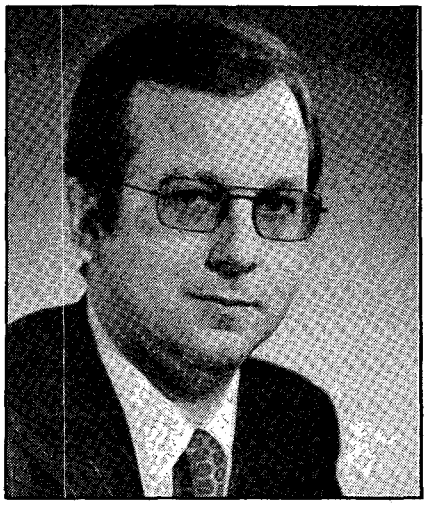
# Does Monopoly Cause Inflation?

# viewpoint



**Alan Reynolds**

Every time inflation speeds up, someone tries to revive the old idea that it is somehow linked to the size of corporations, which is said to be a sign of monopoly pricing. Statistics are freely tossed around that have nothing to do with competition —for example, that "only" a thousand "giant" corporations produce over half of all private goods and services. And it is then simply asserted that large corporations set prices arbitrarily, regardless of demand. This is, for example, a major theme of *Almost Everyone's Guide to Economics* by John Kenneth Galbraith and Nicole Salinger.

Even if every industry in the country were a pure monopoly, however, with no possibility of substitution between them, it would still have no effect whatsoever on the rate of inflation. A monopoly sells less than a competitive firm and thus charges a higher price by restricting supply. But it doesn't pay to keep charging more and more for less and less, year after year. At some point, the loss of sales offsets the added revenue from a higher price. So the monopoly finds the optimal combination of price and volume to get the most profit.

Once a monopoly has found the profit-maximizing blend of volume and price, there is no incentive at all to raise that price and lose sales, unless costs or demand go up. For a price increase to be profitable, demand for the monopoly's product must go up (meaning that people are willing to buy more units at any given price than before) or its supply of the product must go down (meaning that the costs of producing each unit have risen, reducing the amount that the firm can profitably sell at any given price).

If costs are increasing throughout the economy, that is generally a sign of excess demand for final products that is reflected in excess demand for labor and materials used in the production process. And if demand (spending) is increasing rapidly throughout the economy, that clearly has nothing to do with the size of firms or the degree of competition.

A second line of defense suggests that the many alleged monopolies have little incentive to resist large wage increases because they can simply hike prices to cover the cost. If prices are raised beyond the profit-maximizing point, however, sales and profits would decline for a monopoly just as they would for a competitive firm. A so-called wage-price spiral cannot continue without being validated by an increase in the supply of money to finance the increases. Otherwise, the real value of people's money would fall with the rising prices, thus slowing spending and creating an ever-increasing glut of products, services, and unemployed workers.

Another variation on the theme suggests that a slowdown in spending, resulting from slower money growth, does not reduce prices because large corporations escape the market's discipline. According to this theory, it is only by causing unemployment and thereby reducing wage gains that there was any effect on inflation from the slowing of demand in the 1975-76 period.

There's one problem with this theory, though: it bears no relationship to the facts. The rise in consumer prices for nonfood commodities slowed from 13.2 percent in 1974 to 6.2 percent in 1975; similar producer prices slowed from 20.5 percent to 6.7 percent; but hourly wage gains *rose* from 7.9 percent in 1974 to 8.4 percent in 1975. Prices didn't actually fall, on average, because the increases in spending only slowed down a bit—from 11.6 percent in 1974 to 8.1 percent in 1975.

There is no need to get involved in the complex reasons why a sudden slowdown in money and spending is typically reflected first in declining output and only later in slowing inflation. It can simply be observed that, since this phenomenon is clearly not confined to big corporations or monopolies, the monopoly theory does not explain it.

If only some product, service, or labor markets are assumed to be monopolized, and others are not, the irrelevance of monopoly becomes even clearer. Consumers might then spend a larger share of their incomes on monopolized goods and services, but that would necessarily reduce demand for goods and services from competitive sectors. Everyone can't simultaneously spend more money on everything unless there is more money to go around. Higher prices in monopolized areas of the economy would thus be offset by lower prices in competitive areas, leaving no net effect on measures of average prices. Similarly, if a union could raise wage rates in some trade by restricting entry, those foreclosed from such job opportunities would be compelled to seek work elsewhere—thus increasing the supply of labor in other occupations and depressing those wages. Average wage rates would be unaffected.

In short, monopoly might explain why a particular price is relatively high at any moment in time. But monopoly cannot explain why that price, much less the average of all prices, is rising continually, year after year. Nor can monopoly explain why inflation is higher or lower at various times and places, unless the degree of monopoly is subject to huge and sudden gyrations. The structure of US industry and labor markets was surely not much different in 1974 than in 1964, but the inflation rate was 10 times higher.

There is no credible evidence that elements of monopoly are particularly significant in the US economy, except where monopolies or cartels have been deliberately created by government regulation (Postal Service, airlines, trucking, utilities, occupational licensing laws, etc.). But even if it could be shown that monopoly was a pervasive phenomenon, the monopoly theory of inflation would still fail the most elementary tests of logic.

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# money

## Precious Stones: Scouting the Frontier

By Steve Beckner

No less than a dozen firms hawking precious stones as investments set up shop at the recent conference of the National Committee for Monetary Reform in New Orleans. Some were selling diamonds. Some were selling "colored stones" (rubies, emeralds, sapphires, and lesser varieties). Some were selling both.

They ran the gamut—from slick to schlock. All were competing to put up a more impressive facade in the conference's huge display hall, alongside the gold dealers and food dehydrators. It was a battle for the best location, the most professional-looking booth, the glossiest literature. Some were hopelessly amateurish efforts. But most looked pretty convincing. Yet, it was certain that—behind the facades—some firms were less legitimate than others.

But how was one to tell? If you asked any of the dozen about the credentials of their competitors, you would invariably hear the most scurrilous attacks and innuendoes. Almost every firm had something bad to say about every other. And so, for the uninitiated would-be diamond investor, observing this mud-slinging carnival scene, the overall impression must have been, well, muddy.

So, how does the person who is interested in buying precious stones glean the gems from the rubble? Thankfully, the number of fraudulent and borderline-fraudulent firms seems to have diminished. As tends to happen in all markets, the more reputable firms survive, while the others fall by the wayside. But the problem of choosing a dealer persists.

It's not the only problem. Take, for instance, the dilemma of choosing among diamonds and the colored stones. What do you buy? How do you get the best price, now and at resale time? Considering past price performance, what has the greatest price potential?

It behooves every prudent investor to thoroughly check out the vendors of commodities like diamonds. Check the Better Business Bureau, both in your state and in the state where the firm is located. Check Dunn & Bradstreet. Ascertain whether the attorney general in the firm's home state has taken action against it. Demand a company's references—and check them.

Beyond those precautions, there is no substitute for valid certification of precious stones. "Valid" means not only that the certificate is from an independent, widely recognized laboratory but also that the certificate you are given in fact goes with *your* stone.

Diamonds of a carat or larger should be certified either by the Gemological Institute of America (GIA) or the Hoge Raad Voor Diamant (HRD). Stones smaller than a carat should be certified by the European Gemological Laboratory (EGL). The HRD is a Belgian lab, and its certificates, as yet, are not very common in the United States. The chief US graders are the GIA and EGL (both with offices in New York and Los Angeles). While both are qualified to grade all sizes, in practice there has tended to be a division of labor, so that a one-carat stone with a GIA certificate might sell for a slight premium over one with an EGL certificate. In no case settle for a certificate from an unknown lab or buy a diamond "graded according to GIA standards" or by "GIA-trained gemologists."

Colored stones are only now acquiring the blessings of certification. The American Gemological Laboratory (AGL) has been grading colored stones for over a year now. But its certificates are not widely accepted nor its grading standards recognized by the trade. The EGL is in the process of developing its own colored stone grading and certification program, but it is sure to face similar problems. For this reason, more than any other, colored stones have to be regarded as still on the investment frontier—fraught with risks but also filled with opportunities for those willing to take them.

Unfortunately, a certificate alone does not bridge the knowledge gap, even in diamonds. There have been cases where a firm has sent a high-quality diamond to a legitimate lab again and again, thus obtaining a quantity of high-grade certificates, which it then used to sell lower-grade stones. And since, to the naked, untrained eye, it is hard to tell the difference between diamonds, such switching has been successful—particularly when the firm seals the stone in plastic and warns the customer that if he breaks the seal all guarantees of authenticity are void.

There are two ways to avoid this switching problem. One method is for the company to offer an insurance policy guaranteeing that the stone in the cube matches its certificate. Of course, the program has the drawback that one cannot fully enjoy one's diamond, since it is sealed. The insurance policy lapses if the seal is broken, unless opened by an adjuster. (Otherwise, a client could switch stones and claim he'd been cheated.) Then too, the insurance premium, which must be continued by the investor to keep the policy in force, is an extra cost.

The other method is for the diamond dealer to arrange for the investor to receive a loose diamond directly from one of the labs, or to pick the stone up at the lab. The lab can either recertify the stone or, for a smaller fee, verify that the stone and its certificate match. The firm must either provide a money-back guarantee in case the lab does not find the stone to be of the stated quality, or hold the customer's funds in escrow until the lab attests to the quality. Stones must be shipped to the GIA in the name of the customer and not in the name of the firm. No firm has a privileged relationship with the labs in this regard.

The prime proponents of these two approaches are, respectively, Gemstone Trading Corporation of New York and Gemma Corporation of Beverly Hills, California. But that doesn't mean they are the only reputable firms in the industry. Others, including Kohinoor, North American, and Reliance, have long-standing reputations.

The best approach is to make thorough comparisons of a few companies—their records, their prices, and their total programs. Of particular importance is their ability to resell the stone for you when the time comes. Your alternatives are auction houses, jewelry stores, and the classified-ad pages. Buy the best quality stone you can afford. Don't sacrifice quality for size. A general rule is to buy 75-point (¾-carat) or larger diamonds in the D-H color range and the "flawless" to "$VS_1$" clarity range.

Without widely accepted grading standards, it is very difficult for the average person to know what he is buying in colored stones. Even more than with diamonds, you must trust the integrity of the seller. By the same token, liquidation is more difficult. On the other hand, current prices for colored stones do not fully reflect their much greater scarcity—now