

Are Prices Now “Under Control”?

Price forecasters often base their predictions on highly visible events — say, a stock market crash or a drought. In so doing, they tend to exaggerate the influence that such occurrences can be expected to exert on the general price level. Over the long run, our measures of monetary inflating have been far more reliable indicators of the potential for increases or decreases in general prices. Despite recent “restraint” on the part of the monetary authorities, these indicators suggest that the possibility for further sharp price increases remains great.

Forecasts of general price trends during the past several years have been almost as volatile as the events and economic time series that the price analysts follow. In 1985, when the dollar dropped sharply in value on foreign exchange markets, it was widely believed that accelerated price inflation would result from higher import prices. That did not happen. Oppositely, when petroleum and commodity prices plummeted in late 1985 and 1986, and again in 1987 following the October Stock Market Crash, it was said that a deflationary collapse would occur. That did not happen either. The most recent “big event” was last summer’s drought, which at the time many business analysts predicted would send prices skyrocketing during the autumn. So much for that one, too.

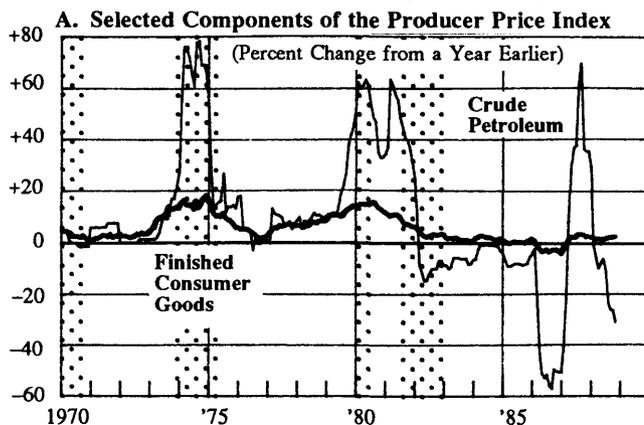
As shown in Chart 1, even very dramatic changes in the prices of some component series (corn, soybeans, crude petroleum, etc.) do not necessarily translate into equivalently higher or lower prices for finished goods. As we have said many times before, the attention given to commodity prices by “inflation watchers” — as well as by monetary authorities who may favor some type of commodity price rule as a guide to monetary policy — exaggerates the importance of things whose market valuations are properly continually in flux and whose relative importance has declined sharply in recent years. Over the long run, changes in our indicators of monetary inflating, especially the Harwood Index of Inflation, have been a far more reliable guide to general price trends than any of the “big events” that usually make the headlines. In our view, a review of some of the principal monetary developments of the past decade may provide a far more useful understanding of the relationship that monetary inflating bears to the general price level than any amount of conjecture about the importance of changes in the price of a commodity or commodities, no matter how much attention they may attract at the time.

The early 1980’s were unusual not only because of “stagflation” (real GNP decreased 0.4 percent between the first quarter of 1980 and the first quarter of 1983, while prices increased about 25 percent), but also because in October 1979, the Federal Reserve Board announced a change in its intermediate targets for policymaking. For most of the postwar period, the Fed used the level and trend of interest rates as its major intermediate guide in deciding the “ap-

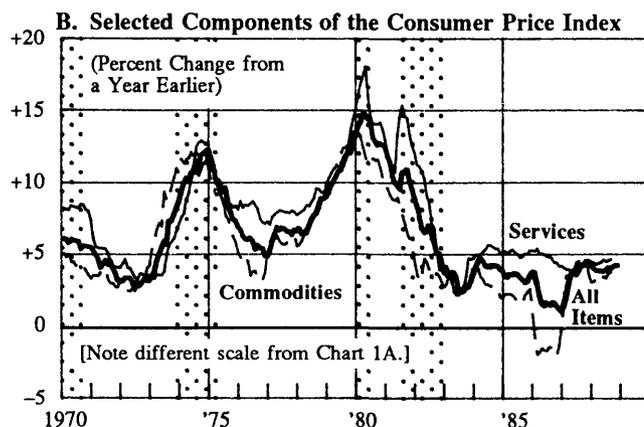
propriate” amount of credit to monetize “out of thin air.” After October 1979, however, Fed officials announced their intent to target the growth rates of bank reserves and the money aggregates, especially the transactions measure of money supply, M1. The officials’ stated goal was gradually to reduce monetary growth to rates that were deemed more

Chart 1
**SELECTED COMPONENTS
OF THE PRODUCER PRICE INDEX
AND THE CONSUMER PRICE INDEX**

Although some component series of the Producer Price Index, such as crude petroleum, have fluctuated wildly during the current business expansion, changes in producer prices of finished goods have been relatively slight (A). Concurrent changes in the component series of the Consumer Price Index have been far less dramatic, and, following a rebound from the “disinflation” of 1984-86, have tended to move sideways erratically (B).



Latest plots, October 1988.



Latest plots: all items, November 1988; commodities and services, October 1988.

or less consistent with long-term, general price stability.

One predictable and immediately evident consequence of this policy was greater volatility of interest rates. These have indeed become more volatile since late 1979, suggesting that the Fed has, at least, been less ready to "peg" interest rates. However, as the top 4 panels in Chart 2 show, there is no indication either that the growth of the reserve aggregates or M1 have become more stable in the short term or have trended downward in the longer term. From the perspective of money supply conditions, and despite the recent sharp "downticks" that seem to indicate a "tighter" rein on the money supply, a trend toward less inflationary monetary policy simply is not yet evident.

Is the Money Supply "Manageable"?

One of the problems confounding monetary policymakers is suggested by the more erratic changes in the t-ratio since 1979 shown in the fifth panel of Chart 2. Even in the short run, the Fed has tight control of Federal Reserve credit, which is the major component accounting for changes in bank reserves and the monetary base. However, the monetary base "supports" both currency in circulation and private bank liabilities (checkable deposits, and time and savings deposits). The amount of currency in circulation is determined by public demand, and its growth rate is not highly erratic. The public also determines what proportion of its claims on banks are held as demand deposits, "Repos," NOW accounts, Super NOW accounts, savings accounts, time deposits, certificates of deposit, etc. The t-ratio measures changes in the public's demand for savings-type balances at commercial banks in relation to its demand for checkable deposits at all institutions offering such.¹

The fluctuations of the t-ratio that reveal shifts in the public's demand for various types of bank obligations are partly attributable to changes in the uses the public makes of the various accounts, whether as transactions balances, savings balances, or a combination of the two. To keep up with banking innovations that have altered the uses of different accounts, the Fed has revised its definitions of the monetary aggregates (M1, M2, etc.) several times during the past few years. It is now widely acknowledged, even by Fed officials, that M1 is a highly questionable measure of transactions balances, and the Fed abandoned M1 targets several years ago.

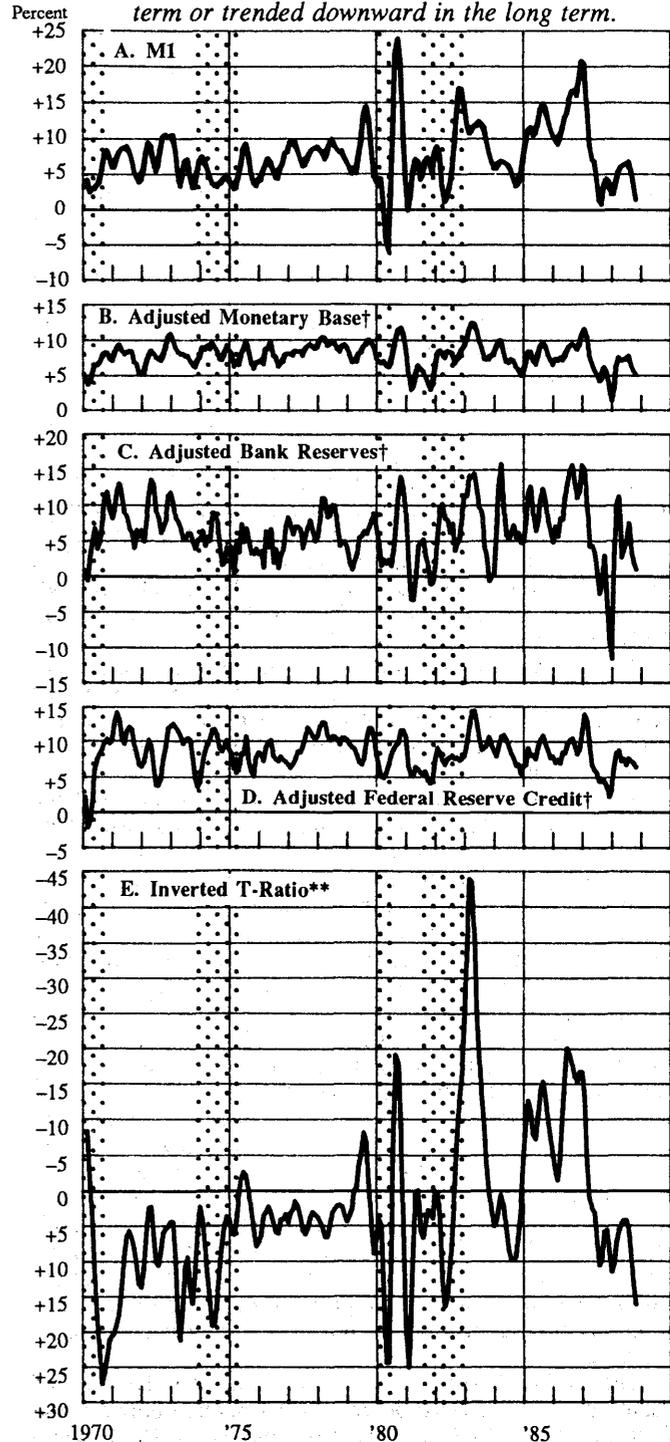
The Fed also admits to not knowing how the public is using various monetary claims. Until 1986, it was required by law to report annual targets for monetary growth to Congress. In practice, however, it often missed those targets, especially for M1. Moreover, having invariably missed its targets on the "high side," it did not attempt in subsequent periods to correct for its errors; instead, the Fed simply announced new targets from successively higher bases. As a result, the actual rate of growth of the money supply from year to year invariably was higher than the average of the announced upper limits for the individual periods. In effect, the Fed's targets between 1980 and 1985 constituted a declaration of fostering monetary expansion in excess of what nearly all analysts believed to be the long-term growth potential of the U.S. economy, which itself has become clouded by recent experience.² For the past 2 years, the Fed evidently has exercised greater monetary "restraint," but

¹ The scale of the t-ratio chart is inverted (reversed) in order to portray its direction of influence on M1 changes; that is, for any given amount of bank reserves, a lower t-ratio will result in a higher M1.

² "Conventional wisdom" subscribes to a 3 percent long-term growth trend. However, for the past two business cycles, real GNP growth falls considerably short of that trend line.

Chart 2
RATES OF CHANGE
IN SELECTED MONETARY SERIES*

Despite the Federal Reserve's repeated attempts to "manage" money and credit, and despite the recent very sharp downticks that seem to indicate a tighter rein on the money supply, as yet there is little, if any, evidence either that the growth of the reserve aggregates or M1 has become more stable in the short term or trended downward in the long term.



* Weighted average of 3-month percent changes at annual rates. † Adjustment is for effects of reserve requirements and is by the Federal Reserve Bank of St. Louis. ** T-ratio is the sum of all savings-type deposits at commercial banks divided by all checkable deposits. Notations: Monthly data. Latest plot of 3-month average is for October 1988, reflecting base series data through November 1988.

**PURCHASING MEDIA IN USE
AIER ESTIMATE — OCTOBER 1988***

Components of M1

Currency	\$209.5
Traveler's checks	7.4
Demand deposits	288.6
Other checkable deposits (OCDs)	<u>277.9</u>
	\$783.4

Add

Overnight repurchase agreements	62.1
Overnight Eurodollars	<u>13.6</u>
	\$859.1

Deduct

Two-thirds of OCDs	185.3
Inactive purchasing media	<u>88.0</u>

Purchasing Media in Use **\$585.8**

Note: Billions of dollars, not seasonally adjusted.

* For a description of the subcomponents of each entry, see our booklet, "Is Deflation Coming?," *Economic Education Bulletin*, February 1988, p. 66, fn.

there still is little agreement on what a proper money supply growth rate ought to be, even assuming that Fed officials could adhere to it. More to the point, the accumulated distortions resulting from decades of monetary mismanagement have not simply vanished: they constitute an economic "time bomb" that has yet to be defused.

The Harwood Index of Inflating

As far as we are aware, the Harwood Index of Inflating is the only attempt to measure the extent to which this flawed money and credit system has distorted economic processes. While it is beyond the scope of this discussion to describe in detail the derivation of the Harwood Index, it may be useful to summarize briefly its development and recent changes in the index and its principal components.³

Basically, the Harwood Index reflects the potential for distortions in economic relationships attributable to inflating, specifically to the monetization of debt incurred for purposes other than for offering newly produced goods in the market. There are two major steps in calculating the index. One is to estimate the amount of purchasing media in use. The calculation for October 1988 (the most recent data available) is shown in the accompanying table. As the table shows, to M1 as officially reported we add "overnight" balances owed to nonbank U.S. entities (since we conclude they would not be held in overnight form unless used in day-to-day transactions) and we deduct items that we believe are not so used. The second step is to divide purchasing media in use into inflationary and noninflationary components.

When dollar demand claims actually were convertible into gold, the noninflationary component of purchasing media in use was the sum of (1) monetary gold (which the banking system effectively was continuously offering for sale at a fixed "price") and (2) the total of short-term, self-liquidating commercial, industrial, and agricultural loans as reported by banks. The inflationary portion of total purchasing media in use also could be estimated from the combined balance sheet of the banking system; it was the

³ For a complete description of the Harwood Index, see our booklet *Money, Banking and Inflating: A Useful Description*, price \$6.

excess of investment-type assets (such as bonds, mortgages, and loans to finance consumption or speculation) over savings-type liabilities (including time deposits and capital accounts).

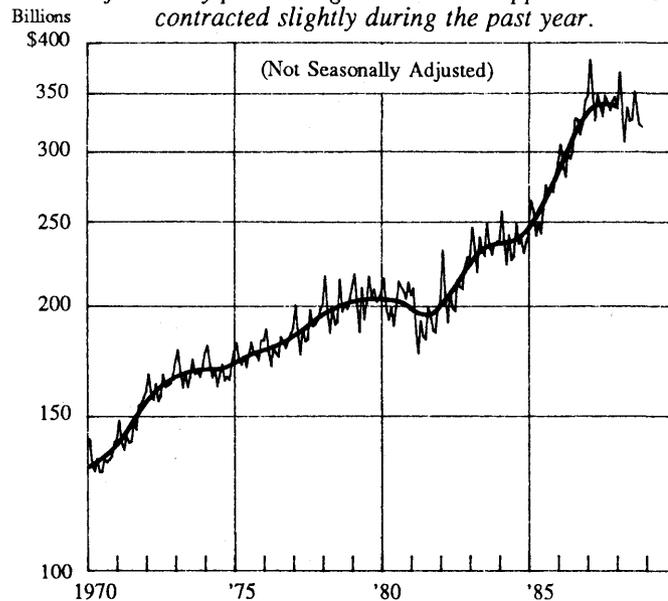
Today the U.S. stock of monetary gold is not continuously offered at a fixed price and the reported categories of bank assets and liabilities have become blurred (as have the criteria for what constitutes a bank). Because reported bank data no longer are useful for this purpose, we now use one-half of monthly manufacturing and trade sales as our estimate of noninflationary purchasing media.⁴ The remainder after the amount of noninflationary purchasing media is subtracted from total purchasing media is deemed to be inflationary. This estimate is shown in Chart 3. It reflects *absolute* inflating, or the amount of inflationary purchasing media outstanding at any given time. The Harwood Index, shown in Chart 4, is the ratio (expressed in index form) of total purchasing media in use to the noninflationary component. It is a measure of *relative* inflating.

As the foregoing discussion may suggest, the Harwood Index is not a precise measure. For example, M1 is the starting figure for our estimate of total purchasing media in use, and any distortions in that series will be reflected in distortions in the index. As a consequence of such uncertainties in the data, the reported Harwood Index thus may differ by perhaps 50 to 100 index points from what it would be if more accurate data were available. (We also should stress that our efforts to construct the index reflect several "heroic" assumptions respecting the creation and use of purchasing media, mainly because few other analysts seem interested in viewing the situation from our perspective —

⁴ This series approximated short-term, *bona fide* commercial, industrial, and agricultural loans during the years 1940 to 1966, when the reported banking data were less distorted by "innovative" banking practices, term loans, speculative inventory loans, etc.

Chart 3
INFLATIONARY PURCHASING MEDIA IN USE
(Monthly and Smoothed*)

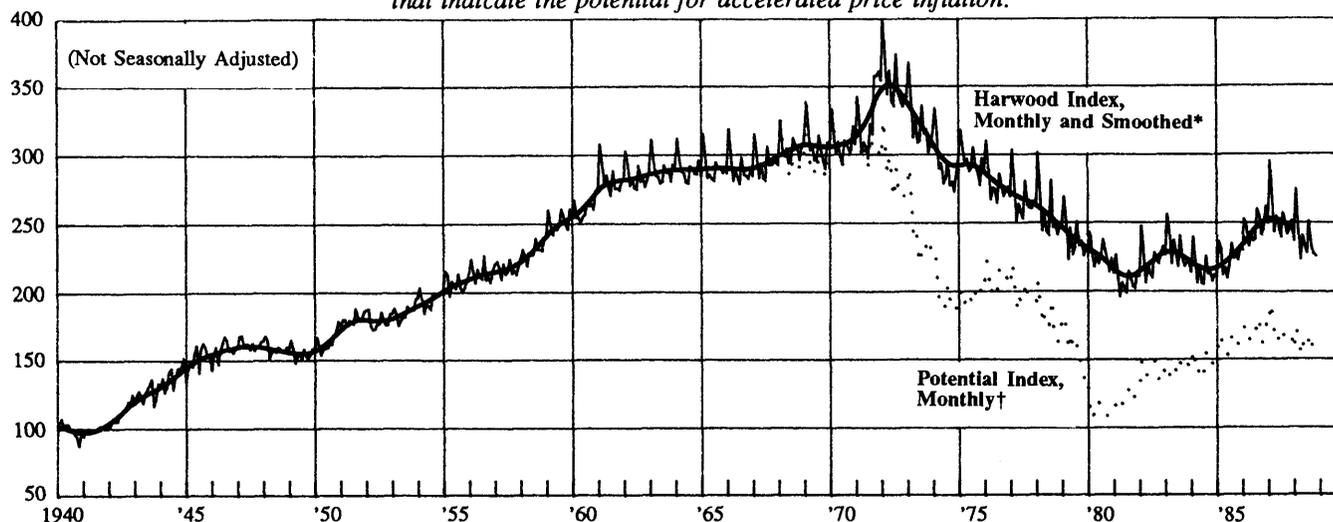
Roughly \$100 billion of excess purchasing media were created in the United States during 1985 and 1986, but there has been little, if any, subsequent inflating. Inflationary purchasing media in use appear to have contracted slightly during the past year.



* Centered, weighted 23-month moving average. Latest plot, October 1988.

Chart 4
THE HARWOOD INDEX OF INFLATING

Following sharp increases during 1985 and 1986, the Harwood Index, a measure of relative inflating, has decreased for the past year or so. Although it is now well below its all-time peak, the index remains at levels that indicate the potential for accelerated price inflation.



* The smooth curve is a centered, weighted 23-month moving average of the monthly data. Latest monthly data, October 1988.

† Index level if convertibility were restored at the average market price of gold for the months plotted and if the "profits" from the higher valuation of official gold stocks were used to retire Treasury securities held by the banking system.

and none of these is involved in the collection and compilation of the data.) But even when extreme plausible values for the variables involved are used, the major Index of Inflation trends evident in Chart 4 remain unchanged: relative inflating increased markedly during the 1940's, 1950's, and 1960's, and decreased during the 1970's.

The peak in relative inflating, which indicates the monetary potential for distortions, occurred around the time that gold convertibility of the dollar ended (1971). However, unlike other episodes, when relative inflating abated as a result of decreases in absolute inflating, the 1970's decreases in relative inflating occurred while absolute inflating continued to increase. The post-1971 decrease in the Harwood Index was attributable not to a withdrawal of inflationary purchasing media from circulation but rather to a rapid increase in the noninflationary component, which in turn resulted from sharply rising nominal prices attached to the goods comprising manufacturing and trade sales.

Although for long-term trends the questionable accuracy of the data used to estimate the Harwood Index probably is not significant, confidence that its short-run trends accurately reveal underlying conditions seems less warranted. Nevertheless, recent developments are worth examining; they may accurately reflect inflationary trends. Chart 3 shows that absolute inflating abated during 1979 and 1980, and actually decreased during early 1981. Subsequently, the amount of inflationary purchasing media in use increased rapidly to new all-time highs in 1982 and accelerated at an unprecedented rate in 1985 and 1986.

These developments seem to be related to the business-cycle contraction of 1981-82, the rapid expansion of business activity during 1983-84, and to the relatively sluggish growth of 1985 and 1986. When general business activity is growing slowly or contracting, the requirements of producers and consumers for newly created purchasing media diminish. However, in an effort to promote growth, the monetary officials have continued to expand money and credit; consequently, both relative and absolute inflating have increased at such times.

The downward trend of the Harwood Index during 1983 and 1984 was similar to that prior to 1981 in that it reflected a rapid growth of noninflationary purchasing media rather than the withdrawal of inflationary purchasing media as in past "deflations" such as that of 1929-32. However, in contrast to the 1971-81 period, the 1983-84 increases in noninflationary purchasing media mainly reflected higher output and sales rather than markedly higher prices. The increase in the Harwood Index in 1985 and 1986 reflects, to repeat, sluggish growth.

The downturn during the past 2 years in both the amount of inflationary purchasing media in use and the Harwood Index reflects both relative monetary "restraint" and higher nominal prices (note that the CPI components shown in Chart 1 recently have attained levels that are higher than in either 1983-84 or 1985-86). The recent movement of the Harwood Index suggests that monetary officials are attempting to postpone the day when the current excess of inflating is manifest in higher prices. However, it should be noted that the recent relatively "tight money" Fed policy has yet to be tested during a time of recession — which many business analysts believe may not be far off. And in any event, the Harwood Index remains at levels that belie any notion that "inflation has been permanently licked."

PRICE OF GOLD

	1987	1988	
	Dec. 30	Dec. 22	Dec. 29
Final fixing in London	\$484.10	\$417.25	\$410.25

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