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# THE FREE MARKET SYSTEM

Dr. Allan G. Gruchy

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Reviewed by: Colonel Tom W. Sills, USA

Date: 29 September 1959

INDUSTRIAL COLLEGE OF THE ARMED FORCES
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# THE FREE MARKET SYSTEM

14 September 1959

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DR. KRESS: General Mundy, General Houseman, Gentlemen: Our speaker this morning, Dr. Allan G. Gruchy, Professor of Economics at the University ofMaryland, is truly an old friend of this College. He has taken part as an instructor in all six of the previous economics review courses, and he would have done so this time except for university commitments. I hope we will be able to have him back next year.

He has truly given us of his wisdom over the years. There is an old proverb, you know, that says, "Knowledge comes but wisdom lingers."

Now, this speaker is also a close student of the school of economics known as institutionalists. You may remember that I referred to that school the other day just briefly.

This morning he is going to give us his observations on the Free Market System, what it has been in this country, and what it possibly may be.

Dr. Allan Gruchy, it is a pleasure to introduce you to this audience and to present you from this platform.

DR. GRUCHY: General Mundy, General Houseman, Members of the Staff, and Members of the Class of 1960: I can imagine no topic in the field of economics which is more controversial than the problem of prices. It seems to me that the approach to prices is almost like the approach to religion or politics.

We have some economists who claim that mild inflation is a worthwhile goal--for instance, Sumner Schlichter. Other economists, such as Gerhard Colm and G. C. Means, claim that inflation of any type is an evil, a social evil. We also have economists who are called deflationists, who feel that in the long run economic systems tend toward deflationary conditions and that the price problem is not the real problem but the problem is that of growth.

Equally reputable economists will tell us that in the long run the main problem is that of inflation. With our modern economy with full employment programs, the tendency now, they say, is to develop inflationary pressures, and the long-term trends are therefore inflationary.

So we have economists, equally reputable, equally well known, on both sides of the question. This, of course, is not new to you, but I cite these facts in order to prepare the way. I don't come here to try to convince you one way or the other.

The famous economist, Roy Harrod, in a recent book, "Policy for Inflation," meets this very question of economists with their divergent

opinions. He tells us that economists, in his younger days, were born as little liberals or little conservatists, those being the main parties in Great Britain, and some of these little liberals and little conservatives grew up to be professional economists and they became deflationists or inflationists. It appears to be something in their blood, he tells us. And of course this is very worrisome to a government official who has to get advice from economists about prices and other matters. But Professor Harrod goes on to say that the thing to do is to find out first of all what an economist is. Is he a deflationist or is he an inflationist? Then, after you have found out, you make allowances for what he says--just as in the case of other men you may have the very finest experts in various fields--speaking now of England--and the Minister would ask, first of all, "Is he a member of the Conservative Party or is he a member of the Labor Party?" Having asked those questions and having gotten the answers, the Minister or any person is then in a position to discount or to weigh the opinions of the so-called experts.

The same thing applies to economists. We have our ingrained views in this country; we are born little Democrats or little Republicans, and we grow up and become economists, some of us, and we become deflationists or inflationists. We become people who follow Keynes, for instance, and in that case we tend to become deflationists, holding that in the long run the economy, in terms of prices, tends to be deflationary and the main problem is not the price problem. This, of course, is

nothing new. The school of economists to which I belong as a very minor member antedated the Keynesian school with the same proposition that the tendency of the economy is toward deflationary outcomes.

Other economists, I just told you, take the view that the economic system is not deflationary in the long run. I am not going to try to solve this problem, This morning I am going to try to give you a number of building blocks. I am going to try to present the problem of prices, markets, and price movements from the viewpoint of a scientist--although I belong to a group of economists, a minority group, perhaps, and although I belong to a political party, I am still able to separate my political views from my economic views. In terms of economics I would say that I am very much like a plumber. When your pipes are plugged up you call a plumber in and he tells you what to do about the pipes. Likewise, you called me in, and perhaps I can tell you something about prices and what to do about them. The plumber is not concerned whether or not you clean your pipes out. If you don't, it's fine; if you do, you pay your $25, and so on. In a sense the economist is in a similar position. If I make a price recommendation, I am not particularly worried if no one accepts it, or very few.

There's a slight difference here, perhaps. As an economist I am more concerned about the welfare of the economy than a plumber would be concerned about the condition of the pipes in your house. But in a general kind of way, we make recommendations and we let it go at that.

Of course, after four o'clock, when I close the shop and become a voter, I vote for parties and I vote for positions, but from nine o'clock until four o'clock during the day I keep my political views separate from my economic views.

This morning I am representing the profession and not a political party or a political viewpoint, although I have told you what viewpoint I represent, and a few of the policies. Perhaps some of you have guessed, perhaps you already know, a few of you.

Coming back to the price problem, I can think of no problem which today commands more interest. Some of you may have just gotten a copy of the Third Report of the Britich Council on Prices, Productivity, and Income, the report of the so-called three wise men, Lord Cohen, a lawyer, Sir Howlett, a business man, and Sir Robertson, an economist, recently replaced by Mr. Phelps Brown of the London School of Economics--three wise men appointed in August 1957 to face the problem of prices.

In Norway a committee has just come forth with a report, a committee of four men, headed by Krudver Havermaa, one of Norway's most famous economists--a committee on prices and incomes. In Norway, since 1952, prices have increased about 20 percent and they are mighty concerned about prices in Norway.

In our own country there has been a rash of bills, as you know. Senator O'Mahoney has a proposal, Senator Clark and Representative Royce have a proposal for a price and wage board, other representatives have brought forth bills along a similar line, to set up other price boards,

and you may have gotten the recent second report from the Nixon Cabinet Committee on price stability for economic growth. The Joint Economic Committee ran a study on price stability and economic growth last year. This year they got another $200,000 and are running a second series of studies on prices and price stability--price investigations.

Last night I calculated that, with the current stock of economists--this is about 10,000--since we use about 100 economists a year at these Joint Economic Committee investigations, the current stock of economists would last us for price investigations about 100 years--10,000 economists. I don't know. I sometimes wonder if we will be going on for 100 years with these price investigations. I am beginning to wonder if we haven't reached the point of diminishing utility in terms of investigation. I was speaking to one of the economists who is on this second round of the Joint Economic Committee--that is, this year's round--and he shrugged his shoulders and said, "It's just the same thing all over again, but new faces--the second crop of 100 of the 10,000 economists."

So the interest in prices is widespread. Governments are concerned. Political leaders are very much interested. Economists are carrying on investigations, and I can imagine no problem which is of greater interest.

In order to lay bare some of the problems in this field, I want to

talk a short while about prices and then pass on to price movements, and then, thirdly, come to the question of price policy and what may be done about prices.

Coming now to the nature of prices, prices to most people, I think, are a very simple thing. I am sure that when the average housewife goes into a grocery store and pays 20 cents for a quart of milk she looks upon the price as being a rather simple thing, and it is. The price of a commodity is simply the amount of money the commodity will command, the amount of money you give up for the commodity. If you buy a bottleof beer and pay 25 cents, you've given up 25 cents for the bottle of beer. A little more technically, we say that the price of a commodity is the power of the commodity to command other goods in exchange, especially money, the power to command other things in exchange.

So to most Americans prices are things they see every day. They pay them, are involved in them, and are very close to them. I don't think the average American, the average housewife, realizes what is behind a price. I don't think that the average housewife realizes, when she buys a commodity, when she pays 20 cents, or 25 cents, for a commodity, that she is doing many things. She is first of all making profits possible for business men. She is secondly paying wages or making wages possible for workers. Thirdly she is giving direction to our flow of resources. When she buys milk she is calling resources toward milk

production, and she is directing resources away from milk production.

So, every time you buy something, you in effect are putting your stamp on the direction of the flow of resources in this country. Since you can't buy all that you want, the things that you don't buy are kept out of the flow of production, and the things that you do buy, of course, are brought in. And of course this housewife maintains the level of production and employment, and contributes to sustained growth when she buys what is being produced. As you all know, high levels of production, high levels of employment, and sustained growth are national goals which are very very important to us.

Also, these things called prices do other things, of which most people, I believe, are unaware, although at times they may realize these developments. The same items, prices, can wash away or erode the income, the wages, and the salaries of these people of whom I have been speaking. They can erode the principal value of bonds and other forms of indebtedness. These same items, prices, can create speculative opportunities, not all of which are in the interest of the Nation. I have in mind the speculative activities which broke out in June 1950, after June 25, 1950.

Also, prices open the doors to boom and bust. I don't say prices are responsible for boom and bust, but I do say that prices provide an avenue for boom and for bust. In other words, the ups and downs of our

economic system are carried on through the instrumentaly of price. With prices in a simple economy you would not have boom and bust. So it is not unusual, then, that some economists have defined economics as the science of price. I refer to Herbert J. Davenport, an economost that you probably have never heard of. In 1913 he defined economics as the science of price. And I can remember when I came along, a few years later, that the professors of my time derided, in a sense, Professor Davenport for his narrow definition of economics. "It is much too narrow," they said, "It is much more than the science of price; it is a materialistic approach; it is excessive attention to markets, to prices; a much too narrow conception of economics."

We were fed on the economics in those days of Alfred Marshall. He had a different view, but somewhat similar. He said that economics is the general theory of the equilibrium of demand and supply. This definition is a little more general and a little more sophisticated, perhaps, than Davenport's, but I can assure you that I have come to have more respect for Davenport in recent years than I had when I was studying him and others in the 1920's.

In Marshall's day they were still concerned about prices, but when Keynes came along after 1929, principally after 1936, although people were concerned with prices yet, the new interests became attached to totals, aggregates--consumption, investment, production, savings--and prices were pushed into the background. Oh, sure,

during the depression we were trying to reflate, to raise prices back to where they were in 1929, but that wasn't the main problem. The main problem was to find work for people, to have production, to have consumption, and later to have savings and investment. Keynes and the Keynesians pushed prices into the background. The so-called micro-economics was pushed into the background. The ~~mackrel~~ macro economics, the new economics, the economics of the large, hence ~~mackrel~~ macro, the aggregates, now took the center of the stage. I can recall reading in Keynes's final chapter of the general theory of interest, "Employment and Money." that after you have reached the level of full employment the forces of the economic system which had been discussed and described by Alfred Marshall, the competitive market forces, would then come into play and somehow keep the full employment or the high level of production at that point.

But all of you know that the situation is entirely different. When we get high employment today, full employment, or whatever you want to call it, we get tremendous inflationary pressures, so that it seems that now, when we get full employment, we almost inevitably have inflation. And what Keynes has to say doesn't seem to be entirely satisfactory, although I'll be the first person to say that what he had to say and what his followers have to say has been extremely useful and is extremely useful. But, on the price problem he had little to

say and, generally speaking, his followers have not too much to say, so that the interest in price has revived somewhat the older economics, this interest in the administered price, which is a micro problem, an industry problem.

I 'd much prefer to think in terms of speaking about aggregates, oh, yes--consumption, savings, investment, production, employment--and also prices--problems of industry, problems of the firm, problems of the trade union. I think we need to combine the two of them. I don't think that Keynes had all the answers, and, if you examine some of the earlier economists--and I have in mind Thorstein Veblin--you will find that they were very much concerned both with what Veblin called the prices of the partly monopolistic firms--that is the large or oligarchy firms as we call them today--and they also concerned with the problems of what they called total product, total consumption, and total investment.

So the pendulum has swung back in the field of economics and today we are much concerned about prices and we have a much higher respect for those economists who define economics as the science of price.

The first topic is the topic of types of prices.

CHART

I have a simple diagram that attempts to summarize some of the major categories of price. This is not an exhaustive diagram or chart, but it gives us a rather good coverage of some of the main types of prices. You will notice on the diagram that there are two general categories

--international and domestic prices. International prices follow the three main categories--the manufactured products,; services, such as banking and shipping, and the primary products, the raw materials, the coffee, the wool, the tin, the jute, and the like. On the domestic scene we have two main categories—wholesale prices and retail prices. Of course these categories, these main categories, are broken down into many subcategories. For instance, wholesale prices may be broken down into raw materials or crude materials, materials that are processed, and then, finally, finished goods. Or they may be broken down into farm products, industry products, various types of raw materials, consumers' durables, consumer nondurables, producers' goods, et cetera.

These categories, at the top, there, the ones I just mentioned, are largely the categories used by economists and by business men, or rather by government officials and by business men, for the purpose of gathering statistics and for reporting conditions in markets, conditions about prices, here and abroad.

The bottom classifications here--market dominated prices, administered prices, and directly controlled or government-controlled prices--are another way of looking at prices, but not the typical way in which business men look at them, or even government officials. This bottom classification of prices is the kind of classification which appeals mostly to economists and people in general who carry on research into the problem

of prices, markets, and price fluctuations.

You will notice that the categories are slightly different. In the case of international prices we leave out directly controlled or governmentally controlled prices. There being no international government, we don't have as yet any method of controlling prices through government in the international field, although there have been attempts of governments to come to price agreements. That leaves in the international field, then, the market-dominated prices and the administered prices.

I want to speak very briefly about these types of prices, these classifications--market-dominated and administered prices. The market-dominated price, as the phrase suggests, is a kind of price which is flexible. It is dominated by the market or the conditions in the market, and is therefore dominated by supply-and-demand conditions. We call it flexible because it reflects changes in the supply and demand conditions. I can't think of a better example of a market-dominated price than that of steel scrap. The Bureau of Labor Statistics a few months ago published a study called "Price Flexibility." They studied some 1789 commodities. One of them was steel scrap. They found that whereas steel bars did not change at all in the three years, steel scrap changed on the average of once a month, from January 1953 to December 1955, a three-year period. Steel scrap is obviously a market-dominated price. A change in supply conditions will bring a

change in price; a change in demand conditions will likewise bring a change in price. In general, market-dominated prices are found, of course, in agriculture and in certain lines of industry, such as the textile industries, the apparel industries, and so on.

The other type of price, the administered price, is a price which changes infrequently over a series of transactions. I mention steel. We don't normally have very frequent changes in the price of steel. This same BLS study that I mentioned just a few minutes ago found that certain products did not change their prices at all during the three-year period--1954-1956. I believe I mentioned 1953-1955. It was 1954-1956. Just by way of illustration: What prices did not change in those three years? The prices of cigarettes, chewing gum, cotton thread, crude petroleum in the Western States, typewriter ribbons, and steel bars did not change during these 36 months.

Now, of course, the statistics don't always tell all the story. Sometimes there are shadings of prices away from list prices. These studies are based upon list prices, so there may be some slight variation from the list prices. But in general they are a good picture of what happens.

At the same time, the prices which changed at least once a month included--I mentioned steel scrap--jute, lumber, agricultural products, beef, rye, potatoes, eggs, and flour--examples, of course, of market-dominated prices.

The administered price, of course, appears in the large-scale industries, where you have big corporations and big unions. The administered price changes infrequently. Now, I want to note just very briefly a few things about the administered prices. First of all, they are not new. We've had administered prices a long time, ever since the first medieval landlord fixed the price on crossing the ford on his river, or the medieval burgher fixed the price on his hotel room in the Middle Ages, we've had prices which have not changed frequently over the year or over the years. Administered prices are prices that can be influenced by one or a few individual, whereas the market-dominated prices are prices that cannot be influenced by an individual or a few individuals.

What is new about the administered price is that today these prices are backed up in the areas of concentration by economic power, by the large business and the large union, and this is the new aspect of administered prices. We didn't have this in the Middle Ages. We didn't have this is the 17th century, or in the 18th century, or in the 19th century. It is economic power in the hands of a few individuals such as a board of directors of a corporation or the executive board of a large trade union.

I shall also point out that the administered price is not an evil price. I don't want you to get the idea that administered prices are by definition bad prices. They are not necessarily bad prices. An administered price is a necessary price. It belongs to a way of doing business. Take for

instance the automobile industry. There are three major concerns here producing automobile products, similar products, similar prices—not identical, but similar. Can you imagine the industries having competitive prices, flexible prices, the automobile firms having flexible prices, each of the three undercutting the other two on a cut-throat basis? It is impossible for them to operate in that manner. They've got to have the same price, roughly, for the same automotive product, and the same thing is true in the steel industry, in the aluminum industry, in the oil industry--certainly at the wholesale level. They've got to have somewhat similar prices. You can't have competition among 3 or 4 or 5 people on a price basis, although you may have competition on a service base or a quality basis.

The only problem to ask about an administered price is: Is it too high or is it too low? It may be a socially undesirable price, but by definition it is not a socially undesirable price. It may be a perfectly satisfactory price. Then we should also observe that the administered price has become rather dominant, especially in Western Europe. I think if you go to Europe today--many of you have been there, some very frequently--you'd be hard put to find a competitive price. The typical business man in Europe belongs to a ring, or a vorbund, or an association, and the association will suggest a price--recommend a price--and most business men will follow that price.

I was in Norway in the summer of 1957 and the Price Director of

the Norwegian Government had just compiled a list of some 407 trade associations, as we would call them, or rings, as the British would call them, in Norway, a very small country of between 3 and 4 million people, and a relatively small economy. That's typical of Western Europe, even for small business men. Of course large business men normally follow administered pricing as we do in this country.

We hear a great about Belgian and Luxembourgian and German competition with American steel. It is true that a Belgian steel producer or a Luxembourgian or a German steel producer will compete with an American steel producer in the United States; but in Belgium, in Luxembourg, in Germany: Do you think the same people who compete with American producers in this country will compete in their own countries? Oh, no. They do not compete on a price basis, these very same producers.

So that, as far as Western Europe is concerned, the competitive price is largely only in the international field. In the domestic field the competitive price is largely an historical museum piece. In our country, where there is a more flexible economy, we have a higher degree of competition, but the trend is in the same direction. Of course we have an anti-trust law which prohibits a lot of price and production policy or activity, whereas in European countries they don't have anti-trust laws. It was only in 1948 that Great Britain passed a monopoly

restrictive act designed to do what our anti-trust law does, and even then on a very limited basis. In most European countries business men are free to form associations, to adjust prices and production as they see fit. The governments, of course, have their policies about prices, which I'll mention later on, but in Europe, in general, there is no general feeling that a business man should not be free to do about prices as he sees fit, and most business men belong to trade associations. So the competitive price is hard to find. The administered price is the dominant price.

I mentioned the British rings. The typical British rings, in the textile field or the boot and shoe field, will not compete. Fortunately Great Britain has a low tariff policy and foreign imports come in, and that keeps British business men within certain price limits. But the same British business men who do not compete at home if they can avoid it will drive the Norwegian boot and shoe producers, or textile producers, to the wall or close to it by exporting to Norway low-priced British textiles and low-priced British shoes, the British textile industry and the apparel industry and the shoe industry being more efficient industries in England, having a broader market.

So they compete between countries, but not to any great extent at home.

CHART

So much for types of prices. I want to speak next about price movements. These prices move up and down. We have price behavior

and I want to talk about how prices move. This chart here will give us a good dea of how prices have moved. I want to explain first of all that there are two kinds of movements. There are individual price movements, where a price moves, like the price of a head of lettuce, the price of a pound of beans, or the price of a ton of jute. Those individual price movements we welcome, because the economy exhibits its dynamism through individual price movements. In various seasons prices go up and down. When things are scarce you expect high prices, and prices move up. There are changes in consumer habits, consumer preference. When the American people don't want commodity "A" but want commodity "B" we expect the price of "A" to go down and the price of "B" to rise as a competitive price. Then some prices go down for technological reasons, individual prices. We expect large industries to lower prices sometimes because they can produce more effectively as they improve the technology of production.

Individual price changes, then, are desirable. They occur quite frequently in some areas, less frequently in others, but they occur in all areas at some time or another. These are no problems, individual price changes. What we are concerned here with in the field of price movement is the changes in groups of prices, changes in wholesale prices, changes in retail prices, or changes in groups within the wholesale price index--changes in raw materials, changes in durable consumer goods at wholesale, or producers' goods at wholesale. These

are the movements which bring us great concern.

This chart shows us what happened to prices from 1953 to 1958. You will notice there are three curves here. The top one is industrial commodities, the red one is total, and the blue one is farm products. This price level here, the total price level, is the wholesale price level, and includes these two groups--farm products and processed foods; and industrial commodities, the prices of which are for all other products than farm products or processed foods. So these two together make up the third price level, the total price level.

In general these prices (farm products) are the flexible prices, the market-dominated prices, and these prices (industrial commodities) in general are the administered prices, the so-called inflexible prices.

Now, you will notice that for three years, 1953, 1954, and 1955, all three price levels were relatively stable, all three groups of prices were relatively stable--the wholesale price index, the index for industrial commodities, and the index for farm products and processed foods. Then, toward the end of 1955 they began to separate. Agricultural prices went down, as you see, very severely; industrial commodities rose and rose continuously, with very little movement downward, by a slow upward step; and the combined two groups of prices, the wholesale price index, rose after 1955, being pushed up or pulled up by this group of prices (industrial commodities) which bulk larger in terms of the amount

of money spent by consumers of all types than does this group of prices (farm products, etc.).

Now, you have heard a good deal about these three years. They are years of price stability, and that is true. Sometimes these three years are referred to as being ideal years because they are years in which we had stable prices.

I want to emphasize in this connection that a price index can conceal perhaps as much as it reveals, and this graph here of price changes, this price level which appears to be stable, if you look at this one alone you say, "Why, yes, that's fine; the wholesale price index was stable." If you ignore these two price levels (industrial commodities and farm products, etc.) of course you may be enamoured with or taken by or impressed by the stability of that red line.

But let me just point out briefly what happened during those three years when we apparently had price stability. As I say, some people look to these three years as being in some way ideal years which should be reproduced, if possible. What happened during those three years? Well, the wholesale price index was stable. It was 111 in 1952. In 1953 it was 110, and stayed at 110 in 1953, 1954, and 1955. Apart from a fractional change it remained at 110. However, as I just pointed out, in those three years the index for farm prices fell from 107 to 89, a drop of some 18 points, indicated by this phenomenon, a drop in the price index for agricultural products. At the same time, the prices for

machinery and automotive products, which are incorporated in this graph here (green), this price trend, rose from 121 to 149, an increase of some 28 points. So, while this index rose 28 points at the end of the period, this index here (farm products) fell 18 points.

If you examine what happened to business and to agriculture during those three years, when the index of wholesale prices was stable and there was not too much change except at the end of 1955 between these two prices (industrial commodities and farm products), not much difference, although farm prices began to fall, in those three years what happened to farm income and to corporate income?

Well, in the three years, 1953, 1954, and 1955, corporate income increased from $36 billion to $44 billion, an increase of $8 billion, or an increase of 22 percent. What happened to farm income in the same three years, when the wholesale price index was stable, but when agricultural prices began to fall, as you see, in 1954 and badly in 1955? In the same period, when corporate profits rose 22 percent, net farm income fell 22.8 percent.

So I would merely raise the question whether those three years of stable prices were such ideal years as many people lead us to believe. Certainly, when business is prosperous--and it should be prosperous, and we hope it to be prosperous--but agriculture is suffering tremendously, you can hardly regard the three years as being any way ideallic.

You will notice also that the recession of 1953-54 started in late

1953 and ran through 1954, so that a part of the price drop on agriculture came from the recession of 1954, but during the recession of 1954 the prices of industrial commodities remained relatively stationary. This was a period, then, of recession, a period of divergency in price in 1955, which divergency became much greater as the years went by.

Now, I am more concerned about the years that came after 1956. You'll see what happened. Industrial prices, as is to be expected, went up, and the fluctuations were not very great. They went up and kept going up in step-like fashion. Agricultural prices fluctuated widely. They went down and up and down and up and then, currently, down again. That is typical of the type of inflexible market-dominated price.

So we have here an illustration of general movements which are of great concern to us, both in the period of so-called price stability, when agriculture was greatly depressed, and in the period after 1955, when the economy in general was prosperous, as you know. We were prosperous in 1955 and 1956. Our prosperity continued until September 1957. Then came the recession of 1957-58, and about April or May of this year the recession was pretty well over and we are now currently in a period of prosperity.

CHART

I have another chart here which I wasn't sure we'd get, but here it is. There was a difficulty in the viewgraph department, but they have done an excellent job, as you will see from the charts we have had so far.

This is a chart which has been prepared by Gardiner C. Means. I want to explain it very briefly. It is a chart showing two types of prices--administered prices and market prices. This chart runs from 1929 to 1957. The administered prices are those that are defined as prices that change less than eight times in eight years. Any price which changes less than eight times in eight years, less than once a year, is an administered price, by his definition.

Then the other group of prices—these are all wholesale prices--those that change 77 times in 8 years, he defines as being flexible prices--77 times in 8 years. These are prices selected from the wholesale price index. They do not, therefore, include all prices but only a portion of the wholesale price index.

He shows us from this diagram how these two groups of prices acted in these years, 1929 to 1957. The broken line here is the flexible price line or curve. The straight line shows the administered prices. Here in the 1920's these two prices were somewhat close together and he regards this as being in a way a normal condition. These prices were in some kind of adjustment.

Then came the depression of 1930 and you will notice that the so-called administered prices declined, but they declined relatively little, whereas the flexible prices, the ones that change 77 times in 8 years, took a precipitous drop, primarily agricultural products and certain competitive

industrial products, textiles, and the like.

Then there was a revival in 1937 and a second recession, as you may recall, and them came the period of 1938-39, and here we have 1941, when the prices again are in some kind of union, some kind of adjustment--the outbreak of the war and the period just before it. Then when the war period came along, you will notice that the flexible prices, the competitive prices, the market-dominated prices, rise, as do the administered prices; but they rise much more rapidly. In other words, the prices that we had trouble with during the war were not the prices of the large industries, the automobile prices, the steel, the aluminum, and the oil. The trouble was with farm prices and the prices of competitively produced products. Those were the firms that were difficult to control under the price administration program.

I recall very well the voluntary program which was started, especially in the Korean War, and the people who behaved were the administered price people, the large industries. The people who misbehaved, if I may use that term, were the small industries, the flexible price industries. Both types of prices rose during the war, but the competitive prices rose more, you see.

Then comes the end of the war period, and once more the competitive prices drop, but the administered prices continue to rise, and we have the more recent situation of about 1954 when they were much more in adjustment, in the sense that they were together, although I would hesitate

to call that a mormal condition.

From then on you will notice that administered prices in 1956, 1957, and up to date have gone up, whereas the flexible prices have come down, and in this case these 77 have remained relatively stationary, with a tendency to fall. So in recent years we have the new phenomenon, the new inflation, in which in spite of, as you know, the recession of 1957-58, at the end here, when our production fell from 145 industrial production to 126, a tremendous drop in industrial production, administered prices continued to rise, although farm prices fell, and the prices of non-durable consumer goods in recent years have been relatively stationary. This is the so-called new inflation, to which I'll have reference very shortly.

CHART

We have here another chart which is a chart produced by the Bureau of Labor Statistics. This chart is a governmental chart. If some of you feel that Mr. Means is perhaps biased in his work--and some of you perhaps do--we can forget about Mr. Means now; this is an official governmental chart. It has all the aura of sanctity that comes from a publication of the Government; it is by the Bureau of Labor Statistics. It is a study made relatively recently, and, as you see from the heading of the chart, it is a study of price flexibility. You could just as well have said price inflexibility. But then, of course, what you do in government is perhaps determined by other than economic reasons, and some people

prefer to hear about flexibility rather than about inflexibility. As a matter of fact, this chart shows more about inflexibility than flexibility.

What they did was to examine 1789 commodities of an index of about 2000 on the wholesale price index. They took this number of commodities and examined their behavior from January 1954 to December 1956, a 36-months period. Then they examined their price changes and classified them by groups. The first group is, no price changes; the next, up to 2 price changes in 36 months; the next group, 3 to 5 price changes in 36 months; and the last group here, 34 to 36 changes in 36 months, or a change on the average of once a month.

You will observe that the bulk of these commodities fall in the groups with very infrequent changes. In the first group there, with no changes, or at the most 2 changes in the 3-year period, there are roughly, out of the 1789 commodities, about 370 items. In the second group, 3 to 5 changes in 3 years, there are 455 items. In the third group, 6 to 8 changes, there are 350 items.

In the first three groups there are 1175 items, or two-thirds of all the items studied. One-third, or the other items remaining, were in groups which changed more frequently. At the other extreme up here we have, in the class of ~~sixxx~~ items that changed 31 to 33 times in 3 years, 50 items. In the last group, items that changed in price 34 to 36 times, there are 115 items. So that, of the items that changed,

you can see that the bulk of them changed infrequently.

As I explained some time ago, the commodities in the first groups over there, the ones that change infrequently, are the industrial commodities, whereas the commodities that changed frequently are the agricultural commodities and such things as steel scrap.

This study shows us, then, the tremendous significance of price inflexibility. The majority of prices do not change frequently. They change over the years, but they do not change as frequently as you might expect or as frequently as the so-called flexible prices change.

I have two other charts here which I want to mention very briefly. These charts show changes in wholesale prices.

CHART

This one shows price changes during the war and the next one shows price changes for the period since 1953. This chart, and the other chart to come, show, as indicated by the legend here, the pink industries, which are competetive. Over here the mixed industries are green, and the concentrated or administrated price industries are yellow. The size of the group is the weight of thecommodity in terms of price and the amount spent on the commodity. So that, for instance, of these two groups here (yellow and green) this group (yellow) is more heavily weighted because there is more spent on machinery and automotive products than there is on metal and metal products. Here is a very slim item over here, hides, leather, and products, which is a very small area,

because, in the total wholesale price index, in terms of the amount of money spent, it has a small weighting.

Now, this chart, which is based on the BLS wholesale price index, shows us that in the wartime period, 1942-47, all prices rose on the average of 50 percent, but this group over here, lumber products and wood products, rose 110 percent, being flexible. This group here, farm products, rose 65 percent. This group, processed food, rose 60 percent.

Coming over here to the administered price groups, as I said, they rose less than the competitive, flexible price groups. This group here, machinery and motor products, in the period 1942-47, rose 30 percent, as compared to 110 percent for lumber and wood products and 50 percent for all products.

CHART

This chart shows the situation in the last few years since 1952. There is a complete reversal. We have had in this period here an inflation of only some 6 or 7 percent, as against 50 percent during the years 1942-47. You will notice that the products that have increased in the last 5 or 6 years are the machinery and metal products group. This group increased about 20 percent, the average being 7 percent. The machinery and motor products group increased about 17 percent.

Here are the flexible prices. Textiles declined. Processed foods increased about 3 percent. Farm products fell some 7 percent during

this period 1953-57.

So you see the behavior of these products in the postwar period has been quite different from the behavior of products in the period from 1942 to 1947.

Now I want to speak about the reactions of the Government to these problems, to these price problems. I have given you a brief picture of what they are. What is the Government's reaction to these developments? Well, the first reaction is that the official policy of the Government, as you full well know, is that we ought to have stable prices. Stable prices do not mean no price changes but that some prices may go up, some prices may go down, but the overall average remains relatively stationary. That is the official government policy.

Some economists disagree with this policy. Sumner Schlichter is a strong advocate of what you might call mild, creeping, inflation. But this is not a policy which is accepted by the President, the Executive of the Government, by the Joint Economic Committee, by the Council of Economic Advisers. Our official policy is one of stable prices.

During this period of time many programs have been followed in order to secure stable prices. I want to mention a number of them. We have, first of all, during the period from 1947 to date, tried a policy of exhortation to business and to labor to restrain price increases and wage increases. We have tried to maintain high taxes, and we have pretty well succeeded in maintaining the high taxes of the wartime period.

We have pursued a monetary policy, one of increased interest rates. We have pursued a budget policy, one of securing budget surpluses. Mr. Truman, as you know, boasts of the budget surpluses he obtained in 1948 and 1949. And of course the current Administration is likewise desperately trying to achieve a balanced budget and perhaps a budget surplus.

Now, in spite of these government policies--exhortation, high taxes, a restrictive monetary policy, balanced budgets, or government surpluses, and reduced government expenditures--we haven't succeeded in curbing inflation. We've had many periods of inflation and, if you agree with me that the period 1953 to 1955, the so-called period of stable prices, was perhaps a phony period, I believe you could say that since 1945 no price period has been in any way a normal price period. In general prices have been going up. The requests for restraint have been largely ignored. The fiscal policy has not been vigorously pursued. We have not raised taxes. I think that today what we need is higher taxes. That would be a very effective force to restrain some of the inflationary pressures.

Monetary policy has been used, but, at the same time that monetary policy has been used, we have had a low production. Our industrial production index has fallen, so that at the present time we are close to where we were a number of years ago. I have compiled a table showing changes in prices and changes in industrial production. That's not total production; it is production of industrial products--finished

consumer goods and durable goods--for four countries--our country, the United Kingdom, West Germany, and Norway. In all these cases 1953 is the base year, taken as 100. In our country, comparing 1953 and 1958, last year, our wholesale price index, which was 100 in 1953, was 108 in 1958--an 8 percentage rise in the wholesale price index. The industrial production index, which was 100 in 1953, was also 100 in 1958. In other words, we were back where we were we had been in 1953, although during the 5-year period we had gone up 7 points, to 107, on the industrial production index.

In the United Kingdom, in terms of wholesale prices, they went up 12 percentage points, from 100 to 112, in the 5-year period 1953-58. Industrial production rose from 100 to 114. They were 14 percentage points higher in industrial production output in 1958 than they were in 1953, whereas we were back where we were in 1953.

In West Germany, the wholesale price index rose 6 percentage points, a little less than ours, in the period 1953-58; and industrial production rose from 100 to 152--almost one-half more industrial production in those 5 years 1953-58 during which our production stood still.

In Norway, the wholesale price index in the period 1953-58 rose 11 percentage points, 3 more than ours. Their industrial production rose 26 percent, or a quarter more, in the period 1953-58, while ours stood still, in the sense that we were back in 1958 where we were in 1953.

So that in our country, whatever we have done about prices, we have succeeded in curbing production. So that in 1958, which was a depression year, we were back where we were in 1953. Today we are out of that low point. The industrial production index today is around 155. The low level was 126 back there in early 1958. But at the end of five years we had made no progress, whereas many European countries had produced a quarter more or a half more or 15 percent more.

So our policies, you see, our tax policies, our fiscal policies, have been accompanied by low production. Our monetary policy has been restrictive. It has curbed production. It has curbed inflation to some extent, although it has not curbed the administered price inflation; and since 1957, August, when the recent recession started, certain things have happened. Since August 1957 the wholesale price index has been quite stable, with a slight upward development. Since August 1957 up to date, farm prices have gone down considerably. Other flexible prices, like textile prices, have been relatively stationary between August 1957, at the beginning of the recession, and the present time.

Since August 1957 wages have gone up . Average hourly wages in industry have risen from about $2.07 an hour, in August 1957, when the recession started, to about $2.20 an hour today. So, in the face of a drop in production, wages have gone up in industry. And the prices of manufactured products, machinery and automotive products, have

likewise gone up considerably since the recession started in 1957, between August 1957 and the present time.

So here, in the face of a tremendous drop in production, farm prices went down, textile prices remained relatively stationary, wages in industry rose considerably, and the industrial products, especially the durable goods, the producers' goods, also increased considerably, a problem, of course, of the so-called administrative inflation, the sellers' inflation, what is called the cost-push inflation, as against the demand-pull inflation of the period 1942 to 1947.

I see my time is about up, so I will leave some of the developments about prices in other countries for the question period.

Thank you very much.

DR. KRESS: Gentlemen, we have to close at 10:00 o'clock. If we have some short questions we can get several in.

QUESTION: Doctor, on one of the charts we noticed that during the recession of 1957-58 the administered prices continued to rise. Would you give us some comments on the basis of that?

DR. GRUCHY: As to why they continued to rise?

STUDENT: Yes, sir.

DR. GRUCHY: I believe I referred to that indirectly during my discussion but I'll be glad to develop it a little further. The reason why prices have increased since 1957, administered prices--well there

are two reasons. One reason is that wages have gone up. For instance, steel wages have gone up, and, in response to that, the steel firms have raised their prices. A second reason why prices have gone up is because some of the industries have been dissatisfied with their profits and so they have raised prices. In other words, in the steel industry, it isn't the case, I believe, that prices have increased only to the amount of the wage increase per ton of steel. They have gone further, above the wage increase. So that in general the main reasons for the increase in prices during the recession of 1957-58 and since have been the power of trade unions to increase wages and the power of certain industries, certain firms, to increase profit margins and prices. Both of these factors have been at work and we therefore have what I would call, since 1957, administrative inflation.

QUESTION: You made a comparison between production in the U. S. and the production in Germany in which you indicated a greater increase in production in Germany in the same period of time. Would you think that production in the U. S. was adequate during this period?

DR. GRUCHY: My answer to that is very simple--no. Of course industrial production is not total production. Gross national product is total production. Although our industrial production, that is, the production of the products of industries, durable goods, and so on, remained the same during 1953 and 1958, our total production increased, that is, the gross national product, which includes farm products and

services, both private and governmental. However, if you measure the changes in total output, that is, industrial plus non-industrial, the average increase from 1953 to 1958 was about 1.8 percent a year. Historically it is about 3 percent a year. As a desirable goal it ought to be 5 percent a year. So, from 1953 to 1958 total output, gross national product, increased a little less than 2 percent. I am firmly convinced it ought to have been closer to 5 percent. And industrial production remained stationary. So from all angles, the GNP angle and the industrial production index angle, our record from 1953 to 1958 has been quite unsatisfactory. There are no political implications to that statement. It is just a matter of economic statistics.

QUESTION: If the foreign countries continue to product goods at the rate that they have, what effect do you think this will have on our prices over a period of time--administered prices, particularly?

DR. GRUCHY: Well, as I mentioned a little while ago, there is some competition yet in the international field, considerable competition, I would say. So that, to the extent that we open our markets to foreign products, to that extent I think there will be a curbing of the trend of administered prices. We already see it in the case of automobiles; we already see it in the case of steel, and so on. So that any tendency in the direction of a low-tariff policy would tend to curb administrative prices, and I believe that would be a favorable development.

In general, as far as Europe is concerned, as Europe gets back

on its feet and replaces our exports because it has recovered from the wartime damage, we will find it harder to sell our products. That, of course, will mean that our runs will be shorter. That may tend to raise costs in this country, because we tend to have large runs of products and sell the surplus abroad. So from that angle the spread of European production, or the improvement of European production, would tend, in the case of our large industries, to lower the runs of production and hence to increase the cost per unit, with a tendency to raise our prices.

Now, as to the combined effect, if we had a low-tariff policy, which tends to lower prices, as against the other policy of developing the rest of the world and which tends to lower our exports and increase our runs, how the two would work out, I don't know. But there would be an offset there. In general I would say that the low-tariff policy would probably win out and would probably tend to keep prices at a lower level in this country. I think that free trade would be a very healthy development, especially with regard to the so-called administered prices.

QUESTION: Doctor, I don't understand why the three major automobile manufacturers can't compete among themselves on built-in prices.

DR. GRUCHY: You mean why they can't compete on a price basis?

STUDENT: Yes, sir, on a price basis.

DR. GRUCHY: Well, first of all, the three firms are large. Their

costs are not identical. Recent studies of the Kefauver Anti-Monopoly Committee have shown that the General Motors Corporation has the lowest cost of production; them comes Ford; and then comes Chrysler Corporation. If we would have these firms competing on a price basis, it is quite possible that the General Motors Corporation would drive out the other two. You would then have a single firm in the field, a monopoly field. In other words, we have a capacity today to produce 10 million automobiles. We normally turn out perhaps some 7 million. So we have a very considerable excess capacity. It is quite possible then that the General Motors Corporation would take over the entire field.

That would give you a monopoly in the industry. You would then have the problem of regulating the monopoly price. That would not be an insurmountable difficulty.

If we don't have the industry taken over by one firm but have two firms left of equal size, they they will both be equally efficient; they will both have the same cost of production; and they will both then, say, having the same profit margin, have the same price. They couldn't get away from the same price. Assuming that Ford and General Motors were about equal on a productive basis, with the same unit costs, or close to the same costs, and with the same profit margins added on to the unit costs, with the average cost pricing principle, they'd have the same prices. If Ford decided to eliminate its profit and undercut General Motors,

General Motors would respond by a similar practice. They'd both make no profits. That couldn't go on indefinitely; they'd both go bankrupt. So you couldn't possibly have the two firms competing on a price basis in the long run.

QUESTION: You indicated that you feel we need higher taxes. I assume you mean Federal taxes. Would you elaborate on the specifics that you have in mind, the purpose?

DR. GRUCHY: Yes. There are two kinds of inflation--demand pull, where demand is excessive; and cost push, where costs push up. Where you have demand pull inflation there is excess demand and excess money, excess bank deposits, excess funds, credits, and so on. There are two ways to absorb excess funds. One way is to reduce bank credit through higher interest rates, higher reserve requirements. As far as other funds are concerned, the way to reduce them is, if I have a surplus fund in my bank account, or if a corporation has a large retained earning, or is building up its retained earnings, the way to curb that corporation's getting excess funds is to tax it, to raise the corporate income tax. If people have large savings, too large for the economy, and inflation is coming from that source, then a high tax will reduce their savings and hence reduce the inflationary pressure, reduce the demand. That would be a demand pull type of inflation being reduced by taxes.

For the other type of inflation, the administered price inflation,

where firms raise their prices and unions raise their wages, the tax policy would not work, because, when a large corporation is taxed, it merely passes on the tax in its price, and when you raise personal taxes, the large trade unions merely figure on an increased wage to take care of the increased income tax. Both the large unions and the large corporations tend to pass on personal and corporate income taxes. So you can't get at them that way.

If, however, they have surplus funds, you can attack their funds with the income taxes. How are you going to curb the power to raise wages and to raise prices? You can't do it through the fiscal monetary policy. It must be some kind of a price and wage board, or it must be some kind of a government price or wage control policy, some kind of a control policy.

DR. KRESS: Dr. Gruchy, the clock has caught up with us. You have raised many points that are going to be used to torment the instructors from 10:30 to 12:00 o'clock. Thank you very kindly for a very interesting discussion.