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# Inflation: Its Causes, Control, And Cures In Our Economy

Jewel F. Hunter McDonald
*Prairie View Agricultural and Mechanical College*

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# INFLATION: ITS CAUSES, CONTROL, AND CURES IN OUR ECONOMY

JEWEL F. HUNTER McDONALD

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# INFLATION: ITS CAUSES, CONTROL, AND CURES IN OUR ECONOMY

By

Jewel F. Hunter McDonald

A Thesis Submitted in Partial Fulfillment
of the Requirements for the Degree of

HD49.5
M32

Master of Arts

In The

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This Thesis for the Master of Arts Degree

by

Jewel F. Hunter McDonald

has been approved for the Department of

Business Education

by

[redacted]

Head, Dept of Business

Date: Aug. 3, 1959

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The writer wishes to express her sincere gratitude to Dr. William C. Ferguson, Head of the Department, for his assistance, guidance and constructive criticisms in preparing this thesis.

# DEDICATION

The writer wishes to dedicate this thesis to my husband, Clinton C. McDonald, my son, Clinton C. McDonald Jr., my daughter, Lynda R. McDonald and my mother, Mrs. Alice P. Hunter.

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# CHAPTER I

## INTRODUCTION

Inflation is one of the most persistent economic problems of out time -- one which we may have to live with for some time to come. It is an old problem which has invaded mankind since money was invented. At the same time, it is a new problem, because it can never be solved once and for all.

Inflation can be understood rather well. Fundamentally, its causes are simple and its effects are easy to recognize. In spite of our knowledge and experience of inflation, an agreement cannot be reached on how to best control inflation and its attacks on our economic system.

There are a number of reasons why inflation is so difficult to control. First, inflation is the result of a combination of causes which vary in importance from one situation to another. We live in a changing world; institutions change, techniques of production are new, new laws modify or replace the old; property and wealth are redistributed, and population grows. As a result, inflationary processes and pressures always reappear in new forms which create new conflicts and interests which must be resolved in the context of social changes and economic circumstances.

Second, inflationary pressures are regenerated by man's conscious or unconscious revolt agains the limitations of his environment. Economics is a science because men in the present economy want more and bigger automobiles, houses, more comfort, governmental services, better schools, job opportunities and greater economic security. Collectively, man want these things for the present and the future; and individually, they want a larger proportionate share, however, rapidly or slowly the total economic situation grows in size. It is one of the tasks of social and economic organization to keep the sum total of all individual demands on the economic system within the bounds of the system's capacity to produce. In our present economy it seems that man has the natural inclination to overload the economy with excessive demands unless he is restrained by the discipline of the market and appropriate monetary and fiscal policies. Inflation is, in a sense, evidence of a lack of social discipline.

Third, in recognizing the problem, there are two vastly different things. Facing the problem raises all sorts of issues of public policy on which disagreement is inevitable. In public policy, not only are there legitimate differences of opinion and judgment in interpreting economic events, but many disagreements because of the differences in value judgments as to the many goals of public policy. Added to these difficulties are the pressures of those persons who want the problem solved in a manner which will provide them with special economic advantages. Naturally, they identify their particular interests with the general welfare. It is, therefore, sometimes exceedingly difficult to distinguish between right policies for wrong reasons and wrong policies for right reasons.

How then shall we face the problem? It has been agreed upon that the issues are important. The effects inflation has upon the economy has been witnessed. In the midst of inconsistent proposals, the clamor for special treatment, the scramble for economic or political advantages must work out solutions to maintain reasonable stability of the value of our money. These proposals will also promote relatively full employment, and orderly economic growth. At the same time, these solutions must be equitable and compatible with our free market institutions.

What we need in this economy is greater public understanding of how inflation works, where, and how these forces are generated, how these forces operate and manifest themselves, and how they can best be controlled in a free society.

Actually rising prices are symptons, rather than causes of inflation. It certainly is the rise in the general level of prices of consumer goods, producers goods and intermediate materials and services going into production which destroys the purchasing power of the dollar and creates the real problems of inflation.

The question now arises, what is inflation? There are many different definitions of inflation. To some, inflation is an increase in the supply of money; to others it is an increase in the supply of money accompanied by a general rise in prices; and still to others it is a general rise in money incomes proportionately greater than any increase in the real resources of the country. In this study inflation shall be discussed as a process -- a process by which the general level of money prices, including the prices of productive services are increased and the purchasing power of the dollar in all major uses is reduced. This process can be described as the rise of prices and incomes, because of the total volume of money spending increases faster than the physical supply of the goods and services on which the money is spent. The total volume of money spending, in turn, depends on (a) the supply or stock of money, and (b) how fast the stock of money is spent. More clearly, when the total volume of money spending, in turn, increases more rapidly than the supply of goods and services bought and sold, the average dollar value -- the average price or price level -- must go up. Inflating prices must, at the same time, involve rising money incomes, since every price is divisible for simplicity. Inflation of prices and incomes occur when total demand for money outruns the total supply of output, blowup both the prices of output and the prices of resources.

Why would total spending increase faster than the supply? Where are the forces generated? These questions will be answered in later chapters, as to the features which bear directly or indirectly upon the problem.

It has been said by some writers on this subject, that money is the pickpocket of prosperity. If too much money is put into the economy, it is assumed that cost of living will be doubled. Prices seldom stand still for any length of time. They are the inevitable results of changing conditions of demand and supply in markets where freedom of competition prevails. Increasing demand or diminishing supply tends to bring about higher prices, and decreasing demand or increasing supply tends to bring about lower prices. Rising prices stimulate production and discourage demand, and falling prices encourage demand and discourage production. When all prices are going up, it is not because everything is worth more, but because the dollar is worth less. The value of a good is its power to command another good in exchange for itself.

War is inflationary, the way it is paid for. The cost of the war not raised by taxes is borrowed by selling bonds. Government bonds are bought by people, savings, banks, insurance companies, commercial and industrial corporations come out of savings, and such bond buying is not inflationary.

After World War II a lot of the bonds were turned into money, and there was more inflation. People cashed their bonds at the banks, and the Federal Reserve as the ultimate buyer under the support program supplied the high-powered reserve dollars needed to support the money supply.

Inflation has charm. It is a delusion, but such a delightful delusion. It affords an apparently easy way out of so many of the daily difficulties that confront us.

Inflation sends up prices on the securities markets, farmers wishing to sell out get fancy prices for their farms, businessmen find it easier to make profits that come from inventory appreciation and higher selling prices, and workers get higher wages.

Inflation wears a false face of prosperity, many people are easily fooled by it. First, it is tolerated, then it is accepted, and finally it is rationalized. In fact, the rationalizing has already begun. During this period we are faced with a choice of three evils. We must accept enough unemployment to keep labor costs from rising, or impose direct Government controls over prices and wages, or embrace inflation. The first is socially undesirable, the second is politically impossible in times of peace -- which leaves inflation as the least of the three evils.

Because of the fact that our business is done in dollars, it is very easy to fall for the idea that more dollars bring more prosperity. The meaning of prosperity is not more dollars, but more goods and services. We as a people can consume only what we produce. If we want to consume more, we must produce more -- and there is no money that will enable us to consume more than we produce. Inflation, where-ever and whenever it is tolerated, is a pickpocket of prosperity, and the bigger the inflation the bigger the pocket picking.

Moreover, there is a world of difference between a creeping inflation and a planned inflation. If the Government were to accept as a national policy a 2 or 3 per cent annual inflation, it would be realized immediately that there would be no point in holding insurace policies or putting money into savings accounts, savings bonds, and other forms of dollar assets. Instead of saving, we would put money into real estate, commodities, and other forms of investment that ride with the rising tide of inflation. This would make us a nation of speculators rather than savers.

It is naive to believe that a deliberate policy of 2 or 3 per cent inflation could be held steady indefinitely. Inflation feeds on itself, and it would not be long before it would accelerate to running or galloping inflation. Moreover, if we are simple-minded enough to believe that a little inflation brings a little prosperity, then why not double the inflation and also double the prosperity? If this is so, then, more money is a royal road to prosperity and it will be easy to make ourselves fabulously wealthy.

Inflation is politically popular. The difficulty of dealing with the problem politically is that too many people like inflationary trends. The effects are as stimulating as they are deceiving. The builders like inflation because houses are easier to sell at high prices. Labor likes inflation because the idea of unemployment, at least disappears temporarily, wage increases come more frequently and with less resistance from management. Governments like it because taxes yield greater revenue and are easier to collect. Inflation also lightens the burden of carrying the national debt. Debtors in all walks of life similarly find their burdens easier to carry under a system of gradually rising prices. Property owners like inflation because realty prices keep rising. Some people have concluded that a steady upward price increase of two or three per cent a year is not only what probably will happen, but should happen for our best interests in the economy.

Those persons who accept an annual increase of two or three per cent in the price level seem to be undistrubed by the fact that long term contracts such as life insurance, annuities and retirement pensions would be largely destroyed. The variable annuity is an attempt to rescue the annuitant from the ravages of inflation. Inflation may benefit some groups temporarily, but in the long run everyone loses, including the Government which was responsible for putting the process in motion.

The smart operator who finds speculation, hoarding, and black markets much easier going than making goods or providing genuine service, will pull a fast one on producers who keep struggling to make goods and services better and cheaper. An atmosphere of mistrust and conflict is likely to develop among the various groups in society; the fixed-income groups, unorganized labor, the retailers, the farmers and many others will find their whole way of life affected and will resent the individuals who owe their social gain to inflation. In our relations to the outside world, foreign trade and travel will suffer from uncertainty concerning the value of the dollar.

Finally, there is the inevitable reckoning. It is not established that good times with high employment and rising living standards must alternate with periods of depression and unemployment. Consumer purchasing power will lag increasingly behind the high level of prices, and reduce demand will lead to cuts in production. There is no surer way to create deflation and depression than to let inflation get out of bounds.

Therefore, inflation must be controlled. Before discussing how inflation can be controlled, the writer shall explain the inflation theories.

The materials used in this study have been taken from current books, pamphlets, magazines and newspaper articles. The books, pamphlets and some reports were secured from the U. S. Government Printing Office, U. S. Chamber of Commerce, National Association of Manufacturers and the W. R. Banks Library.

The writer is attempting to provide the reader with information on inflation, by writing up the study of various books, reports, pamphlets and articles read on the causes, control and cures for the problem of inflation in our economy.

The period covered will be limited to the present day situations.

## CHAPTER II

## THE THEORIES OF INFLATION

Considering the history of the theories of inflation, two main treatments can be distinguished.

One of these theories is the quantity theory of money. This theory regards an increase in the quantity of money as the cause and characteristic of inflation. In this form, if the quantity of money increases, prices will rise and as a result inflation will exist.

Therefore, inflation is regarded as being identical with an increase in the quantity of money.

The changes in the quantity of money often leads to peculiar results.[1] It has been generally agreed that the use of the quantity of money as the starting point is not very appropriate, because there is more than one definite cause of inflation.[2]

The second theory of inflation dates back to Wicksell's famous model in Geldzins and Guterpreise.[3]

In this theory, the personal wish was to rescue the quantity theory of money from all difficulties; the most important point in this theory is, just as the price of any good is determined by the demand for it and the supply of it, so also is the general price

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[1]Hansen, Bent. _A Study in the Theory of Inflation_. New York. McGraw-Hill Book Company. 1957. pp. 7-8.

[2]_Ibid._, p. 9.

[3]_Ibid._, p. 10.

level determined by the total demand for and total supply of the group of goods concerned, the prices of which determine the price-level.[1] Thus, the foundations was laid for an integration of the micro-macro theory in this field. Ordinarily it becomes the task of inflation theory to analyze the factors determining the relation between the demand for and supply of those goods which are of interest for some reasons, and the consequences of this relation for anti-inflationary policy.

The "Swedish" inflation theory, is built on the Wicksellian approach. When attention is focused to the relation between the demand for and supply of goods, the concept of excess demand confronts us.[2]

When spoken of, inflation is usually associated with the increase of prices and/or income, and inso far as an excess demand can be taken as the cause of a rise in prices, inflation can mean a situation where extensive excess demand exists in the markets for the many individual goods.[3]

The writer shall attempt to illustrate by charts the supply, demand and market price wherein the demand and supply are equal. In the second chart an attempt will be made to show changes in the demand and supply.

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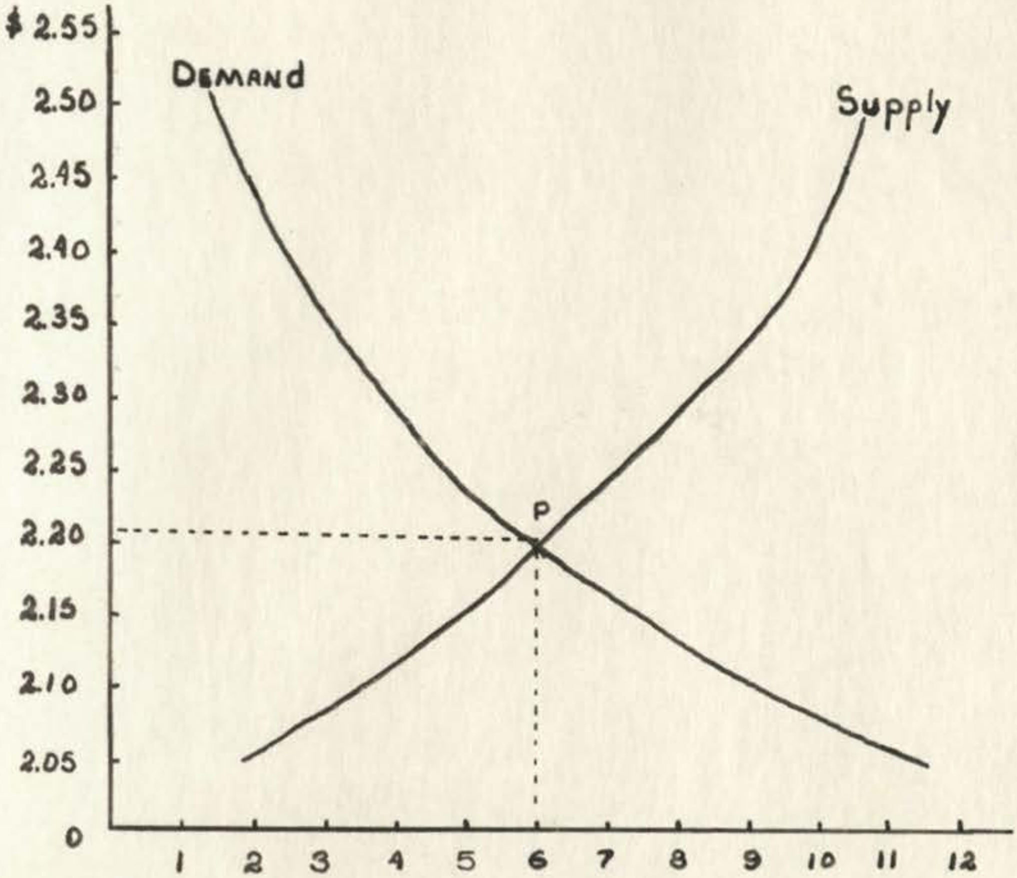
[1]Hansen, Bent. A Study in the Theory of Inflation. New York. McGraw-Hill Book Company. 1957. pp. 15-16.

[2]Ibid., p. 17.

[3]Ibid., p. 18.

CHART A




Quantity - Millions of Bushels

Demand, Supply, and Market Price[1]

These curves show how demand and supply determine the market price. The price will be determined by the interaction of demand and supply will be at the point where demand and supply are equal; or where they are in equilibrium. In the chart with reference to price and quantity, the curves intersect at the point which indicate $2.21, and a quantity of 6,000,000 bushels. This means that at a price of $2.21, 6,000,000 bushels will be bought, and an equal amount will be offered for sale. Therefore the price cannot change until there is a change in the

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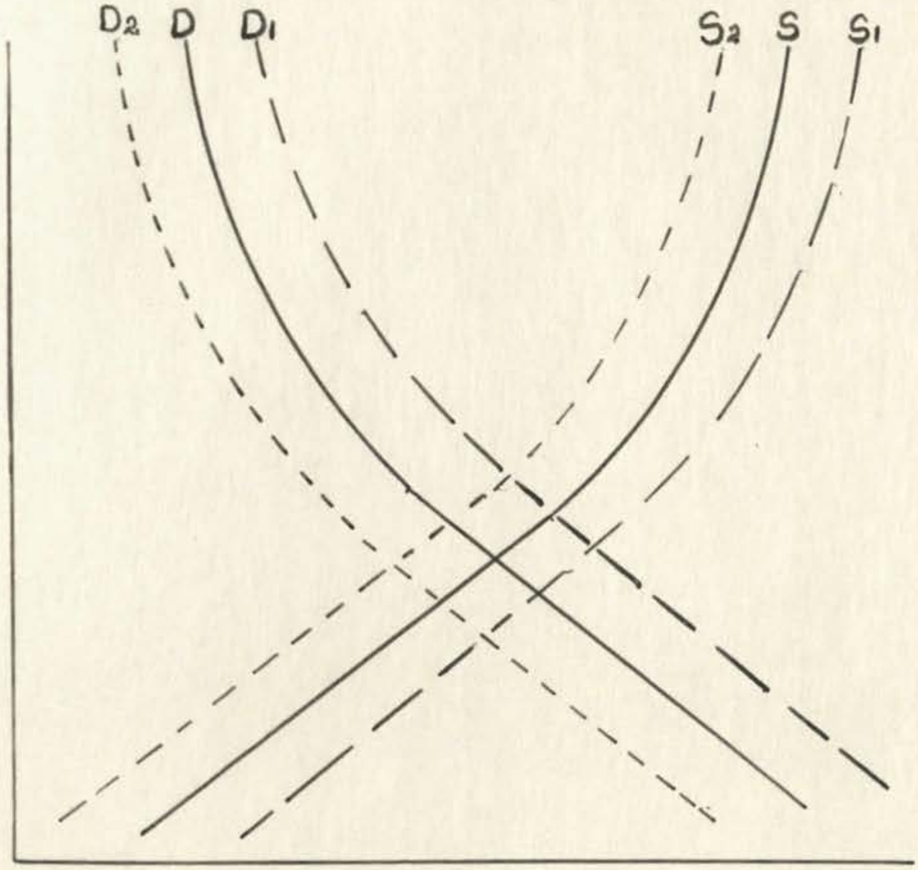
[1] Dodd, James Harvey, Hasek, Carl W., Economics, Principles and Applications, South-Western Publishing Company, Dallas, 1957, p. 199.

relationships between demand and supply. In any new relationship between demand and supply, an increase in demand relative to supply will result in a higher price; and any decrease in demand relative to supply will result in lower prices.




Quantity

Changes in Demand and Supply[1]

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[1] Ibid., p. 201.

The possible D and S relationships are suggested by the D and S curves as shown in the chart, in which D represents the original demand, $D_1$, an increase, $D_2$, a decrease. S stands for the original supply; $S_1$ an increase; and $S_2$ a decrease.[1]

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[1] *Ibid.*, p. 201.

The equation of exchange is a simple mathematical formula with several inclusions; (1) the price level, (2) physical quantity of goods and services exchanged for money in a given period; (3) the average amount of money in circulation, pocket money and demand bank deposits; and (4) the velocity or average rate of turnover of the money.[1]

To simplify this definition, assume that all goods exchanged can be divided into a large number of like units. On this assumption, the price level will be represented by the price of the imaginary good unit. Let P equal the price of a good unit, or the price level; T equal the number of goods units, physical volume of trade; M equal quantity of money in circulation, pocket money and demand deposits; V equal the velocity or average rate of turnover of money.

The equation can now be expressed in this form:

$$PT = MV \text{ or } P = \frac{MV}{T}$$

This means that the price of each good unit, multiplied by the number of units exchanged, equals the money in circulation, multiplied by the average number of times each unit of money is used. The equation only refers to a given economic system and a given period of time. PT is one way of expressing the total money value of goods sold. MV is another way of expressing the same thing. Therefore, the equation expresses one point, the money value of goods sold equals the money value of goods sold. That is only on the assumption that all goods sold are paid for with cash.

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[1] Umbreit, Myron H., Hunt, Elgin F., Kinter, Charles V., Fundamentals of Economics. McGraw-Hill Book Company, Inc., New York. 1952. pp 123-125.

The distinction between open and repressed inflation confronts us in the consideration of the economic policies pursued by different countries.[1]

Repressed inflation is characterized by the fact that prices and possibly wages, are fixed by the institution of direct controls; whereas such controls are not used in open inflation.

Inflation is still referred to in spite of fixed prices and wages in a situation of repressed inflation, due to the fact that a shortage of goods and labor power still exists in the economy. If control of prices and wages is given up, the level of price and the level of wages can be expected to move upwards.

When so many countries introduced price control during the second World War, it was their intention to prevent an excess demand from finding expression in rising prices.[2]

By concentrating on the relation between demand and supply, the thing that seems characteristic of the open and repressed inflation is recognized, which is, the existence of extensive excess demand.

In carrying out the analysis of inflation as a macro-economic analysis, the money value demand and the supply, and consequently the excess demand, must be used.[3]

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[1] Hansen, Bent. _A Study in the Theory of Inflation_. pp. 17-18.

[2] Lerner, A. P., "The Inflationary Process". _A Study in the Theory of Inflation_. pp. 33-35.

[3] _Ibid._, p. 36.

It is a well known consideration that, if an economic system consider every demand for a commodity, factor or claim, as an equivalent supply of money of the same value, and conversely every supply of a commodity, factor or claim as a demand for money, the identity is valid.[1]

In order to give a complete account of the problem of open inflation, it would be necessary to deal with the whole of the problem. However, it become necessary to show how the inflationary gap in the commodity -- markets, the factor-gap, and the speed of the rise in prices react upon one another in simple cases, that is, when the Government does not put on any control on prices and wages.

It is assumed that there is perfect competition in all markets unless something is said to the contrary, and that the expectations are that the price of the moment will persist in the future. Further it is assumed that only one commodity is produced for which only one factor, labor-services is used. The quantity of labor-services per unit of time is a given magnitude, and thus, a given actual production.[2]

In considering repressed inflation, changes in prices and wage-rates take place only when the state permits them; they are assumed to happen only by a change in all prices and wage rates in the same proportion. There exists a special case if the sellers do not wish to keep prices as high as the maxima permitted. In this case the relative prices are also considered constant.

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1 Hansen, Bent. A Study in the Theory of Inflation. pp. 18-20.

2 Ibid. p.21.

## CHAPTER III

## THE CAUSES OF INFLATION

History teaches us: If the money supply increases faster than the flow of goods, prices are likely to rise. In brief: more money competes for fewer goods.[1]

In ancient times increase in the money supply usually came about through the reduction of coins from a higher to a lower state. The same quantity of silver, for instance, was used to coin more money. Historically, the printing of additional quantities of paper money is a more recent form of inflating the money supply. A still more recent form consists of a large-scale increase in lending by banks; this creates additional bank deposits against which checks are drawn just as currency is used to purchase goods.

All these forms of creating new money, without an increase in the available quantity of goods, usually have been employed at the initiative of the government. If a Government finances its armament expenditures by printing money or borrowing new funds from banks, the money supply increases.

The process of inflation may also start with a contraction of the physical supply of goods. For instance, if the quantity of goods available decreases rapidly; and the money supply remains the same, inflation results.

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[1] Katona, George, <u>The People Versus Inflation</u>. Washington. U. S. Government Printing Office. 1952. p. 3.

With this, we can then say, the cause of inflation is thus the gap between the total money in circulation and the quantity of goods that are available for purchase. The larger the gap, the greater the increase in prices.

In modern times an increase in the quantity of money in circulation is not the major factor that breeds inflation. The incomes that people currently earn represent their major source of purchasing power. If total income grows faster than the quantity of goods produced, or if incomes increase while the output of civilian goods remains the same or declines, prices tend to go up.

It is obvious that this is not the normal situation in peace time. Usually an increase in employment and incomes is accompanied by greater output of civilian goods; likewise, higher wages and profits which result from a lowering of production costs ordinary stimulate demand and output.

As long as new armaments are produced by mobilizing men and machines that were formerly idle, a moderate increase in incomes is harmless and may even be beneficial. Things are different if rearmament is to come out of an economy which is very busy already. In this case, millions of people who were formerly engaged in producing civilian goods switch to employment at high wages to produce tanks, guns, and planes, rather than goods they themselves could purchase. Thus, a gap develops between incomes and supplies. Total earnings will rise as a result of higher wage rates, longer working hours, and people being added to the labor force. More money, therefore, will compete for fewer goods.

Currently, the critics cannot agree as to the cause of our inflation. One group says it is basically demand pulling prices higher, and the other group says it is rising costs pushing prices higher. In examining the group between the demand pullers and the cost pushers. The demand pullers stress the fact that we have three great groups of spenders in our economy -- namely, the consumers, business, and the Government whose combined actions exert a powerful pull on prices.

The question may then arise, where do the funds come from to finance aggregate money demand for the output of the economy? The principal source is, of course, current income earned in the process of production. However, total demand at any point is not limited to current income. Consumers may use previously held cash balances, or borrow, to increase their spending beyond current income. Business expenditures on plant and equipment are usually much greater than the sum of currently retained earnings and money capital recovered through depreciation allowances. Businesses may draw down previously accumulated cash balances, tap the money savings of others in the capital markets or borrow newly created money from the banking system. Governments, as we know, do not always balance their budgets. To the extent that current Government expenditures exceed tax receipts, the Government must finance the deficit by borrowing private money savings or by creating new money by borrowing from the banking system.[1]

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[1] United States Chamber of Commerce. The Mechanics of Inflation. A Report of the Committee on Economic Policy, Washington, D. C. 1957, p. 10.

The important point is this: businesses, consumer and Government, separately and collectively, can in any short period of time spend a greater sum of money on current output than the aggregate money value of that output at prevailing prices.

To further explain, when the total demand increases faster than the physical supply, prices are bid up. In other words, inflation occurs when the economy as a whole tries to outspend current income or when the money claims on income are greater than the output to be divided.[1] However, this process is self-defeating because as prices are bid up, total money income also becomes inflated. More dollars are spent, but the value of each dollar shrinks.

It may seem strange that the economy as a whole can attempt to spend more than current income. Why is not overspending in one sector always offset by underspending in another?[2]

The answer to these questions lies in the nature and operation of our monetary and credit system. Inflationary increases in total spending can be financed from two sources: (1) from previously accumulated inactive cash balances, and (2) from creation of new money by commercial banks when they expand their total volume of loans to private individuals, businesses or the Government.[3] In the

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1 Nadler, Marcus. The Menace of Inflation. The Hanover Bank, New York, N. Y. 1957. p. 14.

2 Ibid. p. 16.

3 Ibid. p. 17.

first case, as businesses and individuals draw down cash balances, the existing money supply is used more actively. This only means there is an increase in the rate of turnover of money since the ratio of the volume of the transactions to the supply of money is increased. In the second case, it is the supply of money itself which is increased to finance the increased demand. It is true that for the economy as a whole, the money supply or the velocity of money must increase for inflation to take place. Except under wartime conditions, it is usual for both the supply and the velocity of money to increase together during periods of rapidly rising prices.

While a flexible banking and credit system performs essential functions in our market economy, it also enhances the possibility of inflationary increases in total spending. For this reason, the operation of the banking system and national monetary policy are of crucial importance in the course and control in inflation.

The role of demand in inflation is far more complex than the above discussion. Money is used for many other transactions besides the purchase of products by consumers, businesses and Government. Equally important in inflation is the tremendous volume of outlays which businessmen make, individually and collectively for materials, labor, goods in process, supplies, services and the like. Business demand for productive services and intermediate goods used in the process of production is said to be derived demand for it is derived from and depends upon the market for the finished product. More specifically, derived demand is based on the businessman's expectations as to what final markets demand will be.

Another important source of instability is that of buoyant demand.[1] Buoyant demand for consumer or investment goods sets up a strong derived demand for labor and other inputs used in production. In periods of full employment both final and derived demand put pressure on the physical supply of resources. In boom periods, there are strong incentives for business to increase inventories. Competing buyers of labor inflate wages. Employers grant wage increases more readily so as not to lose production time, and union leaders are able to push more vigorously for higher money wages.

What sometimes appears to be a cost push to the businessman is in reality on the demand side. Higher wages in one industry where demand for output is rising attracts workers away from other industries, incidentally also raising the wages of those who remain. To the businessman, rising costs are a very important cause of higher prices, but when viewed for the economy as a whole, such increases are only the indirect effects of powerful demand pull forces at work in the system.

The role of the demand pull points up some of the complications which arise in attempts to control inflation. First, aggregate demand has many different components and there are so many direct and indirect ways in which total spending can be affected. Secondly, trying to control inflation sometimes amounts to trying to stop inflation after it has been in process for a long time.

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[1] United States Chamber of Commerce. The Mechanics of Inflation. A Report of the Committee on Economic Policy, Washington, D. C. 1957, p. 13.

Another form for the cause of inflation deals with the wage-price spiral. Inflation is also aided by cost pushers. Costs contribute to inflation in three ways: (1) A general increase in business outlays, especially in the form of higher wage costs, may expand money incomes and thereby create additional money demand for goods and services. Consumption demand is particularly responsible for increased income; also increased consumer spending may have further stimulative effects if it induces secondary increases in the level of business investment.[1]

(2) During a period of economic expansion, shortages develop in some materials and in some segments of the labor market. In these areas, prices and wages are bid up. Also, when production is high, additional output can be obtained from existing plant and equipment in strategic industries only at the expense of diminishing physical returns and higher average costs. If a stable general price level is to be maintained, prices and wages in some other sectors of the market would have to fall. But, when wage-cost rigidities prevent such offsetting downward adjustments, the over-all is an upward shift of the general level of prices.[2]

(3) Increased costs in some sectors, particularly those occuring in primary or basic material industries, spread directly and indirectly throughout the system and create an added upward push on prices if credit is available and fiscal policies permit.

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[1] Ibid. pp. 13-14.

[2] Ibid. p. 14.

The economy as a whole, wages and salaries predominate as the largest cost element in the process of production. Increases in money wage rates may operate in several ways to generate inflationary conditions:[1]

(1) Wage rate increases not fully offset by improved productivity in the industries concerned increase per unit costs which producers will attempt to recover through higher prices.

(2) Increased labor costs and prices, particularly if they occur in basic or "supplier" industries, will spread as higher non-labor costs to other industries in later states of production forcing prices up.

(3) Because of wage leadership in collective bargaining and the influence of widening wage differentials on other works, higher wages will be demanded in the industries not directly involved in the original wage push.

(4) As prices rise, wage pressures become cumulative and self-reinforcing. New wage and salary demands in all sectors are made to offset the rising cost of living. These wage increases are meaningful cost-push forces, whatever the initial or generating cause may have been.

There are two related restraints which may partially counteract the cost pushers on prices in a particular situation. First, there is an increase in money wage rates which does not always produce a larger

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[1] Ibid. pp. 15-16.

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volume of income and lead to increased spending. Total compensation of employees also depends on the number of men employed and the number of hours per week these men work. An increase in money wage rates which increase unit costs of a given product might create unemployment and a smaller total wage bill unless employers could pass increased costs along to buyers in the form of higher prices. They could do so only if the demand for the product of this industry were relatively insensitive to price changes. In this case, falling demand and unemployment would occur in other industries not necessarily related to the industry where wages initially rise. General demand conditions must allow for increased money spending in one sector without reducing the volume of spending elsewhere. Unless these conditions prevail, rising money wage rates will likely reduce, rather than expand, total spending.

Second, general demand conditions depend in large measure on monetary and fiscal restraints. If general credit restrictions and deflationary fiscal policy do not permit an expansion of the money supply and aggregate spending, the market will normally and automatically discipline excessive wage and price demands. Although rising and spreading price movements increase the cost of living and destroy any real wage gains from inflationary money wage increases for most workers, such increase may not be futile for particular unions or groups of workers.

It should also be clearly understood that the labor groups, who are able to increase their income during inflation, need not be the ones to suffer from their own excessive wage demands. The unemployment effects may be borne by other industries and workers.

Finally, the role of the costs in the process of inflation varies with the discipline of the market which in turn depends, in a large measure, on whether the Government wants to make market discipline effective by policies of credit and fiscal restraints. Costs play a critical role in inflation. In summing the causes up, the cost-price spiral is also a demand price spiral. Cost elements can be separated from demand elements. The importance of each will only differ from one phase of inflation to another.

In order to understand fully how inflation comes about it is necessary to apply all of our earlier considerations. Inflation arises if and when the inflationary expectations are well justified and people have ample reason to believe that price increases are inevitable.[1]

A gap between the total of incomes and the supply of goods in the Nation -- that is, an inflationary potential is the primary reason for the rise of such expectations.

If popular misunderstandings did not take place, the argument that high profits, rather than increased wage costs, are the cause of rising prices, would merit little if any consideration in serious discussion. This argument has been used repeatedly by labor unions as bargaining devices to divert attention from the effects of negotiated wage contracts on the cost-price structure.

Profits are a fluctuating share of national income. Normally in boom periods total profits increase temporarily faster than other income shares, just as in a recession they fall more rapidly. The problem of

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[1] Bryan, Malcolm. <u>The Idea of Creeping Inflation</u>. An address before the Financial Section at the Annual Meeting of the American Life Convention, Edgewater Beach Hotel, Chicago, Illinois, 1957. p.4.

profits in inflation has shown misleading assertions that wage increases can grow out of profits without increasing prices. Finally, it should be noted that one of the forces in our economy which has an effect on inflation is increased productivity which enlarges the physical supply of goods. If output can be increased as fast as the money demand for output is enlarged, inflation of prices need not occur. Productivity will be increased only if profit margins are large enough to provide businessmen and savers with incentives to invest in new capital equipment.

## CHAPTER IV

## HOW INFLATION CAN BE CONTROLLED

In order to get to the roots of inflation, we must consider the underlying facts and the behavior of the people. The size of Government expenditures that are not covered by taxes and anticipated future deficits are both pertinent. The same holds true for available supplies and anticipated shortages.

The main task is to break the spiral of higher prices leading to higher money incomes and higher demand, thus halting the prices and starting another round of inflation. The most promising way to stop such a trend is by fighting inflation simultaneously on the economic and the psychological fronts.[1] The inflationary gap must be reduced and people's expectations and behavior must be influenced. One method of doing this is that of higher production. Increase in the output of civilian goods helps to check inflation. However, when inflation threats it is often impossible for military reasons to increase civilian supplies. Sometimes an increase could be achieved, but not without further increases in incomes.

The approach to fight inflation concentrates on attacking the gap between purchasing power and the available supplies of civilian goods. If inflation arose solely because of such a gap, an increase in the production of civilian goods would obviously be an effective means to check inflation.

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[1] Hansen, Alvin H. The American Economy. McGraw-Hill Book Company, Inc., New York, 1957. p. 69.

However, under certain conditions -- unfortunately including those in which the inflationary threat is greatest -- it may not be possible to add to civilian supplies. These supplies may sometimes have to be curtailed for military reasons. But, materials for civilian use should never be curtailed more than necessary. During the second World War we managed to increase agricultural output and to maintain it on a very high level, and achievement which aided substantially in the fight against inflation.

Increases in civilian production are possible at times as a counterinflationary move.[1] After the end of the war, when inflationary threats still loomed very large, production was extended. However, substantial increases in production usually take time; often factories have to be built and machinery must be installed before the flow of desired goods reach the markets. The total purchasing power available is swelled further through the incomes of workers who are employed to build the new factories and machines, and to produce the additional goods. Inflation therefore, can hardly be defeated by an increase in production alone, but higher production can help a good deal if it is combined with other policies to be discussed.

The most desirable way to achieve higher production is higher productivity. If the average worker turns out more goods or services per hour, day, or week than he has in the past, this difference may offer room for an increased defense output along with somewhat higher

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[1] Hart, Albert G., Money, Debt and Economic Activity. Prentice-Hall, Inc., 1948. p. 238.

earnings. In other words, a rise in productivity can produce additional goods, services, and incomes. However, a major rise in productivity is usually a long-range affair, therefore, it cannot be relied upon as an immediate or exclusive weapon against inflation.

If people are induced to increase their rate of saving, thus reducing their spending, less money will compete for the supply of goods.

Suppose the American national income -- the total amount of money that the people of this country make -- was 200 billion dollars in a certain year.[1] Suppose further that income taxes amounted to 20 billion; that people altogether saved another 20 billion -- that is, put this sum aside for the bank deposits, for savings bonds, for investments; and suppose that they spend the remaining 160 billion for goods and services.[2] If Congress, in order to check inflation, increased income taxes very greatly, say from 20 to 30 billion dollars, would this necessarily help?[3] The answer was, that people might cut down their rate of saving in such a way that they kept spending 160 billions or thereabouts for the purchase of goods, despite high taxes.[4]

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1 Hansen, Alvin H. The American Economy. McGraw-Hill Book Company, Inc., New York, 1957. p. 83.

2 Ibid. p. 83.

3 Ibid. p. 83.

4 Ibid. p. 84.

This illustration pointed out that one way to curb inflation is by people increasing their rate of saving.

If people voluntarily cut down on their expenditures, or if they are induced or compelled to do so, they will save more. Conversely, if they decide to save more money than they have been saving, they will spend less without any special pressure. Like taxation, a higher rate of saving is a method of draining away spendable money. However, it is not as simple a method, because it involves the question of what happens to the money that people save.

There are two possibilities of what happens to the money. Either the money an individual saves is temporarily taken out of circulation, stored away, as it were -- in which case a genuine reduction of the inflationary pressure occurs. Or else the savings of one person are made available to another person, in which case nothing is gained in the inflationary flight.[1] In other words, increased savings of some people help only if they are not cancelled out by increased dissavings of other people.

If a person were to use part of his income to buy securities on the stock market from another person, the latter might spend what the first person has saved. Likewise, if a person saves by putting money into the bank and the bank increases its loans to other people so that they spend more, nothing has been accomplished. If the bank uses the new deposits to purchase Government bonds, and if the Government used the money to pay for tanks, guns, and planes, savings will cut down spending. The same hold true if a person buys bonds himself.

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[1] Ibid. p. 86.

The best known method used to increase savings was a methods used widely and successfully during the Second World War. At that time large scale campaigns to sell war bonds were organized; people were approached in factories, offices and homes; they read in their papers and heard over the radio that it was necessary to buy bonds. Group pressures and patriotic motives were mobilized, so that it became difficult not to buy bonds.

This idea can seldom be omitted, however, it is one idea of controlling inflation that should be integrated with other ideas.

The most promising way of closing the gap between incomes and supplies is to cut down on the spendable portion of incomes. If taxes, especially income taxes, are raised, people have less money to spend. In theory, it ought to be possible to drain away the entire excess in incomes to the point where the available supplies of civilian goods would be adequate in proportion to the demand; the pressure on prices would then disappear.

Taxes are usually increased in inflationary times not only because of their contribution to price stability, but, because of the need for additional Government revenues. In times of war or mobilization the Government spends huge amounts of money on tanks, guns, planes, and many other things.[1] There are two ways through which the Government can obtain money; through taxes (including duties, imposts, feets, etc.) and through borrowing. Borrowing means that the payment for armaments

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[1] Ibid. p. 88.

is postponed. Attempts are usually made to pay right away for as large a share as possible of the emergency expenditures; and that means raising taxes.

Tax increases undoubtedly represent one of the major weapons in the fight against inflation. But again, the fight cannot be won by relying upon tax increase alone. This idea must be used with some other to curb inflation. Often political considerations result in the enactment of tax increases which are too little and too late. Also, fear of causing undue hardship makes the Government somewhat hesitant to raise taxes sufficiently. This fear may be well justified. During the war, expenditures were so enormous that a very substantial part of all incomes had to be siphoned away in order to balance the economy. Such rates, however, not only would have caused hardship for millions of people but might also have affected incentives working and might have lowerer the morale.

Curbing inflation through the use of controls is another useful method, but this method cannot be used alone.

Wage and salary controls have an important function in arresting the upward spiral of incomes but cannot be watertight and rigid.[1]

An increase in income taxes cuts down the income of those who make more one year than they made the year before and of those who did not improve their position. A freeze of wage and salary rates, on the other hand, discriminated between the two groups.

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1 Ibid. p. 90.

A spiraling process -- higher income leading to higher prices, which in turn bring forth higher incomes -- may be controlled if Government regulations prohibit employers from increasing wages and salaries. In times of inflation some employers might try to draw away workers from their old jobs by offering them higher pay; other employers would have to follow suit in order to preserve their own positions, and the process might lead to an inflationary spiral. However, control of wages and salaries is not a cure-all.

Such control does not preclude those increases in the national incomes which result from the fact that many housewives or formerly unemployed people now find well-paid employment. Incomes may also increase substantially through longer hours of work or more regular work without change in the hourly pay. Interference with wages and salary rates can at best have only the effect of a brake -- and not that of a freeze. For one thing, considerations of an equality of sacrifice are involved here -- that is, the difficult problem of whether it is possible to freeze the profits of enterprise and the incomes of those people who have no well-established rates of pay. There is also the need to motivate people to work hard. If people are given no chance to improve their situation, and if promotions for increased productivity or performance are ruled out, morale and production will suffer. Moreover, if inflation is not completely arrested but only slowed down, the higher cost of living needs to be compensated by wage increases in order to prevent undue hardships. Therefore, wage and salary controls must be flexible, but they cannot do the job alone.

The ruling out of any price increase may appear to some as a direct way of controlling inflation. But the complexity of modern market mechanisms will sooner or later defeat attempts to control all prices rigidly.[1]

Inflation consists of a sustained if uneven increase of the general price level. Does it not follow that the simplest way to stop inflation is by forbidding all price movements?[2] If the Government were to prohibit all price increases at a given date. Inflation would then seemingly disappear. At the first glance, a price stop seems to be the most effective of all the anti-inflationary weapons used in our economy.

On the other hand, the con discussed price control as thus. What would farmers, manufacturers, or retailers do if they were ordered not to sell their products at more than a given price; they would sell to buyers who in one way or another, would make it more worthwhile for them to sell. Buyers would quickly find such means as secret payment, gratuities, or barter arrangements. Giving less value for the same price -- less durable cloth or lower quality food is not difficult in our economy. Ordinarily this is not done because producers and merchants wish to satisfy their customers. After a price stop, buyers and sellers might join forces against the Government; the sellers want more money and the buyers want the goods without the regards for the price or

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United States Chamber of Commerce. The Mechanics of Inflation. A Report of the Committee on Economic Policy, Washington, D.C., 1957. p. 25.

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Ibid. p. 27.

quality. Sooner or later black markets would spread; a few transactions only would take place on the controlled open markets and most transactions would occur on the black markets.

There is truth in the section of price control to indicate that (1) price control of goods with a great many sellers, buyers, and a variety of products of closely related or changing types is a complicated undertaking; and (2) that an isolated price control is bound to fail.

It is true that the businessmen and consumers alike, should approve of price control and to cooperate with it both in their own interest as individuals and in the interest of the Nation.

In period of war, raw materials that go into armaments are short. If the prices of steel, cooper, aluminum, and similar commodities were permitted to go up along with the increased demand for these goods, the Government would pay the heaviest price; tanks, guns and planes would cost more. Since there are relatively few producers of these standardized materials, the control of their prices is not too difficult and it may be applied to the extent of ruling out any profiteering.

Then, should the Government try to hold down the price of the steel which goes into tanks, but not of the steel which goes into the automobiles?[1] If the prices of certain goods are free to rise while other prices are held down, more and more resources materials as well as labor will tend to flow into free markets.

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[1] United States Steel Corporation. Steel and Inflation: Fact vs. Fiction. Broadway, New York. 1958. p. 25.

Necessities of everyday life, such as, food, housing, and clothing items if their consumption exceeds the supplies, ordinarily must be included in the price stabilization scheme; for substantial increase in their prices would make any effort to hold down the wages and salaries inequitable if not hopeless. As long as the demand for housing greatly exceeds the supply, there is an especially strong case for rent control.

This represents only a part of the case for price stabilization. The controls previously discussed are intended primarily to reduce the inflation gap, however, inflation also originated in a widespread expectation of price increases. There is no real way to achieve this result by making people trust that prices will not rise. Yet they should not be misguided. Price control can help to perform service. It can reduce demand for goods by making businessmen as well as consumers abstain from stocking up. Take the case of the Government, through tax increases and wage controls, achieves a balance between the total amount of spendable income and the supplies available. Even such general success will not assure a balance in specific markets for many individual goods. If the prices go upward, expectations of price increases in other commodities will be aroused; businessmen and consumers will use their liquid assets to pile materials and to haord non-perishable goods.

According to a conventional theory, the lower the price the larger the demand, and the larger the demand, the lower the price. However, this does not hold true in all cases. Advancing prices may bring the expectation of further price advances and thus increase the demand for goods. Controlled prices, even if they are much lower, may result in smaller demand. Price control is a means to restrain demand and to arrest a cumulative movement, a spiraling of prices and wages.[1]

How then should price control be administered in order to produce confidence and cooperation? It should not consist of a rigid freeze of every price. Price stabilization means holding the line in general, but not necessarily the price of every commodity. There are always areas where the administrator permit some price increases in the consideration of equity. If this is not done in all markets at the same time, small and gradual advances in the cost of living would be a terrible thing that might happen.

Price control is a complicated undertaking. It easily causes hardships to manufacturers and merchants, and the duty of the administrator is to make such hardships as minute as possible. Controls are fairly easy to handle if they apply to standardized goods that are produced by a few sellers. They are further facilitated by making use of traditional pricing principles.

Production controls, allocation of raw materials and rationing of consumer goods are usually introduced in times of war. These controls help to keep prices stable.

If large quantities of tanks, guns, and planes must be produced, the Government determines who can use critical materials in short supply and to what extent. It establishes priorities or restricts the quantities of various materials that producers of civilian goods may use.

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[1] Ibid. p. 31.

Sometimes the Government has to prohibit entirely the production of certain civilian goods in the interest of military supplies.

Such controls have incidental effects of importance upon the problem of inflation. Assume, that the production and sale of passenger cars to civilians are discontinued in order to conserve for armament purposes. Would the Americans spend the available amounts of money on other goods? It is probable that many other people will save their money which would have been spent on cars. If goods are available but shortages are anticipated, people hasten to buy. If goods are not available at all, some reduction in spending will occur, thereby increasing inflationary pressures.

During the Second World War critical raw materials and many other important consumer goods were subject to Government controls. We can remember the rationing wherein people received ration coupons which determined the quantity of meat, canned goods, gasoline, sugar and etc., they were permitted to purchase. Here again, the primary purpose was not to keep prices down, but to avoid inequality of distribution was the main aim. So rationing it is felt should be avoided if possible because it only creates hardship and annoyance to businessmen and consumers alike. If and when it is needed, it can be used effectively in conjunction with price controls.

Restrictions on credit and the channeling of investments into desired purposes may help to curtail purchasing power.[1]

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[1] Bryan, Malcolm. The Idea of Creeping Inflation. An Address before the Financial Section at the Annual Meeting of the American Life Convention, Edgewater Beach Hotel, Chicago, Illinois, 1957. p. 14.

Another source of purchasing power is borrowing. Ordinarily people buy automobiles, household equipment, and many other goods on installment, or they borrow money from banks or loan companies and use it for certain family expenditures. Purchasing of houses for owner occupancy is done in most cases with the help of a mortgage which the buyer is to repay over a period of years. Expansion of business often requires loans.

In any of these cases, an individual may acquire new facilities without having the money to pay for them. Additional funds and purchasing power are created by borrowing. When inflation threatens or is under way, it is necessary to watch carefully the flow of credit and investment. Often it is essential to apply checks against too extensive use of credit.

The prohibiting of all installment purchases and on all loans might have very undesirable consequences. If some automobiles were available for sale, and the Government stated that all automobiles must be bought for cash, persons with low income would be discriminated against although they might need cars to reach their place of work in order to make a living. Consumer credit, therefore, can be controlled through judicious regulation of the size of down-payments required and of the length of the repayment period.[1]

Again, we have a method of controlling inflation, but never should this method be used alone.

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[1] Hart, Albert G., Money, Debt, and Economic Activity. Prentice-Hall, Inc. New York. 1948. p. 113.

## CHAPTER V

## THE CURES FOR INFLATION

Whether demand or cost is the main cause of inflation, we do know that inflation cannot be present without an over supply of money that leaves a gap between the total spending and the available supply of goods.

It has been advocated at times, that the best way to close the gap is to produce more goods. Increased production alone, however, will not solve the problem because extra output means extra input. The additional man-hours and the extra flow of materials together with increased profit on the extra output will yield additional income -- so we have not made any progress as yet toward curing inflation. The gap remains.

A much more effective way is to remove the surplus money that is doing the damage to the dollar. Making money scarcer means people will have to pay more to borrow it. Money, like everything else, has its price and the price is the interest rate.

The interest rate is determined in the credit market in the same way that the price of steers in the cattle market. Droves of steers depress the market prices; a big demand in the face of light shipments boosts prices. In the credit market, borrowers, consumers, businessmen, and governments -- seek funds from the lenders; insurance companies, mutual savings, banks, savings and loans associations, and commercial banks.

When the borrowers want more funds than the available supply of the lenders, interest rates go up and money is said to be tight. Interest rates have been rising and money has been tight for over a year, primarily because the demand has been greater than could be supplied out of savings.

The Federal Reserve is commended by some and condemned by others for allowing money to get tight and for raising the discount rate. The interest that commercial banks must pay when they borrow from the Federal Control over the money supply is exercised by regulation of the reserves available to commercial banks.

In restricting the supply of money and credit, spending borrowed funds is discouraged because of the increased price of money -- the higher rate of interest. In effect, higher-priced money is substituted for higher-priced goods. The available supply of money and credit then goes to those who are willing to pay the higher price for borrowed money. So money becomes tight, not through an actual reduction in the supply of money and credit, but because of increased demands of borrowers.

Tight money is said to hurt the small businessman, to interfere with the construction of much needed schools, roads, and housing. So it does, but so do rising prices or direct rationing. There is no way in which inflation can be cured and not hurt some other part of the economy. If it is allowed to continue unchecked, ever higher prices and costs will hurt more people harder than the tight money.

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1 Conference on Economic Progress. Consumption Key to Full Prosperity. Washington, D. C. 1957. p. 19.

Uncle Sam can play an important role in curing inflation. He is a big operator who spends at a rate in excess of a billion dollars a week, and that has a terrific impact on our economy.[1] Like many of us, he finds it hard to live within his income and when he does not, he adds to the inflationary pressures.

Money taken from us in the form of taxes reduces our spending power, to be sure, but if the Government spends the money inflationary pressure is not reduced at all. If the Government spends more money than it takes from us in taxes, inflationary pressures are still increasing.

If Uncle Sam lived within his income, and at the same time when inflation threatens have a good supple surplus. If the Federal Government wants stable money and lower interest rates, it can have them by reducing its expenditures and its heavy demands on the money market. With mass prosperity and mass savings, economic welfare requires a dollar that is sound both as a medium of exchange and a store of value.

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[1] Umbreit, Myron H., Hunt, Elgin F., Kinter, Charles V., Fundamentals of Economics. McGraw-Hill Book Company, Inc. New York., 1952. p. 250.

CHAPTER VI

SUMMARY AND CONCLUSION

There is a growing concern over the great problem of inflation. Although many methods have been used in the problem of controlling inflation, it seems to be still a major unsolved problem in our economy. More and more the people are beginning to recognize the serious dangers of inflation and its force on our economic institutions, social structure, and individual self-determination in our economic life. Many people are becomming worried over the outcome of conflicts in varied economic objectives of the government and the possible force of inflation on the economic growth.

The economy as a whole has become more inflation conscious, with more devices being used to minimize the great force of inflation on particular groups.

Escalator clauses are becoming widely used in wage contracts and are now being advocated for other contracts such as government bonds.

More authorities hold that the difficulties of inflation, both economically and politically are not very easily overcome, because, public awareness of inflation will, finally prove to be defensive. Control of inflation is, becoming a political responsibility which cannot be shifted very easily.

It is not enough to be against inflation. We as a people must be able to recognize the crucial importance of the inflationary problem. We must be alert to the real and present dangers of inflation whether it be creeping, chronic, cost or demand induced. We must be aware of its effects on future economic welfare and of what it may do to our economic freedom.

The principal cause of the inflation surge is the sharp rise in the costs of doing business. The increase in wages has outstripped the rise in productivity.

If permitted to run its course, the consequences of inflation will be serious. It reduces the real value of all savings stated in dollars and the purchasing power of the number of persons who are living on a fixed income, as well as those whose income cannot keep pace with living costs.

Inflation stimulates the expenditures of corporations and the installations of labor saving devices. This leads to over-production and both these factors lead to a sharp decline in business activity. Where inflation becomes a way of economic life it brings in serious social and political consequences.

No matter how strong the forces of inflation may be, they can be stopped either by general voluntary restraint in all sectors, public and private, or by rigid credit restrictions implemented by fiscal discipline. So far there is no sign of restraint by the Government or the public.

The problem thus confronting the nation at present is whether to permit the forces of inflation to continue at the expense of the purchasing power of the dollar or to use all measures available to halt them at a cost of a decline in business activity accompanied by unemployment. In either case there is a price to be paid by different segments of the population. If inflation persists the price will be paid by those who live on a fixed income and have assets in fixed sums of money. The greatest burden will fall on those living on pensions, Social Security, and the beneficiaries of life insurance policies.

If, on the other hand, the forces of inflation are checked by credit and fiscal measures, the effect will be paid by those out of work and by those business concerned whose profits will decrease or may be forced to liquidate.

Our economy is confronted with grave threats. We cannot tell what the next few years will bring, and vigilance is definitely needed. The first task is to keep the people fully informed so that they will cooperate with the flexible policies to defeat any threat to economic stability.

Inflation has been checked; its threats cannot be eliminated by the economic measures alone. As long as the danger of communism persists, a substantial part of our natural resources will go into armaments, the Federal defense budget will remain very high, and the civilian supplies will continue to be uncertain.

In facing any threat of inflation we must be prepared to avoid any recurrences that has happened. We must maintain the balance between spending and saving. Government measures against inflation are still needed: high taxes, price and wage controls to the extent that production and consumption are out of balance.

Unnecessary controls should be avoided if possible. As was stated, price and wage controls are a lesser evil than inflation, but they are unpleasant constraints. In particular controls should be flexible, when not required they must be laxed. Cooperation of its people, with public controls should be maintained. This can only be expected if controls are discontinued whenever and whereever possible without incurring economic hazards. We must understand that this strategy of flexible, limited, and multiple controls are just as essential in the interest of a healthy economy.

Regardless of whether more spending or more saving will be needed on the national scale, we should know by now that Government action alone, is not sufficient to accomplish singly the needed results. Consumers and also businessmen must know what actions are needed, and how the goals aimed at can best be achieved. Continued stability of our economy requires full cooperation on the part of all citizens along with Government policies which are both flexible and equitable.

Ultimately, whether we can do these things depends, not only on our recognition and understanding of the problem, but more important, on how politically mature and honest we are in facing it.

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