4

SUMMARY

The Psychosonomics of Rising Prices

H.A. Turner

Explanations of inflation can be divided into two broad classes: "monetarist-expenditure" and "structuralist-social". The first variety views persistently rising prices as essentially caused, in simple or complex ways, by a maladjustment of the supply of money or credit to the supply of goods: even if an inflation is not actually caused by an excessive flow of money, supporters of such views often argue that it could be cured by adequate monetary or fiscal restraints. The second variety regards inflation as a more fundamental symptom of economic and social imbalance: shortages of key goods (such as food or labour) or quasi-monopolistic situations (like strong union wage controls or oligopoly in the supply of goods) force up certain prices: the result is not merely a readjustment of relative wages or prices, but a reallocation of income between social groups; those left behind struggle to keep up, which leads to inflation, and this may extend or accelerate as still other groups react. The favourite prescription of advocates of these views is some kind of incomes policy, perhaps coupled with radical economic reconstruction.

There is something in both types of opinion: we must, however, distinguish between the original causes of inflation, which may no longer be relevant, and the mechanism which keeps it going. The argument here is that this mechanism has assumed an existence independent of inflation's "first cause", and that it now involves not merely economic factors but complex social and psychological ones. (Hence the title). Moreover, both main groups of theories are defective in the major respect that neither accounts for an important fact.

This is that the average annual inflations of individual countries are not spread over a spectrum of rates, from "low" to "hyper", but fall into two distinct clusters. One group of national rates centres around 3% (of course, with fluctuations from year to year); the second cluster tends to average 30% a year, with very much greater variations in annual experience. Existing theories do not explain why inflations should occur (over a quite long period) at just the rates they do; but these clusters are an important clue to the nature of inflation.

2185

The first cluster (which can be called "normal" inflations) might be explained by a tendency for wages in the major branches of faster productivity growth (say, around 7% a year in industrial economies or the modern sectors of less developed countries) to rise in line with productivity. However, wages in other branches then tend to rise at the same rate, which is above their productivity increase, so prices there increase. If average productivity growth is 3½% a year, but the growth rates of individual major sectors are normally spread between 0 and 7%, then average prices will also go up at 3½% annually. This is, of course, not the only force in inflation: for instance, there are world cycles (like the recent upward swing) and "political" cycles in individual countries. But this system (plus the effects of international competition) would explain why most countries vary around the lower, 3% rate of price increase.

The second cluster of countries (mostly South American) suffer from unstable or "strato" inflation. Whatever its original cause - which might have been monetary or structural - inflation has at some time been carried to the point at which there is obvious and severe deprivation of major social groups. These groups then organise in their own defence, or to recover their former position. The result, however, is that the inflation accelerates further, to the point at which the adjustment mechanisms that different groups have established can't work fast enough. (This appears to be about the 50% level of inflation). There is a panic, and people are prepared to accept very severe measures, which slow down the inflation at a high social and economic cost. But there are always groups which feel cheated when the crisis is over, and no organised or powerful group will now accept an income increase which does not include some protection against the chance of revived inflation. This minimum figure seems to be about 10%. This makes a new inflationary upsurge inevitable, and the swing of prices between the 10% and 50% rates produces on average inflation of 30%.

A main difference between "normal" (or equilibrium) inflation and "strato-inflation" is that under the first type social conflicts are mainly about the distribution of the increment to the real national income resulting from productivity growth. Under the second type, however, there are large reallocations of existing real income between social groups, so social conflict becomes much more severe. Once a country has moved out of the "normal" range of inflations, it tends to move up rapidly into the "strato" level, and it becomes almost impossible - not merely economically, but politically and socially - to get back again.

Implications for policy include the following. First, that it has been mistaken for most national "incomes and prices policies" (or whatever they have been called) to concentrate mainly on wage restraint; if price stability is to be achieved, prices in branches of faster productivity growth must come down, which means an active price policy is also essential. Second, that an effective anti-inflation policy must pay a great deal of attention to social equity, which is unlikely to be achieved by wage policy alone. Third, that repeated currency devaluations, floating exchange rates, "crawling pegs" and the like may appear to relieve the major national economic difficulties induced by inflation, but they create social and psychological tensions which may make the inflation worse.

Cambridge, U.K.
May 1971