DEBATES

Why Problems do not go away. The Case of Inflation *

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This is an attempt to explain why certain problems, economic and otherwise, which have been subject to treatment by policy makers, have persisted over many years far beyond declared expectations, in spite of the measures taken to solve them. Assuming that the problems are soluble, the following hypotheses will be explored.

Certain problems have persisted and will not go away because the measures used to solve them are irrelevant, inadequate, or unsupported and, therefore, are incapable to solving those problems.

The measures are irrelevant because they tend to focus on issues other than those causing the problems; or if relevant, they are applied with less intensity than necessary, and with less material and moral support than needed to make them succeed.

Accordingly, it should be unrealistic to expect those problems to be solved in these circumstances.

Among the problems that do not seem to go away are the persistent and/or recurrent inflation, the persistent inequality of income and wealth distribution, the ever-present agrarian defects that have defied extensive measures of agrarian reform, and the industrial and economic backwardness of most developing countries in spite of the numerous programmes of development that have been instituted. In this study I shall concentrate on the fight against inflation,

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as a recognized problem, a target of conscious policy, and a persistent problem nevertheless.

A look at the history of western economies, Britain, the U.S., France or Canada, will show that price inflation has been a recurrent problem during the last century and a half at least. Though it was been the subject of treatment by monetary and fiscal policies in the last half century, the frequency and the level of price increases have been little affected or they have been worsened. If correct, this observation will cast doubt on the effectiveness of the measures that have been applied to cope with inflation. I would suggest further that these measures could not have been more effective because they were not intended to be so nor were they capable of being more effective.

These hypotheses will be investigated with the aid of the following paradigm:

CHART 1

SOURCES OF PROBLEMS AND APPROPRIATE MEASURES

Sources of problem *:	Philosophy	Institutions	Administration	Operation
Intensity of crisis:	Extreme	Very High	High	Evident
Necessary solutions:	New or restructured Philosophy	Institutional Replacement	Administrative Overhauling	Rigorous Enforcement
Quality of measures:	Revolutionary	Radical	Reformist	Medicinal-Pacifier

* The four sources may be described jointly as the Behavioural Structure of the system.

The problem must be diagnosed according to its origin and intensity before a solution and a method of implementation can be prescribed.

The problem may originate in the basic philosophy of society or in the economic doctrine of the economy, and therefore can be treated only at that level; or it may originate in the institutions or laws which reflect the philosophy or doctrine and hold the system together; or it may originate in the administrative structure responsible for interpreting and upholding these laws; or the problem may reside in the daily operations or implementation of policy.

These sources may be described jointly as the Behavioural Structure of the system. The intensity of the problem will vary according to its origin. The most intensive problem would be related to the philosophy, while the least intensive would relate to the daily operation. Chart 1 summarizes the interdependencies of the paradigm.

If the problem results from a contradiction between the philosophy and the problem situation, it would help little to introduce solutions that deal with the administration. Similarly, if the administration requires overhauling, it is useless to prescribe new rules and expect enforcement of those rules by that same defective administration.

I suggest that the problem of inflation is inherent in the philosophies or doctrines of these Western economies while the attempted solutions have been addressed to the administration and/or the operation. Instead of revolutionary or radical measures as befits the gravity of the problem, the attempted solutions have been partly reformist but mostly medicinal pacifiers. It is not surprising, therefore, that the effects have been modest or nonexistent. It is possible that the policy makers do recognize the futility of their policies but introduce them mainly as medicinal pacifiers.

The study will be in three parts. First, I shall elaborate the proposed paradigm, define the concepts, and expand on the theory and logic of the proposed processes of problem solution. Next, I shall illustrate the usefulness of the paradigm with regard to inflation. In that section, I shall summarize the frequency and levels of inflationary upsurges in the last century or so, the types of measures used to fight inflation, and the apparent effects, or lack of, of these measures. In the final section I shall summarize the results and draw tentative conclusions.

The conceptual framework

Problems exist within a context which may be society, the economy, or any other self-contained organization. The organization may be a system or a subsystem guided by the philosophy of the system and based on its institutional framework.

The philosophy is a set of perceptions which may originate within the system, or it may be adopted, adapted, or imposed; it may also be any combination of these. The philosophy may be transmitted from above, or it may reflect changes in behaviour at the grassroots level; e.g., in the market place.

The philosophy is interpreted into rules of behaviour or institutions — laws, common agreements, and traditions. As philosophy changes, the institutions must be adjusted or they become obstructive and/or contradictory; failing to change the institutions would then create a conflict with the perception or the philosophy. Given that the philosophy is a perception and the institutions are forms of interpretation, it is conceivable that a certain degree of flexibility will exist to absorb minor conflicts without endangering the system. However, should the gap between the institutions and the perceived philosophy be wide, a breakdown in the system becomes highly probable. To the extent that various interpretations of the philosophy may prevail, the interpretation that is publicly invoked by the legislators, policy makers and the administration as the ideal will be the recognized philosophy of the system. Accordingly, an important attribute of the institutions is their ability to create administrations that can and will uphold them and see to it that they are implemented in the everyday affairs of the system, as if they were in harmony with the philosophy.

The philosophy concept proposed here may have certain similarities with other sociological and economic concepts in the literature. An important sociological formulation has been presented by Neil Smelser as an extension of his joint work with Talcott Parsons.* (Neil J. Smelser, *Theory of Collective Behavior*, New York: Free Press, 1963.) Smelser's formulation includes four " hierarchical components of social action... Values, Norms, Mobilization into organized roles, and Situational facilities " (p. 32.) Each of these components is specified at seven levels of specificity. Strains may occur at any level of specificity in this system if the conditions for social action are obstructed.* (*Ibid.*, p. 68ff.) However, it is not clear how feasible it is to specify values at these seven levels without generating constant conflicts within the collectivity in which a plurality of values usually exists. It may be that generality and vagueness are necessary characteristics of values utilized to accommodate variations among groups.

Another sociological approach to collective behaviour has been more recently synthesized by Eisenstadt in what he descries as the ground rules of the *macro societal order*, or what Edward Shils had earlier called *societal centers*. The major ground rules would specify the qualifications for membership in the group, the rules of distributive justice and equity, the criteria of regulation and access to power, the needs and goals of collective activity, and the harmonization of these rules with the broader societal goals. Change in the ground rules or societal centers would amount to a revolutionary change in society, depending on how much discontinuity has been effected. (S.N. Eisenstadt, *Revolution and the Transformation of Societies*, New York: Free Press, 1978, pp. 28-29 and 217-218).

An interesting approach to the analysis of problem solving or change in society is that proposed by Lyman and Scott, according to whom the world (of power) is based on myths such as wisdom and knowledge, divine sanction, courage and heroism, consent and majority rule, tradition and custom, and inevitable historical forces. There may be other myths. Change (to solve problems) may be impossible without dramatically challenging and overcoming the myths which tend to sustain problems and hide the reality of their existence. (S.M. Lyman and Marvin B. Scott, *The Drama of Social Reality*, New York: Oxford University Press, 1975, Chapter 6, pp. 115-16).

Barrington Moore follows Marx by looking at the mode of production as the determinant of social class ideology and exploitation as the underlying factors of social causation. Problems may be difficult to overcome without changing the mode of production. (S. Rothman, " Barrington Moore and the Dialectics of Revolution: An Essay Review," *American Political Science Review*, 1970, 64(1) 61-82).

The idea of revolutionary change has also been treated by Thomas Kuhn who considers it a revolutionary change when " one paradigm is replaced by another, when a new and highest-level conceptual scheme which governs all lower-level experimentation and theory replaces another ". (Isaac Kramnick, " Reflections on Revolution: Definition and Explanation in Recent Theory," *History and?*, p. 32) Kramnick concludes that " revolutionary change... might be described as the rare case of an abrupt transformation of one conceptual scheme, one set of organizing principles with another... " (*Ibid.*, p. 34).

Another approach that seems relevant though partial and limited in coverage, is the theory of institutional change by Lance Davis and Douglass North. According to their approach, institutions change when the benefits of change exceed the costs, and when the power distribution among the competing parties which lobby for or against change is decided in favour of one group or the other. These benefits can be realized through economies of scale, externalities, reduction of risk and transaction costs. However, the authors take the " fundamental rules " of society as given. They do not treat change of these rules or of the philosophy on which they are based. Yet most of the chronic problems facing society tend to be related to the philosophy and the fundamental rules holding society together.* (Lance Davis and Douglass North, *Institutional Change and American Economic Growth*, Cambridge University Press, 1971).

While these various concepts may be helpful in dealing with change in society in general, I shall focus on specific problems and why they do not seem to go away in spite of the efforts expended for that purpose, even after these problems have been identified as such by the people who are in authority.

A problem is what the policy makers and the experts consider to be a problem. In other words, the problem must be recognized and declared as such before it qualifies for treatment. According to this paradigm, the problem is a deviation of the behaviour from the ideal, and the goal or policy objective is to remove the deviation and restore the problemless state of the economy. Such a problem, however, may prevail because of conditions in the problem situation which cause a deviation from the ideal at one or more levels of what may be called the "Behavioural Structure" of the society, or of the economy, which identify the source of the problem. The behavioural structure, as noted above, consists of the philosophy or doctrine on which the society (economy) is founded, the institutions, the administration, and the daily operation affecting behaviour. Let us look at these concepts in some detail in an economic setting.

The economic philosophy or doctrine is the set of perceptions of the ideal society or economy, as seen by the members of that society or economy. These perceptions are indicated by specific strategic indicators. In the economic context, these strategic criteria represent directly or indirectly the thought of society on ownership, decision making, allocation of factors of production, distribution of costs and benefits, and competition and market structure or system of exchange.

The economic institutions should reflect the philosophy with respect to these same indications in the form of laws of property and inheritance, roles of the legislature, roles of the state, the individual, and the group in decision-making; they would include also antitrust and corporate law, and laws governing banking, interest, trade regulations, tariffs, excise taxes, subsidies, etc.

These laws usually are interpreted and upheld by the administration which includes the authorities with power to interpret and apply the laws: government departments, the central bank, courts of justice, labour unions and trade associations, etc.

The administration, however, is represented in the daily operation by a layer of hierarchy, official and unofficial, who implement and/or supervise the implementation of the laws; these include field supervisors, law enforcement agencies, commercial banks, mailmen, etc.

Each of these levels of the conceptual structure is capable of facilitating resolution of the problem, and of obstructing it by misinterpretation, miscommunication, or by failing to perform according to expectations. The gravity of the crisis or intensity of the problem would be greater, the more closely the conflict originates at the philosophy or doctrine level, and the less intensive it is, the closer its origin is to the daily operation level. The distribution of intensity, however, is discontinuous since the differences between the four levels are not quantitative only, but also qualitative, as in Figure 1.

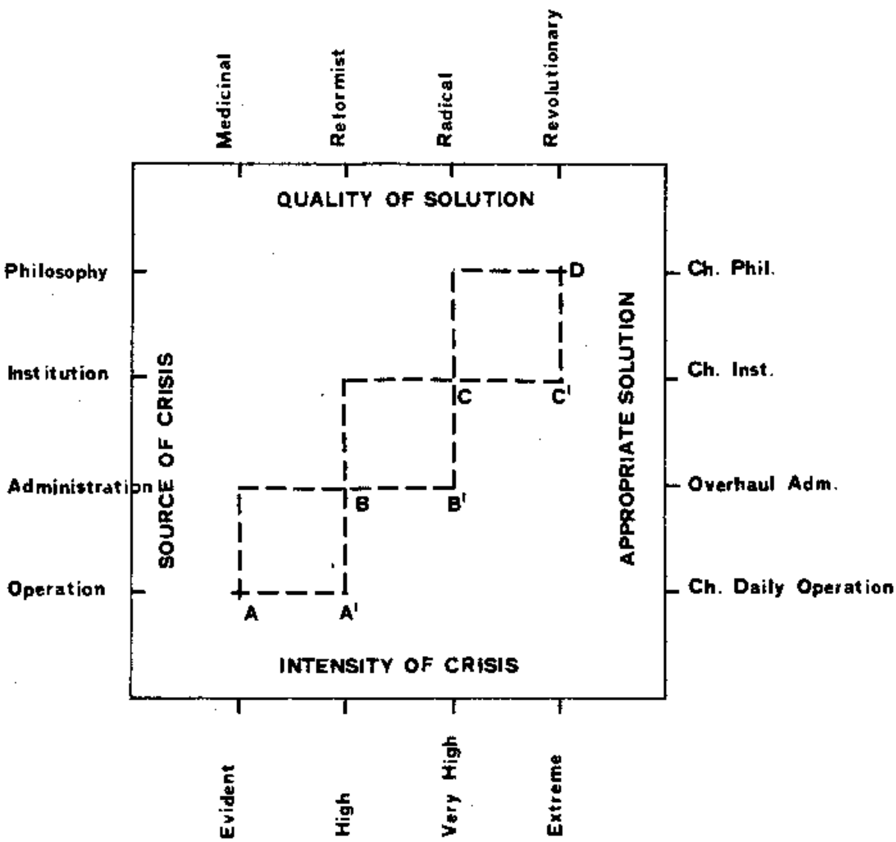
According to Figure 1, a crisis originating in the philosophy or doctrine would be extremely intensive, and must be dealt with by changing the philosophy, which is a revolutionary action. The same coordination may be applied to the crisis at each other level such that the intensity, the form of solution and its quality can be observed simultaneously. The crisis, however, may be observed within a range at each of these levels of the behavioural structure, but it changes abruptly to the next level upward or downward, rather than gradually as if on a continuum.

To understand the way by which a problem arises, let us look at two scenarios which represent two ideal behavioural structures of the economy.

Scenario One: The economy is founded on the premiss that there is perfect competition, free-market distribution, allocation and decision-making. Inflation, as a rise in the price index, in this case will not prevail because demand and supply will tend to equilibrium with stable prices. (The concept of inflation will be treated in more detail below.)

Scenario Two: The economy is characterized by perfect planning and allocation, distribution, and decision-making are engineered according to plan. Inflation cannot exist within the economy because the necessary adjustments will have been made during the planning process.

The perfect or ideal case would include institutions, administrations, and daily operation mechanisms that are fully in harmony with the philosophy, and no crisis should be beyond solution in the normal functioning of the eco-


Medicinal
Reformist
Radical
Revolutionary
QUALITY OF SOLUTION
Philosophy
Institution
Administration
Operation
SOURCE OF CRISIS
D
C
C'
B
B'
A
A'
APPROPRIATE SOLUTION
Ch. Phil.
Ch. Inst.
Overhaul Adm.
Ch. Daily Operation
INTENSITY OF CRISIS
Evident
High
Very High
Extreme

nomy. However, if the market is not perfect, or if the institutions, administration, or daily operation are not in full harmony with a perfect market, it is possible, or even certain, that a breakdown will ensue and a crisis will occur (e.g., inflation).

It is possible, for example, that a crisis would occur if a policy were instituted to deal with a problem *as if* the economy were characterized by perfect harmony between its four levels of the structure when no such harmony exists, or as if perfect competition were prevalent when it is not. This may be the greatest weakness of most policies against inflation in market economies: they are introduced *as if* the market were perfectly competitive though it obviously is not.

It is equally destabilizing to introduce policies to deal with a crisis or a problem in a planned economy *as if* the plan were fully in harmony with the philosophy of the economy and with its three other levels of the behavioural structure when these harmonies do not exist. In other words, the failure may be due to making the wrong assumptions about the crisis, its origin, and the substance of the behavioural structure.

Alternative solutions

Suppose the problem is diagnosed as a result of a contradiction between the actual situation and the behavioural structure. The policy objective would be to solve the problem by creating harmony between the resulting situation and the behavioural structure. The problem situation may arise because of any one of 15 types of conflict, eight of which involve conflict between the actual (problem) situation and the philosophy, while the other seven involve harmony with the philosophy but conflict with one or more of the other levels of the behavioural structure, as in Chart II.

CHART II

HARMONY AND CONFLICT BETWEEN POLICY OBJECTIVES AND LEVELS OF BEHAVIOURAL STRUCTURE

Harmony/Conflict	By Type of Problem Situation															
with:	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Philosophy	—	—	—	—	—	—	—	—	+	+	+	+	+	+	+	+
Institutions	—	—	—	+	+	+	—	+	—	+	+	—	+	—	—	+
Administration	—	—	+	+	—	+	+	—	—	—	+	—	—	+	+	+
Operation	—	+	+	+	—	—	—	+	—	—	—	+	+	—	+	+

— = harmony
\+ = conflict
1 (1) – total harmony
7 (2-8) – harmony with philosophy but conflict with one or more of others.
7 (9-15) - conflict with philosophy; harmony with one or more of others
1 (16) – total conflict

If there is harmony between the problem situation and the philosophy but conflict with other components of the behavioural structure or the problem situation, the behaviour of the component must change accordingly. Suppose, for example, that the problem is due to the fact that the field supervisors are not doing their job, not well trained, not adequately supported, or simply unwilling to comply; in this case the solution will be to deal with the situation, by training, support, or replacement of the operation staff. The same would apply if the problem is due to the failure of the administration to behave in harmony with the ideal as determined by the philosophy of society: training, support, or replacement will be the recommended solution. Should the conflict originate in the institutions, amendment of the laws or their replacement would be necessary. The quality of these solutions, in the sense of the difficulty of implementation, dislocation and costs, would be progressively more serious: medicinal, reformist, or radical, as it gets closer to the philosophy, in which case the solution would be revolutionary

However, should the conflict be due to an inconsistency between the problem situation and the philosophy or doctrine of society, the solution must be either to modify that situation or change the philosophy; one might conceive of a combination in which case a convergence between the two types of solution may be possible. However, to change the problem situation may seem unlikely if it had become widespread and accepted by a large group in society. To force these people to comply could lead to a serious instability and a breakdown of the ties that hold society together. On the other hand, to institutionalize the problem situation or deviant behaviour would render the basic philosophy of society irrelevant and the contradictions even more serious. The obvious solution in this case is to change the philosophy of society, but that would be a revolutionary solution which may face resistance. It is possible that the solution or the change of philosophy may have already started by noncompliance of the institutions, the administration, and/or the daily operation, if not by a formal announcement. The solution will be revolutionary only if the philosophy changes, and will be complete only if all other components of the behavioural structure change too. The most serious situation is when total conflict exists and all levels of the behavioural structure are to be changed. This is likely to happen in the case of foreign occupation and the imposition of a new philosophy which renders it imperative to have a new behavioural structure in harmony with the new philosophy. The same applies if a new economic doctrine were adopted by conscious policy, rather than as an evolutionary process. The easiest solution would be when the problem situation is fully acceptable and in harmony with the conceptual structure, in which case it would simply be redesignated as a non-problem situation.

The effectiveness of problem solving may be facilitated or obstructed during the process of implementation, depending on whether the ideal situation, the policy objectives, and the measures adopted are in harmony with each other, and with the conceptual structure at its various levels. It is possible, for example, for the policy objective to fall short of the ideal situation or to be different from it altogether; in that case, the conflict will be compounded. Similarly, if the measure chosen is in harmony with the philosophy but falls short of the policy objectives, then implementation may be impossible or it would be simply useless. In summary form, the harmony or conflict must be assessed at various stages of the solution process, including diagnosis of the problem, determination of the policy objectives, and selection and implementation of the specific measures, as in Chart III.

CHART III

HARMONY AND CONFLICT BETWEEN THE SOLUTION PROCESS AND THE BEHAVIOURAL STRUCTURE

	Problem Situation	Policy Objective	Measure Selected
Philosophy			
Institutions			
Administration			
Operation			

The diagnosis of the problem can only point out the source of the problem and the ideal policy objective which would be to create an ideal or problemless situation. However, the actual policy objective or the objective adopted by the policy makers may deviate from the ideal policy, in which case the expected results may form a new problem situation.

It is also possible that a given policy objective be achievable by a variety of measures. Choice of the measure in this case and its ease of implementation may determine whether the policy objectives would be realized, or whether the ideal can be restored.

Inflation as a problem

Inflation in this context is a rise in the consumer price index (or some other measure) over and above a given level of price fluctuation, which lasts longer than a given period. The rise in the index and its persistence are presumably beyond the control of the policy makers, and therefore, they constitute a potential problem; otherwise, they would prevent the rise rather than try to cure if after it has taken place. This definition raises questions whether price increases decreed in the planned economics would qualify as inflation. Strictly speaking there can be no inflation in the planned economy if the authorities wish to prevent it and resort to means other than the price mechanism to substitute for the allocative functions of prices. (Black market prices may indicate suppressed inflation but do not apply in this context.)

Suppose that the real income per capita in the planned economy declines, either because of resource depletion, a disproportional increase of population given the resources, or because of an unfavourable change in the terms of trade with other countries. In each of these cases, the authorities must find a way of either increasing the income or reducing the consumption or other expenditure. Assuming resources cannot be increased, the reduction of consumption becomes inevitable (assuming other expenditures cannot be reduced), unless the deficit can be financed by loans, gifts, or some form of dissaving. To reduce consumption, prices may be increased, wages decreased, or physical allocation exercised. Whichever policy is adopted, it seems clear that the planning authorities can prevent inflation if they decide to do so. They also may use price increases to generate savings, reallocate the resources, or redistribute the incomes. In all these cases, " inflation " may be considered a tool of economic policy, and therefore, need not be considered a problem or a target of policy.

This, however, is not the case in the market economy. The philosophy of this society presumably favours private ownership and market decision-making in which purchasing or selling powers are the main qualifications; the allocation of factors is determined in the market place and so are the benefits and burdens in the economy; competition is the process by which the interests of the actors are satisfied. Accumulation of wealth is admired, as evidence of initiative and achievement. The institutions and administration are assumed to be in harmony with this philosophy; they protect its potential effects and the daily operations promote them.

This philosophy is reflected in the laws of the country, its common traditions and expectations, and in the expected behaviour of government, the central bank, the law courts, and the employers and workers' organizations. The same is expected to be characteristic of the behaviour of the enforcers of the laws and administrative decisions, such as the public prosecutor, the district attorney, the police officer, the mailman, and the local banker.

Ideally, inflation should not exist in this system. Yet it has been recurrent for over two centuries, and is considered a threat and a cost to the economy, at least in official declarations, and therefore, is subject to policy treatment. Continuous attempts have been made to control inflation, apparently with little success. Why the problem of inflation does not seem to go way, in spite of these efforts, is the issue the rest of this paper will deal with.

Hypotheses

1. Inflation has continued to be a problem because the measures used to remove it have been irrelevant, inadequate, or not well supported and hence could not have succeeded.

2. While inflation may have been declared unacceptable in this market economy and may be regarded as inconsistent with the philosophy of a perfectly competitive economy, it is not inconsistent or incompatible with the existing institutions, administration, or daily operations.

3. A policy objective to only reduce inflation (not eliminate it) is not consistent with the presumed philosophy, but it is in harmony with the institutions and the administration, and therefore, it reflects a conflict between the various levels of the behavioural structure and may be difficult to enforce in the daily operations.

4. The measure used to "control" inflation cannot succeed because they are not intended to do so and because they are introduced and implemented according to institutions and by administrations that are not totally opposed to inflation.

5. The measures used to deal with inflation are more political and propagandist than they are economic or genuine attempts to control inflation. Hence, they *succeed* by *not* removing inflation while giving the impression that they are there to control it. (A theoretical discussion of these hypotheses is contained in Appendix 1.) Let us look at these hypotheses in an historical perspective.

Inflationary tendencies

Inflation has been characteristic of western economics throughout the modern period, alternating with declines in the rate of price increases, and with occasional declines in prices, especially in recession or depression periods. A survey of wholesale price fluctuations in the UK, US, France, and Canada since 1850 shows a certain degree of regularity of price increases, with the periods of inflation increasingly long as we approach the present. The survey also shows a certain degree of parallelism between the trends in the four countries, with certain lags which seem to be fairly constant. It also suggests that the annual price increases have become higher in more recent years, as shown in Table 1. The longest periods of inflation have come since 1938, the first overlapping with the World War II period, and the second beginning in the 1950's. World War I was also a period of high and protracted inflation.

Why have these inflationary tendencies persisted for such long periods and become a little more severe than in the early years surveyed, in spite of the upsurge of action to fight inflation in the later years? Were these actions or policies ineffective, or were they irrelevant, as seems to be indicated by the similarities of the trends among the four countries, even though their policies were not similar?

The policies and measures utilized have included monetary, fiscal and in-

TABLE 1

INFLATIONARY PERIODS IN WESTERN ECONOMIES SINCE 1850

Percentage Increases in Wholesale Price Indices

United Kingdom Period	Years	% Cum. Change	Average Ann. Increase %	United States Period	Years	% Cum. Change	Average Ann. Increase %
1850–57	6	37.9	6.31	1851–55	4	29.4	7.35
1858–60	2	8.6	4.30	1861–64	3	89.9	29.97
1861–64	3	7.0	2.33	1879–82	3	19.0	6.33
1865–67	2	2.9	1.45	1886–88	2	4.9	2.45
1870–73	3	15.0	5.00	1896–1900	4	19.6	4.90
1887–1900	4	21.4	5.35	1909–10	2	12.0	6.00
1903–07	4	15.0	3.75	1911–12	2	7.4	3.70
1908–20 *	10	136.8	13.68	1914–20	6	91.0	15.17
1933–37	4	28.2	7.05	1932–37	5	29.4	5.88
1938–51	13	163.9	12.61	1939–48	9	78.4	8.71
1953–76	23	134.1	6.83	1949–51	2	15.3	7.65
				1953–60	7	8.3	1.19
				1963–77	14	83.1	5.94
Canada				**France**			
1870–73	3	13.5	4.50	1851–56	5	36.8	7.36
1879–82	3	10.5	3.50	1869–72	3	10.4	3.46
1886–90	4	7.9	1.98	1887–89	2	8.5	4.25
1896–1907	11	31.7	2.88	1897–1900	3	18.1	6.03
1908–12	4	10.3	2.58	1904–07	3	15.1	5.03
1913–20	7	98.1	14.01	1909–12	3	15.1	5.30
1922–24	3	5.4	1.80	1913–20	7	187.4	26.77
1932–37	5	23.1	4.62	1922–26	4	83.4	20.85
1939–51	12	96.7	9.08	1934–52	18	467.7	25.98
1959–73	14	52.8	3.77	1955–76	21	117.6	5.60

Based on different series.

* 2 years with no price index change.

frequently price and wage guidelines or controls; the controls were mainly during the war years. A survey of these monetary and fiscal policies, especially the former, suggest that they were of short-run emphasis, aimed at minor adjustments, and therefore, were incapable of curing chronic inflation.* (H.G. Johnson, *et. al.*, *Readings in British Monetary Economics*, Oxford, 1972, chapters 29 and 30; Susan Howson, *Domestic Monetary Management in Britain*, *1919-38*, Cambridge University Press, 1975; J.E. Wadsworth, *The Banks and the Monetary System in the United Kingdom, 1959-71.*) This observation, however, is not surprising since there were basic problems facing these measures and policies, rendering them barely effective, among which are the following:

1. The economic philosophy in these western countries with regard to inflation has been ambiguous and confused. According to the perceived philosophy, ownership, inheritance and accumulation, and profit making are protected and encouraged. Decision-making is free by the individual or the legal person, and exchange in the market is determined accordingly. Allocation and distribution are determined by the price mechanism and competition. In its ideal form, this philosophy will not allow or tolerate inflation, at least not below full employment, and only to allow technological change to expand the production capacity. Yet, neither in the UK or in the US, nor in France or Canada is there an explicit statement to indicate the idealization of an inflationless economy. There are, of course, declarations and pronouncements by policy makers, academicians, bankers, and industry leaders that inflation is undesirable, detrimental, and even that it is ENEMY NUMBER ONE. (*Economic Report of the President, 1980.*) But nothing in the institutions and laws of these countries, which should reflect the philosophy of society, makes inflation an enemy of the economy or society. Neither the Constitution, nor the regulations, nor the Common Law make it mandatory to control inflation or prevent it, or forbid or even discourage behaviours that lead to inflation, regardless of whether these laws would work or not. Thus, while inflation may be contrary to the philosophy of these market economies, the chronic inflation which has characterized them has not been condemned as such, nor have the people entrusted with upholding that philosophy rebelled against the inflation which they rhetorically disdain.

One of the effects of this ambiguous philosophy has been the increasingly libertarian attitude entitling each to individually diagnose the inflation problem and prescribe measures to deal with it uniquely, without any danger of being inconsistent with the philosophy of society. Out of this looseness and ambiguity has come confusion, lack of agreement on the diagnosis of the problem and on the measures to deal with it. There has also arisen the feeling that policy makers have the " right " to fail in the fight against inflation and still be able to blame it on others. This confusion is well reflected in a survey of opinion of 20 economists, ranging from Milton Friedman, who depends on the Federal Reserve (Central Bank) system and control of monetary growth as a means to control inflation, to that of J.K. Galbraith who advises " a firm legal hold on prices, wages and incomes," to E. Ray Canterbery who proposes " a new social contract. Mandate the 1,000 corporations (largest) to include equal representation — of labour, business and consumers — on their boards." Robert L. Heilbroner would " impose permanent wage and price controls... on the thousand or so largest corporations, along with a structure of taxation designed to prevent too great a build-up of purchasing power." In the end, Heilbroner believes "capitalism... will again evidence its extraordinary institutional and ideological flexibility and accept 'socialistic' controls as the only means by which it can extend its nervous, expansionary life". (David Mermelstein, "The Threatening Economy," *N.Y. Times Magazine*, December 30, 1979. Another array of viewpoints, policy proposals, and suggestions is contained in Arthur M. Okun and George L. Perry, eds. *Curing Chronic Inflation*, Washington, D.C.: The Brookings Institution, 1979.) What this means is that while the philosophy of society may be opposed to inflation, it does tolerate inflation and even encourage it by promoting the institutions under which inflation has prospered, while the experts and policy makers debate semantics, hypothetical situations, and fictitious economic environments that are free of inflation. Nothing illustrates better this contradiction between the ideal market economy and the reality than Milton Friedman's fictitious competitive economy which he has been preaching as if it were existing or has ever existed in the western economies or elsewhere. (For a good treatment of Friedman's dream world see, Gus Tyler, "The Friedman Inventions," *Dissent*, Summer 1980, 279-90).

2. The policies against inflation, whether monetary or fiscal, have been introduced and implemented in the context of institutions (formal or informal) which protect the behaviour leading to inflation and the benefits accruing from that behaviour. The laws of the four countries protect the rights of the economic and business actors who contribute to inflation, including the oligopolistic corporations, financial institutions, and other profit makers. They protect their benefits from inflation, justify the inequalities resulting from it, and sustain the market structure in which they function, with its rigidities, loopholes, imperfections, and the ambiguities which hinder enforcement of the policies against inflation. The laws on which the central banks are based are such laws which protect the system in which inflation has been chronic. The laws on which commercial banking, credit, and private investment are founded tend to protect and encourage the behaviour of these agencies which benefit from inflation. Indeed, the institutions on which government, as an administration, is based, protect behaviours leading to inflaction, including those of the administration itself, such as inflationary financing through tax revenue and the national debt. There are antitrust laws which might tend toward perfect competition. However, the difficulty of winning a case of antitrust and the superficiality of the sentence in case of conviction help to dilute the impact of these laws to the extent of rendering them sterile and useless. In other words, the laws of these countries and the other institutions seem to be in harmony with the chronic inflation that has prevailed regardless of its inconsistency with the philosophy of these countries.

The apparent sterility deriving from the vague substance of these institutions is augmented by the lack of agreement on how to combat inflation, even when there is agreement on the objectives of the policy. Given the ambiguous philosophy, the laxity of the institutions, and the competing power groups that influence the institutions, the experts, legislators, academicians, and other inflation fighters add to the confusion by proposing policies and measures which are contradictory, often irrelevant, and decisively ineffective. They try to reconcile and almost justify inflation by suggesting that it is more in harmony with the philosophy of society than the measures necessary to eradicate inflation; for example, it is better to have inflation than regulation; it is better to have inflation than to interfere with the institutions governing ownership, individual enterprise, and profit making. In other words, whether inflation and these institutions can actually be reconciled or not, they are perceived to be reconcilable by the interest groups which influence those institutions including many economists who are leading apologists for the false harmony of the institutions with inflation.

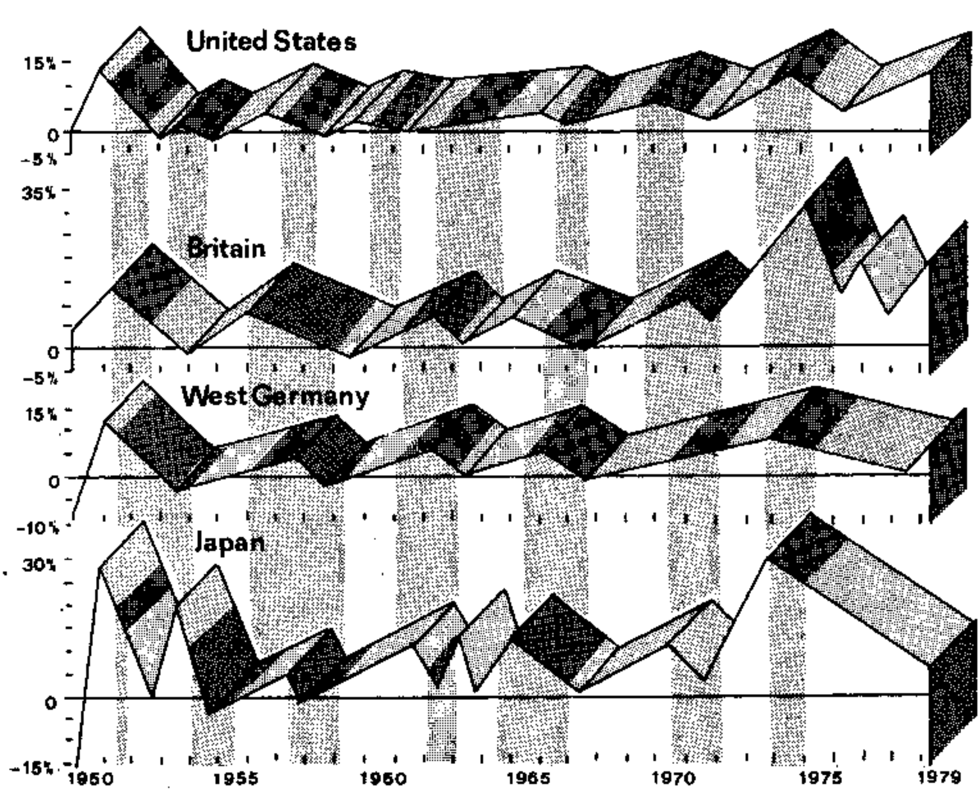
Given the established institutions and the apparent toleration of inflation, social expectations have developed to the effect that price inflation is to be expected, that it is there to stay, and that the inflationary period will be followed by a price decline or a recession, and therefore, little needs to be done about it. Former fighters of inflation have become apologists and experts on how to live with inflation. (James Tobin and Leonard Ross, "Living with Inflation," *New York Review of Books*, 6 May 1971; Peter Passell, "Learning to Live with Inflation," *New York Times*, 2 June 1977.)

This somewhat defeatist (or realistic) attitude is backed up by circumstantial evidence. Inflationary periods have been followed by periods of recession, and both inflation and recession seem to have continued to recur regardless of the policies enacted against them, as shown in Figure 2. However, while a recession may follow inflation and may slow it down, it does not follow that the recession cures inflation, especially since the negative effects of the recession may be more grave than those of inflation. The recession cure would be like prescribing death to cure the disease. Furthermore, the recent upsurge of stagflation tends to dampen the curative potential value of the recession. (Stagflation is not a new phenomenon; it occurred between 1933 and 1937 and again between 1940 and 1942; M. J. Ulmer, "Old and New Fashions in Employment and Inflation Theory," *J. Econ. Issues*, XIII, 1, March 1979, 3-4.) Indeed, the attempts to deal with inflation have apparently focused on controlling inflation, rather than on eliminating it. They have aimed at keeping it within a "reasonable" range — presumably the range within which the benefits of inflation can be realized. The flexibility of the institutional framework, the lack of a legal basis for controlling inflation, and the costs that may have to be incurred in its control tend to strengthen the expectation that inflation is here to stay.

3. The policies which sustain inflation and which are in harmony with the institutions are also acceptable to the administration which has the respon-

Recession and Inflation: Evidence from Four Countries

Rate of change in consumer price index, shaded areas indicate a recession



Source: Geoffrey H. Moore, " A Truism: Recession Slows Inflation," *New York Times*, Novembrer 18, 1979.

sibility to implement them, whether as part of the government, or the central bank or of the public corporations. These agencies and administrative bureaucracies are subject to influence and lobbying by the power groups which benefit from inflation, but they themselves have little reason to fear inflation or to want to eliminate it. As a matter of fact, they may have strong arguments in favour of inflation, among which are the following: (These arguments are based primarily on the experiences of the US.)

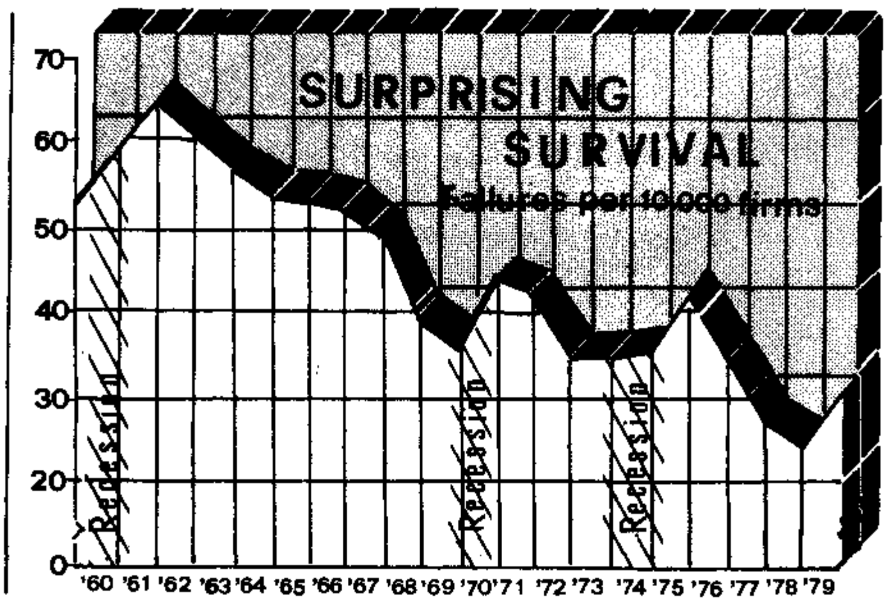
a. Inflation periods tend to be profit periods during which business corporations increase their profits, the treasury increases its revenues, and employment tends to increase — although stagflation may slow down employment. Despite the frequent complaining against inflation on behalf of and by business, business profits in the US have kept rising throughout the last inflationary period. According to the *Wall Street Journal* the first drop in corporate profits since 1975 came only in the second quarter of 1980, after the recession had hit, especially in the auto industry. (July 31, 1980, pp. 1, 10.) Actually, the 1979 year which was the peak of the last inflationary period was highly profitable, as shown in Table 2. Out of 912 corporations reporting, 79 (9%) reported a loss; 12 corporations (1%) reported " no change " in their profit-loss accounts; 216 (24%) reported declining profits; and 605 (66%) reported increasing profits. Those reporting increasing profits displayed a range of profitability: 113 corporations (19%) reported net income increases per share between 1 and 10 percent; 158 (26%) reported increases ranging between 11 and 25 percent; 156 (26%) reported increases between 26 and 50 percent; 50 corporations (8%) reported increases between 51 and 75 percent; 31 (5%) reported increases between 76 and 100 percent; and 97 (16%) reported increases of

Table 2

NET INCOME PER SHARE YEAR ENDING DECEMBER 1979-MARCH 1980

Firms reporting	Number	Percent	Firms reporting increases: Range of Increase	No.	Percent
Net Loss	79	9	1-10%	113	19
No Change	12	1	11-25	158	26
Decline	216	24	26-50	156	26
Increase	605	66	51-75	50	8
			Over 100	97	16
Total	912	100	76-100	31	5
			Total	605	100

Based on " Digest of Earnings," reported by firms; *The Wall Street Journal*, first half of 1980; survey by author.



Source: The Wall Street Journal, March 12, 1980, p. 46.

over 100 percent; thus, 55% of the corporations raised their net incomes by more than 50% in that inflationary year.

b. The administration may have another reason to hesitate in the fight against inflation. There are fewer business failures during the inflationary years than in other years, as illustrated in Figure 3. During the period 1960 and 1979 failures increased directly following the recession but declined as inflation "soared." Apparently inflation is a healthier period for business than recession, although the decline in failure may be attributed in part to government aid to business.

c. A third incentive for the administration to restrain itself in fighting inflation is the political payoff inherent in compromising with other power groups. The beneficiaries of inflation are powerful, protected by the institutions of the country, resourceful, and in political campaigns they can deliver. It should not be surprising, therefore, to see rules bent, policies compromised, and exceptions made in trying to restrain price increases. This sort of trade-off tends to take place even within the administration itself, especially between the treasury and central bank, as the policy surveys of the UK and the US clearly indicate.

d. It should come as no surprise that implementation of the policies against inflation is in the hands of economic groups who themselves benefit from inflation: they are debtors at least as much as they are creditors; they are property owners who look forward to capital gains; and they are shareholders and partakers in the affluence of an expanding inflationary economy, by illusion and in reality. The expectation of inflation thus becomes an expectation of benefits. (Melville J. Ulmer, *op. cit.*, p. 15.)

4. The above " intended or unintended " obstacles in the fight against inflation are well represented in the daily operations or in the application of the policy: policies leading in one direction are often counteracted by policies leading in other directions; officers in charge of implementation are left in the cold with no power or authority; policies are changed or repealed before they have had time to be effective; and the measures are often superficial or so weak that they can hardly scratch the surface of inflation. The end result is a failing policy and a demoralized enforcement machinery; inflation goes on.

Probably the most interesting approach is to " doublethink " inflation away. " Instead of coming to grips with the perverse realities of inflation, a disturbingly large number of bureaucrats and economists are trying to lick the inflation problem by popularizing a statistical euphemism designed to sell both themselves and the people on the idea that inflation really is not so bad. The C.P.I. (Consumer Price Index) measurement has become the whipping boy instead of inflation." Thus, by confusing the definition and discrediting the measurement of inflation, inflation may cease to be a problem. (Janet L. Norwood, " Washington and the Maligned C.P.I.." *New York Times*, February 10, 1980).

One of the more effective measures against inflation could have been the wage-price guidelines policy. However, manipulation by politicians, compromises, and depletion of the authority of the people in charge have rendered the programme a political tool rather than a well-intended and serious effort to stabilize prices.* (" Inflation Fighter Learns the Rules of Battle Politics," *The Wall Street Journal*, February 22, 1980; " Inflation-Fighter Kahn Feels Slightly Deflated by His Lack of Clout," *The Wall Street Journal*, July 11, 1979 for a characteristic description of the impact of Alfred Kahn, the " czar " fighting inflation on behalf of the US President.)

A newly revived and distorted aproach is what has been described as the supply approach to inflation. (Martin Feldstein, " Inflation and Supply Side Economics," *The Wall Street Journal*, May 20, 1980.) The basic idea is to increase output and productivity by means of lower taxes and higher savings. There is no assurance, however, that such a policy would be more effective than the demand side policies, so long as rigidities exist in the market and the beneficiaries of inflation are protected by the institutions of the country. This approach can succeed only if the policy directly leads to higher output and rapidly enough to absorb the pressure of demand without raising prices.

5. Finally, while the policy objectives may have implied it, it is not evident that fighting inflation has been a major target either in the UK or in the US. The objectives of monetary policy in the UK since the mid-XIXth century have aimed at free trade, budget surplus, trade surplus, high gold and convertible funds reserves, and at maintaining the status of London as a world money market. Following the wars, the policy usually has aimed at absorbing the demobilized service people, reducing the burden of interest payments on the national debt, and at promoting investment; in 1947 curtailment of investment income was another policy objective. (Susan Howson, *op. cit.*, p. 40; F.W. Paish, *Studies in an Inflationary Economy. The United Kingdom, 1948-61*, Macmillan, 1962, chapter 8.) A study of a more recent period finds the objectives of policy to be still vague and that there "seems to be some difference between the *announced* and actual (revealed) judgments." It also shows "the relative unimportance of the price level in comparison with the other two objectives," the balance of payments or convertible funds reserves, and the level of unemployment. In other words, controlling inflation again fails to be explicity a major policy objective. (Douglas Fisher, "The Instruments of Monetary Policy and the Generalized Trade-off Function for Britain, 1955-68," in H.G. Johnson, *et. al.*, *op. cit.*, pp. 550-52).

There is a lot of rhetoric in the US about fighting inflation, but the main policy objectives seem to have been political: to appear to be fighting an ongoing war against inflation more than to actually fight it. There is more symbolism than reality in these programmes. (Arthur Schlesinger, Jr., "Inflation: Symbolism vs. Reality," *The Wall Street Journal*, April 9, 1980.) One might say that the whole office of Alfred Kahn is mere symbolism since Kahn has neither the authority nor the resources to make or implement policy.

The call for a balanced budget is another form of symbolism, as if a balanced budget, which restricts demand while there is unemployment, would cure inflation. In his ridicule of this idea, Arthur Schlesinger, Jr. invokes the "law of social errors recently propounded by J.K. Galbraith. Galbraith's law is that things go wrong when remedy is allowed to prescribe diagnosis." According to Schlesinger, "since balancing the budget is so available and convenient a remedy, Presidents cannot resist the temptation to define the problem in terms that a balanced budget would cure." A balanced budget, however, should not be dismissed so easily. Combined with a commitment to maintain full employment, a balanced budget could work if the government seriously want it to.

Conclusions

The fight against inflation has not succeeded; the problem of inflation does not seem to go away; yet the same tools and policies that have been used for more than half a century are still in vogue, especially in the UK and

US. A few voices are being heard suggesting that these tools cannot succeed and new approaches are necessary. Walter Heller has according to a cost-benefit evaluation concluded that wage-price controls would be less costly than doing without them, but they would succeed only if a long list of conditions were satisfied, which is unlikely. (Walter Heller, "The Case for Wage-Price Controls," *The Wall Street Journal*, February 27, 1980.) Arthur Burns, the former chairman of the Federal Reserve Board, suggests that gradualism in fighting inflation would not do; "fairly drastic therapy will be needed," presumably only of the traditional type. (*U.S. News and World Report*, October 15, 1979.) But can these measures be drastic enough to restore perfect competition? Thomas Mayer, in a novel, though hardly promising approach, suggests that a constitutional amendment would be necessary to fight inflation. Mayer proposes to break the inflation expectations through an anti-inflation amendment which would obligate the Board of Governors of the Federal Reserve to maintain price stability within a specified range, as if the tools available to them would work, which is doubtful, given the behavioural structure of the US economy and society. ("Using the Constitution to Fight Inflation," *American Banker*, November 29, 1979.)

A different suggestion has come from a Soviet economist who obviously is critical of capitalism and is not an apologist for that system. According to his approach, inflation must be seen in a global perspective, in which case the following measures would be needed to cope with it:

> "Special priority for the problem of structural unemployment of minorities and young people.
>
> Special incentives stimulating price restraint — and disincentives penalizing excessive price increases. When incentives do not work, direct price controls are necessary.
>
> Cutting military expenditure to levels consistent with price stability. Recent Soviet proposals to control and reduce armament spending are a serious basis for international action.
>
> More planning, with the special goal of preventing macroeconomic inbalances and disproportions. Noninflationary government spending, aimed at increasing the productive potential, should be promoted.
>
> Restriction of monopolistic price practices and pressure group tactics.
>
> International agreements assuring the stabilization of world prices for raw materials and manufactured goods, and eliminating discriminatory practices from world trade.
>
> A coordinated effort to return to money systems based on gold.
> (STANISLAV M. MENSHIKOV, "Fighting the Battle of Stagflation," *New York Times*, February 13, 1977.)

All these proposals are either medicinal or reformist, in the context of the above paradigm. The problem resides in the philosophy and the institutions, and therefore, it is necessary to deal with inflation at that level by revolutionary or radical measures. It seems necessary either to change the institutions so as to prohibit inflation and the causes leading to it, including the benefits accruing from it, or change the philosophy and the institutions toward a centrally planned economy. The only other alternative that may be feasible is to compromise the philosophy, declare inflation as natural, and thus restore harmony between the philosophy and the other components of the behavioural structure and learn to live with chronic inflation in a pseudo-market economy. Does this mean the problem will go away? No, it means the problem will be exterminated by redefinition of the problem situation. The behavioural structure will be harmonized. The beneficiaries of inflation will be admired and those who suffer will learn to accept their inferior position in the economy, or decide to rebel and apply revolutionary actions to change both the philosophy and the institutions, and together with the policy-making machinery.

APPENDIX 1

INFLATION AND THE BEHAVIOURAL STRUCTURE

The problem of inflation may be illustrated in terms of the behavioural structure as follows:

Definitions:

Problem Situation	I:	Inflation exists but that is totally unacceptable;
	II:	Inflation exists at an unacceptable rate.
Policy Objective	I:	Abolish inflation;
	II:	Reduce inflation to an acceptable rate.
Measures:		MP = Monetary Policy; FP = Fiscal Policy; PC = Price Control

Chart IV describes the relationship between these variables and the behavioural structure in dealing with inflation:

CHART IV

RELATIONS BETWEEN INFLACTION FIGHTING AND THE BEHAVIOURAL STRUCTURE IN A MARKET ECONOMY

	Problem Situation		Policy Objective			Measures		
	I	II	I	II		MP	FP	PC
Philosophy	+	+	—	+	I:	+ —	+ —	+ —
					II:	+ —	+ —	+ —
Institutions	—	—	+	—	I:	+	+	+
					II:	—	—	—
Administrations	—	+	+	—	I:	+	+	+
					II:	—	—	+
Operation	—	—	+	—	I:	+	+	+
					II:	— +	— +	+

+: conflict; —: harmony; — +: in harmony, but not fully acceptable; + —: not in harmony but acceptable.

In this formulation, inflation at whatever rate is not consistent with the economic philosophy of society, and its existence would be a problem situation. Policy objective I is to eliminate inflation altogether; this would be fully consistent with the philosophy, but none of the measures would be consistent with that philosophy in the sense that no such measures should be necessary; however, since the problem situation is to be eliminated, these measures would be tolerable. In other words, to the extent that inflation violates the philosophy of society, normally unnecessary measures would be tolerated to restore the inflationless situation. The same applies to Problem Situation II; while inconsistent with the philosophy, as a policy objective to reduce inflation, it would be tolerable.

Inflation in this economy should be inconsistent with the institutions that fully reflect the philosophy. However, in reality inflation is not inconsistent with these institutions since there are no laws that prohibit inflation, nor do the institutional foundations on which the administration is built mandate the prohibition of inflation. On the contrary, these institutions tend to protect the actors in the economy who benefit from inflation and provide no protection for those who suffer from it, as illustrated by the tax laws, the corporations charters, the mandate to the central bank and the powers delegated to the administrative authorities. (Minor cost of living allowances are legislated but nowhere enough to compensate for inflation.) Therefore, Policy Objective I or the elimination of inflation is inconsistent with the Institutions, and the three possible measures must be rejected as ways of realizing that objective. However, Policy Objective II is in harmony with the institutions as it tries to reduce inflation to an acceptable level as determined by the administration. To do this, all three types of measures are consistent with the institutions to the extent that they do not violate the rights of those who are protected by the institutions — the inflation beneficiaries!

Problem Situation I is consistent with the administration in the sense that inflation is not unacceptable. However, Problem Situation II is inconsistent with the administration inasmuch as it may be different from the specific rate of inflation which has been declared acceptable. Therefore, Policy Objective I is inconsistent with the administration but Policy Objective II is consistent. The administration does not seek to eliminate inflation, but only to reduce it to the acceptable level.

Given this freedom of administrative interpretation of the acceptable inflation level and its status as a problem, the administration accepts no measures to deal with Problem Situation I since the corresponding policy objective is rejected. However, to realize Policy Objective II, MP and FP are acceptable, but PC is not. MP and FP are flexible, vague, and slow in effectiveness. The inflation beneficiaries protected by the institutions can hedge against these measures, and the results can be such as to permit continuous reinterpretation. In contrast, PC is quick, and if thoroughly applied, can be quite effective and capable of reducing the advantages of the inflation beneficiaries. Therefore, PC is usually rejected by the administration, as contrary to the philosophy, difficult and costly to implement, and unwarranted in a non-crisis (peace) situation.

The operation presumably reflects what the administration determines, but this is not necessarily so. For instance, there is no reason for the operation level of the structure to consider any level of inflation as unacceptable; both Problem Situations I and II may be consistent with the operation. However, as far as choosing a policy objective, the operation echoes the administration by rejecting Policy Objective I and accepting Policy Objective II. Similarly, all three measures are rejected as irrelevant to Policy Objective I. The operation, however, makes itself effective in the implementation of the measures to realize Policy Objective II. While MP and FP may be in harmony with the operation, the implementation is usually half-hearted, incomplete and often sabotaged (legally) by using all possible loopholes to avoid inflicting harm on the inflation beneficiaries. Thus, while certain MP measures are intended to reduce the money supply, other measures are used to increase it; while FP may intend reduction of certain expenditures, measures are taken to increase other expenditures. In contrast, PC is usually rejected as inapplicable, unenforceable, and an infringement on the rights of the people.

Thus, the fight against inflation in this economy reflects a conflict within the behavioural structure: certain levels of the structure reject inflation, but others accept it and benefit from it. This conflict in the market economy seems to be resolved by deviating from the philosophy or by announcing measures against inflation, but gradually accepting it as inherent in the economy. This explains why inflation cannot be eliminated and why its reduction to an acceptable level is a moot policy incapable of achieving that target. And if there were a danger of such achievement, the definition of "acceptable level" would be changed, and the constituents would be reminded that they ought "to learn to live with inflation" as their new ethos. This may explain why the measures adopted to control inflation in the western economies are mostly irrelevant, wasteful, and incapable of realizing that objective.