Inflation – An Endemic Problem of Modern Capitalism

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The growth of modern capitalism in the 19th century meant a century of falling, rather than rising prices[1]. The engine which drove the industrial revolution forward was making things *cheaper,* in all branches of the economy (with the possible exception of the building industry). The textile revolution meant that cheap factory-made goods displaced relatively expensive hand-made products. Even when the displacement was complete, when power-driven machinery and the factory system became general in the cotton industry in the first half of the 19th century, prices continued to fall with improvements in productivity. We know from recent research that the very large increase of British exports in the first part of the 19th century was associated with an adverse change in our terms of trade, because owing to the intense competition between individual manufacturers, every improvement in productivity was passed on to the buyer in lower prices. (The market was dominated by *wholesalers* as intermediary traders; the manufacturer was dependent on wholesalers for orders and this meant keen price competition between manufacturers. The competition between wholesalers meant in turn that lower prices were rapidly passed on to the final buyers, home or foreign[2].

Of course the movement of prices was much under the influence of the trade-cycle – both the short cycle which had a periodicity of 8–10 years, and the long waves (Kondratieff) of 50 years. Food and raw material prices rose or fell according as the growth of demand exceeded or fell behind the increase in supplies; these in turn reacted on industrial prices, both on account of the effect of food prices on wages and of changes in material costs. However, as we now know, wages were not as closely tied to food prices (the price of corn) as the classical economists suggested. They rose and fell with the state of the labour market; and manufacturers' prices sometimes moved in a contrary direction to costs, on account of demand influences. A bad harvest caused food prices to *rise,* and the purchasing power of farmers to *fall,* which resulted in lower demand for manufactures; this in turn had an adverse effect on wages as well as profits. (A recent study by Robert Boyer[3] has shown that in the 18th and early 19th centuries wages in the Paris region moved in inverse relation, and not in direct relation, to food prices. When food prices rose owing to a bad crop the demand for urban labour fell and jobs were more difficult to find; so that workers were doubly hit – by lower money earnings owing to a fall in demand, as well as by higher food prices.)

In the 20th century all this had changed – particularly if we date the century from 1920, rather than 1900. While agricultural and raw material prices continued to move up and down with short-term changes in demand or expectations and remained very volatile, the prices of manufactured goods were increasingly fixed by the producers who became "price-makers". They then became "administered" prices, determined by the leading producers – (there is always price leadership under oligopoly). Berle and Means in their book on *The Modern Corporation,* published in 1932, found that the 100 leading corporations then accounted for something like one half of the manufacturing output of the U. S., and that these corporations followed the practice of "administered prices" which were changed at very infrequent intervals. The leading producer in each industry fixed prices and others followed them. At the same time wages became increasingly determinded collectively in negotiations between trade unions and employers.

This change-over from flexible to rigid prices in industry was concomitant with the manufacturers acquiring "brand control". New products (I think bicycles was one of the earliest examples) were sold under the makers' own brand; this practice was aided by the discovery of modern advertising. Modern advertising and manufacturers' brand domination went hand in hand. It was also aided, in the U. K. for quite a long time, by re-sale price maintenance contracts – which were only made illegal in this country in the early 1960s.

Under this system improvements in productivity often took the form of quality improvements, rather than a price reduction. A Singer sewing machine kept selling around the same price but almost each year they brought out a better product. Cadbury's 2d bar remained a 2d bar for 50 years or more, but sometimes it contained more chocolate and milk, and sometimes less, depending on the change in cocoa and sugar prices. Industrial wages rose with profits; they rose during a boom, but thanks to trade unions fell very little in a depression – this ratchet-like behaviour was another factor making for relative rigidity of industrial prices. The inter-war period introduced a host of new products for mass consumption – motor cars, vacuum cleaners and so on, all of which were priced and marketed in the same way.

However, in *primary products,* by contrast, competition worked in the same way as in the 19th century – productivity improvements were rapidly passed on in lower prices; increased demand sometimes caused spectacular increases in prices. Arthur Lewis' studies[4] have shown that the huge improvements in sugar cultivation brought no benefit to the farmer or planter, since prices fell as fast and fully in proportion to the rise in yields per acre.

It is this combination of highly competitive primary product prices and rigid industrial prices which was characteristic of the 20s and 30s of this century, and no doubt contributed to the severity of the Depression after 1929. World War I ushered in an inflation the whole world over which came to an end with a bang in Britain in 1921, and in other leading industrial countries in various years up to 1925. From then on prices were stable or gently falling, until the Great Depression which brought primary product prices crashing down, and made industrial prices moderately lower. Althought the experience of individual countries differed a great deal I think one can say that the inter-war period was on the whole another period characterised by falling rather than rising prices.

As against that the experience of the post World War II period was a very different one. The much-heralded post-war recession which wrought such havoc after World War I did not materialise. For a time it looked like coming at around 1949, but then the outbreak of the Korean war brought an end to this, and ushered in a unique period of prosperity and industrial expansion marked by a steady creeping inflation in all *industrial* countries, combined with a remarkable stability of raw material prices on the average (many individual commodities tended to fluctuate up and down but in the average the level of prices in 1970 was the same as in 1950). Industrial growth in the U. S. and U. K. owed a great deal to heavy armament expenditure after 1951; in Japan, Italy and Germany on the other hand to an unprecedented export boom in steel, machinery, ships, motor cars, chemicals and many other commodities. But it meant continued full employment in Britain, and to a lesser degree in the U. S., and an unprecedented expansion of employment (particularly industrial employment), through immigration from abroad or the countryside in Germany, Italy and Japan. (Fast growing countries had on the whole a higher rate of creeping inflation than the slow growing ones.)

However, since the early 1970s we have entered a *new phase* of far more rapid inflation – a world wide inflation which has had no previous precedent in peace-time either in its wide-spread nature or in its amplitude, combined with relatively stagnant output and sharply rising unemployment. Manufacturing output in Britain in December 1980 was no higher than it was in 1967 (and it is 21 per cent lower than the peak output in 1973). In the course of 1980 alone there was an unprecedented fall in output of 15 per cent. In other leading industrial countries (with the exception of the U. S.) progress has slowed down to around 2 per cent a year (as against a customary 5 per cent in the 1950s and 1960s) though in contrast to Britain output has not actually fallen. World commodity prices stopped rising in 1974 and then fell for a time; then started rising rapidly again when demand revived in 1976; since then they fell, then rose and are now falling again – they appear to be far more responsive to even small variations of demand by the industrial countries.

The wage-led or wage-induced inflation of the industrial countries which was a creeping inflation of 2–3 per cent a year in the 1950s and the 1960s became, if not a galloping inflation, at least a cantering one – with the Government's main policy concern being how it could manage to produce a cost of living index which showed an annual increase in single digits rather than in double digits. A single digit counted as achievement. (This was by no means confined to the U. K. but it was worse in the U. K. than in most other developed countries).

The particular questions which I want to discuss are – was this development inevitable, and where will it lead to?

I do not want to waste time with what I regard as fatuous explanations – such as failure to control the money supply or excessive Government borrowing. In fact it could be shown that the countries which had the lowest rates of inflation – like Germany, Switzerland and Japan – in the last five years had high increases in the "money Supply" relatively to the growth of incomes as compared with countries with rather high rates of inflation like the U. K. or the U. S. (when the money supply is broadly defined).

Nor do I wish to spend a great deal of time in refuting the view that these post-war inflations were due to the pursuit of Keynesian policies of demand management which resulted in a chronic excess demand for labour that drove up wages. This again is easily refuted by an appeal to historical events. In Britain in the latter part of the 1950s inflation was well-nigh extinguished; yet over that period unemployment was well under 2 per cent (with the single exception of 1957 when it was 2,1 per cent) and unfilled vacancies exceeded considerably the number of unemployed. This was even more true of Germany where for a long time at least there were only 200,000 unemployed and over 600,000 registered unfilled vacancies, yet there was comparatively little inflation.

Any integrated theory of inflation would have to be capable of explaining the rate of increase in the world price level (measured, say, in U. S. dollars, which comes nearest to being a universal currency) and would have to take account of both the demand-pull and cost-push elements and their inter-action. Inflation due to an excessive pressure of demand (too much money chasing too few goods) occurs in periods when supplies of essential goods are restricted (as in war-time) or in less developed countries, owing to their inability to remove local shortages by importing from abroad (due to a severe balance of payments constraint). But it also occurs when the increase in demand coming from the urban (or "industrial") sectors of the world economy tends to outstrip the increase in availabilities of primary products, whether foodstuffs or industrial raw materials. This happened for various reasons in the early 1970s, even before the oil price explosion. In the early post-war period the production of basic foods tended to outstrip the growth of market demand, but owing to policies of market intervention in all the main producing countries (developed during the Great Depression), the normal price effects of these surpluses – the price collapse – was prevented. Instead *large excess reserves* were built up – in grains, coffee, sugar, tea, and also strategic reserves of many non-precious metals. In the course of the 60s consumption caught up with production (which was itself held down by acreage limitations); the excess reserves diminished and finally (rather unexpectedly) disappeared when, following exceptionally bad harvests in China and Russia, large grain purchases were made in the U. S., as a result of which grain prices went through the 'ceiling' support price, for the first time in 30 years.

On the other hand the rise in industrial prices which went on at a steady rate since 1950, and at an accelerated rate towards the end of the Vietnam war period, was entirely *cost-induced* – and in my view it was *not* due to a shortage of supplies – with buyers bidding up prices. It was a cost-induced inflation of industrial prices – due to wages rising invariably faster than productivity, whether or not this was aggravated by a rise in food and raw material prices. I should like to concentrate on this type of inflation since this is the kind that has been mainly relevant to our own society. It is a consequence of the increased concentration of economic power both on the side of capital and on the side of labour – of militant trade unionism combined with monopolistic price policies in industry.

The first point I wish to emphasise in this connection is that the main objective of trade unions is to preserve the status of their members in relation to *other* groups of workers. This is the importance of the "going rate" which in this country develops each winter in the course of the annual round of wage increases. The magnitude of the wage increases reached in some key settlements early in the round (with the motor car workers, the lorry drivers, sometimes the dustmen and other classes of public employees) gradually evolve what the "going rate" of settlements is going to be, and it is the fear of particular classes of employees of *not* getting the „going rate" which leads to the violent behaviour we have witnessed in the past.

At the end of each round of sharply fought wage increases, often accompanied by strikes, the relative earnings of each group of workers is much the same as it was before. As Wynne Godley has recently shown, while average earnings increased by 300 per cent in the 15 years 1963–1978, the rise in earnings was remarkably uniform. In nine out of fourteen component industries, the deviation from the average was less than 5 per cent, while in only two cases was it more than 10 per cent[5].

So wage settlements follow the "leading settlements" in each pay-round. But what determines the wage increase of the *leading* settlements, which the others are determined to imitate? In the last years of the Labour Government, the Government wanted a general increase of 5 per cent following on an increase of 14 per cent in earnings in the past year which had meant a rise in real earnings (after allowing for a rise in prices) of 5–7 per cent. This was much more than the rise in national real income; it was essential therefore that it should be followed by a relatively modest increase. So why was the Government's 5 per cent target so unacceptable to the workers?

I think the key moment which settled the fate of the Government's incomes policy in the current round occurred in the afternoon when the Ford workers at Dagenham walked out, instantaneously and spontaneously, on hearing of their Company's offer of 5 per cent – and long before the current expiry of the previous settlement – and the workers of Dagenham were quickly followed by those in all the other Ford plants. The support for strike action, sudden and unexpected, was well nigh 100 per cent and they refused to listen to improved Company offers for many weeks. The answer in my view had nothing to do with hardship due to low earnings – earnings of Ford workers were good by any standard. The reason was that Ford previously announced an increase in *profits* of more than 100 per cent from £ 100 m. to £ 246 m. in their last trading year; at the same time the total annual wage bill of their 57,000 employees came to only some £ 200 m., 5 per cent of which was only £ 10 m. What made the Ford workers so militant was the simple fact that the Company offered to increase the *total* pay roll by some £ 10 m. in a year in which they made an extra £ 140 m. The Company could of course have well afforded (might even have preferred) five or six times that sum on the basis of their cash flow or profits flow – which the workers felt that they had made for them. It is this feeling that they are entitled to a fair share of any increase in a company's profit which seems to me the key to wage inflation and is the basic difficulty with any incomes policy.

Ford is a price leader in the motor car industry. The other motor car companies which are far lesse efficient have their prices set for them by Ford – with the result that their profits are squeezed and generally not sufficient to enable them to invest on the scale that would be required to maintain their competitive position. (An extreme example of this is Leyland – see the Ryder report).

Now oligopolistic price-leaders the world over are 'keen' to pay their worlers *more* than they can get elsewhere, and raise their wages in line with the rise of productivity – so that everyone should share in the prosperity of the enterprise.

This is the policy of all successful oligopolies – of Fiat in Italy, Ford, General Motors or du Pont in the U. S. They reap the benefits of their policy, as Galbraith described, in good labour relations, the ability to pick the best workers and of always having a queue of workers to fill any vacancies. It is also the best way of "killing off" competitors, as Northcliffe found out before World War I, when he doubled the wages of London printing workers to the benefit of the Daily Mail, and Ford in Detroit when in 1906 he doubled the wages of his workers. He could afford it, and his competitors could not.

So long as labour is not *strongly* unionised (as it was not in America until recently) it is possible for successful enterprises to pay higher wages for the same work than the rest of industry. But with 100 per cent unionisation this is not possible (or only to a limited extent). Hence the wage increases of the most successful firms, whose productivity increases are well *above* the average, set the standard to which the *average* enterprise must conform.

Since in each industry, the level and the growth of productivity show very large differences between the average and the most successful firms (of the order of 2 to 1 or more)[6] collective wage bargaining – divided between many industries and many unions competing with each other, and conducted sometimes on an establishment basis, sometimes on an individual firm basis and sometimes on an industry basis- involves the *pursuit of two incompatible objectives:* the first to maintain, and if possible, improve the workers' share in the net product of industry, and the second to maintain, and if possible to improve, their real earnings in relation to other classes of workers – i. e., to maintain their position in relation to *average earnings.* As profit growth and productivity growth varies greatly as between good and bad firms and as between growing and declining industries, these two incompatible objectives are reconciled, and can only be reconciled, by inflation. The less efficient firms must raise prices to avoid going bust *despite* the fact that they are normally price-followers; and their price-leaders follow suit sooner or later, since in the short-term, they would otherwise be faced with inability to satisfy demand – not only long queues but much larger queues than those of their competitors. It is no good for Ford to sell cars at *half* the price of other comparable cars, if at the same time they have a waiting list or a delivery period which is so much longer than that of other makes. Hence the wage increases which they grant and which they can well afford without having to raise their prices, sets a process in train which in the end causes them to "fall in line" and to raise their prices as well, thereby increasing their profits even more. Hence there is a built-in accelerator in this kind of wage-price spiral. (We could sum up the situation by saying that the object of wage negotiations is to demand either one of two different objectives, whichever is the greater.)

I confess I cannot see *how* this problem can be satisfactorily resolved. One country can alleviate the problem at the expense of others by external success, which enables it to lower raw material prices through currency revaluations – but this is a temporary advantage, since the policy succeeds only so long as reductions in the rate of inflation in terms of domestic currency are re-inforced by a diminished growth of profits and in consequence of lower wage claims. Thus Germany has now reached the point where it does not want further currency revaluation, though it knows that in its absence its rate of domestic inflation will become greater.

I should like to end this discourse by a review of the various lines on which the problem could be tackled – though I confess I do not regard any one of them as a starter, except perhaps as a very long term solution.

(1) One would be to abolish trade unions, the right to strike and the

system of collective bargaining, and then entrust some independent tribunal with the job of fixing wages and changing differentials when necessary. This requires a totalitarian regime of some kind, whether Fascist or Communist. (Chile under Pinochet, who managed to hold wages down by getting rid of unions and strikes etc. is an example – it remains to be seen how long it will last. Other dictatorial or quasi-dictatorial regimes in Latin America – like Brazil – have failed to hold down inflation mor than temporarily).

(2) A different kind of solution would be to nationalise all large oligopolies, so that the large differential profits of the most go-ahead enterprises would accrue to the state, and not to private owners. U. K. experience does not suggest that state enterprises are any less prone to strikes etc. than private firms, but since, in our mixed economy, it is almost invariably the private sector which is the pace-setter, it is not necessarily conclusive in the context of an economy in which the private sector is restricted to small-scale enterprises in services etc. At any rate there seems to be one country: Austria, where *all* large enterprises were nationalised after the war, which managed to introduce a centralised system of wage-determination, which is non-inflationary and where workers are not strike-prone. But Austria is a small country, which suffered a great deal first from Nazi rule, then the widespread war devastation, then foreign military occupation etc. – events which produced a degree of social cohesion and on common objectives which prevailed in Britain also *during* the last war, but which is not easily attainable in peace-time.

(3) Abolish the distinction between capitalists and workers by transforming all enterprises into worker-cooperatives. This is the favourite of a small group of ex-Socialists who rely on the success of the "Mondragon experiment" in the Basque provinces of Spain. However, these Basque cooperatives consist of small-scale firms – of 400 employees or less, just as the similar Baden-Scott Fellowship in Britain. The only comprehensive example of a cooperative system of production is Yugoslavia, and it may be that Yugoslavia will evolve a form of organisation of human societies that will serve as a pattern to others. For the moment, however, Yugoslavia is still a one-party state and despite this it has not been conspicuously successful in controlling inflation which is much higher in Yugoslavia than in other Socialist countries, and much higher also than in many Western countries[7].

(4) Compel (by law, backed up by monitoring institutions) oligopolistic price leaders to pass on their cost reductions promptly to the consumer. However, if they really did follow this policy, the consequence would be that the less efficient forms would not survive – or rather only survive so long as the price leaders'buyers were "rationed" through long delivery dates. Very often, moreover, the large profit increases which induce the inflationary wage increases are the consequence of the successful introduction of some new product – like the Xerox copying machine, or the mini-computer, and it is difficult, in these cases, to prevent exceptional profits from being earned without inhibiting the most important forms of technical progress.

(5) Syphon off the excessive profits by means of an Excess Profits Tax, as in war-time. In the last war the E. P. T. was 100 per cent which had a very steadying effect on wages – without noticeable ill-effects on the running of the economy. But this was in war-time, where the state was the main, if not the sole buyer, and where the "Dunkirk spirit" served as a substitute to material incentives, the comparative absence of which is supposed to account for the poor performance of British industry in the field of product-innovation, quality etc.

None of these solutions seem to me to be practical or viable, in the timespan of the coming decades, or even the coming century, within the framework of a democratic society and a mixed economy.

I should like to end where I began. 20th century capitalism is an outgrowth of 19th century capitalism, which did *not* suffer from our present dilemmas – in which output and productivity growth were essentially cost and price-reducing, not wage-rising. There were no oligopolies, and until late in the century, no trade unions. But however great the nostalgia for those good old days, there is no way of putting the clock back. Whatever the dreams of people like our right-wing Tory politicians, or our right-wing economists, the Keith Josephs and the Hayeks, there is no way of restoring the free-market system of the 1850s. Even the most successful of the newly industrialised countries – countries like S. Korea and Taiwan – manage such a system for a comparatively short period, until the stage is reached in which labour is organised and begins to demand higher wages. And then they gradually become exposed to the same problems – of which my own country, Britain, suffers most, simply because it is the oldest industrial country in the world.

Notes

1 Between 1812 and 1896 prices fell by more than 50 per cent.

2 In the quarter of century 1820–1845 export prices of cotton goods fell by ⅔ rds.

3 Wage Formation in Historical Perspective: the French experience, *Cambridge Journal of Economics,* June 1979, pp. 99–119.

4 Cf. *e. g., Aspects of Tropical Trade 1883–1965,* the Wicksell Lectures, Stockholm, 1969.

5 See W. A. H. Godley, "Inflation in the United Kingdom" in L. B. Kranz and W. Salant *Worldwide Inflation,* Washington DC., Brookings 1977, table 2. Since this paper was published, Mr. Godley has extended the series of this table 2, to cover the years up to 1978, and the statement in the text refers to the extended series.

6 Each employee of Marks and Spencer and each square yard of shop floor space has three times the value of sales as in the average of the distributive trades. Productivity at Ford is at least twice as high (in terms of numbers of cars per worker per year) as that of British Leyland.

7 See *World Bank,* World Development Report, 1981, Table 1.