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PROBLEMS OF ECONOMIC INSTABILITY

The economic history of the United States shows an unstable pattern of growth. While there has been long-run economic growth, it has taken place within a continuing sequence of business cycles. At various times in the recent past, Americans have suffered economic instability in the forms of inflation, unemployment, and slow growth. Each of these problems deserves closer scrutiny.

Inflation and Its Problems

One form of economic instability is called inflation, a general increase in the level of prices. As we have seen in Chapter 12, inflation can be measured by an index, such as the Consumer Price Index. The CPI, compiled by the Bureau of Labor Statistics in the United States Department of Labor, measures changes in average prices paid by consumers for a wide array of goods and services. The CPI statistics show that the average level of prices paid by consumers has more than tripled in the last 20 years. Measured by the base of 1967 = 100, the CPI was about 330 in 1986.

EFFECTS ON CONSUMERS Why should the average person be concerned about inflation? Remember that the price of every good or service equals the sum of the incomes (profit, interest, wages, and rent paid for its production. Every price increase, then, must result in an increase in some income. Thus, if all prices doubled, all incomes would double. In that event, inflation might be thought to do no harm.

The problem with that argument is that during a period of inflation, all incomes do not keep pace with rising prices. To be sure, some people stay ahead of inflation because their incomes rise even more rapidly than prices. Salaries increase most quickly in employment markets in which supply remains low relative to demand. Other incomes rise at the same rate as inflation. People earning these incomes enjoy a standard of living no better or worse than before.

The people most seriously affected are those whose incomes do not rise equally with price increases. They suffer a decline in their real standard of living. The most likely victims of inflation include retired persons living on fixed incomes such as pensions. Other victims include low-income persons receiving transfer payments, unskilled workers, and the unemployed. In other words, those hardest hit by inflation are often those who can least afford it.

Since inflation causes some people to gain and others to lose, it frequently turns attention from economic growth to questions of redistribution of income. Income is transferred from those who cannot increase their incomes at the same rate as the rise in prices to those whose incomes rise more rapidly than prices. Usually the losers then seek from government some means of maintaining their standard of living. They might ask for **indexing,** linking incomes directly to general price levels. Price controls are yet another example of an effort to cope with the effects of inflation. Neither promotes long-term economic growth. In fact, both have a negative effect on growth.

EFFECTS ON SAVINGS Inflation also undermines the function of money as a store of value. As the price level rises, the purchasing power of the dollar declines. For example, the same $1.00 that would have purchased 100 cents' worth of goods and services in 1967 will buy only one third as much, or about 30 cents' worth, today.

Moreover, as people come to believe that inflation is permanent, they usually adopt the view, "Buy now, as things will never be cheaper." They tend to spend their incomes quickly and save little or nothing. While this behavior may be rational in a period of inflation, it has damaging effects on economic growth. Today Americans habitually save only 5 to 6 percent of their incomes, the lowest savings rate in any industrial country. Without adequate saving, the nation lacks the means for investment to power future growth. Since inflation has contributed to reductions in saving, it is one of the reasons why the economy is no longer operating at its full potential. Reducing inflation could reverse this situation.

EFFECTS ON FOREIGN TRADE International trade is also affected by inflation. If prices of American goods rise faster than those of other nations, customers, both foreign and domestic, will shun the higher-priced goods. If the United States cannot sell its goods to other nations, it will not be able to afford to buy goods from foreign countries. Such an outcome would have a harmful effect on world trade. American export industries would be injured, and economic growth would be reduced.

EFFECTS ON GROWTH Although all of these outcomes of inflation are significant, perhaps the most harmful is that inflation creates uncertainty. This uncertainty, in turn, leads decision makers to reduce their risks. When entrepreneurs are reluctant to take risks, the economy stops growing. Thus, inflation creates an environment in which confidence in the future is made more difficult. Such an atmosphere discourages long-run business commitments, striking another blow to future growth.