Stop Panicking Over Inflation

Why liberals should hate Volcker and Greenspan and love low interest rates

by Paul Craig Roberts

Just the facts, ma'am.

The 1980s has been a period of low inflation, yet the fear of inflation has grown, leading savvy business-folk of moderate means, and those of great fortunes to their demise.

Take the Hunt brothers of Texas, whose sloppy guesstimates about the rate of inflation cost them *$4 billion*. Back in 1979, driven by an almost apocalyptic fear of inflation, the Hunts placed their faith in silver. They were convinced that inflation would roar unabated, making all paper money worthless. They were equally certain that the value of precious metals would soar. So they began to hoard silver, storing it in vaults around the world with the vision of rising Phoenix-like from the impending destruction of the dollar. They even envisioned themselves issuing their own silver-backed bonds once inflation ravaged the world's currencies.

Unfortunately for them, but fortunately for the rest of us, the dollar didn't sink to the value of the proverbial continental. Inflation cooled, and like so many other prices, the cost of silver actually tumbled, falling from $34 an ounce in February 1980 to just $11 the next month. Today, it is $5.80.

Despite the immortal failure of the Hunts, hundreds of thousands of investors continued to manage their money as if inflation were preordained. They leveraged themselves with debt, secure in the conviction that inflation, which allows a debtor to pay off his creditor in cheaper dollars, would make them winners. Farmers were KOed as the average value of farm land fell by half, from $1,053 per acre in 1979 to $564 in 1988 (in constant dollars). In Grapes-of-Wrath fashion, the farm-credit system collapsed, and the sight of a farmer auctioning off his tractor and his memories became commonplace. To stem the destruction, direct government payments to farmers soared 1,300 percent from $1.3 billion in 1980 to $17 billion in 1987.

The unexpected collapse in the price of farmland, energy, and precious metals, together with the Fed's high interest policy, helped push the country's savings and loans into bankruptcy. There are many villains in the S&L crisis, but one that is rarely fingered is the fear of inflation. The S&Ls had shoveled loans out the door—convinced that asset values could only rise. Today, of course, their enormous miscalculation could cost us more than $100 billion.

The point here is that the fear of inflation has consequences as real as inflation itself. These days those fears have found their focus: Alan Greenspan, chairman of the Federal Reserve Bank. It seems that every

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day there are new calls for him and the Board of Governors to raise interest rates, even though the rates rose a full 3 percentage points last year. In late February, *The Washington Post* expressed doubt whether Greenspan "has done enough" by raising rates; Robert Samuelson of *Newsweek* has sounded the alarm for higher rates in three columns. (On April 12, his column in the *Post* was headlined "The Case For a Recession.") And Greenspan seems to be heeding the call. He's already indicated that he's inclined to tighten the reins—a move that could throw people out of work, crush more businesses, and revive all the horrible scenes of the early eighties, when the recession (hard as it may be to remember for those who have prospered) ruined many lives.

(Of course, high interest rates do cheer some, especially people with a lot of cash stashed in money market funds and, perhaps, foreigners who buy our Treasury bills. As a percentage of total budget outlays, net interest paid by the federal government rose to 14 percent in 1988 from 7.7 percent in 1978. In 1964, it stood at 6.9 percent. In 1987, interest payments on the debt totaled $139 billion, a sum almost identical to the budget deficit.)

It's become conventional wisdom that higher interest is just the dose of castor oil the economy needs. A recession now, so the thinking goes, will prevent inflation later. But suppose these latest fears of inflation are exaggerated, just as they were for the farmer who borrowed himself into bankruptcy, or for Bunker Hunt. If that were the case, then high interest rates would be more like poison than chemotherapy. Obviously, we need to be mindful of inflation, but a look at some of the scares of recent years will be enough to make one very skeptical of those who cry wolf.

Quench the flames

But, first, a couple of basics. It is the fear of the economy overheating that has led so many people to look to the Federal Reserve as a savior. According to the standard reasoning, as the economy grows, the demand of consumers outstrips the capacity of the economy to produce goods. Bottlenecks snag production. Labor shortages sprout up. Prices rise. Wages rise to keep up with prices. And on it goes into the infamous "wage-price spiral" that was on everybody's lips a decade ago.

Enter the Federal Reserve. It's supposed to be *the* inflation-buster. While it cannot decree what interest rates will be, it has several levers it can use to raise and lower them. If the Fed pushes up interest rates, then the economy pulls over into the slow lane—business will be less inclined to borrow and expand; likewise, consumers won't buy. A slow economy quenches the flames of inflation. When the price rise hit in February, virtually every paper in the country ran a story saying that the Fed needed to step in. Everyone quoted in the *USA Today* and *New York Times* stories following the announcement of the January inflation figures exhorted the Fed to raise rates still higher. In March, headlines in papers as different as *The New York Times* and *The Washington Times* sounded the alarm. "Rate Rise Expected from the Fed," *The New York Times* proclaimed, "Economists Can See Little Choice After Surge in Price Index." Washington's conservative daily echoed those fears: "Interest rates must increase to beat inflation—economists."

But there is no reason to worry so. Economic growth per se does not cause inflation. Time and time again, the American economy has proven it can meet demand. Look past the 1970s to the rest of our history. Between 1800 and 1940, the U.S. economy grew tremendously. Yet, in 1940 the wholesale price level was the same as in 1800. Taking shorter periods, statistics from Robert Barro's *Macro Economics* show an average annual growth rate in real GNP of 4.6 percent for the period 1840-1900—a hot performance. During this period, which includes the Civil War and the rise in prices that almost always follows wars, the inflation rate fell. The post-Civil War period until 1900 was an era of rapid expansion in real output accompanied by price deflation. In the 1920s output rose *and* prices fell. Besides, other countries, such as Japan, have faster rates of growth and less inflation.

It used to be that liberals understood this, but somewhere along the way liberal values underwent a transformation. Massive unemployment, bankruptcies, and the destruction of wealth ceased to be evils to avoid and became praiseworthy. It was astonishing to watch *The Washington Post*'s Hobart Rowen and *The New York Times* editorial board defend Paul Volcker's record and demand his reappointment.

Why have the views changed? A cynic might suggest that the interests of liberals have changed. Today liberals are part of the bond-holding class that fears, more than anything else, inflation. (Since bonds pay a fixed rate of interest, bondholders dread inflation.) For their part, conventional Republicans fear that the budget deficits will yield killer inflation. Liberal Keynesians fear that growth will inevitably be followed by inflation. And the experience of the rise of inflation in the seventies left many thinking that high interest rates are the only cure.

Frightened out of its wits

Whatever the reason for this shift in attitudes, killer inflation has been sighted more often than killer bees. And each new sighting proves equally absurd. Look at the banks. Back in 1982, as the Third World debt crisis peaked, foreign governments pleaded with Volcker to ease up on interest rates. The chairman finally relented, believing that the worst recession since the thirties had broken inflation and that continued high rates threatened the stability of the Third World and the large banks that are its creditors.

Amazingly, the banks still expected high inflation. The expectation of renewed inflation caused them to delay for several years any realistic approach to their loans to Latin America and Africa. Bank economists, egged on by weekly apocalyptic pronouncements by Reagan's budget director, David Stockman, assured their bosses that it would only be a matter of time before the prices of oil, copper, and raw materials in the Third World soared, making it possible for countries like Mexico to pay back the loans. Obviously, that inflation never materialized and the Third World remains mired in debt.

In retrospect, the banks should have built up their reserves in order to deal with the loans. But the belief that reflation was just around the corner caused creditors and debtors to dig themselves in deeper, thus delaying for some years the recovery of the Third World from the Volcker recession of 1981-82.

Just Take This Medicine

We agree with Paul Craig Roberts that the danger of inflation is widely overestimated. But that doesn't mean there aren't steps we can take to make sure that it does not become a serious threat to our economy. Pushing up interest rates, as the Federal Reserve Board has been doing, is *not* the right step. If the Fed continues along this path, a recession is practically certain. Why risk such an unhappy result when, instead of using the blunderbuss approach of higher interest rates with the overkill of the economy that they usually provide, we can take specific actions aimed directly at the *causes* of inflation?

The major cause of double-digit inflation in twentieth century America has been specific shortages of things people want. The inflation of the late 1940s was due to the shortage of consumer goods at war's end. As the economy got back on a peacetime footing, inflation abated. Interest rates didn't have to go sky-high; in fact, in 1948, as inflation cooled, the Fed's discount rate was 1.5 percent.

The problem with shortages held true in the 1970s, even as lots of people tried to place the principal blame for inflation on something else. Liberals pinned the blame on LBJ's escalation of the Vietnam war. Monetarists fingered Arthur Burns, Nixon's Federal Reserve chairman, who sped up the money supply in time for the 1972 election. Other culprits were the rise in wages of auto workers—and those in other industries—without increases in productivity and the 1973 wheat deal with the Russians, which drove up prices by reducing domestic supply.

All these things did, indeed, contribute to the inflationary spiral of the time. But the biggest culprit was a shortage—a shortage of oil brought on by OPEC, which we can thank for a 26 percent price hike in 1973-74 and a 56 percent boost in 1979-80. (Not surprisingly, the only years other than 1946-47 that inflation actually went into double digits were 1974 and 1979-1980.) Because the price of domestically produced oil followed OPEC's lead, the fact that we imported less oil than, say, Japan was of no help. Indeed, the OPEC hike was particularly inflationary in America because we guzzle far more oil than any other country on earth.

Since the main cause of the higher prices of recent months has once again been OPEC, oil prices should remain our primary target. How can we persuade OPEC to be reasonable? One way is to sell oil from our Strategic Petroleum Reserve to keep prices down and stem panic caused by shortages like the Valdez incident. Another way is to enact standby gasoline rationing authority, and make it clear that we will use it if prices get out of line. Because we consume so much of the world's oil, the prospect of a sudden reduction of demand through rationing should have a sobering effect on the oil-producing nations. And they are not unaware of the danger that too high a price will decrease demand, as it did in the early eighties. Their concern was enough to prompt this story in *The New York Times* of March 29: "OPEC Wants Its Prices to Stay Under a $20 Top."

The budget deficit is an obvious and often-cited cause of today's rising prices. Here are others and what can be done about them:

► **Medical costs.** In marked contrast to the mostly single-digit inflation we have been experiencing through most of this decade, Medicare payments to doctors have been rising 17 percent per year. Fourteen billion dollars is wasted each year on unnecessary surgery. The answer in both cases is tough regulation of doctors rather than higher interest rates.

► **Trade barriers.** Tariffs and quotas can be a good thing—a way of helping an industry that's on the mend. But too many barriers protect inefficient industries and keep prices high. Hobart Rowen recently made a convincing case against steel quotas that effectively limit imports to 20.2 percent of U.S. consumption. Because of those quotas, steel prices increased

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