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Harding College Department of Business and Economics

The entrepreneur*

FREEDOMS FOUNDATION HONORS ECONOMIC REPORT

— On February 22, 1977, we at the Center received the following notification in the mail from Valley Forge, Pennsylvania: "The Trustees and Officers of the Freedoms Foundation at Valley Forge announce with pleasure the selection of the Center for Private Enterprise Education by the distinguished National and School Awards Jury to receive the Valley Forge Honor Certificate Award for 'Free Enterprise: The Greatest Story **Never** Told (Until Now)' report, the 1976 Economic Education Program, an outstanding accomplishment in helping to achieve a better understanding of the American Way of Life." If free enterprise is catching, and we believe it is, then 680,000 people were exposed to it in our 27 projects last year.

— D.P. Diffine, Director

Inflation: Its Anatomy and Physiology

by W. Philip Gramm

W. Philip Gramm is a professor of economics at Texas A&M University in College Station, Texas. Professor Gramm has published articles in various economic journals on topics ranging from environment to monetary and banking theory. He is a consultant to the U.S. and Canadian Governments on matters of energy and economics. Professor Gramm presented this paper at Harding's Fifth Annual Management Seminar on January 28, 1977.

We are today experiencing the most prolonged period of rapid inflation in the history of the United States. While we have had short periods where inflation rates have been more intense, a decade of high inflation rates is without precedent in the history of the Republic. As an index of how severe price increases have been for the last decade, the consumer price index, which measures the price of a market basket of goods and services purchased by the American consumer, is up 75 percent. This harsh economic fact suggests two questions: (1) how did we get in such a mess, and (2) how do we get out?

The first question is easy to answer. There are data on inflation which go back to the 15th century, when gold was discovered in America, transported to Spain, and permeated the European market. Since that time there has **never** been a prolonged general price inflation that was not preceded by and directly related to a growth in the money supply. In our economy, growth in the money supply occurs principally when the Government spends more than it taxes and prints money to make up part of the deficit.

The History of U.S. Inflation

We have incurred five major inflations in the history of the United States: the Revolutionary War inflation, the War of 1812 inflation, the Civil War inflation, the World War II inflation, and the Vietnam War inflation. All five of these inflations have had the same cause — a rapid increase in the money supply. Under the Articles of Confederation, the Continental Congress did not have the power to tax. It was therefore forced to issue paper currency to fight the Revolutionary War. The paper currency units were called Continental Dollars. You have all heard the saying "not worth a Continental," a statement derived from the fact that when Continental Dollars were redeemed at the end of the Revolutionary War, they were redeemed at two cents on the dollar in gold and silver. The paper currency depreciated very rapidly because of the tremendous quantity which was issued. In essence, the Continental Congress was entering the American market and competing against private citizens for goods and services with newly issued Continental currency, buying goods at a more rapid rate than the economy was producing them. Prices, therefore, were driven up.

In reviewing our first inflationary experience as a nation, it is important to note that at the end of the Revolutionary War the Congress established the First Bank of the United States, which systematically withdrew Continental Notes from circulation. Prices then leveled off and fell back toward their original level.

The next major inflation in American history followed the War of 1812, which was basically a carbon copy of

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the Revolutionary War inflation. The principal methods of deriving Federal revenue was imposing import taxes on tariffs. But we were at war with our major trading partner, England, and tariffs had fallen off drastically. In order to fight the war we therefore issued large quantities of paper currency which produced a rise in the general price level. Again, however, to the credit of our forebearers, when the war was over the Congress established a Second Bank of the United States that redeemed paper currency at par. Prices leveled off and declined back toward their original level as the paper currency was withdrawn from circulation.

The next major inflation in American history occurred during the American Civil War. The Federal Government ran a $1 billion deficit, which was without precedence in history. It financed a large part of this deficit by issuing Greenback Notes. These Greenback Notes expanded the money supply by over 150 percent, and prices roughly doubled from 1860 to 1865. At the end of the war taxes were left at their war-time level and Government spending was cut back drastically. The Government surplus drew Greenbacks out of circulation and theTreasurer of the United States burned them. As the money supply declined prices fell off, and by 1879 we went back on the gold standard at exactly the same par value that existed in 1860 because prices had been driven back down to their previous level.

The next major inflation in American history occurred in World War II. The Federal Government ran a large deficit and the money stock more than doubled as the Federal Reserve monetized a part of the debt. As the Government entered the market armed with newly printed money, it drove up prices, increasing overall prices by over 60 percent during the Second World War. By the end of 1946, we were approaching a balanced budget, and by 1947 price increases had ceased. We established a period from 1947 to 1962 (except 1950) when proved to be one of the most prolonged periods of stable prices and stable economic growth in the Twentieth Century.

The Current Inflation

The next major inflation in American history occurred with the initiation of massive Government expenditures on the Vietnam War. **We are today in the fifth major inflation in American history — and its source is identical to the four inflations that preceded it. The current inflation differs only by the fact that it has been carried over into a peacetime period; this is the only peace-time inflation of any real significance in the entire history of our country. Our present inflation has been caused by the fact that since 1965 the Federal Government has run a $200 billion deficit and has financed about 40 percent of that deficit by printing money.**

It is fundamentally important to note the difference in the impact on the economy caused by Federal financing through taxation and borrowing, as opposed to printing money. When the Government taxes and spends the receipts of those taxes, the ability of the private consumer to purchase goods and services is diminished by the amount of the tax. Therefore, the increase in total spending as a result of the increase in Government spending is quite small. If the Government goes onto the bond market and sells bonds, competing with private firms and private individuals for loanable funds, the competition simply drives up interest rates as Government diverts funds away from private investment projects. In this case, private spending falls by the amount that public spending increases. In the case of selling Government bonds to the Federal Reserve, which in turn gives the Treasury the capacity to write checks drawn on the Federal Reserve, there is no corresponding decrease in private spending. So the increase in Government spending represents a net increase in total demand for goods and services.

While we in economics have a lot of data on inflation, we have even more data on wage and price controls. In fact, our first history of wage and price controls occurred 5,000 years ago when price controls were imposed in the fifth dynasty of ancient Egypt. Pericles imposed price controls in ancient Athens, and Diocletian imposed wage and price controls in ancient Rome. **And from the fifth dynasty of ancient Egypt to President Nixon's Phase IV price controls, all of these experiences have one thing in common — not one has ever worked. And they do not work for a very simple reason: they freeze prices at a level where the quantity demanded exceeds the quantity supplied. They simply turn price increases into shortages and stifle the incentive to produce, therefore causing output to fall.**

We have in fact produced a minor miracle in the United States in the 1970s, in that at various times we have produced a grain and a meat shortage through Government policy — in a country that has the most fertile land, the highest level of capital equipment and technology in agriculture, and the best educated farmer in the world. We have produced shortages of critical inputs to the production process, sending the country into a recession.

If one looks at what the Government says it is doing in its "anti-inflation" policy, and then looks at the growth in the monetary base to see what it is actually doing, there is only one conclusion that can be drawn. That conclusion is that Federal anti-inflation policy since June of 1969 has been a "fraud." **Over the last 12 months the monetary base has grown at almost an 8 percent**

annual rate. Never in history has such a rate of monetary expansion failed to produce rapid inflation.

Pointing The Finger of Guilt

When the Federal Government, in June 1969, stopped trying to do anything about inflation it turned its activities toward developing scapegoats in order to get Americans to blame their neighbor for their problems. Had the scapegoat strategy not been so effective, it would be humorous. How does this strategy work? Well, you have all heard it. It works basically as follows. A bureaucrat goes to a businessman and says, "Why are you increasing your prices?" And the businessman says, "Because our costs are rising." And then the bureaucrat says, "What is your major cost?" And the businessman says, "labor." And then the bureaucrat concludes, "Well, labor unions cause inflation." And then the same bureaucrat goes to union leaders and says, "Why are you demanding such high wage increases?" And union leaders note that the consumer price index is up 6 percent in the past year, and that wages of hourly workers are 2 percent lower than they were a year ago in terms in real purchasing power dollars. And the bureaucrat says, "Well, who sets prices anyway?" And the labor leaders say, "businessmen." And the bureaucrat concludes, "Well, through price collusion and administered prices, businessmen create inflation."

We are all aware of the impact of inflation on income redistribution, particularly on those with fixed salaries, the old, and the poor. There is no question that this is a major cost of inflation. But an additional, more important cost is the impact caused by diverting funds from traditional channels and disrupting the link between the saver and the investor. In this way, we are today planting seeds which will yield lower economic growth rates for a decade.

Government: The Cause of Inflation

How do we stop the inflation? Inflation has one cause and it has but one cure. And that one cure is to slow the rate of growth in the money supply. This can be accomplished only by closing the Government deficit. Our inflation has resulted from the prevalence of a bankrupt (and bankrupting) idea within Government that money solves problems. If one looks at the historic growth pattern of Government spending over the history of the United States, it is very easy to discern within the last 15 years there has been a fundamental change within our Government. From the birth of the United States it took over 180 years for the Federal budget to grow from roughly zero to $100 billion to $200 billion, and it has taken only four years for it to grow from $200 billion to $300 billion. In only the last two years the Federal budget went over the $400 billion mark. Despite the fact that Federal tax collections have grown by 110 percent over a decade, over three times the rate of economic growth, the Federal Government has failed to live within its budget. According to former Treasury Secretary William Simon, **the Federal Government is deficit financing at such a rate that today it is absorbing 60 percent of all funds raised in U.S. capital markets.**

The best personal example that I have witnessed of the bankruptcy of Government with regard to new and viable ideas was a call I received back in January 1975. I was working in my office at Texas A & M and my secretary, who gets excited with very little provocation, came into my office and said, "Dr. Gramm, you're not going to believe this, but the President of the United States is on the telephone." And I said, "You're right, I don't believe it." Nevertheless, I picked up the phone and a very stern sounding lady said, "Is this Dr. W. Philip Gramm of Texas A & M University?" I said, "Yes, Ma'am." She said, "Dr. Gramm, this is the White House calling."

So I sat on the edge of my chair awaiting some message — some mission from my President — and a member of the White House staff came on the phone. He said, "Dr. Gramm, your name has been given to us by some very, very important people. We think you might be the kind of person that can help us develop a new and viable energy program, a system of Government controls and subsidies, a system of Government and industry mutual research and project participation. And as an index of our commitment to this project we are willing to commit $20 billion."

He went on and used every 25-cent word in the English language. When he got through, being an Aggie, I said simply, "It is a happy coincidence that out of 211 million Americans you have called the right man, because I know exactly what to do." I told him that I envisioned a system which was not going to cost a penny, but in fact would make money. It would be so productive that we could tax its output and finance Government programs on the basis of its productivity. I told him that I envisioned a system whereby we would allow people to own property, and we would allow them to combine this property with their God-given talents to produce output. We would allow them to sell output in a free market so that each individual, in attempting to maximize his own welfare, would operate at maximum efficiency. And each consumer, in attempting to maximize his own individual welfare, would economize on the things that were scarce and therefore expensive, and substitute for them things that were abundant and therefore cheap. In such a system, by rewarding production and innovation, we could assure a maximum level of economic growth. I told him that I was basically a modest person and that I wanted him to know this was not totally my idea; that in fact if he would like a written reference, he might look at Adam Smith's **Wealth of Nations**, written in 1776. And I hung up.

Well, I assumed that I would never hear from the White House again, but indeed they went to a great deal of trouble to get in touch with me. And that's how, as I expressed it, for about a two-month period, while I didn't invent free enterprise, I had the sole Washington distributorship on it.

Conclusion

If we are to ever put an end to spiralling prices, shortages, high interest rates and, economic stagnation, we must stop the growth of Government and put our monetary and fiscal house in order. To reverse the trend of fiscal irresponsibility we need strong leadership, which is a scarce commodity in Washington today. We must resist the siren song of more and more Government spending and more and more Government controls, and stand up for the free enterprise system which has made us prosperous and free.

The hour is late. It has become quite fashionable to proclaim the inevitability of the demise of our system. Such a philosophy is a convenient escape. For if there is not hope, we are not obligated to do anything. In fact, there is no real reason for pessimism. We have human talents on our side. We have money and economic power on our side, and most important, we have history on our side. We have, in the American free enterprise system, the most successful economic system in the world. It has elevated us from a powerless nation, 90 percent of whose citizens were in poverty — by any measure — at the time of the Revolution, into the greatest agricultural and industrial power on earth. So successful is our system and so high are the aspirations of the American people that we define poverty at an income level that is higher than the average income level of the world's second most powerful nation. Yet, paradoxically, this great system is under attack at all levels of Government, and is being replaced by a system which has never worked in history and which is working effectively no where in the world today. The greatest product in history is not selling for the simple reason that it has no salesman. Those within our Government who supposedly represent our views are defending our system with an ineptitude unparalled in the history of the Republic. To reverse this trend we need but a unit of will.

I wish to tell you today that I am optimistic about the future of America, and I am optimistic about the future of the American free enterprise system. If we have learned anything in the 1970s, it is that big Government cannot solve problems, and that spending more of the taxpayers' money cannot turn a bad idea into a good one. Everywhere I go in Texas and in our nation I find the American people feel a sense of helplessness. They know big Government is not working, they know something is out of kilter, but they don't know what to do about it. What we need today, more than at any time in the history of the United States, is a new wave of leadership to turn this country around. We need this leadership to fulfill the ideals and aspirations of a revolution which occurred almost two hundred years ago. In the coming struggle for the survival and the success of the American experiment, I call upon you as our business and civic leaders not to be merely passive observers, but to be active participants. While I cannot speak for the the actions of others, in my own case I mean not only to participate, I mean in that participation to lead.

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