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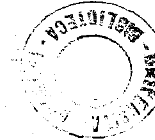

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require the development of models of fiscal policy and reputation along the lines suggested above.

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THE POLITICS OF INFLATION AND ECONOMIC STAGNATION
A Review Essay

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1. Introduction

The volume *The Politics of Inflation and Economic Stagnation* (The Brookings Institution, 1985, 612 pp.) edited by L.N. Lindberg and C. Maïer, contains sixteen essays originally presented at a 1978 conference organized by the Brookings Institution. The authors are primarily political scientists, historians and sociologists, with the exception of a few economists. The central theme of the volume is the worldwide economic malaise of the 1970's. Even though some of the chapters have been marginally updated to reflect the events of the early 1980's, the general focus is on issues that were relevant in the previous decade. There is no discussion in the book of what we have learnt from the important policy experiments of the 1980's.

The volume is divided into five parts. Part 1 contains two introductory essays by the editors. Part 2 focuses on group interests and group interaction in the political and economic spheres, with essays by Hirschmann, Keohane, Crouch and Zysman. Part 3 contains five essays, on the interaction between government institutions and individual citizens, by Hibbs, Klein, Cameron, Barry and Wooley. Part 4 analyzes the experiences of four industrial countries during the 70's: West Germany (Kloten, Ketterer and Vollmer), Sweden (Martin), Japan (Yamamura) and Italy (Salvati). Finally, in part 5 the editors suggest some tentative normative conclusions.

2. Political causes of inflation

As one can gather from the title of the book and from the professional qualification of the authors, all the essays in this volume focus on political and institutional aspects related to the inflationary process. But the approach taken by most of the authors differs in many important respects from the one

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generally advocated by economists. Economists have identified two distinct issues in their analyses of inflation [see Brunner (1975)]. The first one concerns the relationship between money supply and the general price level. One can venture to say that this issue is no longer controversial among economists. The empirical evidence has convincingly established the proposition that inflation is a monetary phenomenon, in the following sense: over long periods of time, there is a very tight relationship between the rate of inflation and the rate of growth of some monetary aggregates.

The second issue is how to account for the growth of money supply. Things here are much more unsettled, and on this issue economists are seeking the help of political scientists and historians. But note that economists are very specific on both the nature of the question posed to political scientists and on the methodological standards they expect from the answer. The question focuses on the decision process of the monetary authorities. The method consists of an analysis of the incentives and of the constraints of the individuals involved in the decision process that is being studied.

An economist in agreement with the above statements would be utterly disappointed in reading this book. The authors (with the exception of Hibbs and Wooley in part 3) explicitly or implicitly reject the idea that the roots of the inflation problem lie in the decision process of the monetary authorities. They tend to believe that prices and wages are formed in an economic vacuum, and that they are unresponsive to market conditions. Many of them also reject the standards of methodological individualism, and 'presuppose that social outcomes derive from contending group interests and are best explained in reference to group preferences' (p. 51). Their analysis, accordingly, focuses mostly on group rivalries in the conflict over the distribution of income, on institutional aspects of the labor market, or on structural features of the real economy. The general picture that emerges can be briefly summarized as follows: price stability is a public good. Each group has an incentive to free ride on the provision of this public good, by choosing an 'inflationary strategy of income augmentation' (p. 67). As every group tries to do so, this free riding process results in generalized inflation. The antiinflationary recipe, accordingly, is a form of 'neocorporatism' or, in more romantic terms, 'moving from the logic of conflict to that of cooperation' (p. 581).

This prisoner's dilemma view of inflation is, to me at least, genuinely incomprehensible. What do the 'inflationary strategies of income augmentation' consist of? Presumably, some of the authors here are referring to political lobbying and pressures to obtain fiscal privileges. But if this is the case, it is hard to see what can be gained by analyzing this phenomenon at the level of the groups who are the ultimate beneficiaries of such privileges, rather than by focussing on the institutional details of the electoral and budget processes, or on the incentives and constraints of the individuals involved in the fiscal policy decision making. Moreover, an analysis of the decision process of the monetary authorities who have to choose whether or not to monetize these pressures should be central in this story. Other authors seem to argue that the distributional conflict is a cause of inflation directly through the mechanism of price formation in product and labor markets. But in this case too, the issue is not clearly posed. These authors seem to confuse absolute with relative prices: in the presence of a nominal anchor provided by the monetary authorities, the bargaining process of contracting parties determines only relative prices, and not their absolute level. Moreover, it is not clear how the authors can escape the conclusion that these relative prices are determined primarily by market conditions.

Of course, the idea that inflation can be understood as the equilibrium outcome of a non-cooperative game is quite attractive for many economists. However, such a game is quite different from the one envisaged by most of the authors of this book: it is a game played between the monetary authorities on one side and the private sector on the other side. In this set up, inflation emerges as an equilibrium outcome essentially because of the lack of a non-distortionary fiscal instrument, combined with the inability on the part of the monetary authorities to precommit to a specific course of action [cf. the seminal work of Kydland Prescott (1977) on the time inconsistency of non-inflationary monetary policy]. The solution to this kind of prisoner's dilemma consists of institutional reforms that change the policymaker's constraints, or its incentive structure – see, for instance, Rogoff (1985).

Needless to say, this recent development in the theory of economic policy is completely ignored by all the authors of this book. More generally, the notion of rational expectations is mentioned only twice in a book of 600 pages, just to be quickly dismissed. It is assimilated to the 'supply-side' view of economic policy, and it is summarized as follows (p. 43): 'The essential view of the supply-side and ≪ ratex ≫ view is the psychological premise that economic decisions by individuals and organizations are based more or less exclusively on marginal costs and on expectations of future inflation.'

3. The political economy of antiinflationary policies

The authors of this volume emphasize the conflict over the distribution of income as a major *cause* of inflation. In the previous section I argued that this emphasis is misplaced, and that the search for political causes of inflation should instead focus exclusively on the politics of monetary policy. In this section I want to suggest that the emphasis on the existence of a political conflict over the distribution of income may nonetheless be appropriate, if we analyze inflation from a different point of view – namely, if we ask the question of *how to stop* inflation (rather than the question of what are the causes of inflation). My argument can be briefly stated as follows: the implementation of an antiinflationary program forces the government to make

some decisions concerning the distribution of income, that would otherwise be left to the working of anonymous market forces. In the absence of a broad political consensus in support of the program, the government is unable to make such decisions, and the antiinflationary program is accordingly a lot harder to implement. I want to elaborate more on this point.[1]

Once inflation is under way, expectations of future inflation get incorporated into nominal contracts (typically, in labor and financial contracts). Any antiinflationary monetary policy violating these expectations causes large redistributive gains and losses, which in turn have adverse effects on the level of economic activity. At the same time, a lack of credibility generally prevents the government from announcing well in advance that an antiinflationary policy will be started at some specific future date. These problems are well known to economists and policymakers.

In principle, the government could avoid the output losses that result from unanticipated deflation by adopting a currency reform similar to the one suggested in Leijonhufvud (1984): the government should legislate a time table according to which outstanding nominal contracts ought to be adjusted for the immediate and unanticipated cessation of inflation. Some variant of this scheme has in fact played a prominent role in the stabilization programs currently under way in Argentina and Israel. In Argentina, this device has been applied to outstanding loan contracts. In Israel, a substantially analogous scheme has been applied to labor contracts, by suspending all forms of backward – looking indexation and by predetermining a specific time path for nominal wages.

It is clear however that for this kind of program to be successful, the pattern of income redistributions implied by the legislated rate of conversion of nominal variables into real magnitudes must be politically acceptable. This condition directly concerns the degree of political cohesion and the legitimacy and popular support enjoyed by the government, irrespective of the institutional aspects of the monetary policy decision process. If the political climate is such that this condition is not met, then there may be only one other way to stop an ongoing inflation–namely, to separate completely the institutions in charge of the money creation process from the political control of the government and of the legislature, and to engineer a sharp unanticipated deflation. The monetary history of Europe in the 20's suggests that this is how most European hyperinflations were ended. To the extent that nominal contracts outstanding during an hyperinflation are generally of short duration, such an unanticipated deflation may create only relatively mild output losses.

Stopping a rapid inflation may be facilitated by the existence of political consensus in a second respect–namely, by allowing the imposition of direct

[1] This point, and many of the arguments that follow, have been suggested to me by Axel Leijonhufvud in several discussions on this topic.

price and wage controls during the early phases of the disinflation. As documented for instance in Dornbusch and Fischer (1986), these wage and price controls, by arresting inflation more rapidly, lead to an immediate improvement of the fiscal deficit in real terms. This in turn can add credibility to the fiscal and monetary aspects of the program.

It is unfortunate that none of these issues is discussed in the volume edited by Lindberg and Mayer. For it is probably here, in the investigation of why it is so hard to arrest an ongoing inflation, that the analysis of the politics of money creation needs to be integrated with the analysis of the conflict over the distribution of income.

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