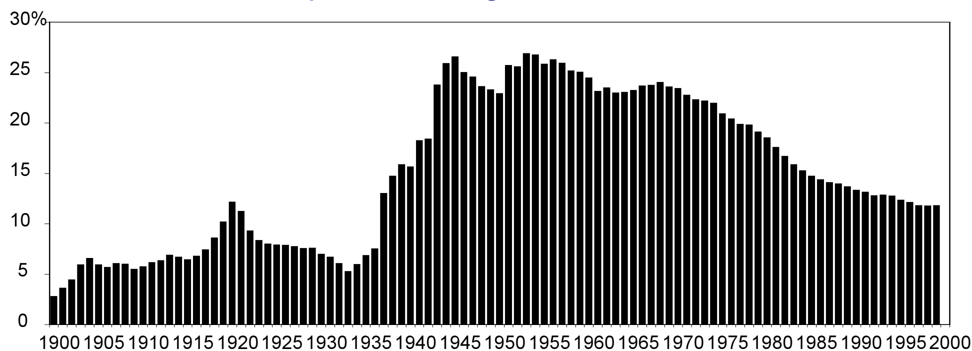
Americans took away from the trauma of the 1930s a single, overriding lesson: Deflation = Disaster. After World War II, there was a palpable fear that the bad times of the 1930s would return. The economy grew rapidly in the late 1940s and America's international stature was at all-time highs, yet stocks languished at the same levels as in the mid-1930s. Even after stocks rallied strongly in the 1950s, Americans glanced nervously over their shoulder at those fateful years 1929-33. When, in January 1955, the Dow Jones Industrial Average was rising above the 1929 high, the Senate Committee on Banking and Currency held hearings on the dangers of Wall Street speculation. One expert witness, Harvard Professor John Kenneth Galbraith, unsettled

the stock market by drawing parallels between the 1920s and the 1950s, prompting such newspaper headlines as "EGGHEAD SCRAMBLES MARKET." In fact, however, by the 1950s, a number of new structural features in the economy forestalled deflation:

- Most states adopted so-called "fair trade" laws in the 1930s in response to price cutting by chain stores. The laws, which were finally repealed in 1975, allowed manufacturers to set minimum resale prices on their products.
- The Interstate Commerce Act of 1887 and the Motor Carrier Act of 1935 allowed government bureaucracies to set rates.
- Regulation of electric and phone utilities facilitated the provision of service to rural areas by setting prices artificially high in cities and suburbs. This rate-setting mechanism provided no incentive for utilities to cut costs.
- After the East Texas oil rush of 1931 sent oil prices down from $1.00-plus to $0.10 a barrel, the Texas Railroad Commission began to limit oil production in the state, which gave it considerable influence over oil prices.
- Most important, the power of labor unions increased dramatically in the 1930s and 1940s (Chart 5), giving wages a strong upward bias.

As historian David Hackett Fischer has put it, these changes meant that the price structure increasingly had "floors but no ceilings." The "inflation rate" is a weighted average of price changes in thousands of items; if many of them can only rise in price, this imparts a strong inflationary bias to the whole index.

Chart 5: Union Membership as a Percentage of the Civilian Labor Force



Source: Historical Statistics of the United States: Colonial Times to 1970 (Part 1); the Bureau of Labor Statistics.

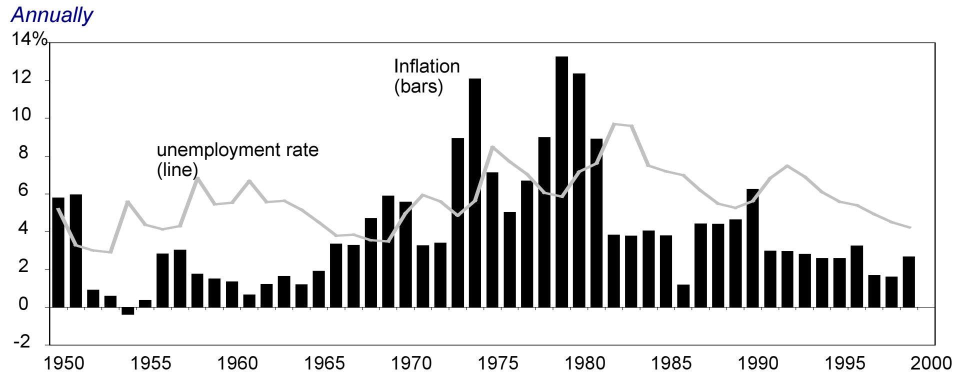
Inflation in Check Under Eisenhower . . .

The inflationary bias in the economy of the 1950s did not immediately lead to high inflation because President Eisenhower, who had witnessed hyperinflation in Europe in the late 1940s, was a vigilant inflation fighter whose press conferences were filled with praise for balanced budgets and a "sound dollar." As Chart 6 shows, there was a 1.4% upward creep in the price level during Ike's two administrations (1953-60), and consumers started to consider peacetime inflation normal. (The comedian Henny Youngman joked, "Americans are getting stronger. Twenty years ago, it took two people to carry ten dollars' worth of groceries. Today, a five-year-old can do it.") But

Eisenhower, who had witnessed hyperinflation in Europe in the late 1940s, was a vigilant inflation fighter.

Eisenhower controlled inflation with recessions, which occurred in 1953, 1957-58 and 1960. Of course, the cost of moderate inflation was slow economic growth; real GDP grew just 2.9% annually over the eight years Eisenhower was president.

Chart 6: Unemployment and Change in the Consumer Price Index
Annually



Source: DRI.

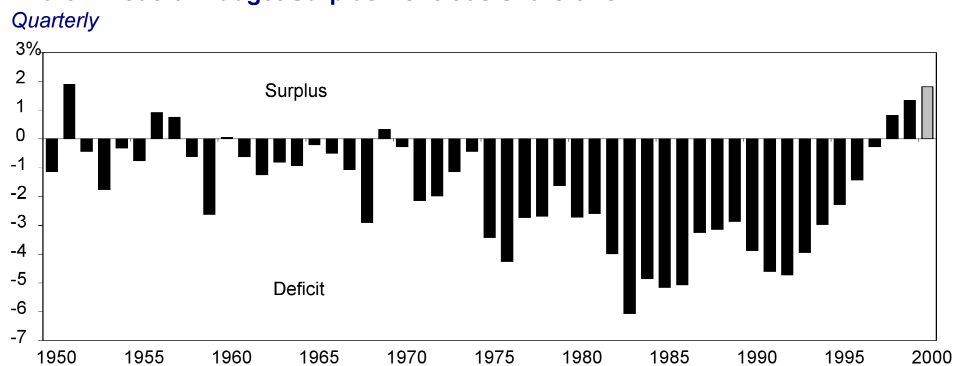
. . . and JFK

Kennedy brought to Washington neo-Keynesian economists who planned to use deficit spending and accommodative monetary policy to expand GNP 4.5% annually without increasing the rate of inflation.

Democrats insisted that slow economic growth and high unemployment were too steep a price to pay for low inflation, and they carried their point in the 1960 Presidential election. Promising to "get the country rolling again," John Kennedy brought to Washington a group of neo-Keynesian economists who planned to use a judicious mixture of deficit spending and accommodative monetary policy to expand GNP 4.5% annually without increasing the rate of inflation. Given the excessive slack in the economy inherited from the Republicans, they argued, this was not an unreasonable goal, and to impose price discipline on less competitive economic sectors, they called for "guidelines" holding wage increases to 3.2% per year.

For several years, President Kennedy's "new economics" was a spectacular success. Between 1960 and 1964, GDP grew 4.6% annually. But because productivity growth accelerated with GDP, inflation was held to 1.2% per year—slightly *below* the inflation of the 1950s. Better still for Democratic constituencies, the Federal budget deficits that were part of this more stimulative economic policy made room for new social programs (Chart 7).

Chart 7: Federal Budget Surplus/Deficit as Share of GDP
Quarterly



Source: Congressional Budget Office.

Guns, Butter and Inflation, 1965-70

These impressive accomplishments produced a rising tide of economic hubris, a feeling that America could transcend the costly trade-off between inflation and unemployment. Policymakers did not appreciate just how much they were benefiting from the suppression of inflationary expectations during the Eisenhower years, nor did they recognize that Keynesian fiscal policy consistently veered toward extra spending and budget deficits today, to be balanced by budget surpluses at some unspecified date in the distant future (Chart 7). But it was easy to overlook such dour realities in the heady expansion of the mid-1960s. A *Business Week* article entitled "Soaring, and Then Some" counted among the "lessons" of recent experience the "fact" that "the U.S. was not perpetually chained to a business cycle" and was "well able to exceed its historic growth rate."

This hubris led to President Johnson's decision in the mid-1960s to fight both the War on Poverty and the rapidly escalating War in Vietnam without raising Federal tax rates. As *Fortune* confidently stated, the U.S. economy was "so immense that it can take almost any foreseeable defense increase in stride." But in fact inflation picked up in 1966 to a 3.4% rate, forcing the Fed to tighten, which triggered a credit crunch and an economic slowdown. Growth reaccelerated in 1968, but the economy slid into a recession in 1970. The inflation problem of the late 1960s was well-entrenched because two complementary causal mechanisms were at work:

President Johnson decided in the mid-1960s to fight both the War on Poverty and the rapidly escalating War in Vietnam without raising Federal tax rates.

- *Demand pull*: LBJ's two-front war on the Vietcong and domestic poverty simply outstripped the nation's resources, causing prices to rise.
- *Cost push*: Once prices started to rise, threatening living standards, unionized workers demanded higher cost increases, which started a "wage-price spiral." Thus, when in 1966 inflation outstripped wage gains, an economist fretted, "The unions will want to make up for that next year—just as a starter."

The Case for Inflation

The subtext of America's battle with inflation was a resolute refusal to flirt with the "D-word"—deflation. There was nothing wrong with the U.S. economy that a nice, long recession would not have cured—a recession that raised unemployment high enough that workers would settle for lower wage gains while corporations were frightened into reducing prices and cutting costs. Americans refused to adopt anti-inflation policy for several reasons:

- Most important, the devil Americans knew (the deflationary disaster of the 1930s) was far more scary to them than the devil they did not yet know: high and accelerating inflation.
- Conventional wisdom in the economics profession held that, in the trade-off between unemployment and inflation, unemployment was clearly the greater evil. Inflation was a mere inconvenience while unemployment entailed a permanent loss of output; every week a worker was unemployed was a week lost forever.

- To the extent that inflation was a problem, many economists believed, it could be managed with wage and price controls.
- Inflation had much stronger political allies. Labor unions—a bulwark of the Democratic Party, but one that Richard Nixon also courted from time to time—favored inflation over unemployment because unions had the market power to get wage gains in excess of inflation. (That was the essence of "cost-push inflation.") In a throwback to the critique of deflation in the late 19th century, it was also argued that inflation mainly hurt capitalists (particularly bondholders) while helping workers by keeping unemployment low. So, particularly at a time of radical ferment and racial unrest, the Federal government tended to favor inflation.

Price Controls Cause Prices to Spiral Out of Control

The U.S. did not take the threat of inflation seriously in the early 1970s.

For all of these reasons, the U.S. did not take the threat of inflation seriously in the early 1970s and could not bring itself to adopt stern deflationary policies. And even after inflation did become much worse than anyone expected, politicians reached for ineffectual administrative solutions that merely compounded the problem.

Following the shallow recession of 1970, in the spring of 1971, the Nixon Administration found itself firmly mired in the muck of stagflation—inflation at 4.4%, unemployment at 5.9%, the economy recovering slowly, and the dollar sinking because of America's big trade deficit and inflationary drift. With the Presidential election just 15 months away, the Nixon team attempted to clear-cut this thicket of problems with a dramatic "New Economic Policy" announced in August 1971, which featured these measures:

- A 90-day wage and price freeze designed to break inflationary expectations, and to be followed by a "Phase II" program of wage and price "guidelines" administered by a network of committees.
- Ending the convertibility of dollars into gold and allowing the dollar to float against other currencies—a "temporary" policy that continues to this day.
- Stimulative monetary policies and assorted tax cuts designed to reduce unemployment (and assure Nixon's reelection).

Like a motorist who guns the engine while keeping his foot on the brake, this program accelerated economic activity and attendant inflationary pressures while clamping a temporary lid on prices. It was a cynical, statist policy that served President Nixon's short-term political needs and did serious damage to the economy. But the fact is that the New Economic Policy reflected the received wisdom of America's leading economists and policy bureaucrats. This was simply the logical culmination of the "guidelines" and "jawboning" advocated by most Democratic economists for well over a decade.

Price controls and guidelines made it far more risky for companies to invest in new capacity, because they could not be sure they could charge enough to cover their higher costs. Not surprisingly, once controls were lifted, supply and demand imbalances

produced a surge in prices in 1973, when food prices soared and the CPI rose an alarming 8.9%. Against this inflationary backdrop, OPEC was able to quadruple oil prices in 1974, causing the CPI to rise 12.1%. With the stock market collapsing, the Fed tightening, and shell-shocked consumers paying a huge tax to OPEC, the economy fell into a severe recession in 1974-75, in which unemployment doubled to a peak of 9.0%.

Learning to Live with Inflation, 1975-79

The 1974-75 recession proved that there was no simple "trade-off" between inflation and unemployment—that once the inflationary cat got out of the bag, it clawed the economy to pieces and sent unemployment soaring as well. But so tolerant of inflation—and fearful of deflation—were policymakers, that they did not move to quash inflation in the late 1970s, but rather tried to learn to live with it.

The 1974-75 recession did not break the back of inflation; for example, wage increases were higher in 1975 than in 1973. Recovery from the recession was slow at first, and the central economic issue in the 1976 Presidential campaign was how to sustain the recovery without reigniting inflation. Republican Gerald Ford favored a sober, if uninspiring, echo of the Eisenhower years: fiscal restraint, slow growth and a gradual reduction of unemployment. But the Democrats insisted that high unemployment was an unconscionable waste of resources that should be ended with a stimulative fiscal policy. Stronger growth would not boost inflation, they argued, because the 1973-74 price spiral had special, "exogenous" causes—quadrupling of oil prices, a 40% jump in food prices, and decontrol of wages and prices. Such factors would not recur, and cost-push inflation could be contained via "jawboning" by the Federal Government's Council on Wage and Price Stability.

Upon entering the White House in January 1977, President Carter pursued a stimulative fiscal policy, and for the next three years, both GDP growth and inflation tended to exceed expectations. By 1979, inflation was at 13.3%, which could not be blamed on "exogenous" factors such as OPEC or bad harvests. Yet even then, economist Michael Boskin notes, "The overwhelming bulk of leading economists argued that we should learn to live with this high inflation, indexing more contracts and government programs, and attempt to stabilize the inflation rate at around 10 percent. The thinking at the time was that the substantial cost of disinflation was unbearable." Carter haplessly tried to rein in prices with "voluntary guidelines." In a typical press commentary, *Business Week* wrote in 1979,

> "Despite Carter's assurance that his wage-price guidelines are 'beginning to take hold,' unabated price pressure is pushing the Administration's anti-inflation program to the brink of collapse. The chances for wage moderation in upcoming labor negotiations, especially the critical Teamsters bargaining this spring, are being threatened by the likelihood that inflation and the economy will stay strong through the second quarter."

In essence, Carter's anti-inflation policy was to rely on the willingness of unions and corporations to magnanimously restrain wages and prices.

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America Abandons Its Pro-Inflation Policy, 1979-82

By 1979/80 two newcomers to Washington's corridors of power, Paul Volcker and Ronald Reagan, pursued an anti-inflation mandate.

By the fall of 1979, the CPI was advancing at a 13% annual rate, and inflation was finally recognized as being not a minor and manageable nuisance with no "real" economic cost, but rather a serious threat to prosperity. This realization created an anti-inflation mandate for two newcomers to Washington's corridors of power: Paul Volcker (appointed Federal Reserve Chairman in the autumn of 1979) and Ronald Reagan (elected President a year later). Volcker's tight monetary policy caused a sharp but short recession in 1980, and when that failed to break the back of inflation, it was followed by a longer downturn in 1981-82 that brought inflation down to 3.8%.

While Volcker attacked inflation from a monetary perspective, Reagan attacked it from the supply side. He immediately curbed the power of labor unions by breaking a strike by air traffic controllers. And he increased incentives to produce by reducing marginal tax rates. Though it has been derided for creating large budget deficits, Reagan's "supply side" tax cuts were a conceptual breakthrough, because they reminded the nation that inflation could be controlled with less pain by increasing output rather than by curbing demand. A third key element of the new anti-inflation policy, which was first implemented by President Jimmy Carter, was deregulation of key industries, notably trucking, railroads, airlines, telecom and financial services.

This combination of structural reforms and back-to-back recessions was certainly painful, particularly for commodity-producing areas such as the Farm Belt and the oil states—not to mention Mexico and Latin America. Yet the cost of slashing inflation (in terms of lost output) turned out to be only one-third as high as Keynesian economists had forecasted.

Today, Inflation Has No Political Support . . .

Inflation is really a policy stance, one that currently has virtually no political support.

Viewed in a historical context, it is easy to see why today's economic circumstances are very unlikely to lead to high inflation: As we have seen, inflation is really a policy stance, one that currently has virtually no political support, for these reasons:

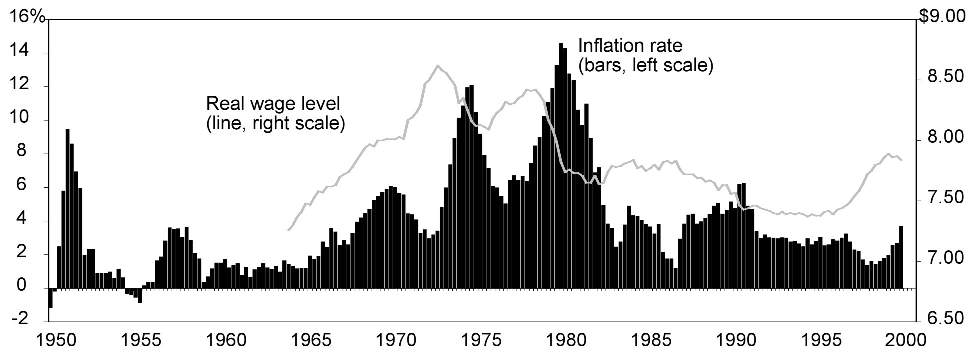
- War, historically the most common source of high inflation, is not a visible threat at the present time.

- Today's baby boomers grew up in an era when inflation—not deflation—was the chief economic problem. In contrast to their parents, baby boomers are not driven to avoid deflation at all costs, and they know, from personal recollection of the 1970s, that inflation does not stay low for long. No one has more harrowing inflation nightmares than Alan Greenspan, who was Chairman of the Council of Economic Advisors from 1974 to 1977.

- In contrast to both the late 19th century and the 1960s, inflation does not have a political constituency today. In the 1960s, most economists assumed that there was a "trade-off" between inflation and unemployment, which implied that a little more inflation might be O.K. if it reduced unemployment and helped the poor. But with the U.S. economy now less inflation prone, there is no such trade-off. From 1992 to 1998, both unemployment and inflation declined at the same time to very low levels

(Chart 6), making this the "best of times" for investors, businesses and workers alike. Consequently, no interest group is advocating a slightly more inflationary economic policy. Indeed, it is widely recognized that no group benefits from inflation for long, because it eventually leads to recessions and deflation, as well as declining real wages (Chart 8).

Chart 8: Real Average Hourly Wages and Year-Over-Year Change in CPI
Quarterly, wages in 1982 $s

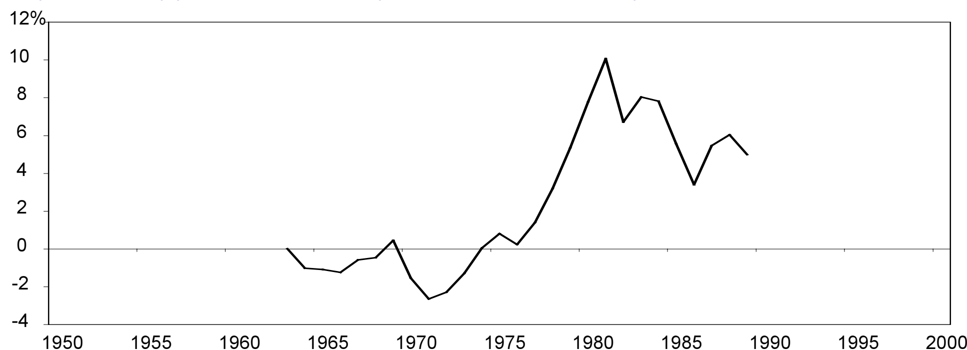


Source: DRI.

■ A potent contingent of Americans who oppose inflation is investors. For a while in the 1950s and 1960s, stocks were considered an effective hedge against inflation, but this was disproved by the market catastrophe of the 1970s, when real stock prices fell 43%. Stocks were not an inflation hedge because corporations had to pay taxes on illusory profits created when inventories rose in price and when there was under-depreciation of plant and equipment (because the cost of building new plants far exceeded depreciation charges based on historical book values). Knowing how dangerous inflation is, investors will not give Washington the "benefit of the doubt" if inflation picks up. With about half of adult Americans—and more than half of American voters—owning stocks, this is a large and influential group (and destined to become even more so if Social Security is partially privatized). By contrast, investors in the 1960s were slow to recognize the inflationary threat, which is why real bond yields were usually negative between 1964 and 1973 (Chart 9).

In the 1950s and 1960s, stocks were considered an effective hedge against inflation. But, stocks were not an inflation hedge because corporations had to pay taxes on illusory profits created when inventories rose in price and when there was under-depreciation of plant and equipment.

Chart 9: Real Bond Yields
10-year Treasury yield less forward 10-year CAGR of CPI, annually



Source: DRI.

. . . or Economic Foundation

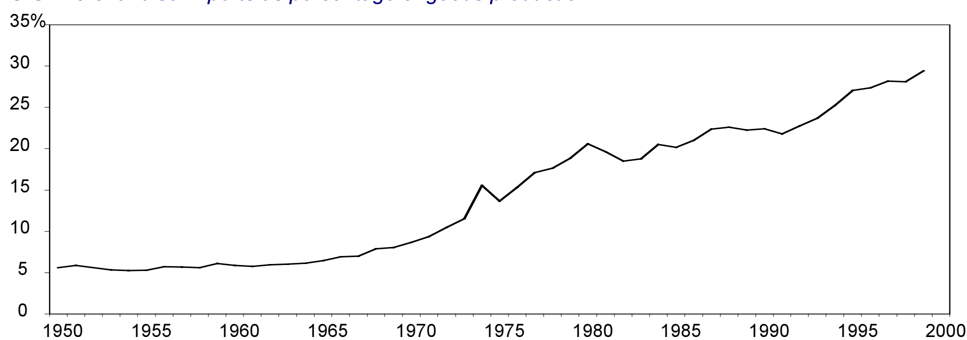
Today, a wide variety of factors lend the economy a deflationary bias, which should make Mr. Greenspan's inflation-fighting efforts easier:

In the 1950s and most of the 1960s, the U.S. suffered from a shortage of foreign competition. Today, America faces tough competition from nearly every continent, and import penetration is at all-time highs.

- *Foreign competition.* In the 1950s and most of the 1960s, the U.S. suffered from a shortage of foreign competition. Europe was recovering from World War II; Korea and Taiwan were still largely agricultural; and even Japan was just starting to challenge American manufacturers of consumer electronics. Today, America faces tough competition from nearly every continent, and import penetration is at all-time highs (Chart 10). Moreover, economies around the world are restructuring and becoming even tougher competitors. For example, Europe is becoming a more efficient unified market; Mexico is booming as a base for low-cost manufacturing; and China's economy is likely to be streamlined as a result of its entry into the World Trade Organization (WTO), which will expose inefficient state-owned enterprises to foreign competition.

Chart 10: Import Penetration

U.S. merchandise imports as percentage of goods production



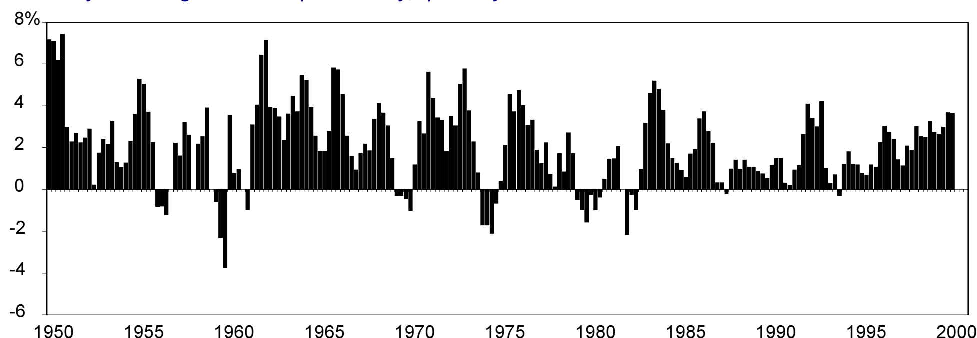
Source: DRI.

A key reason for the high inflation of the 1970s was the diversion of capital from saving labor to saving energy.

- *Strong productivity growth.* A key reason for the high inflation of the 1970s was a sharp and unexpected slowdown in labor productivity that had a variety of causes, including the influx of inexperienced baby boomers into the labor force, the "cultural revolution" of the late 1960s, more stringent environmental regulations, the diversion of capital from saving labor to saving energy, and the negative effects of inflation itself (why cut costs when it's so easy to raise prices?). (See Chart 11.) Recently, productivity has been better than expected, driven higher by, among other factors, the use of the Internet in a vast array of corporate applications—everything from inventory management to production control to customer support. These benefits are still in their infancy and will ramp up as applications are improved and broadband access becomes widely available.

Chart 11: Productivity

Year-to-year change non-farm productivity, quarterly



Source: DRI.

- *The info economy is driven by excess* while the industrial economy was driven by shortage. When information is digitized, the copy is the original; text, audio or video can be continuously sent to screens around the world. In the 1960s, families sat around the TV for a half hour each evening to get their daily dose of news from Walter Cronkite; now the Internet offers "all news, all the time"—general news, sports news, financial news, news in any language and from any part of the world. And much of this Internet content is available for free: games, maps, financial data, recipes, weather forecasts and restaurant reviews.

- *The Internet pricing revolution.* By making it possible to instantly collect and compare all prices for an item, the Internet makes markets more efficient and therefore less inflation-prone. And, of course, Internet-based transactions are much cheaper than those based on paper. Although conceptually simple, it will take several years to actually digitize the nuts-and-bolts arrangements of markets for everything from auto parts to chemicals to restaurant equipment. As this occurs, it will place downward pressure on prices.

By making it possible to instantly collect and compare all prices for an item, the Internet makes markets more efficient and therefore less inflation-prone.

- *Budget surpluses, not deficits.* In every year of the 1970s, the Federal budget had deficits that were usually higher than the Treasury Department planned or economists expected—despite the fact that high inflation was boosting taxable incomes and pushing taxpayers into higher tax brackets. These deficits were highly stimulative and inflationary, because they were driven by defense spending (during the Vietnam War) and higher social spending designed to reduce poverty. Today, by contrast, it is Federal surpluses that are higher than expected, which is anti-inflationary because the surpluses are used to pay down Federal debt, which—all else equal—tends to reduce interest rates. While inflation was high and damaging economic performance, Federal tax receipts were lower than expected while inflation-indexed expenditures (such as Social Security benefits) were greater than expected. Today, the reverse is true, and with the Congressional Budget Office assuming real GDP growth over the next decade of just 2.3-2.5% per year, more positive surprises are likely. Although there is naturally pressure to increase spending in some areas, notably health care, politicians are striving to shrink, rather than expand, welfare rolls—the precise opposite of the situation in the 1970s.

- *Deregulation continues* in such important areas as telephony and electric power, which account for 4.7% of the CPI. The cost of telephone service has dropped 1.4% over the past year, and PaineWebber expects households' power costs to decline 6% from 1999 to 2003 and another 10-20% in several major states by 2010.

- *Wall Street's boom finances new capacity*. Lately Fed Chairman Greenspan has been worrying about how strong stock prices have boosted consumer spending and exacerbated inflationary pressures. But, in sharp contrast to the 1970s, when the IPO and venture capital markets virtually dried up for a few years, today's buoyant financial markets and strong profits are financing rapid expansions of capacity.

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