5-1952

Inflation and Deflation

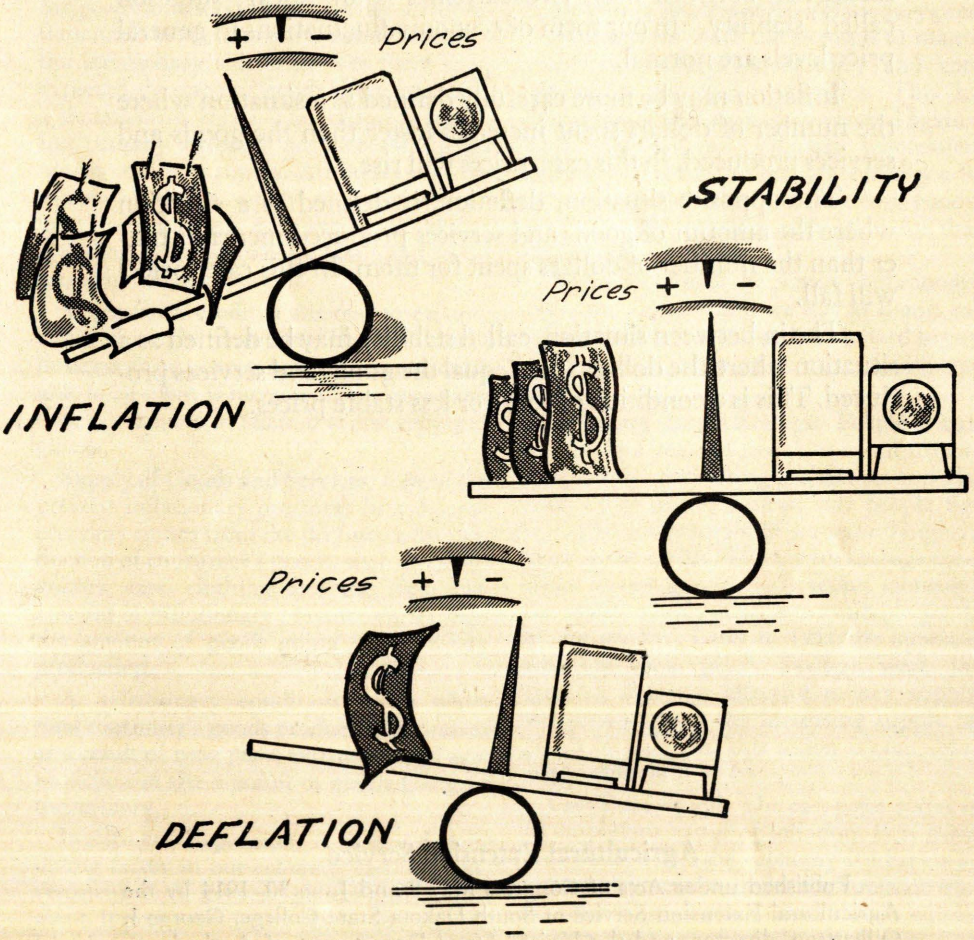
Lyle M. Bender

EXTENSION CIRCULAR 482 MAY 1952

INFLATION

And

DEFLATION



AGRICULTURAL EXTENSION SERVICE

SOUTH DAKOTA STATE COLLEGE, BROOKINGS

U. S. DEPARTMENT OF AGRICULTURE

What Is It?

Inflation and deflation are words of many different meanings. They refer to the changes in general price levels. Inflation refers generally to a situation where most prices are rising. On the other hand, deflation refers to a situation in which most prices are falling. In between these two extremes is an "ideal" situation called "stability." In our form of economy fluctuations in general price levels are normal.

Inflation may be more carefully defined as a situation where the number of dollars spent increases faster than the goods and services produced. In this case, prices will rise.

The opposite situation, deflation, is defined as a situation where the amount of goods and services produced increases faster than the number of dollars spent for them. In this case, prices will fall.

The in-between situation, called stability may be defined as a situation where the dollars spent equal the goods and services produced. This is a condition of more or less stable prices.

Agricultural Extension Service

Published under Acts of Congress May 8 and June 30, 1914 by the Agricultural Extension Service of South Dakota State College, George I. Gilbertson, director, and the United States Department of Agriculture, cooperating.

INFLATION and DEFLATION

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Causes of Inflation and Deflation

There are many causes of inflation and deflation. Six different causes are described.

Changes in Money or Credit Supply: On the money and credit side of our economy changes in its supply in relation to demand for goods and services may bring about inflationary or deflationary conditions. On the inflationary side whenever there is an expected shortage of goods there is usually a scramble for them. This requires financing, usually through an increase in the money or credit supply. An increase in the money or credit supply may come from many sources such as, government deficit spending, increase in bank loans and an increase in consumer credit.

When bank credit is allowed to expand, either through borrowing by individuals, business or by government the money available to be spent is increased. It means more dollars available in relation to the supply of goods.

Supply of Goods and Services: One of the greatest inflationary pressures in a defense economy comes from the decline in the production of consumer's goods, such as refrigerators, cars, clothing and the like. The amount of inflationary pressure varies with the amount of goods going into military production.

A deflationary condition arises when total consumer's goods production increases as a result of new plant expansion and or a reduction in the amount of goods going to the military.

Investment Expansion: A strong destabilizing factor in our economy is capital investment such as new plants and equipment. It puts pressure on raw materials and labor at times when existing plants and labor are fully employed. It increases incomes without creating immediate consumer goods to offset higher incomes. It is inflationary in the short run and deflationary in the long run.

Inventory Building: An inflationary pressure may come from the attempts of manufacturers, wholesalers, retailers and consumers to increase inventories. This increase means that manufacturers bid against each other for raw materials; wholesalers against each other for manufactured goods; retailers against each other for retail goods; and you and I against each other for that sugar, those tires, etc.

The other side of the picture, deflationary pressures, come when we stay at home, eat off the pantry shelves, and work hard to pay off our short term debts or replenish our savings.

Spending from Savings: People's attitudes about savings may also be an important factor contributing to inflation or deflation. Early in the Korean war people figured that goods might be scarce and high in price in the future. Those with savings used them to buy goods. Such action increased the money supply relative to available goods in the market. Early in 1951 the opposite situation took place. Savings were increased, thus the effective money supply was smaller than the increasing supply of goods for sale and this action is contributing to deflation.

Cost-Price Spiral: The cost-price spiral is an important cause of inflation. It is most important when the economy is near or at full employment or under the strain of war or defense production. Under such conditions a shortage of goods causes prices to rise. Labor is fully employed or there may be shortages. With this set up, organized

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labor can use their power to push wages up and prices usually rise with them. Often, under these conditions, wage rates tend to increase faster than labor productivity. Also, when goods are in short supply and labor and plants are fully employed, industry may tend to push up prices faster than costs and plant productivity. This new income or purchasing power makes further price increases possible.

Effects of Inflation and Deflation

Not all price rises are bad. Neither are all price declines bad. Gently rising prices encourage increasing productivity. Gently lowering of prices tend to encourage more consumption of goods produced by industry and agriculture. Probably what concerns us most is the rapid rise in prices when our economy is operating at a full plant capacity and full employment level. Three effects are described.

Effects on Output of Goods and Employment: The effects of inflation on production of goods are mixed depending on the amount of inflation and its rapidity. A mild inflation increases employment and production. Rapid inflation distorts employment and production.

Inflation may offset workers' productivity and willingness to work if consumption goods are very scarce and if inflation destroys the value of savings.

In deflation the growing unemployment of labor and capital causes the total of the community's well-being to be less. Almost everyone loses in a bad deflation or depression.

Effects on Debtors and Creditors: Inflation tends to favor people who owe debts. Deflation, on the other hand, tends to favor those who receive payments for debts. Farmers and others who are in debt gain from inflation as the price rises making the debt easier to pay.

Effect on Profit Receivers and Fixed Income Groups: In periods of inflation people on fixed incomes stand to lose a great deal. This group includes all those on salaries, and people who receive money incomes in the form of pensions, interest on bonds and saving deposits, annuities, and rents that are fixed by long term contracts. These folks suffer because any type of money payment received such as life insurance benefits, loan repayments or bond redemption means much less in terms of goods and services it will buy. In periods of deflation these groups tend to gain relative to other groups.

During periods of inflation people who receive profit such as businesses and farmers gain from rising prices. During the inflation prices rise faster than costs. However when deflation takes place the gains by these groups are narrowed and may be lost.

Methods of Controlling Inflation

We can now deal with some of the major proposals for controlling inflation. Since deflation is the other side of inflation, the proposals for controlling deflation would usually be the opposites that are proposed for controlling inflation.

The major suggested proposals for controlling inflation can be classed into three groups as follows:

"Do Nothing" Policy

This policy is one of allowing the price system to work "freely" at all times. The price system is the basic mechanism which allocates resources and guides production and consumption.

By following this procedure we would eliminate all administrative costs and the inconvenience of other schemes, and would insure the continued operation of a "free" market. It would tend to encourage people on fixed income to shift quicker to defense jobs to maintain their standard of living.

On the other hand, if prices were permitted to move freely through the inflationary cycle there would be many inequities created between different income groups. When we reach the condition of full plant use and employment, rapid inflation would take place as a result of wage–price battles. In order to provide adequate military production it would mean greatly increased taxes and or a higher national debt.

Monetary and Fiscal Controls

Monetary and fiscal control is an attempt to control the causes of inflation. This policy would still allow prices to allocate resources throughout the economy. It would allow and encourage increased production, but would attempt to drain off the increased demand it creates. It attempts to get at the problem by indirect methods that interfere less with the freedom of individuals. The essential features of this plan are:

A. Monetary Controls:

1. **Change in Reserve Requirements of Banks:** In our banking system each bank's loaning ability is limited by the amount of its reserves. A rise in the reserve requirements of member banks means that the member banks can make less loans on a given amount of reserves. It limits expansion of credit beyond that needed for general business at any particular level.

2. **Open Market Operations:** The open market operations of the Federal Reserve System is another method of influencing the money supply. This is accomplished by the buying and selling of government securities in the open markets of the country. Since these securities must be either bought **from** someone or sold **to** someone, someone's bank account must be increased or decreased in the process.

3. **Interest Rates:** Changes in the interest rates may help in controlling inflation. Interest rates can be influenced through changes in the supply of money brought about by open market operations, changes in reserve requirements, and changes in discounts for member banks. A higher interest rate may slow down investment when materials and labor are short. It would also tend to encourage some people to save more.

4. **Margin Controls:** The ability to control margins in stock and commodity markets can help control inflation by preventing speculation in the markets on money borrowed from banks.

5. **Consumer Credit Controls:** These controls generally apply to short term installment credit for autos, etc. and longer term housing credit. Such controls require certain down payments and specifies the length payments can run. It is designed to limit the amount of money people spend on scarce goods.

B. Fiscal Controls

Fiscal controls or policy is in general an attempt by the government, through the treasury, to slow down inflation by removing the excess demand through taxation. It can also operate on the expenditure side by removing excess demand by cutting government spending.

1. **Balance the Federal Budget:** Under a war time or extended period of defense building we face the possibility of deficit financing. Such financing is inflationary if financed by borrowing from banks. If borrowing is done out of savings by individuals etc., it will not be as inflationary. If we wish to avoid inflation a part of the over-all problem is to bring the budget more nearly into balance. This may be done by reducing the expenditures or raising the receipts or by adjusting both.

Public improvements and other expenditures should be judged on the basis of efficiency of operation and the general effect on the nation as a whole.

2. **Income Tax:** A properly levied income tax is a strong weapon to fight inflation. To be made effective the tax must exclude the minimum living costs. It must be progressive to a degree.

3. **Reduce the Volume of Government Loans and Guarantee of Loans:** The object

of this program, in times of inflationary pressures, is to hold down the demand for materials and services thus reducing the pressure on prices.

4. **Coroporation Excess Profit Tax:** One of the most popular taxes is an excess profits tax. The excess profit tax does little to prevent inflation because, corporations are usually savers in good times.

5. **Consumer Sales Tax:** A tax of this sort would do little to control inflation. It has an advantage over excise tax because it would not be figured in prices to aid the cost–price push. It would adversely affect people with low incomes.

C. Voluntary Controls

People and business themselves can help to reduce inflation. One of the ways is to expand production quickly wherever possible. As a means of controlling inflation in the very short–run, this method is not very effective under full employment conditions. Another way—buy only what is needed. Current spending power can be reduced by more saving and paying off of debts. Voluntary credit restriction on speculative loans sponsored by the banks and other lending groups is another way of reducing spending power.

D. Appraisal

There are many advantages claimed for the monetary fiscal control system. It is designed to get at the cause of inflation. This proposal would not interfere too drastically with the normal automatic operations of the market. Such a plan is inexpensive from the standpoint of administrative costs.

On the other hand this plan may not move fast enough and far enough to control inflation in its early phases. There is a possibility that controls would be too hard. It is not possible to prevent inflation due to cost–price spiral or spending from savings. It would be difficult to prevent sharp price rises on industrial commodities. Some of the monetary controls do not touch all banks.

Monetary and Fiscal Policy With Some Direct Controls

This alternative for the control of inflation would use all or a part of the monetary—fiscal, and voluntary controls just discussed along with a system of direct controls. By direct controls we mean those acts of government that reach down and restrict individuals and business firms directly.

The monetary—fiscal and voluntary controls get at the real causes of inflation. Direct controls are used to get at the rapid rise in prices when plants and labor are fully employed as in a war or defense economy. They can help check price inflation temporarily, slow down its rate of progress, but they cannot prevent inflation.

A full system of direct controls may include control of rents, wages, basic material prices, retail prices, allocation or rationing of basic materials and rationing of retail goods. The range of control may be limited or all inclusive depending mainly on the degree of mobilization.

Characteristics of Direct Controls

Rent control, sets forth ceilings on different types of dwelling units. Since housing is short, in periods of rapid development, such as in war or mobilization, such ceilings serve to equalize the sacrifices necessitated by the defense program in that prices of scarce commodities are held within the reaches of low income groups. For the longer run, rent controls, may reduce home construction and improvement. Should construction and improvements be slowed down due to long, continued controls, such action may create an excuse for further government action, such as subsidies or public housing projects.

Wage Controls involve the setting of limits on wage and salary increases based on some current historic base. Its purpose is an attempt to slow the cost–price upward movement in price at times when labor and plant capacity are nearly or fully employed. Some flexibility is needed in order to help attract labor to more needed jobs by way of wage increases in high priority work.

Price Controls and Rationing: One set of controls apply to industry namely—basic materials price control (non-farm) and allocation or rationing of basic materials. The other set of controls are retail price controls and rationing of retail goods.

Because the law of supply and demand operates whether prices are determined in free markets or administered markets, basic materials price control and allocation along with retail price control and rationing must go together. If prices are arbitrarily held below what they would be a free market, then that means that there will not be enough to go around at the lower price and allocation or rationing must be used to provide an orderly distribution of short supply.

The degree of allocation or rationing that may be necessary depends on how strong we use the monetary–fiscal and voluntary controls. If these are fully adequate there will not likely be a serious amount of excess demand to bring on wide spread allocation or rationing.

The object of a general price freeze is an attempt to check speculation on the part of everybody. A general freeze is not expected to be absolute for all time nor on all commodities. Some flexibility is essential. Such a freeze order is an attempt to slow down or suppress a rapid rise in prices.

An Appraisal

Proponents of this alternative—a combination of monetary fiscal and direct controls—claim that direct controls achieve immediate results while waiting for the slower indirect program to become effective. Price ceilings tend to equalize the sacrifices, brought about by the defense program. In the case of flexible agricultural prices, ceilings may prevent wide variation in prices between commodities and lessen wide and sometimes undesirable shifts in production. Under conditions of mobilization, full employment and a sellers market, it is difficult without such controls to prevent strong groups from shifting their burdens of the defense effort to others through wage increases, price increases and higher profits. Finally, direct controls along with monetary–fiscal measures, makes it possible for the defense establishment to procure necessary goods at reasonable prices.

Opposition to any system of direct controls has been vigorous. Much of the dissention in regard price controls center around the intensity of the war or defense effort. Few people would advocate price controls if the defense program were taking only 5 to 10 percent of the national income. On the other hand many would advocate price controls if we were in an all out war and our war efforts were taking 40–50 percent of our national production. Opinions differ greatly on the in-between zone, where 15–20 percent of the national income goes to our defense effort. If the defense program is to become a long, drawn out one there is a danger that controls may become permanent. To guard against this danger the purpose and extent of such controls must be clearly stated, and must be definitely limited as to duration.

Furthermore, the function of our price system—to guide production and ration goods, would be largely ineffective through the establishment of arbitrary price and wage ceilings. This is especially true for most agricultural products whose prices are generally flexible—that is price moves up and down readily with changes in supply and demand. Price controls on flexible price goods generally do more harm than good. Direct controls do not attack the true source of trouble, but direct attention toward the symptoms of price inflation. Any direct control also requires large quantities of manpower, both within government and industry to administer and keep the necessary records.

Controls if absolutely rigid may also hamper production efforts by failing to allow the necessary price incentives or by distorting the price structure between the raw material and its manufactured product.

Summary

In a democracy such as ours the mass of people must be informed. It is essential that they understand the broad principles involved in problems of national affairs such as inflation and deflation. Citizens must not only know **what** they want and **which** of their wants are most important; they must also have the information and insight to know **whether** and to **what extent** a given program will lead to satisfaction of those wants.

Decision as to which route we will follow in this extended period of defense preparation with its inflationary and deflationary tendencies, must be made by an enlightened public. Whatever action is taken must reflect the will of the people. Such action depends upon a better understanding of the main issues involved.