

(The following material was subsequently submitted in response to Representative Brock's questioning; see p. 422, preceding.)

Question. Is monetary policy less appropriate or less effective under conditions of "cost push" or "demand shift" inflationary pressures than under conditions of "demand pull" inflation? Is it possible to differentiate in practice as to when one or the other of these situations is dominant?

SUMMARY

Business fluctuations in the United States since World War II, while differing from one another in many ways, have had features in common with respect to the interactions of demands, output, costs, prices, and profits. The description of these relationships provided below indicates that the problems of inflationary pressures arise during the expansion phase of the business fluctuations characteristic of industrial economies, when demands are expanding. In the early stages of a business expansion, production and employment are likely to increase without generating widespread upward pressures on prices and costs. Continued expansion in demands eventually generates upward pressures on prices and costs as output in some industries reaches high levels in relation to capacity and unemployment is reduced. If the pace of expansion is moderate and competitive conditions are maintained, increases in prices and costs are likely to be confined to a relatively few markets. On the other hand, if demands expand rapidly and expectations are ebullient, increases in prices and costs are likely to become widespread.

With respect to the second of the two questions raised, once the process of inflation is under way, it is usually not possible to determine whether the dominant influence on prices stems from "cost push" or "demand shift." Since prices of goods and services represent costs to someone, increases in costs are one of the ways by which inflationary pressures are transmitted through the economy. At the same time, increases in some costs are promptly reflected in income payments and thus exert an influence on demands. Through this interaction of demands, prices, and costs, the inflationary process is initiated, and once in operation, the demand and cost elements interact in such a manner that they cannot be disentangled as separate and distinct forces.

In the chain-reaction process of demands, prices, and costs, the most direct influence that monetary policy can exert is on demands for goods and services. Through its influence on credit availability and on liquidity, monetary policy endeavors to maintain a climate of demands and expectations during business upswings that is conducive to a high rate of utilization of available resources without widespread upward pressures on prices and costs. Should upward pressures nevertheless develop, monetary policy can help to restrain them. Appropriate monetary policy can limit the funds that may be made available through bank credit to finance the expansion in demands stimulated by the income effects of price and cost increases, by expectations, and by other forces.

When business activity is high, prices generally are advancing, and the community expects continuing advances in prices, a monetary policy that restrains the use of bank credit is an appropriate and necessary tool. Whatever the causes or the means of propagating inflation, expansion of bank credit would influence both spending and expectations and so would provide additional impetus to the price-cost spiral. Under these conditions, individual and group efforts to hedge against inflation or to protect against it by tying contractual arrangements to price indexes would tend to aggravate inflationary forces.

In appraising the effectiveness of monetary policy, a number of factors must be considered. The formation of policy, first of all, depends on current assessments of developing business and financial conditions and, despite improvements in economic intelligence over the years, it is not possible always to judge accurately the strength of the forces developing. Other activities of the Federal Government, furthermore, have an impact on levels of production, employment, and income, and thus they influence needs for greater or lesser degrees of monetary ease or restraint. These policies, consequently, may complicate or simplify the task and they may inhibit or enhance the performance of monetary policy. Government policies that affect the functioning of markets and those that directly affect prices—such as import duties and quotas and antitrust policies—also bear on the effectiveness and results of monetary policy. The