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A Primer on Macroeconomics for South Dakotans

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A PRIMER ON MACROECONOMICS

FOR SOUTH DAKOTANS

by

Philip Favero*

Economics Staff Paper Series No. 79-2**

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This paper was improved by a critique by Harry Greenbaum.

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A PRIMER ON MACROECONOMICS
For South Dakotans¹

Introduction

What is macroeconomics, you ask; and what does it mean to me?

Macroeconomics is the study of aggregate economic conditions, such as a nation's employment, unemployment, and general price levels. Throughout history nations have experienced boom-to-bust cycles--times of employment and prosperity, followed by times of unemployment and hardship. Macroeconomics provides policy makers with ideas to promote economic stability - ways to combat the twin economic evils of unemployment and inflation.

¹Parts of this primer incorporate an adapted version of a booklet prepared by the Cost of Living Council entitled "Inflation: On Prices and Wages Running Amok." (1973). The booklet suggested the conversational style used in this primer and, in many cases, provided the exact wording to simplify complex economic concepts for non-professional readers.

The South Dakota Economy

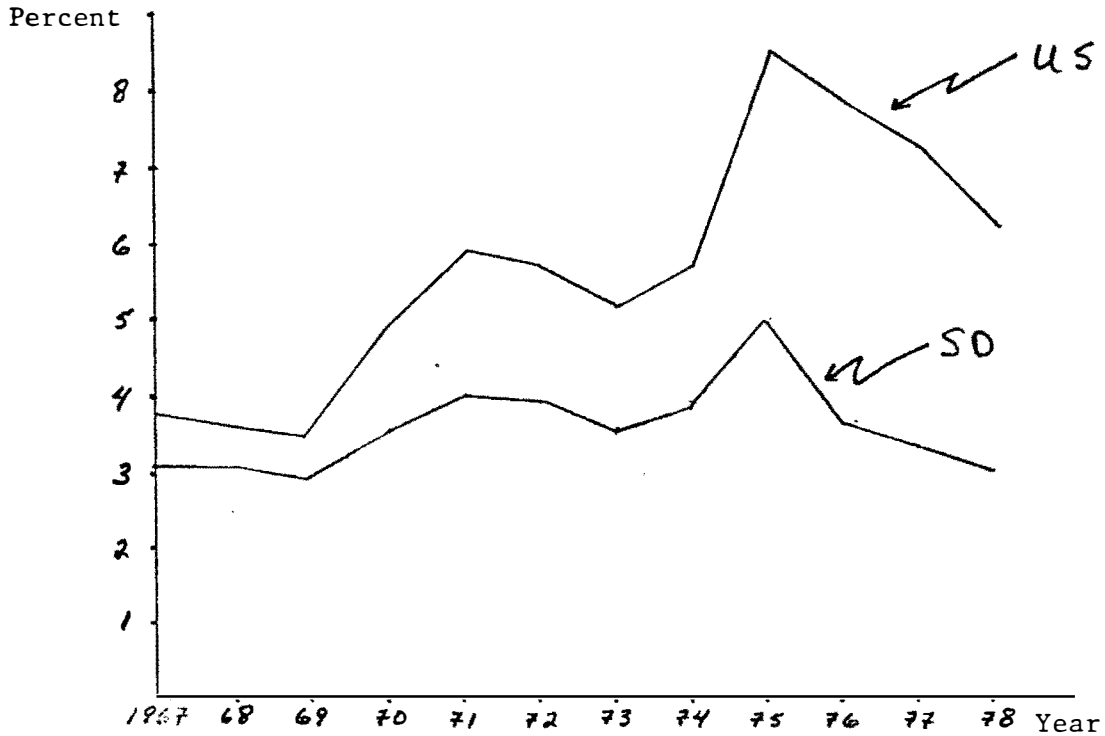
Unemployment

In a way, South Dakota's economy is not typical, since unemployment here differs from the national scene.

Figure 1 illustrates the fact that in recent years, unemployed workers in South Dakota have totaled about three to four percent of the state's labor force. National unemployment rates have been higher and have exhibited more variability than the South Dakota rates.

Figure I

Average Annual Rate of Unemployment--U.S. and South Dakota (1967-1978)



Sources: South Dakota Annual Planning Report (S.D. Dept. of Labor); Economic Report of the President.

Employment stability in South Dakota is explained, in part, by the nature of our economy. We are involved, in the main, in food production, services, and light manufacturing. Purchases of our products are not as postponeable as are

purchases of durable goods such as cars or refrigerators. Demand for our products, in other words, is stable.

In addition, the level of unemployment in South Dakota has been reduced by the historic rural-to-urban migration flow of recent decades. Many rural migrants left our state and many of those outmigrants are likely to have been unemployed workers seeking job opportunities elsewhere.

A low and stable unemployment rate does not mean, however, that South Dakotans are unaffected by recession. Self-employed people, who comprise a large part of our state's labor force, may receive substantial drops in income during a recession. South Dakota farm income, for example, is affected by national economic conditions.

Inflation

Unlike the problem of unemployment, the problem of inflation does emerge full-blown in South Dakota. Almost everybody knows what inflation is, right?

"Inflation is when things cost more to buy," says a voice from the back of the room.

Wrong.

At times, things cost more for reasons that have nothing to do with inflation. Wheat costs more after a drought, for example, or after the Russians place a large purchase order. Moreover, prices for some goods will fall, even during a period of inflation.

Try this definition: Inflation is a general and persistent rise in prices.

Various measures of inflation exist. These differ among themselves because prices do not change evenly.

One yardstick is the Consumers' Price Index, a monthly tabulation of the retail prices of most of the things most of us buy as consumers. Prices throughout the country for 400 selected goods and services are checked every month. These current prices are then compared to prices charged for the same items in past years. The comparison is then expressed as an index of how current prices compare

to prices charged in 1967.

If, for example, it costs \$210 to buy the same goods this month that \$100 could have purchased in 1967, the Consumer Price Index for this month is 210.

Another measure of inflation is the Producer's Price Index (PPI for short), known previously as the Wholesale Price Index. This index relates current wholesale prices to prices charged for the same items in the past; it is watched closely because it often forecasts future increases in retail prices.

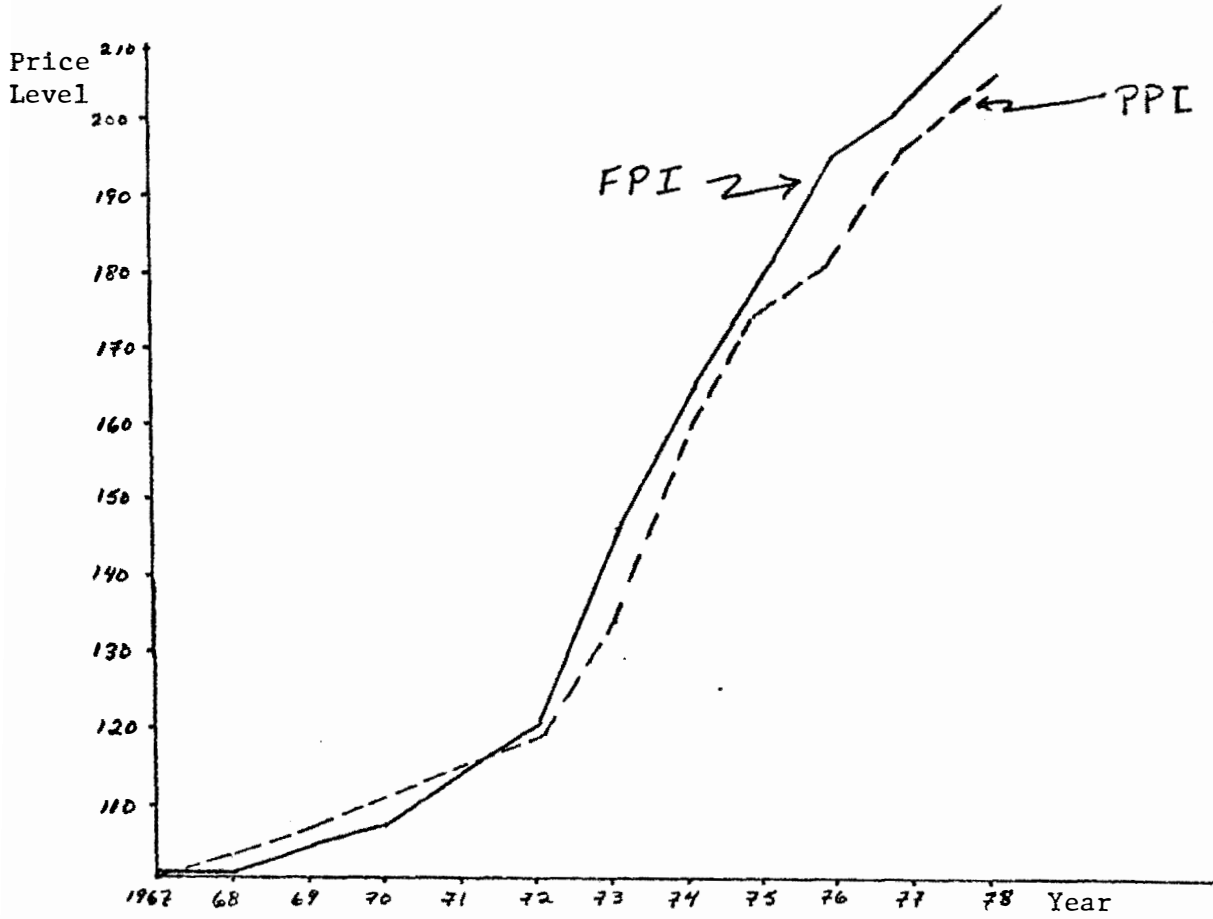
Other price indexes are calculated for prices paid by producers in certain sectors of the economy such as in agriculture or by state and local governments. There are also price indexes for certain types of consumer goods such as food or fuel. These specific indexes are not true measures of inflation because they reveal only part of the price picture. But they are useful for explaining the causes or consequences of general inflation.

One specific price index, the one for all commodities purchased by farmers for production purposes (call it Farm Production Index, or FPI for short), can be compared with the Producer's Price Index.² Figure 2 illustrates the comparison of these two price indexes for recent years and reveals that, indeed, inflation does have a full-blown impact in South Dakota. The two price indexes have tended to move in the same direction over time, with the agricultural index somewhat higher than the general index in recent years.

²Price changes for various specific production commodities used in farming are shown in the Appendix.

Figure 2

Producer's Price Index and Farm Production Price Index (1967-1978)



Sources: Economic Report of the President, Agricultural Statistics (USDA).
1967=100.

Effects of Inflation

Who Gets Hurt?

"That's a dumb question," suggests that voice from the back again. "Isn't everyone hurt?" In a sense, yes, everyone is hurt. But in the short run, some people may protect themselves from inflation by raising their selling prices for goods and for labor. Some, in the short run, may even gain. Let's consider first the obvious losers, those who are hurt even in the short run.

RETIREED PEOPLE. Some retired people live on fixed incomes - private pensions, matured insurance policies and the like. When prices go up, there's nothing they can do but spend less. Social Security benefits are now tied to inflation but such benefits may cover only a small part of living costs.

PEOPLE WITH SAVINGS. Some people try to spend less than they earn so they can save money for a special purpose--the downpayment for a house, a pick-up, a special vacation or what-have-you. Others save money for an emergency, the "rainy day" they know is coming sometime.

Usually, people save their money in banks, savings and loan associations or government bonds. Say, for example, that they earn five percent interest on their savings. For every \$100 in savings, they have \$105 at the end of the year. But suppose, again for example, that during the same year there is an inflation of ten percent. At the end of the year, that \$100 in savings will buy only as much as about \$90 would have bought at the beginning of the year. Even adding the \$5 interest, the saver can buy only as much as \$95 would have bought before.

When conditions like this exist, people lose purchasing power by saving. This erosion of savings in times of inflation undermines one of our basic values--thrift. It also deprives our economy of savings as a resource for investment. Investments are the source of new production and improved productivity for the future.

LOW-INCOME PEOPLE. Many low-income people have lost during recent years of inflation because they spend a large part of their income on food. Food prices

have risen even faster than the Consumer Price Index. Low-income people, too, often don't have transportation which would allow them to shop widely for bargains. And, very important, they don't have the extra money to spend on things that are hedges against inflation, such items as real estate, money mutuals, or antiques.

SELLERS OF LABOR AND GOODS. Men and women who are unable to get salary increases or to raise the price of their products to match the level of price increases lose during inflationary periods. Of course everybody tries to avoid losing, but nobody really knows how much prices are going to increase and some are more able than others to affect prices.

The Other Side

There's another side to the question of inflation. In the short run, some people benefit.

Who benefits?

PEOPLE WHO OWE MONEY. People who are in debt sometimes benefit from inflation. If there's a 10 percent inflation for one year, a person who borrowed \$100 is able to pay the loan back in a year with dollars that only have the purchasing power of \$90.

Inflation only works to the borrower's benefit, however, if the lender hasn't figured the cost of inflation in his interest rate. Generally, the main borrowers who benefit from inflation are people with home mortgages established in times when future inflation was not anticipated by lenders.

PEOPLE WHO OWN REAL ESTATE. People who own their homes or land often appear to benefit from inflation, at least in the short run.

Say a family buys a house for \$20,000. Ten years later it is able to sell the house for \$30,000. It looks like the family has made \$10,000 on the house. But what happens when the family tries to buy a similar house? It is likely to find those houses priced at \$30,000 too. The \$10,000 "profit" seems to have vanished.

Similar, farmers who bought land at \$100 an acre benefit by inflation when they use rising land values to obtain credit or when they sell their land at \$700 an acre. Farmers attempting to expand their acreage and especially those attempting initial purchases of land bear the high price for land burden, however. Moreover, in South Dakota where we use a heavy ad valorem property tax to finance local governments, increasing land values mean increasing taxes to finance governments which are themselves facing increasing costs.

Beating the Game

So now you have the picture.

During inflation . . .

. . . people who save money lose; people who owe money win.

. . . people on fixed incomes lose; people who can get big wage hikes break even - maybe even win.

. . . people who have cash in the bank lose; people who have purchased real estate win.

"Simple," says the voice from the back of the room. "Once you know how inflation works, just protect yourself."

Wrong again. Sorry, but . . .

Sooner or later with inflation everybody tries to beat the game. When that happens we get into a social trap and everybody loses.

Take the man who loans money. He's no fool. He knows inflation is going to make the dollars he gets back worth less. So he adds this cost to his interest. Say he was planning to loan money at 6 percent interest. He figures inflation will decrease the value of his dollars by 10 percent. So he decides to charge 16 percent interest.

The man who borrows money doesn't think inflation is such a good idea after all under those conditions.

Or take the people who normally save money. They don't like the idea of their money going down in value. So they demand higher interest rates. Or they

decide to spend the money on something instead of saving it.

Now people who want house mortgages aren't happy about inflation. Since people put less money in banks and savings and loan associations, there's less money available to lend and the money that is available costs more in interest.

Or take the wage earner. He's no dumbbell either. He figures inflation is going to cut the value of his paycheck so he wants more. Say he would normally settle for a five percent pay hike. But say he expects a 10 percent inflation. He demands a 15 percent wage increase instead.

A social trap is created because, in the short run, everyone is rewarded for raising prices, raising wages, saving less and buying more. All these actions create, in the longer run, precisely the kind of inflationary situation which everyone wants to avoid.

Fingers get pointed and blame gets fixed. Even the collective agreements which underly economies, governments and societies can be shaken when people are looking for someone to blame about inflation.

"Relax and Enjoy It"

Sometimes you hear the argument: why not relax and enjoy it? Why not settle for an inflation rate of say, eight percent, and tie everything to it. Let wages, salaries, interest payments, pensions, and prices - the whole works - go up eight percent a year and be done with it?

For one thing, tying all income and expenses to a fixed rate of increase is tough. Those who are unprotected would lose heavily. But say we could index all income and expenses at a fixed rate of increase; what then?

Unless the same thing was happening in other countries, that is, unless inflation was at the same rate or greater in other parts of the world, we'd begin to price ourself out of world markets. Reductions in our exports would be especially hard on South Dakota's economy because our state is a major international exporter of agricultural products.

But others would be hurt too. Our ability to import goods from other

countries is ultimately based on our ability to trade exports in return. Importing more than we export creates balance of payment deficits and a declining value for our dollar. Neither an annual payment deficit nor a limited decline in the dollar's value is necessarily bad. In fact, the declining value of the dollar tends to remove a trade deficit since it reduces the prices for those who want to buy our exports and increases prices for us to buy imports. But again, a chronic balance of payments deficit and continuous declining dollar value threatens our ability to import.

Another consequence of indexing for inflation is the removal of inflation's sting. Retired people or people with savings would be better protected. That might remove, however, our willingness to combat inflation and result in a chronic inflation problem.

There are reasons a nation would find it hard to live with chronic inflation.

Inflation is disruptive. If people don't have a good idea of what prices will be in the future, they can't plan.

Sometimes projects are postponed indefinitely because of this uncertainty.

People spend more and more of their time trying to beat inflation. This means they have less time to spend in productive work. Everybody tries to become a speculator.

Perhaps worst of all, continuous inflation can make a mockery of those things that make our society work - hard labor, saving, planning, and our democratic institutions.

What Causes Inflation?

An index of prices such as the Consumer's Price Index will tend to rise when for a set of goods at a given level of the price index, demanders are willing and able to buy more than producers are willing and able to supply. We can look for the causes of inflation in two places then: demanders willing and able to buy more and producers willing and able to supply less.

Demand Inflation

Here's a way to visualize one kind of demand inflation.

Suppose a group of cattle buyers go to an auction prepared to spend all the money they have. The sale begins. A first steer is shown and people start bidding. The price is bid higher until all but one buyer quits bidding and he gets the steer. Prices for other steers may go higher or lower but eventually, every steer will be sold and every buyer will be out of money.

Now suppose the same buyer group goes to a similar auction the next day. Each person starts out with the same amount of money. There are the same number of steers to be sold.

But suppose that just before the bidding begins somebody comes along and gives each person an extra \$100. Now these people are all eager to buy beef, just as eager as they were the day before. They also are just as willing to spend every penny they have to buy beef—including their extra \$100.

The bidding begins again. Soon everybody notices that the bidding on each steer is going higher than the day before. Everyone realizes he must bid higher than the day before or he won't get any beef. So everybody bids higher and higher and higher.

When the auction is over, everyone is once again out of money. As a group, they haven't purchased any more steers - there weren't any more to buy than the day before. But the price of the steers averages considerably more than the day before. The supply was the same, but people had more money so prices went up. The same sort of thing happens throughout the nation when the supply of money

increases faster than goods. Of course when this happens, money is being used to buy more than one thing. It is chasing cars, cattle, radios and refrigerators, everything.

And, of course, when people have more money to buy these things, the people who produce them try to make more of them. They try to make more radios and refrigerators and more cars and more cattle . . . Cattle?

You see one problem right away. It takes two years to produce more cattle.

The situation with radios and refrigerators and automobiles is a bit different. More can be produced pretty quickly but the new units could be more expensive. For the moment, let's stick to the cattle example.

More Money. Where, you ask, does the extra money come from? Surely nobody is going around the country passing out \$100-bills. No.

The extra money can get into the nation's spending (bidding) activity in a number of ways.

Remember what happened after World War II? People took lots of money out of their savings accounts and started spending it. That's an example of a spurt in private demand. While the actual supply of money didn't increase, idle money got spent. Economists call that change an increase in the velocity of money. Sharply increased spending by individuals and companies can cause inflation if there aren't enough goods to supply this demand. This is one form of demand inflation. That demand can come from foreign countries as well, providing more buyers and more money to compete for the existing supply.

Another way for extra money to get spread around the nation is through the Federal Reserve System (or FED, for short), which is run by the government. The FED issues all the paper money used by the economy. (Look at the dollar bills in your pocket.) The FED also attempts to control the amount of money available to banks for lending.

The regulation of the amount of money available for spending in the economy is called monetary policy. Efforts by the FED in late 1979 are to reduce the growth rate for the money supply as a way to dampen inflation.

There's a third way for money to get spread around a nation. The Government can plan a deficit and spend a lot more than it collects in taxes and other revenue. The relationship between what a government spends and what it takes in is an expression of its fiscal policy. At times the government will deliberately spend more than it receives as a way of perking up the economy. At other times excess spending will be prompted by external events. Increased Government spending without increased taxes during the Vietnam War is viewed by many as an initial cause for inflation during the 1970's.

Three things, then, can contribute to demand inflation: private demand, monetary policy, and fiscal policy. Each can be measured and, to some extent, controlled.

But there's a fourth factor that is much harder to measure and control: what people expect to happen to prices.

If people think prices are going up tomorrow they are likely to rush out and buy as much as they can today. They may use savings or attempt to borrow money to buy things at what they think are bargain prices. Money velocity increases.

Businesses are also likely to build big inventories stocking up more goods than they really need.

So add another factor to the causes of demand inflation: price expectations, which increase the velocity of money.

Supply Inflation

Private goods and services (as opposed to government services) are provided by private firms and workers. When firms and workers are willing to continue their supply of goods and services only at a higher price (or wage), supply inflation occurs. Supply inflation is double trouble because it's accompanied often by rising unemployment.

Let's look at two recent examples of supply inflation.

In 1973 the Organization of Petroleum Exporting Countries (OPEC) began to rapidly raise crude oil prices. Energy costs rose for American companies. Continued production of goods could continue only at higher prices.

Second, crop failures during this same 1972-1974 era increased agricultural prices greatly. Food prices rose. In addition, labor demands for wage increases also occurred since food makes up about 25 percent of the cost of living.

The result of OPEC price hikes and crop failures was supply inflation - rising prices accompanied by rising unemployment.

Government can combat supply inflation by initiating fiscal and monetary policies to reduce demand. But since supply inflation tends to be accompanied by unemployment and since a reduction in demand would add to that unemployment, the policies would be unpopular, if not unwise.

Some economists say that supply inflation is often just a second phase of demand inflation. After demand is lowered and some prices level off, they say, labor and business "catch up" with the previous inflation by getting higher wages and higher prices.

Maybe so, say other economists, but neither business nor labor could do this in the face of declining demand if they didn't have the "market power" to enforce their will because competition is limited or restricted in some way.

It isn't necessary to settle this argument now, but you might want to form an opinion.

Your opinion on this point may influence your opinion about what Government can do about inflation.

What the Government Can Do

To figure out what the Government can do to stop inflation, you must first figure out what is causing the inflation you want to stop. The cure should match the disease.

Say, for example, that the inflation is caused by excess private demand - demand so strong that there just aren't enough workers and factories to produce everything that people want to buy. (Remember again what happened after World War II.)

One way the Government can reduce demand is by increased taxes. The more taxes people and corporations must pay, the less money they have left to spend. People have less money to spend on consumer goods - things like bicycles, refrigerators, electric can openers, etc. Corporations have less money to invest in new factories, warehouses, stores, etc. The pace of the economy slows down.

In addition to reducing private demand, increased taxes can help the Government achieve a more balanced fiscal policy. We've seen that the Government can contribute to inflation by spending more money than it receives. Government can bring its budget into balance by spending less, taxing more - or both.

Spending less will involve some difficult choices. Many of those, for example, who want the government to spend less in general are strong promoters of some kinds of spending, say military spending.

Increasing taxes is, of course, a very unpopular thing to do. People don't like paying more taxes for any reason, even if they are told this is necessary to curb inflation. And politicians don't like to take the blame for anything that is this unpopular. Another disadvantage is that it takes many months - sometimes more than a year - for new tax laws to be passed.

Another way that demand can be cut back is by reducing the supply of money. The Federal Reserve System - which is part of the Federal Government - can do this in a number of ways.

The FED can sell Government bonds on the open market. Banks are usually

the biggest purchasers of these securities; the FED collects from the banks by deducting the bond price from reserve deposits held for the banks. As a result of these confusing but important transactions, the banks have less money to loan. This is the main way the FED reduces the nation's money supply.

In addition, the Federal Reserve can raise the amount of money banks must keep in reserve against deposits. (Banks lend or invest money they don't have to keep in reserve.) The Federal Reserve could, for example, say that banks must keep one dollar on reserve for every five dollars in deposits. If the previous requirement had been to keep in reserve only one dollar for every ten dollars on deposit, this change would reduce the amount of money available to the bank to lend.

The FED also has the power to raise or lower discount rates - the interest rate the FED charges when it loans money to banks. It also can set margin (down payment) requirements for the purchase of stocks and bonds.

Some Problems

So Government, then, can reduce demand through either fiscal (increased taxes, decreased spending, or both) or monetary (reducing the money supply) policies.

Either way, there are problems.

UNEMPLOYMENT. If demand is cut back too quickly or too sharply millions of people can find themselves out of work. That's because with less demand for goods, factories will produce less; workers will be laid off.

And people will have less money to buy services. A family may decide not to fix a broken television set; that means less work for the repairman. With less money in his pocket, the repairman may decide to spend less money for extras - a fishing rod or a bowling ball. So stores that sell fishing rods and bowling balls have fewer customers; they decide to lay off some sales clerks.

The whole thing starts snowballing and before you know it inflation is not the nation's number-one problem; unemployment is.

Teenagers are more likely to be out of work during periods of high unemployment than any other age group. Blacks and other minority groups also suffer more from unemployment than others.

HOUSING. The building of new homes and apartments is very sensitive to Government attempts to influence demand in the economy, especially by regulation of the money supply. When the money supply is cut, banks and savings and loan associations have less money for construction loans and mortgages. Soon builders discover that prospective house buyers can't get mortgages, so they build fewer homes. If a builder has more houses already built than he can sell, he may stop constructing houses at all.

Carpenters, plumbers, brick masons and all the other tradesman who build houses have less work to do. Many become unemployed altogether.

And families who want to buy homes discover they can't. A family may have been dreaming of a home and saving for it for years, only to discover that through no fault of its own, it cannot get a mortgage.

SMALL BUSINESSES. Many small firms such as family farms and independent retail stores are in business in South Dakota. Small firms are generally hurt more than large companies by restrictive monetary policies. The small businesses are hurt more by rising interest rates because they have less ability to generate capital internally, they do not have access to foreign banks, and their lines of credit, if any, tend to be soft.

Thus, just as we have seen that inflation is disruptive, attempts to disinflate the economy can be disruptive also.

So the task of the officials who set the Government's fiscal and monetary policy is to achieve a fine balance between too much and too little. Too much Government spending relative to taxes and too much money floating around can produce inflation. Taxes that are too high, severe reductions in Government spending, or policies that result in a scarcity of money can lead to hardships for particular groups or to a general recession.

Incomes Policy

An attempt by the Government to influence wage and price decisions outside the regular working of the economy is called an "incomes policy."

An "incomes policy" can be gentle or it can be tough.

Some administrations, such as the Carter Administration, have developed "guidelines" for wages and prices. These guidelines have been based on what government economists figured would not upset the economy. Usually most attention has been focused on major industries. The Carter Administration has attempted to put "teeth" into its guidelines by saying that Government will buy goods and services only from firms that comply.

Presidents and their aides have attempted to persuade union and industry officials to accept the guidelines voluntarily. They do this both publicly and privately. Such attempts at persuasion are called jawboning.

Sometimes jawboning has worked. Sometimes it hasn't. Guidelines seem to break down when demand strains the country's production capacity.

CONTROLS. Direct controls on wages and prices are a more severe form of incomes policy.

During World War II and the Korean War, the nation had very strict wage and price controls, along with rationing of most items. The controls regulated the price of almost everything and took tens of thousands of officials to administer.

More recently, during the Nixon Administration, controls were imposed again. The general agreement among economists is that those controls "failed". They failed in that even though inflation was temporarily reduced, once controls were lifted, the price level zoomed to a level no lower than it would have been without controls.

PRO AND CON. Wage and price controls, and even guidelines, are controversial.

Some economists oppose any form of incomes policy. They say guidelines amount to unwarranted attempts by the Government to influence the free workings of the economy. Usually these economists say guidelines won't work anyway. And they are horrified at the prospect of direct controls.

Other economists favor guidelines but oppose controls. They say Government has an obligation to set rough standards for business and labor to follow but shouldn't attempt rigid controls. Rough standards are appealing if they serve to reduce expectations of future price increases. Remember, expectations of future price rises can increase demand and insure that such rises do occur.

But workers and firms may well maintain their expectations if guidelines or even controls are imposed. Guidelines, they might reason, can be avoided or ignored. And controls are unlikely to last forever.

Controls are unlikely to last forever because our economy uses a price system, in part, to allocate resources. For some economists the workings of this price system and the "efficient" result are the strongest reason for avoiding price controls.

By efficiency, they mean that:

When demand for an item goes up in a free economy, the price increases. So does the profit. When other manufacturers see how profitable the item is, they decide to begin manufacturing it also. Soon the supply of the item has increased so much that it catches up with the demand. If production is increased even more, the price can go down. But the point is that prices have served to "signal" an increased demand for a product and to bring about an increase in the supply of the product.

The mechanism also works to allocate labor and capital (money). When people see wages in a particular trade going way up, more and more people decide to enter that trade. The same thing works for capital: people invest their money where they can get the greatest return.

Some other economists, however, note that the real world or at least part of it doesn't work like economic textbooks say it should. These economists point out that wages and prices in many industries hardly ever come down; they only go up. Instead of lowering prices, manufacturers in these areas simply produce less. Workers in these industries don't suffer pay cuts, although they make

less overtime when demand is down. Instead of wages going down, fewer people are employed.

In fact, these economists note, wages and prices in these industries may go up even when demand falls.

These companies and workers are somehow protected from the competitive forces of a free economy.

Sometimes, one or two firms in an industry are so large that they don't have to worry about another company starting in business to compete with them

In some cases one, two or three firms produce such a large share of the market that they set the price and smaller producers follow.

Labor unions, by striking or threatening to strike, are often able to win wage increases even when demand for what they produce - and therefore for the worker's services - is declining. And union contracts set a minimum on the wages of all members; their wages seldom go down.

For all of these reasons, this third group of economists say that the Government must step in and regulate prices and wages during periods of "supply" inflation.

Fiscal and monetary policies curtail "demand" inflation, but they can't do the job alone in time of "supply" inflation. Direct controls, they say, are needed to regulate industries which escape the consequences of lower demand.

This is a controversial position. Economists are likely to be arguing about it for a long time to come.

TAX-BASED INCOMES POLICY. Another, relatively new incomes policy is the Tax-Based Incomes Policy, or TIP for short. Several variations of TIP have been proposed although none have been tried. All variations have in common the idea of using Government taxes to affect supply inflation. Workers and businesses would be rewarded through tax breaks for meeting price guidelines and (in some versions) punished if they didn't meet those guidelines.

For example, suppose the Government wants to limit wage increases to 8 percent a year. Legislation would be passed to reward workers an additional bonus, say 2 percent, for wage settlements of 8 percent or less. Then workers who settled for say a $7\frac{1}{2}$ percent wage increase, would end up with the settlement plus the bonus, or $9\frac{1}{2}$ percent. The workers getting the bonus would be ahead of another group of workers who broke the guidelines and achieved a 9 percent wage increase without any bonus.

In late 1978 President Carter asked Congress to enact a version of TIP known as "real wage insurance." But uncertainty about the consequences of the proposal have prevented its passage.

Supply Enhancement

Recent experiences with "supply inflation" and concern with our national ability to produce have led some economists to consider how supply might be increased through government efforts. A variety of proposals have been made. Some proposals are novel. Economists are not in general agreement about which to support.

One old idea being revived again is a tax credit for business investments. Both private investments and some kinds of government spending, such as road construction or manpower training, are first a part of aggregate demand but then, eventually, they add to supply because they increase productivity. Disagreement exists over whether the investments should be made by public or private organizations and whether particular programs such as tax credits for private investments are wasteful or are fair.

Other proposals involve reducing capital gains taxes and reducing taxes on interest from savings. Both measures would, it's argued, create more willingness to save and to invest. Still another idea being tried is to offer a Government wage supplement to companies for payment to newly hired previously unemployed workers.

All these supply enhancement proposals need to be put into the perspective of historical experience. Prior to the Great Depression, most economists held to

the classic rule known as Say's Law. That is, "Supply creates its own demand" or, in other words if supply is increased demand will follow. That law is no longer believed by most economists today so that even if supply enhancement policies do seem desirable in a given situation, policies which affect demand are unlikely to be completely discarded.

What Would You Do?

Well, now you see the problem.

Inflation can result from increased demand. This can be the result of increased private demand, increased Government spending, or increased money supply.

Inflation can also result from decreased supply. Sometimes the decrease in supply results from external shocks such as OPEC and sometimes supply decreases even when demand falls because of market power.

Where Are We Now?

The past five years began with the lifting of price controls in late 1973 and into 1974. Without controls, prices zoomed upward to a level about where they would have been without the control experience. Meanwhile, production began to falter, fall, and then plummet in late 1974 and 1975. The U.S. economy experienced its longest and hardest recession since the 1930's. Real production fell by about 6 percent during the period late 1973 to early 1975 and unemployment rose from less than 5 percent to nearly 9 percent. The twin evils of macroeconomics - unemployment and inflation - haunted the economy together.

Then a moderate recovery began in 1975. Unemployment declined, but only to the level of a bit under six percent in late 1979. A 6 percent unemployment rate would have been considered intolerably high in the 1960's.

The inflation rate fell in mid-1975. Shocks of food and fuel price increases had passed. The surge in prices after controls were lifted also had passed. Recession during 1974 dampened inflation.

But beginning in early 1979 and continuing throughout the year, prices have soared again. The annual rate of inflation, as measured by the CPI is about 13 percent. The nation appeared to be suffering from both demand inflation, especially in the form of consumer expectations and supply inflation, in attempts by labor and business to "catch up".

In October, 1979, the FED took strong action to limit the growth rate of money supply as a way to break the grip of inflation. Prime lending rates at

major banks quickly rose to 15 percent.

Prospects for 1980 point to a likely recession, one which may involve both rising unemployment and, for a time, continued rapid inflation.

Some Choices

So, reviewing what has been said about the causes and cures of inflation, consider these anti-inflation options available to the Government:

Increased taxes and/or decreased Government spending.

Decreased money supply.

Guidelines and jawboning.

Wage and price controls.

TIP.

Supply enhancement.

Notice that there's a problem with at least the first four choices. No matter which of these options is chosen, somebody gets hurt.

Let's look at the choices, one by one.

INCREASED TAXES AND/OR DECREASED GOVERNMENT SPENDING. First taxes. Taxes are never popular and tax increases are even more unpopular. But assume you decide increasing taxes would be a good way to reduce demand.

First you have to decide which taxes to increase - individual, corporate or both.

If taxes are increased too high, then people won't have much money left over to buy things and businesses will have less money to invest. The result could be a recession, with a lot of people out of work.

Reducing government spending also requires deciding what spending to cut. Who, in effect, will pay for fighting inflation with fewer programs or benefits?

Requiring a balanced Federal budget may sound like a good idea in a period of inflation. But what happens during the next recession? Taxes would need to be raised or Government expenditures reduced to make up for reduced income tax

revenues during the recession. These policies would only deepen the recession, creating an even larger deficit as incomes and income taxes fall.

DECREASED MONEY SUPPLY. The same danger - a recession and unemployment - is posed by cutting too sharply into the nation's money supply.

In addition, reducing the nation's supply of money increases interest rates of almost every kind. And since interest rates are often one element of cost, the short term effect could be to increase prices.

Construction of new homes, as we have seen, is particularly vulnerable to increased interest rates.

High interest rates create particular hardships for South Dakota because of the many small businesses here.

GUIDELINES AND JAWBONING. The key questions here are: Will they work? Will business and labor heed guidelines that are merely suggestions? And is it fair for the Government to single out a few industries for the harsh publicity that sometimes accompanies jawboning?

WAGE AND PRICE CONTROLS. You already have read some of the pros and cons of controls. Critics of controls say they distort the economy and can cause shortages. Black markets could develop. Administration can be cumbersome and complex. And once even temporary controls are installed, they are difficult to get rid of. Prices tend to jump upward when controls are lifted.

But those objections aside, you may decide that wage and price controls are necessary. Then you must decide some other tough questions: Should all wages and prices be controlled? Should controls regulate only certain segments of the economy? Should only big companies and big unions be regulated? Where do you draw the line?

TIP. Using the Federal income tax as an incomes policy tool is untried. Major questions include: Who should be covered; what tax incentives are necessary to make it work; and how much will it cost?

SUPPLY ENHANCEMENT. Here again, some of the suggestions are new although others

such as tax credits for investments have been used previously. Each suggestion needs to be studied on its merits. Some say that tax credits for investments, in addition to stimulating more inflation initially, are wasteful and tend to directly benefit the rich - even if they do moderate inflation in the long run. We have noted for all supply enhancement proposals that they will not, of themselves, guarantee a sufficient demand in the future to prevent recession and unemployment.

No Perfect Solution.

As you can see, there isn't any one "correct" answer to the inflation question. There's no perfect solution. Every option has its disadvantages; almost every choice hurts someone.

Most plans to combat inflation involve a number of approaches: fiscal policy, monetary policy, incomes policies, and supply management.

The material in this paper will help you understand the reasons various anti-inflation programs are suggested. It also will help you decide which anti-inflation proposals you favor and which you oppose.

At times the plans you read about in the newspapers or hear on television will seem a bit complex. But it would pay you to figure out just what is being proposed.

After all, it's your money.

Appendix

—Prices paid by farmers: Index numbers, by groups of commodities, United States, 1965-77¹
[1967 = 100]

Year	Family living indexes							Production indexes					
	Family living (all commodities)	Food	Clothing	Housing ²	Autos and auto supplies	Medical and health care ^{3,4}	Education, recreation, and other ^(*) (4)	Production (all commodities)	Feed	Feeder livestock	Seed	Fertilizer	Agricultural chemicals
1965.....	95	95	92	97	97	89	95	96	97	90	102	103	98
1966.....	98	100	95	98	98	93	97	100	101	103	98	102	99
1967.....	100	100	100	100	100	100	100	100	100	100	100	100	100
1968.....	101	103	105	104	105	106	104	100	94	104	104	94	101
1969.....	109	108	112	107	109	113	109	104	96	117	105	87	100
1970.....	114	114	119	109	113	120	115	109	101	122	112	83	99
1971.....	118	116	124	113	120	128	120	113	105	125	124	91	100
1972.....	123	123	131	118	121	132	124	121	106	149	135	94	103
1973.....	133	143	143	127	130	137	127	146	160	192	157	102	105
1974.....	151	165	162	149	153	149	135	166	194	143	215	107	119
1975.....	166	178	174	168	172	167	147	182	187	134	245	217	160
1976.....	178	183	183	175	184	184	153	193	191	154	241	185	174
1977.....	181	(5)	(5)	(5)	(5)	(5)	(5)	200	186	158	261	181	157

Year	Production indexes—Continued							Prices paid (total commodities)	Interest	Taxes	Wage rates ⁵	Production, interest, taxes, and wage rates	Commodities, interest, taxes, and wage rates
	Fuels and energy ^(*)	Farm and motor supplies ²	Autos and trucks ²	Tractors and self-propelled machinery ²	Other machinery ²	Building and fencing	Farm services and cash rent ⁶						
1965.....	98	99	93	92	93	97	-----	96	79	87	26	94	94
1966.....	98	99	95	95	96	99	-----	99	90	94	93	99	99
1967.....	100	100	100	100	100	100	-----	100	100	100	100	100	100
1968.....	101	102	107	104	104	106	-----	102	112	110	108	102	103
1969.....	102	104	112	111	110	113	-----	106	125	120	119	107	103
1970.....	104	108	120	116	116	113	-----	110	134	129	123	112	112
1971.....	107	111	131	122	122	121	-----	115	142	138	134	117	118
1972.....	108	114	127	125	130	131	-----	122	154	142	142	125	125
1973.....	116	120	145	137	139	147	-----	142	180	145	155	143	144
1974.....	159	147	161	161	159	181	-----	161	216	154	173	169	164
1975.....	177	168	191	195	197	206	-----	177	254	165	192	156	160
1976.....	187	184	212	217	225	215	-----	187	287	173	210	193	191
1977.....	202	165	234	238	248	229	-----	195	331	193	225	208	202

¹ Index values for 1965 through 1975 were revised and published in May 1976 using 1971-73 weights. Indexes were reordered and several new indexes introduced. Revised monthly indexes for January 1965-April 1975 are available upon request.

² New or restructured index; values for years prior to 1965 are not available.

³ Based on Consumer Price Indexes of Bureau of Labor Statistics.

⁴ Beginning 1977, based on Consumer Price Indexes of Bureau of Labor Statistics.

⁵ Discontinued.

⁶ New index; values for years prior to 1971 are not available.

⁷ Simple average of seasonally adjusted quarterly indexes.

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Source: Ag Statistics (1978) p. 457.