

# Re-evaluation of the Cost-Push Theory of Inflation and the Monetary Environment

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- I. General Meaning of Wage-Price Spiral
- II. Evaluation of Cost-Push Inflation Theories
- III. Appropriateness of Monetary Policy

The advent of the cost-push thesis of inflation has given rise to a controversy about the efficacy and appropriateness of restrictive monetary policy as a counter-inflationary weapon. This weapon enjoyed its greatest prestige during the time when the quantity theory was at the height of its glory. Critical attacks on this theory and the efficacy of monetary policy occurred, of course, even before the cost-plus thesis appeared on the scene. One of the most vigorous attacks was launched by *John M. Keynes* who focused his attention on the possibility that counter-cyclical monetary policy might fail because of **improper** response on the part of the business community to such policy. *Keynes* wrote from a depression vantage point and during a period when there were numerous attempts by the monetary authorities to life the economy out of the doldrums with the aid of **easy** money. For *Keynes* it was the so-called **liquidity trap** that could spoil the success of the expansionary attempts of central banks. Since World War II, however, the nature of the monetary problem has changed from a fight against depression and deflation to a struggle with the forces of more or less chronic inflation. It is in this postwar economic climate that the cost-push theory gained a foothold among monetary theorists. This explanation of inflation is based on a strongly modified view of the pricing mechanism. Instead of basing their inflationary analysis on a system of competitively flexible prices---and hence, on a price level which is **passive** in the sense of being determined by the monetary climate---they operate on the assumption of a system of "administered" prices in which **autonomous** price-level changes (i.e., changes not induced by variations in the money supply) can and do occur. Needless to say that the resultant attack on the quantity theory spilled over into the area of monetary policy and reopened the question of the appropriateness of restrictive monetary policy as a weapon against undesirable price-level behavior, this time the accent was on the prevention of inflation rather than deflation.

The purpose of this paper is to re-evaluate the validity of the cost-push inflation theory with a view to deriving inferences for practical economic policy formulation. For analytical purposes the study is divided into three parts;

1. General Meaning of the Wage-Price Spiral.

2. Evaluation of the Cost-Push Theories with Subdivisions:
  - a. The Unqualified Cost-Push Thesis.
  - b. The Qualified Cost-Push Thesis.
  - c. Other Cost-Push Thesis.
3. The Meaningfulness of Monetary Policy.

### I. General Meaning of the Wage-Price Spiral

It has recently become the custom to refer to inflation as the wage-price spiral. At first glance, this phrase appears to be a revealing and extremely potent substitute for the word inflation, because it seems to be suggestive of its underlying causes. It is nevertheless well to keep in mind that this new term actually amounts to nothing more than a juxtaposition of two economic variables without indicating which of these two is the **active one**. At best, the term is suggestive of interaction between two undoubtedly important economic phenomena. It goes without saying that a rapid expansion of the supply of money, or its velocity, is bound to involve an increase of both prices and money wages. It should also be obvious that the wage-price spiral is compatible with both basic causation hypothesis of inflation, namely the cost-push and the demand-pull theorems which are currently discussed. In fact, we may say that in regard to these two theorems the term wage-price spiral is totally neutral. It is a truism, like the exchange equation.

Hence, if the term is to gain special meaning, it must be specifically related to either one or the other of these rivalry hypothesis. This has been done by various writers. One of the most representative of those writers who relate the term wage-price spiral to the cost-push hypothesis is *Sidney Weintraub* who maintains that the high-wage pressure of modern labor leaders furnishes what may be called the **engine** of inflation.<sup>1)</sup> His sharp critical attack on the *Fisherian* exchange equation heightens the impression that he rejects the demand-pull inferences which are usually associated with the use of that equation. Although such inferences do not follow with logical necessity, it is in a fact that the exchange equation draws attention to the quantity of money, and hence to the subject of the monetary authorities entrusted with the manipulation of the supply of currency and bank deposit money. In this sense, the question of **easy** or **tight** money comes to the fore, and along with it the question of whether or not there exists a demand-pull. Considerations of this type are exactly the ones which *Weintraub* and other critics of the exchange equation regard as inadequate--- a blind alley that fails to pose the problem of inflation fruitfully. The cost-push theorists argue that the problem of inflation must be studied from the viewpoint of a **production economy** rather than an **exchange economy**. In other words, the genesis of inflation lies in the sphere of production, and it is here, particularly in the area of wage negotiations, where the proper approaches to the analysis of inflation can be made.

1) Sidney Weintraub, *A General Theory of the Price Level, Output, Income Distribution and Economic Growth*, Chilton Co., 1959,

## II. Evaluation of the Cost-Push Inflation Theories

### a) The Unqualified Version:

This theory claims that inflation is caused by money wages increasing at a greater rate than that of productivity. The validity of this theory rests on the proof that wage rate increases produce commensurate increases in total aggregate demand<sup>1)</sup>.

One possible answer to the enigma of why excessive wage increases have not produced unemployment is the aggressive union leaders, using the power of their positions to insist upon, bargain for, and obtain higher wages for their members. Industries, seeing their profit margin squeezed, have raised prices to restore profits to their previous levels. The basic force behind the inflation is, nonetheless, excessive wage increases, with industry playing a passive or defensive role in this sequence of events. *Keynes's* assumption of neutrality of money wages, a pure cost-induced (wage) inflation is compatible only with an aggregate demand for labor function that is perfectly inelastic. Assuming initial full employment, wage rate increases produce commensurate increases in total effective demand, and the level of employment is absolutely unchanged, but the level of commodity prices has risen as a result of the wage plan. Total employment is thus completely insensitive to either increases or decreases in the general level of money wage rates. In other words, the sole result of the wage push is inflation and nothing more.

This *Keynesian* proposition is at variance with the classical position according to which the demand for labor is sensitive to movements of the level of wage rates. The result of the wage push is a loss of employment which will be the more severe, the more elastic the demand schedule for labor.

But, this *Keynesian* proposition is challenged because general money-wage changes can result in parallel changes of real wages by considering the possibility that the level of prices does not adjust completely to variations in money wages because the total effective demand for goods and services does not adjust completely to the wage changes<sup>2)</sup>. Therefore, we may find a situation where new investment demand would decrease due to the burden of a wage increase and result in the failure of total effective demand to rise in the same proportion as the general rise in wages. Such a situation, of course, would assume a negatively inclined function for the demand for labor.

Even if a rise in wages is economically justified and is financed by a shift of money income from profits to wages, it can be undertaken without inducing a rise in consumer prices only if the supply of consumer goods is increased to same extent as the increase in consumer expenditure. This may involve no great difficulty with moderate wage increases, which is to say, perhaps not more than five per cent in the course of a year. If the rise in wages is accompanied by an equivalent reduction of the expenditures of other sectors, and if allowances are made for

1) L. E. Gallaway, "the Wage-Push Inflation Thesis, 1950-57," *American Economic Review*, December, 1958, pp.48, 967-72.

2) William Fellner, "Employment Theory and Business Cycles," in *A Survey of Contemporary Economics*; Ed. H. Ellis, Vol. I, p.78.

additional savings by the wage earners, it will be possible to meet the increased demand by a diversion of consumption goods from nonwage earners to wage earners, by drawing down inventories, and by changes in the pattern of inputs.<sup>1)</sup> In the long run, apart from the effects of productivity on supply, the restoration of real wages to an appropriate level will require some shift of productive resources to consumer goods industries. In contrast to this adjustment that an economy can make to a moderate wage increase, there is no way by which production can be rapidly shifted to match the increased consumption expenditure that accompanies a massive rise in wages.

Apparently, during a period of rising prices the consumption of wage earners is maintained by drawing down cash balances, by running into debt and by using durable goods purchased during a previous period of relatively high wages. After a massive wage increase, the higher wages are used to restore cash balances, to repay debt, and to buy durable consumer goods to be used for a considerable period in the future. The actual level of consumption varies much less than the level of wages relative to prices. On this point *Warburton* states, **When business and individuals find their cash balances shrinking, they attempt to conserve them; when they find their balances growing at an unusually rapid rate, they use them more freely<sup>2)</sup>**. Therefore, an excessive increase of wages will increase total effective demand, but somewhat less proportionately than wages and prices have risen. The final result therefore is some degree of unemployment.

Now, let us return to the monetary environment. If the supply of money is constant, that is both the quantity of money and its velocity are unchanged, the result would be unemployment as there is no monetary means of paying the higher wages. Such unemployment would distribute itself throughout the economy depending upon the elasticity of the demand for the products of those firms granting the initial excessive wage increases.

If a firm enjoyed a perfectly inelastic demand schedule, it would realize no decline in effective demand and the level of employment within its confine would remain unchanged. However, the increased amounts of money spent for its products would necessarily reduce the effective demand for other goods and the consequences of the wage and price increase would be transferred to them. On the other hand, if a firm has a perfectly elastic demand schedule, an increase in money costs which transferred itself to higher price would produce a halt to the purchase of that firm's goods by consumers, and the substantial labor force of that company would become unemployed. Actually, since there is some elasticity of demand for all products, the unemployment effects of wage-price increases would be shared by the firm granting those increases and also by the remainder of the economy.

There must be then, at least implicitly, in the arguments of the unqualified wage push inflation theorists, some considerations given to a modification in the existing monetary environment if the unemployment effect of excessive wage

1) See, for example, Harold M. Levingston, *Unionism, Wage, Trends, and Income Distribution*, Ann Arbor, 1951, pp.65-79.

2) Clark Warburton, "The Misplaced Emphasis in Contemporary Business-Fluctuation Theory," *The Journal of Business*, 1946, pp.205-206.

increases is not to take place.<sup>1)</sup>

b) The Qualified Cost-Push Version:

Theorists following the classical assumption concerning the shape of the demand for labor schedule recognize the fact that if aggressive unions gain wage increase greater than productivity, the final result will be some degree of unemployment. However, the unemployment caused by a wage-push could be offset by the automatic income-supporting response by government.<sup>2)</sup> This possibility is referred to as the **qualified** wage-push inflation thesis. The meaningfulness of the qualified theory depends, therefore, upon the existence of a binding offsetting program.

As far as the United States economic policy is concerned, there is no absolute binding responsibility to maintain full employment. We have had large government deficits in the fifties, but it is far more reasonable to assume that government deficits were primarily for national security. The recessions of 1953-54, 1957-58, and 1960-61, together with the substantial unemployment which accompanied them, indicate that the government was not committed to an unmitigated full employment program. These recessions were characterized chiefly by contraction of business inventories, combined with the reduction of federal purchases for national security. Nevertheless, the defense expenditures did support employment, but this fact has nothing to do with the issue at hand.

Given some deficit financing, it is easy to see the increase in aggregate demand as being a result of loan-financed government expenditures since there exists increasing power in those sectors of the economy which initially received the increased payment from the government. Although the deficit in question may have nothing to do with a deliberate effort by the government to maintain full employment, the *de facto* result is that employment will benefit from it. Naturally, there will be effects not only from the original spending by the government but also by the subsequent rounds of private spending in accordance with the familiar multiplier principle.

Also, since the adoption of a flexible credit policy following the Treasury-Federal Reserve Accord in 1951, the total of loans and investments of commercial banks increased more than the gross national product, measured in current dollars, and faster than the real gross national product.<sup>3)</sup> Thus, credit expansion in the period of 1951-1960 accelerated faster than the actual requirements of the economy. On the other hand, the Federal Reserve System's stepping up of its

- 1) Theorists who recognized this answer that absolute control of the MV function of the equation of exchange is virtually impossible in the economy today. See Fallaway, p.1037. They state that they are inherent within the system of forces which could and do provide the monetary means of fulfilling this theory. This point will be further discussed in the latter part of this study.
- 2) According to Gallaway. op. cit., p. 970, "Federal expenditures increased from \$39.6 billion in the fiscal year 1950 to \$69.3 billion in the fiscal year 1957. In the aggregate these expenditures totaled nearly \$500 billion in the period and exceeded receipts by some \$17 billion."
- 3) See Federal Reserve Board, Annual Report of the Board of Governors. 1950-1962, and also, Federal Reserve Board, Federal Reserve Bulletin. 1950-1962, and Economic Indicators, October 1963, p.31, published by U.S. Government Printing Office.

tight money policy in May, 1958, and toward the end of 1959 was followed by the recessions of 1957-1958 and 1960-1961.<sup>1)</sup>

c) Other Cost-Push Theories:

In addition to the aforementioned versions of the cost-push inflation thesis, there are many other versions to be found in the current literature. These differ from each other partly by the type of cost which they single out as being the dynamic elements of cost-push. Aside from the wage-push theories, we find theories dealing with higher taxes, higher tariffs, and higher overhead costs as potential causes of inflation, all of which are considered of a rather long-run nature. Since, however, the wage-push version has received so much attention than any of the others, it shall receive our concentration here.

(i) *Weintraub's* Theory (Quasi Cost-Push Theory):

Studies of *Weintraub* can be viewed as an attempt to demonstrate that his theory on reality conforms to the *Keynesian* theory of wage rate neutrality. Using the information contained in the comprehensive national income statistics of the United States Department of Commerce covering the last few decades, he emerges with the conclusion that the general level of industrial prices varies in close relationship with changes in the money-wage rates which are not offset by corresponding increases in productivity.

His empirical study appears to prove that the level of prices is a function of the producer's **make-up** as against labor cost times money wages divided by the average product per worker<sup>2)</sup>.

$$\begin{aligned} Z &= kwN \\ PQ &= k wN \\ P &= kwN/Q = kw/A = kR \\ w/A &= R \end{aligned}$$

The sales proceeds ( $Z$ ) are equal to some multiple ( $k$ ) of the wage bill, that is, of the money wages ( $w$ ) times the volume of employment ( $N$ ). The symbol  $Q$  will denote physical output while ( $A$ ) will signify the average product per worker, so that  $A=Q/N$ .

He proceeds to formulate a law in terms of the proposition that the price level varies in strict proportion with changes in  $R$ . In short, an increase in  $R$  will produce and has produced in the past, a closely proportionate increase in the level of prices.

*Weintraub* is aware of the fact that a rise in  $R$  cannot translate itself into an increasing price level without a corresponding increase in total effective demand unless, of course, total employment and output were to fall. He also realized that a fall in employment and/or output generally is not conducive to a

1) *Ibid.*

2) *Weintraub*, op. cit., pp. 9-10. Also see A.P. Lerner, "On General Theory," *American Economic Review*, March 1960, pp. 1127-1131. What *Weintraub* fails to perceive is that his magic  $K$  is a constant in both directions. That is, it cannot only translate increases in the  $W/A$  function into prices, but also can convert price increases into wage increases. Just as  $P$  can be predicted from  $W$ , if  $K$  is constant,  $W$  could be predicted from  $P$ . *Weintraub's* analysis, as he presents  $K$ , may be applicable to the inflation in question, but this important modification must be considered.

price inflation even in an environment characterized by administered prices, although a combination of falling employment and rising price is not possible under these conditions.

He rejects the view that a tight-money policy operating through the supply of loanable funds to business can directly prevent money wages from increasing. To support his criticism of this view, which is so familiar from writings of the quantity theorist, he draws a distinction between a **direct** influence of tight money and an **indirect** influence. Subsequently, he proceeds to deny that tight money policy exercises a direct influence on level of money wages, whereby he adds that it is precisely a direct influence that the quantity theorist has in mind. According to him, tight money policy could only have an indirect influence on the level of money wage rate. The gist of his argument is well presented in the following passages:

**Without ample funds business firms will curb labor hire and reduce their output. They can pay a higher wage per man to those who remain employed —if they are pressed by market forces to do it.**

**Any business, no matter how limited its funds, can always pay some men more by dismissing other employees.**

**I conclude that this argument that restrictive money supplies directly reduce money wages is based on a fallacy, pure and simple. The *modus operandi* of monetary policy is different. Its influence is on Q and in this way, on W (total wage bill). The path has been claimed.....**

**Operating on M (quantity of money) carries its punch on the roundabout, obliquely rather than directly.<sup>1)</sup>**

Weintraub's admission that a tight money policy is bound to have a curbing effect on employment, output, price level, and wages—however indirect the effect may be—is very significant. It shows that he, too, is of the opinion that the wage-push cannot translate itself into a rising price level unless there is an expansion of total effective demand which, in turn, depends, in his own view, upon the expansion of the quantity of money. For those economists to whom the importance of the monetary factor does not hinge upon the validity of the naive notion that the M of the equation of exchange is always the independent or active variable and the related notion that only a change in M has a direct influence on P, the position of Weintraub on the significance of a tight-money policy is hardly a heresy. In fact, the above passage of Weintraub is bound to suggest that his wage-push inflation thesis is only a *quasi* cost-push theory. The criterion of the true wage-push theory is that no questions are raised concerning the monetary climate.

However, there is every reason to believe that if tight money does have any effect on inflation, then it is not unreasonable to assume that the effect would be felt initially at the bargaining table in the restraining of wage demands. There is as much justification for this view as there is in assuming that a decline in prices and wages must come only after a general decline in employment and output. Equally, if collective bargaining is not affected by credit restrictions,

1) Weintraub, op. cit., p. 76.

there is no special reason to believe that higher wages and prices must be affected by the following recession, under the given assumption.

One of the characteristic features of *Weintraub's* theory is that he dismisses the equation of exchange and particularly the velocity concept, as a worthless analytical tool. By contrast, let us now turn our critical attention to those cost-push theorists who emphasize the velocity of money in their reasoning.

(ii) The Automatic Velocity Income Version

According to this view, cost increase of any sort can be the engine of the inflation, but the price spiral consequences are actually made possible by increases in *M* or automatic increases in the velocity or both. For them, obviously, there must be an automatic upward shift in velocity when money supply is constant, but the validity of this doctrine rests on the proof that wage-cost increases, in time of restrictive monetary policy, are automatically translated into an increase in velocity, and the direct result of such a mechanism is price inflation.<sup>1)</sup> Unfortunately, no such proof has been forthcoming.

First of all, the velocity increases are presented as a direct and regular consequence of tight money, rather than merely as something which happened to take place in that mush discussed period of 1955 to 1959 during which, in the United States, velocity rose by 15 percent<sup>2)</sup>. The operational link between tight money and increasing velocity is said to be the tendency of rising interest rates to diminish the amount of privately held money, which previously satisfied the precautionary and speculative types of motive, in favor of earning assets.

However, this *Keynesian* assumption of the liquidity preference function with a varying rate of interest is only half of the increased velocity explanation. Funds which are potentially available for use must actually be used before velocity can increase and we must keep in mind the difference between an increase in velocity and a reduced liquidity desire. It is true that during the *era* referred to both of these factors occurred concurrently but there is no compelling reason to think that this must happen. The particular conditions which bring about this simultaneous and important effect involve issues more properly addressed, not as opponents of this doctrine, but as the contrary doctrine, the demand-pull theory of inflation.

We can better understand this need to examine demand by remembering that

1) R. T. Seldon, "Cost-Push Versus Demand Pull Inflation, 1955-1957," *The Journal of Political Economy*, February, 1959, pp. 8-19. On this point, Seldon presents six ways in which an increase in factor costs automatically produces an increase in either *M* or *V*. They are as follows:

1. Cost increases expand the stock of money.
2. Velocity of money passively adjusts to the needs of the community.
3. Cost increases have changed velocity of altering tastes. If increased labor costs have redistributed national income in favor of lower income group's whole income, velocity is high, the natural result is that the average rate of velocity increases.
4. Cost increases raise the velocity of change expectations.
5. Cost increases have raised velocity via higher interest rates.
6. Cost increases have raised velocity by expanding the volume of money substitutes.

2) See Johnson, *op. cit.*, p. 1034.

if employers yield to excessive wage demands, they do so only after having assumed that the nature of demand will be absorbed by the mark-up in prices. If these, then, are the requirements for an increase in velocity, they rest finally on entrepreneurial decisions and therefore cannot be considered **automatic** at all. This conclusion is not altered by the fact that there can be found examples of **automatic** velocity increases in industry under certain conditions of duress, due to contractual obligations, for example. To trace the potential role of the demand factor in adequate form is to approach the explanation of inflation in terms of entrepreneurial expectations.

Acquiescence in **excessive** wage demands, it should be noted that there exists a factor which acts to place an upper limit on increase in velocity. Managements view liquid funds as rather important tools and in times of tight bank credit may be very reluctant to permit a decrease in these funds for various reasons connected with sound management and with the image of sound management. Therefore, a moderate tight-money policy maintained over an extended time period can eventually restrict effective demand once this upper limit is met, and thus have an influence on inflation.

(iii) Ineffectiveness of the Central Banking Restrictive Efforts Because of Institutional and Political Considerations.

This school of thought asserts that the central bank could effectively curb inflation if a certain amount of unemployment were accepted as the necessary price. Unfortunately, society has an extremely low tolerance for even minimal amounts of unemployment and it is because of this that monetary and fiscal policy suffers a severe political handicap. Proponents of this view take it for granted that unions persistently seek wage increases in excess of productivity. Rather than face the political implications of the unemployment that such demands would produce, the monetary authorities acquiesce, and monetary and fiscal policies which maintain high levels of output and employment, although they may be inflationary, are permitted. The result is creeping inflation of unending persistency.

There are economists who simply accept chronic inflation as a cost of full employment. The monetary and fiscal authorities would simply relax credit controls enough to permit a two to three percent annual increase in prices, and fight to hold the inflation within those limits<sup>14</sup>. This is related to the cost-push notion, at least in the sense that it is predicated upon the assumption of **excessive** cost (wage) increases. At the same time, however, it does emphasize that an expansion in total money demand is necessary to permit the wage push to generate inflation and such a monetary expansion has actually been permitted to take place in the period under consideration. This increases in total money demand, while not to be viewed in the sense of the quantity theory as the active variable in

14) Gottfreid Haberler, "Creeping Inflation Resulting From Wage Increases in Excess of Productivity," in *Problem of U.S. Economic Development*, Vol. 1, 1959, pp.137-147. Also see, James S. Dussenberry, "Underlying Factors in the Postwar Inflation," in *Wage Prices, Profit, and Productivity*, The American Assembly, Columbia University, June 1959, pp. 61-68.

the process of inflation, is nevertheless presented as a cause of inflation in the sense of a necessary condition.

Since an expansion of total money demand may not necessarily involve an increase in  $M$ , but could be brought about simply by an increase in velocity, it must be emphasized that the critics of the cost-push inflation thesis must reject the doctrine of the passiveness of velocity changes to changes in cost. Otherwise, their theories would qualify as the cost-push doctrine. Their argument must be that a tight money policy can offset the influence on total money demand of a rise in velocity.

To them, several possibilities exist as to why, in a certain historical period such as that of 1950-57, the general level of prices rose. First, government deficits obviously increased the money stock of the community although these deficits were not created for the purpose of maintaining full employment<sup>1)</sup>. Hence, for example, increased farm-price supports, or foreign aid, neither of which is in any way based on full employment commitments, provided the needed funds as adequately as if based on that commitment.

However, federal deficits for whatever purpose, are not essential for an expansion in the quantity of money. A lax Federal Reserve policy which permits the banking system to freely engage in increased circulation of demand deposits may be equally or totally responsible for the increase in  $M$ . The Federal Reserve, by not raising the discount rate, by not increasing reserve requirements, or by not aggressively engaging in the open market sales, permits member banks to maintain the potentials for feeding the inflationary fires, which are based on increased business costs. The failure of the Federal Reserve Board to effectively pursue a tight money policy can make just as great a contribution to inflation as any government deficit. Furthermore, if the Board acts only on  $M$ , rather than the  $M \times V$  function, the damage can be just as severe.

#### (iv) Inflation in the Administered Price Sector Can Well Become a Log-Rolling Type of Movement.

If excessive wage increases are granted to labor, prices may shortly be expected to rise also. However, the immediate effect is that wage earners realize at least a temporary increase in their real wages. Since they are individuals who generally have high marginal propensities to consume, it is logical to conclude that they quickly spend this additional increase for consumption goods. The effect of this is that unexpected windfall profits are accumulated throughout the economy. These become the bait of other unions whose wages have remained fixed while prices have been increasing. Consequently, they gain wage increases which then bring about further windfall profits. This process continues as an ever spiralling price rise as the original gains continue to circulate throughout the system<sup>2)</sup>. It must be asserted, however, that once again the monetary environment must be favorable to permit the original increase to proceed with the absence of unemployment. Within this assumption, then, the log-rolling process is possible.

1) Gallaway, op. cit., pp. 969-970.

2) A. G. Hart and P. B. Kenen, *Money, Debt and Economic Activity*, Prentice Hall, 1965, pp. 275-291.

There is some validity in the assertion that traditional quantity theory cannot explain today's system of administered prices. The reasoning is that traditional theory places its emphasis on the **passive** nature of prices and the **active** nature of the quantity of money variable, relative to the scale of prices. This fact, however, is not responsible for the concern about the importance of the monetary climate in connection with phenomenon of a general rise in the scale of prices. It is this question of the monetary climate with which our study is primarily concerned.

### **Appropriateness of Monetary Policy**

As our analysis of the cost-push thesis of inflation has shown, the charges of inadequacy of monetary policy has been made in several forms. In the extreme and least reasoned form, the question of the monetary climate appears to have been entirely forgotten. Cost-push stands for inflation, pure and simple. But even among its proponents who realize that a cost-push cannot translate itself into inflation without an expansion of either the quantity or the velocity of money, the value of a restrictive monetary policy as a preventive device has been seriously questioned. The charge of ineffectiveness varies between the argument that a tight money program is bound to be offset by the **passiveness** of velocity (automatic velocity increases as a direct result of monetary restrictiveness), on the one hand, and the argument that the influence of tight money is merely roundabout in the sense that it will first have to reduce employment before it can affect money wages and commodity prices, on the other hand. In either case, reliance on restrictive monetary policy as a counterinflationary weapon is held in low esteem, and it is not surprising that a search for better ways of checking inflation was going on in this camp.

In our critical evaluation of the cost-push thesis, we have attempted to show that both the hypothesis of velocity passiveness and of the roundabout nature of the tight-money influences on the price level are subject to serious analytical doubts. It has also been shown that the actual events of the fifties---including the remarkable episode of 1957-58 during which the economy experienced a combination of tight money policy, recession and continued inflationary tendencies---cannot be considered to furnish an empirical proof of the validity of the cost-push theorem, partly because of the half-hearted nature of the tight money policy itself, and partly because of the fact that substantial federal budgetary deficits occurred during these years. These years did not demonstrate that a determined tight-money program was able to check inflation. In other words, it would be premature to say that this remarkable combination of recession and maintenance of high prices has demonstrated the validity of the view that a system of **administered** prices is impervious to a policy of monetary stringency and that, therefore, such a policy is an inherently unimportant weapon under modern pricing conditions. This experience proves more against the degree with which the Federal Reserve System practiced tight money than it does against the potentialities of the weapon as such. Of course, if we look for the reasons why the monetary authorities were reluctant to use harsher controls, we quickly come up

with the political impracticability of such action due to the sensitivity to unemployment. This fact is pointed up somewhat by indications that tight-money policy has greater influence over output and employment than over wages and prices. In spite of the differences, however, in the practical application of a tight-money policy, no new and better method has yet come forth to cause us to consider it an obsolete tool of policy.

*Weintraub* has made an interesting proposal for the creation of a Federal Reserve Agency, which would take action of an educational nature when important wage negotiations come up. Their task would be to try and gauge the possible effects of agreements which would potentially be inflationary and to make public their forecasted effect on prices. In the light of this, both union and management would be influenced to reach reasonable decisions due to the possibility that Congress might be stimulated to take action. In short, **self-policing** of industry would be highly indicated inasmuch as it has been done in other industries.

Theoretically, this proposal is not without merits. Whether or not one agrees with *Weintraub's* theory that inflation is caused by wage-push is not so important. The fact is that here we have one of the most important areas of administered prices, and some form of control of this area would seem desirable in view of the tremendous concentration of private economic power which lies behind it. But, theoretically, persuasiveness is a far cry from feasibility. If monetary restrictive policy is hampered by political difficulties that prevent it from being applied with sufficient determination, how much more must the proposed methods of the direct government intervention with wage negotiations suffer from a political handicap?

Broadly speaking, to propose to substitute a direct control for an indirect one is a highly questional procedure unless we are willing to give up almost entirely the market price. This nation's whole economic and political tradition is one of private economic and political freedom.

*Weintraub's* proposal has merit only if the suggested procedure could work under the form of **voluntarism**, in the sense that the sheer presence of such a control **watchtower** agency would persuade union leaders and management to raise their sights in wage negotiations beyond the group interests and to abstain on behalf of the welfare of the entire nation from reaching agreements that have undesirable overall economic and political consequences. Until now, the results of voluntarism have not been sufficiently impressive to justify any hope that *Weintraub's* **watchtower** approach would become effective.

Consequently, this experimental suggestion by *Weintraub* cannot be considered as a satisfactory replacement for the traditional restrictive monetary policy since the political forces which prevent a more effective monetary do not seem to differ significantly from forces which would stultify direct wage legislation.

The only remaining proposal that has been made, is to strengthen the competitive features in our economy. The general idea would be to decentralize private economic power, on both sides of management and labor, sufficiently in order to prevent agreements between these two parties that cover too vast a section of our economy. Legislation providing the administrative machinery for this type

of approach is, of course, available insofar as the managerial side is concerned. What has been impossible so far is to bring organized labor under the anti-monopoly provisions of the **Sherman Act** and the **Clayton Act**. There are no signs that changes will occur in this respect. Broadly speaking, this type of approach is subject to the same kind of criticism that is applied to *Weintraub's* formula. Theoretically, it has its merits, but from a practical point of view, it is wanting.

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