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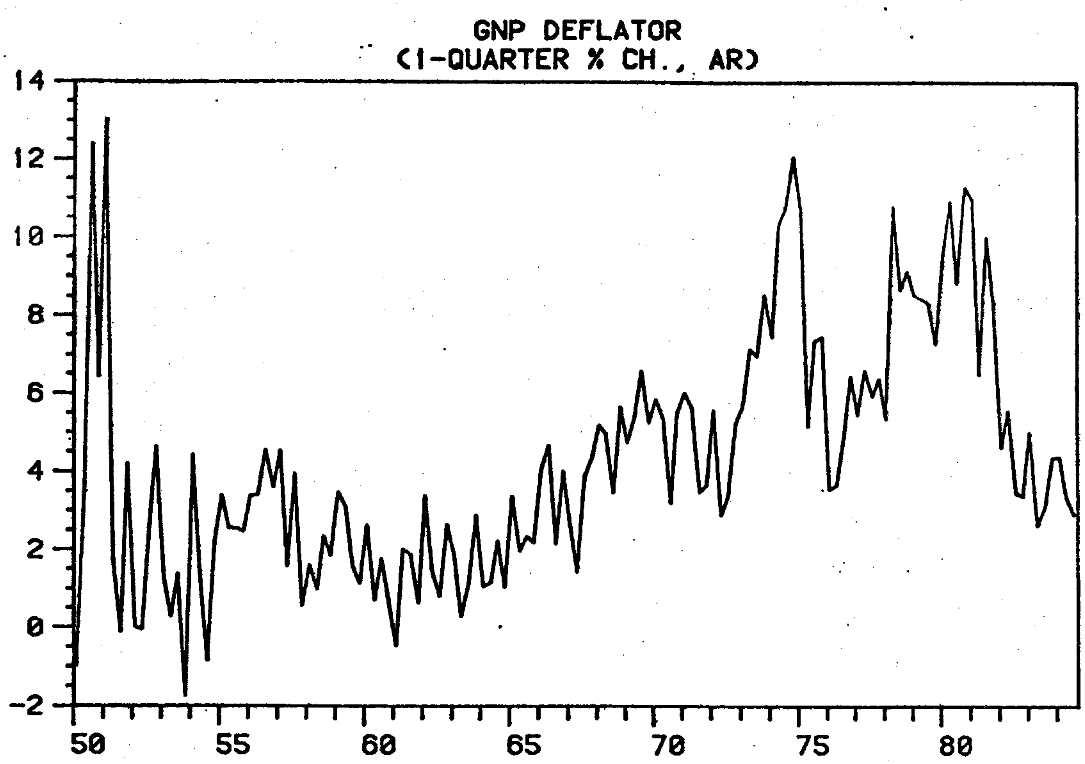
Fallacies About Current Inflation

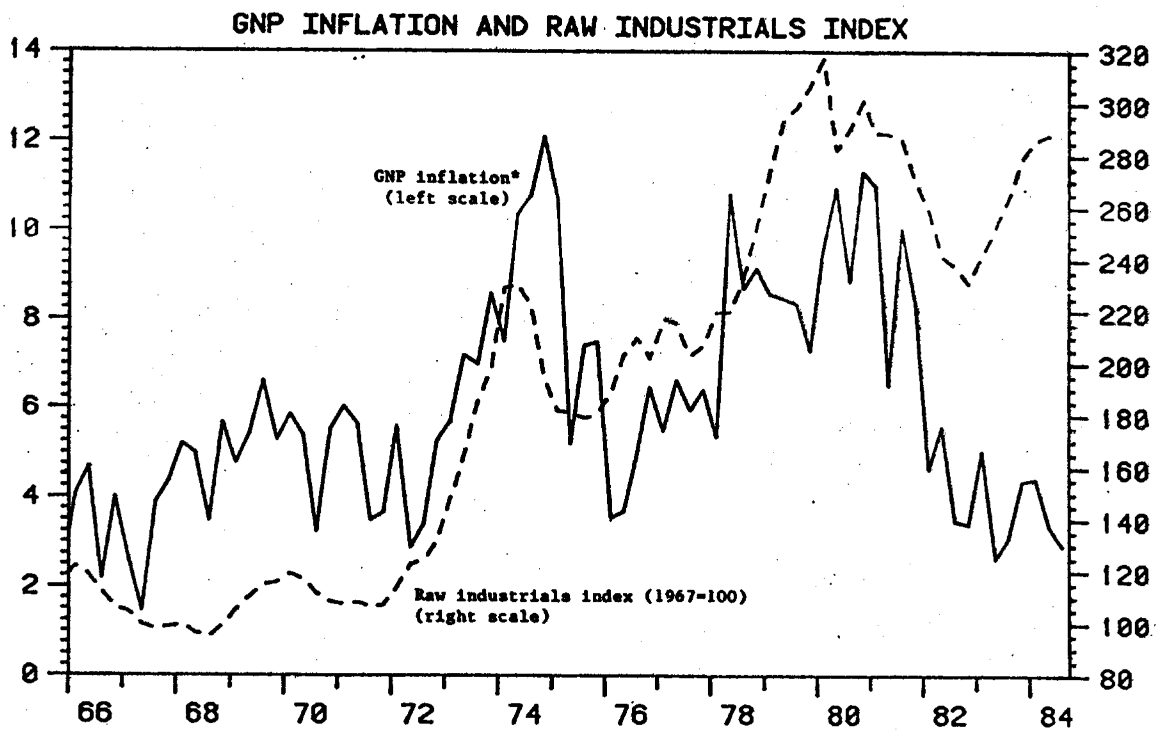
by Allan H. Meltzer

Two fallacies have received much attention this summer. One is that the U.S., or perhaps the world, is in imminent danger of deflation — defined as persistently falling prices. The other is that the decline in the prices of gold and a few selected commodities presage a decline in all prices — that the decline in gold and commodity prices is a leading indicator of future changes in all other prices and wages.

For the past six months, the most frequently cited index of prices paid by consumers, the consumer price index, has increased at an average annual rate of 4 to 5 percent. This rate is slightly higher than the 3 to 4% rate of increase in consumer prices during the six months before President Nixon ordered a freeze on prices and wages in 1971. The comparison between the two periods shows how much some people's perceptions about inflation have changed after nearly two decades of sustained inflation. A rate of inflation that in 1971 seemed so intolerable that many urged the government to impose price controls is now discussed as a forerunner of deflation. This is nonsense, plain and simple.



Inflation is lower than in the late 70's but inflation, not deflation, remains a problem. The fact that the prices of gold and some other commodities have fallen in recent months says very little about the future rate of inflation. At the start of the prolonged inflation in the late 60's, the index of spot market prices of raw industrial materials (base 100 in 1967) fell from a peak of 123 in March 1966 to 94 in July 1968. During the same period inflation rose; by mid-1968 the 6-month average rate of increase of consumer prices reached 5% for the first time since the Korean War. Between 1976 and 1978, spot market raw material prices rose by 33 percent while the rate of increase in consumer prices rose by about 1 percent. The index of sensitive material prices fell in at least one month during each of the years of rising inflation in the late 60's and most of the 70's. In three years the index fell, on average for the year.



* 1-quarter percent change (ar), GNP Implicit Price Deflator

These casual comparisons suggest what more careful analysis shows: there is very little relation between movements in either spot commodity prices or sensitive commodity prices and future movements of broad based measures of prices like the consumer price index or the GNP deflator. Predictions about future deflation based on a few months of falling commodity prices are unreliable.

The two fallacies about current inflation reflect two common errors in public discussion of inflation. The first is the failure to separate temporary changes that keep the inflation rate above or below its long-term average. The second is the confusion between individual price changes and the sustained changes in the rate of change of broad based price indexes.

Temporary and Persistent Inflation

The distinction between temporary and persistent inflation is always useful but never more than now. Currently, the true, "underlying," or persistent rate of inflation is about 1 1/2% higher than the rates that are currently reported. The difference arises mainly because the (trade weighted) exchange rate for the dollar rose by about 10% to 12% in 1982 and 1983 and again so far this year. The rise in the exchange rate holds down the dollar prices of imported goods and thus holds down the rate of increase of the indexes of consumer and producer prices. Dollar prices of imports rise by the average rate of increase in world prices minus the rate of appreciation of the dollar against foreign currencies.

Current estimates suggest that a sustained increase of 10% in the trade weighted dollar exchange rate lowers the reported rate of price increase by approximately 1.5% within the next twelve to eighteen months. This estimate implies that the annual increases in the exchange rate during the recent three years reduce the currently reported rate of inflation by 1.5%.

The effect of exchange rate appreciation on inflation is temporary. If the dollar stabilizes near its current value against other currencies, consumer prices will rise at a faster rate even if monetary, fiscal and trade policies remain on precisely the same path they are now expected to take. A stable exchange rate would remove the downward influence on consumer prices caused by the appreciation of the dollar. Domestic prices of imported goods would then reflect the average rate of increase in foreign prices. Since appreciation of the dollar reduces inflation by an estimated 1 1/2%, prices would rise by 5 to 6% instead of the 3 1/2 to 4 1/2% rate currently reported.

Notice that the dollar must appreciate 10% a year to keep currently reported rates of inflation 1 1/2% below the persistent rate of inflation. That's why it is best to regard the current rate of inflation as an underestimate.

If the dollar falls from its current perch, reported inflation will rise above its persistent rate, as it did in the late 70's or in 1980. Then, rates of inflation of 17% or 18% were reported. These rates were a mixture of persistent inflation of about 8 to 10% a year and temporary, one-time changes in prices resulting from oil price shocks and a fall in the dollar in 1978 and 1979.

The Lower Tail Theory

Journalists like to blame inflation on the prices that rise most rapidly. A typical report singles out the most notable price increase in a particular month and "explains" that inflation rose 4% because food prices rose by 8% or gasoline prices rose by 10%. Years ago Karl Brunner named this process "the upper tail theory of inflation" because inflation is blamed on the prices that rise fastest.

Recently, emphasis has shifted to deflation, so we now hear "the lower tail theory of deflation." Prices are falling because selected raw material prices or gold and precious metals prices are falling. Again this is nonsense.

The statement that prices are rising does not mean that all prices rise at the same rate. Even at 10% inflation, some prices may fall for a month or more. During the high inflation of the late seventies, prices of computers, microchips and a few other goods fell. Sensitive materials prices fell for at least one month during years when inflation rose rapidly. The fall in these prices, weighted by their share in the price index, did not prevent broad based price indexes from rising.

Inflation is a sustained rate of increase in a broad based index. Deflation is a sustained rate of decline. The lower tail theory of deflation confuses the reported decline in a few commodity prices with the movement of the broad based index.

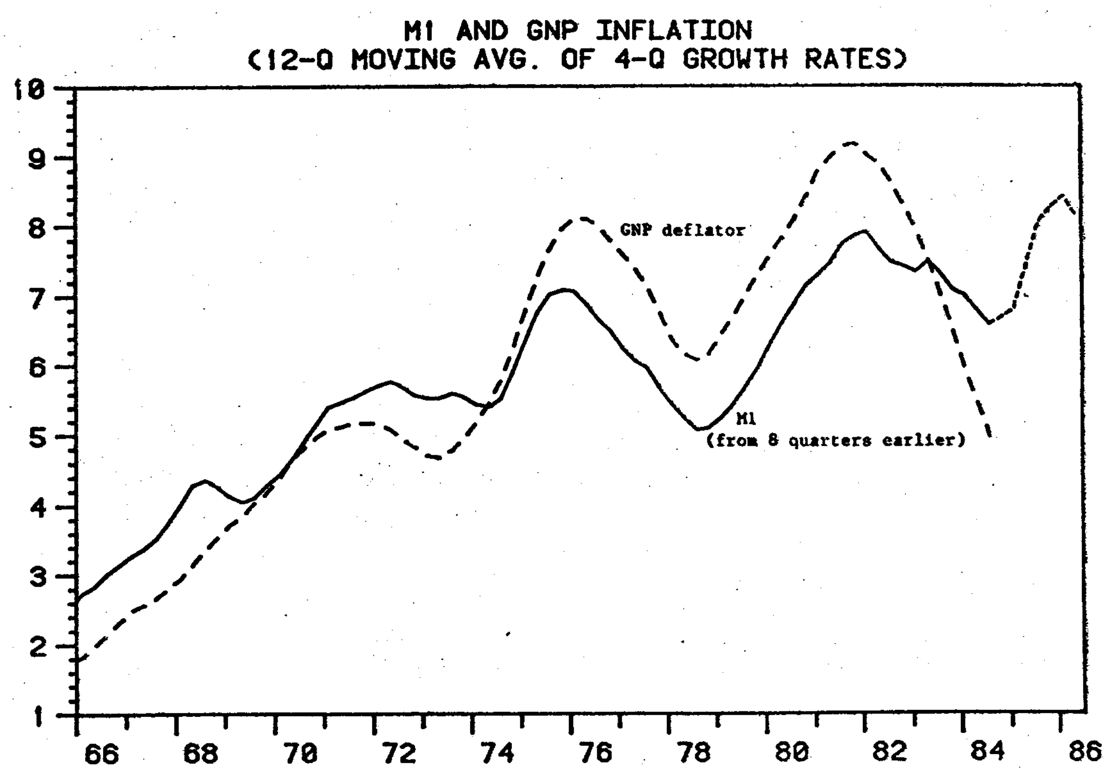
A final point concerns world wide deflation. It makes a great difference when viewing the prices of internationally traded commodities whether they are quoted in dollars or in foreign currencies. The price of oil is an example. The price is set, and quoted, in dollars. A decline in the dollar price lowers the price index in the U.S. and has a temporary effect on U.S. inflation. A decline in the price of oil may also strengthen the dollar by improving the terms of trade for the U.S. The price of oil in foreign currencies will rise if the effect of the appreciation of the dollar offsets the decline in the dollar price of oil.

Most of the world does not see the fall in commodity prices and cannot understand talk about deflation. Appreciation of the dollar against foreign currencies raises prices of imports quoted in dollars. Foreign governments' complaints about the strong dollar are mainly complaints about the price increases paid by foreign importers of raw materials. Exporters who compete with the U.S. in U.S. and foreign markets enjoy the benefits of lower prices, measured in dollars, for the goods they sell in competition with U.S. producers. They complain when the dollar falls, not when it rises, because a fall in the dollar is a temporary benefit to U.S. exporters and U.S. producers of goods that compete with imports.

Conclusion and Forecast

Prices are now rising more slowly in the United States and in other developed economies than at the start of the decade. Inflation remains a problem, currently, and for the indefinite future. Talk of deflation, or of the dangers of deflation, is nonsense.

Forecasts of Federal Reserve officials in their Mid-Year Review are that inflation will be 5 1/2% in the year ending in fourth quarter 1985. This forecast seems to me to be optimistically low by about 1 percentage point. It has its best chance of being correct only if: (1) the Federal Reserve keeps money growth (M1) near the mid-point of its projected range for 1985, about 5 1/2%, (2) the dollar remains near its current value, and (3) there are no major shocks to oil (or other commodity) prices.



At 5 1/2% inflation prices double every thirteen years. This prospect seemed so intolerable only slightly more than a decade ago that many of the participants in financial markets, and many others, believed price and wage controls were needed to keep inflation from getting out of control. Now that we have experienced much worse, 5 1/2% inflation seems tolerable to many. But, it should not be.

Our goal as a nation should be price stability by the end of this decade at the latest. Price stability means that the persistent rate of inflation would be zero. With zero inflation broad-based price indexes would rise in some years and fall in others, but the long-term average -- the persistent rate -- would be zero, and people would be able, eventually, to plan on that belief.

Recent discussion of deflation suggests that many would not recognize price stability if we had it. The fact that some prices fall while the broad based indexes rise is a normal consequence of market processes. It would be unfortunate if the Federal Reserve believed the comments about deflation or acted on them. Fortunately, they do not.

RECENT ECONOMIC INDICATORS

MONEY AND CREDIT	AUG 1983	SEP 1983	OCT 1983	NOV 1983	DEC 1983	JAN 1984	FEB 1984	MAR 1984	APR 1984	MAY 1984	JUN 1984	JUL 1984	AUG 1984
M1, BIL. $	517.40	518.90	521.60	523.00	525.30	530.00	532.90	535.10	535.30	541.00	546.20	545.60	546.40
% CHANGE, A.R.	5.98	3.53	6.43	3.27	5.41	11.28	6.77	5.07	0.45	13.55	12.16	-1.31	1.77
M2, BIL. $	2135.30	2147.90	2167.20	2182.10	2196.20	2206.70	2222.50	2229.50	2242.70	2258.40	2272.00	2281.10	2289.60
% CHANGE, A.R.	5.02	7.32	11.33	8.57	8.04	5.89	8.94	3.85	7.34	8.73	7.47	4.91	4.56
TOTAL RESERVES, BIL. $	35.22	35.31	35.32	35.25	35.28	35.50	36.07	36.10	36.10	36.43	37.23	37.18	37.32
% CHANGE, A.R.	0.82	3.08	0.34	-2.42	1.16	7.85	20.78	1.27	0.03	11.28	29.99	-1.76	4.65
NONBORROWED RESERVES, BIL. $	33.67	33.87	34.47	34.34	34.51	34.79	35.50	35.15	34.87	33.44	33.93	31.25	29.30
% CHANGE, A.R.	-2.43	7.14	23.76	-4.53	5.92	10.26	27.48	-11.09	-9.21	-39.52	19.20	-62.73	-53.88
ST. LOUIS BASE, BIL. $	197.60	198.80	200.10	201.60	202.40	204.10	205.20	207.50	208.40	210.00	212.80	212.60	213.30
% CHANGE, A.R.	8.24	7.54	8.14	9.38	4.87	10.56	6.66	14.31	5.33	9.61	17.23	-1.12	4.02
NON-FEDERAL DEBT, BIL. $	3914.40	3942.90	3973.60	4007.80	4052.20	4090.20	4124.20	4169.50	4215.90	4261.50	4306.30	4349.20	NA
% CHANGE, A.R.	9.03	9.10	9.75	10.83	14.13	11.85	10.44	14.01	14.20	13.78	13.37	12.63	NA
TOTAL DEBT PROXY (6-M. SMOO. %)	8.80	8.40	9.10	9.30	9.20	10.40	11.30	11.20	13.90	15.60	16.10	17.70	NA
INTEREST RATES													
FED FUNDS RATE	9.56	9.45	9.48	9.34	9.47	9.56	9.59	9.91	10.29	10.32	11.06	11.23	11.64
3-MONTH T-BILL	9.34	9.00	8.64	8.76	9.00	8.90	9.09	9.52	9.69	9.83	9.87	10.12	10.47
30-YEAR T-BOND	11.82	11.63	11.58	11.75	11.88	11.75	11.95	12.38	12.65	13.43	13.44	13.21	12.54
NEW ISSUE AAA UTIL.	12.81	12.56	12.48	12.70	12.86	12.60	12.90	13.41	13.77	14.59	14.54	14.14	13.50
MORTGAGE COMMITMENT RATE	13.81	13.73	13.54	13.44	13.42	13.37	13.23	13.39	13.65	13.94	14.42	14.67	14.47
INFLATION INDICATORS													
CPI (% CHANGE)	0.37	0.37	0.40	0.36	0.23	0.63	0.36	0.23	0.46	0.19	0.16	0.29	0.45
PPI, FIN. GOODS, (% CHANGE)	0.39	0.10	0.17	-0.07	0.17	0.59	0.38	0.41	0.00	0.03	-0.03	0.27	-0.10
HRLY. EARNGS. PRIV. NONFARM (%)	-0.13	0.52	0.52	0.09	0.36	0.44	0.05	0.35	0.50	-0.16	0.39	0.36	-0.16
RAW INDUSTRIALS INDEX	266.14	268.02	274.52	280.24	282.61	283.77	283.94	289.56	288.56	289.40	285.69	279.15	275.56
% CHANGE	3.75	0.71	2.42	2.09	0.84	0.41	0.06	1.98	-0.35	0.29	-1.28	-2.29	-1.29
FOODSTUFFS INDEX	271.45	269.23	254.30	251.89	263.18	274.99	267.92	281.27	284.60	295.24	287.99	276.16	271.22
% CHANGE	10.37	-0.82	-5.54	-0.95	4.49	4.49	-2.57	4.98	1.19	3.74	-2.46	-4.11	-1.79
GOLD, $/TROY OZ.	416.65	408.60	391.35	386.50	385.14	370.51	389.29	392.90	381.44	378.58	374.59	344.70	346.83
CIBCR INFL. INDX (6-M. SMOO. %)	15.36	13.19	13.02	13.08	11.26	11.28	12.78	10.45	14.44	17.54	15.24	12.76	7.93
MULTILATERAL EXCH. RATE, U.S.$	129.77	129.74	127.50	130.26	132.84	135.07	131.71	128.07	130.01	133.99	134.31	140.54	140.21
% CHANGE	2.49	-0.02	-1.73	2.16	1.98	1.68	-2.49	-2.76	1.51	3.06	0.24	4.64	-0.23
LEADING INDICATORS													
LEADING INDEX (COMMERCE)	158.90	160.20	162.50	162.60	163.50	164.40	167.00	167.40	168.30	168.80	166.60	165.30	NA
% CHANGE	0.44	0.82	1.44	0.06	0.55	0.55	1.58	0.24	0.54	0.30	-1.30	-0.78	NA
COINCIDENT TO LAGGING RATIO	127.70	130.60	132.30	132.60	133.00	136.70	135.60	134.10	133.50	132.50	132.50	132.50	NA
% CHANGE	-0.47	2.27	1.30	0.23	0.30	2.78	-0.80	-1.11	-0.45	-0.75	0.00	0.00	NA
CIBCR LEADING EMPLOY. INDX. (%)	0.07	1.66	1.31	0.71	0.96	0.95	0.50	0.13	1.37	-0.43	0.37	-0.37	0.06
CIBCR WEEKLY LEADING INDX. (%)	-0.39	0.91	0.58	-0.38	-1.03	0.91	1.28	-0.13	0.00	-0.51	-0.38	-1.09	1.30
COINCIDENT INDICATORS													
COINCIDENT INDEX (COMMERCE)	140.80	143.30	145.00	145.90	147.50	149.50	150.60	151.00	152.60	153.80	155.20	156.50	NA
% CHANGE	0.07	1.78	1.19	0.62	1.10	1.36	0.74	0.27	1.06	0.79	0.91	0.84	NA
INDUSTRIAL PRODUCTION	151.80	153.80	155.00	155.30	156.20	158.50	160.00	160.80	162.10	162.80	164.30	165.80	166.20
% CHANGE	1.40	1.32	0.78	0.19	0.58	1.47	0.95	0.50	0.81	0.43	0.92	0.91	0.24
CAPACITY UTIL., MFG. (FRB)	77.30	78.40	78.90	78.80	78.90	80.10	80.90	81.00	81.50	81.70	82.10	82.80	82.80

RECENT ECONOMIC INDICATORS - CONTINUED

25-Sep-84

EMPLOYMENT INDICATORS	AUG 1983	SEP 1983	OCT 1983	NOV 1983	DEC 1983	JAN 1984	FEB 1984	MAR 1984	APR 1984	MAY 1984	JUN 1984	JUL 1984	AUG 1984
CIVILIAN EMPLOYMENT, MIL.	101.48	101.88	101.97	102.61	102.94	103.19	103.89	104.14	104.40	105.29	105.75	105.40	104.97
% CHANGE	0.26	0.39	0.09	0.62	0.33	0.24	0.68	0.24	0.25	0.85	0.44	-0.33	-0.40
CIV. UNEMPLOY. RATE, (%)	9.50	9.20	8.80	8.40	8.20	8.00	7.80	7.80	7.80	7.50	7.10	7.50	7.50
NONFARM PAYROLL EMPLOYMENT, MIL.	89.92	91.02	91.35	91.69	92.03	92.39	92.85	93.06	93.45	93.79	94.14	94.35	94.51
% CHANGE	-0.39	1.22	0.36	0.38	0.37	0.40	0.49	0.23	0.42	0.36	0.37	0.23	0.17
AVG. WEEKLY HOURS, MFG.	40.30	40.70	40.60	40.60	40.60	40.90	40.90	40.70	41.10	40.60	40.60	40.50	40.40
INITIAL CLAIMS, UNEMPLOY. INS.	410.90	386.45	388.61	387.99	388.78	367.94	348.45	354.29	360.97	350.42	353.07	372.71	364.81
CIBCR COINC. EMPLOY. INDX. (%)	0.13	2.33	0.97	1.03	1.40	1.13	1.37	0.12	1.47	0.84	1.14	-0.41	0.00
CONSUMER SECTOR													
RETAIL SALES, BIL.$	98.28	99.54	100.92	101.90	102.44	106.60	105.48	103.87	107.51	108.24	109.32	107.14	106.23
% CHANGE	-0.56	1.28	1.39	0.96	0.53	4.06	-1.05	-1.53	3.50	0.68	1.00	-1.99	-0.85
TOTAL AUTO SALES, MIL. UNITS, AR	9.04	9.00	9.91	9.61	10.60	10.73	10.69	9.96	10.24	10.97	10.84	10.61	10.01
DOMESTIC	6.73	6.87	7.16	7.07	8.02	8.10	8.57	7.81	8.12	8.42	8.25	8.30	7.68
IMPORTED	2.31	2.13	2.75	2.54	2.58	2.63	2.12	2.14	2.12	2.55	2.59	2.31	2.34
PERSONAL INCOME, BIL.$, AR	2759.90	2785.00	2814.90	2834.20	2860.40	2897.40	2923.50	2940.60	2968.50	2978.80	3006.50	3026.70	3042.80
% CHANGE	0.55	0.91	1.07	0.69	0.92	1.29	0.90	0.58	0.95	0.35	0.93	0.67	0.53
REAL D.P.I., BIL.$, AR	1100.80	1106.40	1118.20	1123.30	1131.30	1141.80	1149.20	1151.80	1160.80	1163.10	1172.40	1174.40	NA
% CHANGE	0.13	0.51	1.07	0.46	0.71	0.93	0.65	0.23	0.78	0.20	0.80	0.17	NA
PERS. CONSUMP. EXP., BIL.$, AR	2179.60	2192.40	2216.50	2228.20	2245.90	2288.80	2267.60	2273.20	2310.10	2340.10	2347.90	2349.10	2350.30
% CHANGE	0.34	0.59	1.10	0.53	0.79	1.91	-0.93	0.25	1.62	1.30	0.33	0.05	0.05
REAL PCE., BIL.$, AR	1014.80	1016.70	1028.30	1031.30	1037.60	1052.80	1040.40	1039.10	1053.90	1067.70	1071.00	1066.60	NA
% CHANGE	-0.06	0.19	1.14	0.29	0.61	1.46	-1.18	-0.12	1.42	1.31	0.31	-0.41	NA
HOUSING SECTOR													
HOUSING STARTS, THOU. UNITS, AR	1873.00	1679.00	1672.00	1730.00	1694.00	1980.00	2262.00	1662.00	2015.00	1794.00	1877.00	1763.00	1537.00
HOUSING PERMITS, THOU. UNITS, AR	1671.00	1540.00	1650.00	1649.00	1602.00	1799.00	1902.00	1727.00	1758.00	1745.00	1768.00	1565.00	1508.00
NEW HOME SALES, THOU. UNITS, AR	558.00	597.00	624.00	636.00	755.00	681.00	712.00	682.00	649.00	615.00	630.00	630.00	NA
BUSINESS SECTOR													
NEW FACTORY ORDERS, MFG. BIL.$	176.36	180.34	182.91	186.61	188.37	188.67	191.34	196.48	189.72	193.68	190.62	192.45	NA
% CHANGE	1.09	2.25	1.43	2.02	0.95	0.16	1.41	2.69	-3.44	2.09	-1.58	0.96	NA
MFG. ORDERS, DUR. GOODS, BIL.$	88.82	91.51	94.78	97.99	98.44	99.44	102.35	105.18	98.32	102.26	99.17	101.43	100.48
% CHANGE	1.07	3.03	3.57	3.39	0.46	1.01	2.92	2.77	-6.53	4.01	-3.02	2.27	-0.93
NONDEF. CAP. GOODS ORDERS, BIL.$	22.89	25.30	25.50	24.68	24.89	25.09	27.02	26.86	25.89	28.96	28.03	27.34	25.61
% CHANGE	3.75	10.52	0.81	-3.21	0.86	0.80	7.67	-0.58	-3.63	11.87	-3.21	-2.46	-6.34
MANUFACTURING AND TRADE:													
INVENTORY CHNG., BIL.$, AR	34.86	32.40	26.24	27.38	34.60	44.71	109.85	66.60	99.53	58.22	11.06	53.21	NA
INVENTORY/SALES RATIO	1.35	1.34	1.33	1.32	1.30	1.29	1.32	1.33	1.33	1.32	1.32	1.34	NA