

Wages and Inflation (*)

I. Initial Assumptions

I shall not go into the logical relationship of wage rates to the other variables of the market economy. This relationship has often been analysed and I do not think it contains any controversial points of importance. Rather than repeat what is well known and uncontroversial, I intend in this paper to discuss some practical questions pertaining to wages and the control of the monetary system. Before entering upon this task, I shall, however, by way of summary state the assumptions on which the subsequent reasoning is based. For the sake of brevity I shall speak only of a rise in wages.

1. Money wages may be defined as the price of labour, but differ from the prices of goods in not having any equilibrium value. The price of potatoes, e.g., has an equilibrium value, determined by the condition that in a market economy demand must equal supply. The price of labour, wages (henceforth denoted by W) do not equilibrate demand and supply of labour. On the contrary, in a closed system and in the absence of government interference by price control, rationing, etc., the system may be in equilibrium with any value of W .

(a) The reason for this peculiarity is that in the absence of government interference a change in W means that the purchasing power of the wage-earning population immediately increases proportionately. Entrepreneurs are therefore able to raise their prices proportionately with sales remaining unchanged and with an increase

(*) The present article is a paper read at the *Round Table on Inflation* of the International Economic Association held in Elsinore, 2-10 September 1959. The text will subsequently be published by Macmillan & Co. Ltd., London, in the International Economic Association's volume on Inflation which will give the record of the Elsinore Conference.

in profits proportionate to the rise in W . They will be induced to act in this manner, first, because their costs rise proportionately to W , secondly because market conditions are improved. In fact, with unchanged employment they will be unable to meet demand if they fail to increase prices proportionately. Thus a change in W tends to engender a proportionate change in P (the general level of prices).

(b) It is clear that when W and P are interdependent, and under certain conditions proportionate, W cannot equilibrate the labour market because demand for and supply of labour are dependent on real wages (W/P) and the real price of labour from the point of view of the entrepreneurs, which is also W/P . Whereas the entrepreneurs, on the basis of a given W/P , are able to determine the amount of labour they want to employ, it is not possible by the wage contract which determines money wages to adapt real wages so that the supply of labour is equal to demand. Thus in the market economy there is no mechanism determining employment. It has to be determined by outside interference, e.g. by credit and fiscal policy.

(c) So far I have tacitly assumed a closed system. However, what I have said applies to an open system (a system with foreign trade) on condition that there is equilibrium in the balance of payments. In this case, W in other countries being constant, the rate of exchange must be raised at least at the same rate as W if employment is to be maintained.

2. Thus W is not an endogenous variable of the system, it is an exogenous, specifically a political or institutional variable. It has to be fixed, directly or indirectly, by human action. It may be fixed by a government decree, providing for a fixed price of some commodity (e.g. gold) or service (e.g. an hour of a certain quality of labour) or by establishing a certain procedure for the determination of W (e.g. the Dutch system of wage control). W could also be fixed by contract between individual workers and employers or by the labour market organisations.

3. The level of W does not affect the equilibrium level of W/P and it is therefore indifferent to the equilibrium level of employment and total real income too. A change in the level of W is thus a purely monetary change, it expresses the change in P , due to mo-

netary changes as distinguished from changes in P due to technical changes, including blocking of production by monopolistic manipulations.

4. The process of change in W is not indifferent to W/P , employment and total real income. Such a process is what people really mean when they speak of inflation (deflation). However, it is not at all clear how and to what extent W/P and total real income will change in the course of the process. This is one of the problems which will be discussed later.

II. Inflation and real income

It is hardly possible by empirical research to ascertain how a process of rising W affects total real income, the latter being determined by employment and the productivity of labour at given employment. I think that equally plausible arguments may be advanced for the view that an inflationary process leads to either lower or to higher total real income. I shall discuss both views later.

I. Does inflation lead to a higher degree of employment?

The prevailing school of thought holds the view that the process of rising W (inflation) promotes a higher average level of employment and real income, at least if it is of a moderate character, than would prevail if the level of W were stable. The reasoning is that with a stable W the incentive to consume and to invest, in short total demand, would not be sufficient to absorb the supply of labour. The expectation of rising W , on the other hand, would stimulate demand especially for durable commodities (investment demand and demand for durable consumers goods) because their cost may be expected to rise in the future (or to fall less) and that something could therefore be gained by accelerating buying.

It could be argued, it is true, that this would be a matter of interest rates. If, with a stable W , total demand were insufficient, interest rates could be lowered to such an extent that the level of total demand desired was achieved. To this it may be answered that for technical (or institutional) reasons it may be impossible to

establish a rate of interest low enough to maintain full employment when W is stable.

(a) *Is a rise in W in excess of the rise in average productivity critical?*

Specifically, it is often maintained that a rise in W , insufficient to absorb the rise in productivity, would be detrimental to employment because it would be associated with a falling P , which would induce a postponement of buying.

However, this element does not constitute any additional argument, because the stimulating effect of a rising W is independent of the movement of productivity. In fact, it only means that the greater the rise in W , the greater is the stimulating effect on total demand and employment. This stimulus does not begin to work just at the point when the rise in W exceeds the rise in productivity — it is there regardless of the rate at which W rises.

As evidence of the validity of the theory here discussed, reference is sometimes made to the development in the U.S.A. during the late twenties (the so-called New Era) and the subsequent collapse. During the period 1924-29 W was fairly stable in the U.S.A., whereas P showed a tendency to fall, at least from 1928, and this is taken as the cause of the collapse. I do not think that this evidence in any way supports the view in question, for the reason that the Federal Reserve System during 1928 introduced severe credit restriction, which may very well explain the slight fall in prices and the subsequent collapse as well. At any rate it would not be easy to prove that either the one or the other would have appeared in the absence of the restrictive credit policy.

If we take into consideration the fact that total demand may be increased by low rates of interest and by reduction in taxation, I do not think it is possible either on *a priori* grounds or by empirical evidence to demonstrate that a stable W would make it impossible or even difficult to maintain full employment.

(b) *Inflation and interest rates.*

Neither would a rising W necessarily lead to higher employment than a stable one. For the stimulating effect of a rising W might conceivably be neutralized by a correspondingly higher level of the rate of interest. If, for example, we consider the period from the middle of the nineties to the outbreak of the first world war, we find that a fairly constant level of W turned into a steep and

rather uniform rise and that, at the beginning of the period, the level of interest rates shifted upwards by a considerable amount (1).

Thus we are able to ascertain that there is some connection between the level of the rate of interest and the trend of W . But the evidence available is not sufficient to decide whether the adaptation of interest rates has fully compensated the effect of the movement of W on total demand.

The business cycle ran its course during the period of fairly constant W and falling P from the middle of the 70'ties till the middle of the 90'ties as well as in the succeeding period of rising W and P till the outbreak of World-War I. However, it may be that the peak employment left a larger margin of unemployment and that the troughs of the depression were deeper during the former than during the latter period. There is some indication that this was the case. At any rate, the two depression periods of the former period were not surpassed in severity until after 1929. But we must admit that many other factors than the movement of wages and prices may have played a part.

Perhaps we may be allowed cautiously to conclude that during the period in question there is no strong evidence in favour of the hypothesis that the rise in W led to an essentially higher level of activity than would have prevailed if W had remained fairly constant (2).

(c) *Inflation and economic activity under the present institutional framework.*

The case just discussed pertains to the institutional framework ruling during the gold standard era before World-War I. The probable connection between inflation and economic activity may be entirely different under the present institutional framework.

One of the characteristic features of the postwar political scene is that most governments consider inflation as the supreme evil, and they sometimes seem to be willing to sacrifice anything short of national existence to prevent this evil (3). As no government pos-

(1) JØRGEN PEDERSEN, "Forholdet mellem Renten af Laan med kort og lang løbetid", *Økonomi og Politik*, 4. årgang 1930, p. 268 ff.

(2) For a study of the period in question cf. WESLEY C. MITCHELL, *Business Cycles*, New York, 1927, and JØRGEN PEDERSEN, *Arbejdslønnen i Danmark*, København, 1930.

(3) That is why inflation could be tolerated during a war.

sesses authority to control W directly to such an extent that a rise in W and in P could be prevented, they are inclined to resort to measures restricting economic activity, not only periodically when there is a threat of an excess demand for labour, but permanently, so that the average margin of unemployment becomes higher than would be the case in the absence of a rise in W .

Such a policy may be justified on the basis of two theories:

1) Wages do not concern the monetary authorities but are a matter of negotiations between the parties on the labour market. Inflation is reflected in the movement of prices. Prices depend on the quantity of money, which is controlled by the central bank. Therefore, whenever there is a rise in the price level (even if it is caused by adverse technical changes) the central bank will restrict credit.

However, in spite of the quantity theory of money, credit restrictions can only affect prices via a reduction in total demand, and as wages do not fall this spells unemployment.

Taking into consideration not only that the efficiency of labour tends to decrease with the number employed, but that the rate of change in W is positively correlated both with the movement of P and the degree of employment and that, at the same time, it influences the movement of prices, action against inflation on the above mentioned theory certainly leads to a low degree of employment, and the lower the employment the stronger is the tendency to rising W .

2) The other theory is that the rate of increase in W is strongly influenced by the degree of employment. Therefore, in order to combat inflation, the authorities, have to restrict employment. How much depends partly on the sensitiveness of wage rates to the degree of employment and partly on the zeal for combatting inflation.

It may be argued that, so far, there is little evidence that action has been based on this theory, for on the whole the average degree of employment in a comparable period after World-War II has been much higher than after World-War I, and, simultaneously, a high and sustained rate of inflation has been going on, whereas in the interwar period the fight against inflation led to highly fluctuating economic activity, terminating in a permanent depression.

This is true, but it may signify that so far the maintenance of this high degree of employment has been considered more important than preventing inflation, or perhaps it simply means that the various governments have not been aware of the connection between the degree of employment and inflation or have not been able to persuade the people that less inflation should be bought by sacrificing employment.

At any rate the fact that, in comparison with the inter-war period, the level of employment has been high, does not prove that it would not have been still higher if demand had not been curtailed in order to prevent or retard an autonomous rise in W (i.e. "cost-push" inflation).

The consciousness of continuous inflation due to an autonomous rise in W and the fear of the ultimate consequences have been growing recently. In addition, the international organisations such as the O.E.E.C. and the I.M.F., have persistently urged governments to take vigorous action against inflation, preferably by resorting to so-called monetary policy (i.e. credit restrictions), the effectiveness of which has allegedly been proved by age-old experience and praise has been lavishly bestowed upon those governments who have acted on the advice.

The theory developed in these circles to-day seems to be that restrictive action should be taken at an early stage of the revival from a recession, in order to prevent a boom. More and more governments, with the government of the U.S.A. leading the new crusade, are taking this advice against inflation.

It is obvious that this will lead to a lower average degree of employment than would have prevailed if the inflationary pressure had been less or entirely absent. In the U.S.A. the downward trend of the degree of employment is already clearly discernable. In 1958 the Western European countries experienced the lowest degree of employment during the post-war period, but it remains to be seen whether this will develop into a permanently lower degree of employment.

Thus there seems to be a good case for the view that there is a negative correlation between the pressure for increase in W and the degree of employment and total real income within the present institutional framework.

2. Inflation and the productivity of labour

The difficulty of ascertaining the relationship between inflation and productivity is greater than that of ascertaining the relationship between inflation and employment. Many problems are involved:

(a) *How does productivity vary with the degree of employment (in the short and in the long run?). Suppression of the rise in W and productivity.*

How does it affect productivity when the authorities adopt the policy of trying to suppress a rise in W by general demand-curtailling means (credit and fiscal policy), thus creating a low and fluctuating level of employment? We shall not here consider the effect on productivity of the shift to the left or the right of the curve representing the marginal productivity of labour under constant technical conditions, but *only* the effect of the policy in question on the position of the productivity curve. In other words, the question is: Does the degree of employment and its fluctuations affect the productivity curve, and if so, in what direction?

I think we must admit that we do not know much about it and that arguments could be advanced in favour of very different answers.

Thus it may be argued that when sales and profits are reduced because of demand-curtailling measures resulting in a fall in employment, firms will try to reduce costs, whereas assured profitability leads to indifference towards improved methods.

As far as I can see, however, this argument does not affect the average level of employment but only its fluctuations. And even so it may not hold. Amongst other things it must be taken into consideration that shrinking profits during depression deprive the entrepreneurs of the financial means to introduce improved methods requiring capital investment.

On the other hand if we are speaking of productivity at a certain "equilibrium degree of employment", I can see no reason why there should be any connection at all.

(b) *What is the effect on productivity of the (unsuppressed) rise in W ?*

If we neglect the possible effect on the average level of employment, there can hardly be any doubt that the effect of a rise in W on productivity will be in the downward direction.

If the authorities adopt a policy of maintaining full employment, a balanced budget and equilibrium on the balance of payments, so that the whole system is currently adapted to the rise in W , the effect of a given rate of rise in W on productivity would be less than if the system of relative prices were distorted.

But let us consider the more realistic case: a continuous rise in W not fully compensated by a higher level of interest rates. This will distort the system (will make people act differently from the way they would have acted in the absence of inflation) and will lead to a rise of P in relation to W , i.e. a fall in productivity.

Now, this is likely to happen in several cases: (1) if interest rates are kept down by maintaining a permanent budget surplus; (2) if the rate in the rise of W is greater than expected; (3) if the rate of change of W accelerates so fast that the adaptation of other variables cannot take place, so that a general flight into goods develops. Stocks of all kinds of goods are accumulated, consumption out of given income is increased, the supply of labour is decreased, and people turn to bargaining in kind: division of labour deteriorates; (4) if countries in which W increases more than the average increase for the whole trading community fail to adapt the rates of exchange and resort to import restrictions, import duties and export subsidies, which distort production and foreign trade.

Most of those cases are liable to occur. In any case, there is a greater likelihood of one or more of them becoming active the stronger is the inflationary tendency and the more the authorities try to combat inflation by interference with the spontaneous adaptation of the system and without possessing the power to control wages directly.

However, post-war experience seems to indicate that a considerable inflation combined with some degree of distortion of the system could take place without very damaging effects on total real income. It is true that it is impossible to measure how real income would have developed in the absence of inflation and at the same degree of employment, but in comparing the countries of Northern and Western Europe it is not possible to find any clear correlation between the degree of inflation and the development of real income, and there can hardly be any doubt that if a lower degree of inflation had to be bought by maintaining a lower degree of employment, the outcome, as far as real income is concerned, would have been in favour of letting inflation run its course.

This could with certainty be inferred from the experience of the inter-war period, in which the attempts to reestablish the pre-war price level and gold parity had devastating effects on employment and in addition caused a couple of revolutions.

In trying to infer anything from the post-war period it should be kept in mind, however, that uninterrupted inflation has not been allowed in any country; it is possible that had this been the case, inflation might have accelerated to such an extent that the case mentioned above under (3) would have developed.

III. Measures for the control of wages

I have said that the control of inflation, or in more precise terminology of the monetary system, is equal to a control of W . This is true regardless of the action taken by the authorities and of the theories on which it is based. Thus it was as true under the rule of the quantity theory and the gold standard as it is under a theory of functional finance.

I. Effect of the structure of the labour market

I have tried to establish that whether W is fixed by individual contract or by collective bargaining, employment is determined by total demand and not by the degree of competition on the labour market. This does not mean, however, that the structure of the labour market is without significance with respect to the behaviour of W .

If workers are unorganised or if trade unions do not play any significant part in the determination of wages, the development of W will differ from the development under a system of prevalent collective agreements. In the first system W is much more closely tied to the demand for labour than under a system of strong unions.

In his *General Theory of Employment, Interest and Money*, J. M. Keynes speaks of semi-inflation, meaning by that term the rise in wages which occurs during an increase in economic activity and before full employment is attained, because in some branches "bottle-necks" will develop. As full employment is approached, more bottle-necks will emerge and consequently more wage increases occur, until full employment is reached. If, in this situation, there is still a surplus demand for labour, according to Keynes wages

increase without limit until the surplus demand is removed, and we have what Keynes in 1936 termed "true" inflation.

It is worth noting that both kinds of inflation are "demand induced". Thus in 1936 Keynes, in spite of the fact that he was living in a society in which the labour market was highly organised, did not have sufficient imagination to envisage a so-called "cost-push-inflation".

Presumably the Keynesian theory fits the facts fairly well in a society where labour organisations are weak or absent. But if trade unions are very strong, as in modern societies, wages will behave differently. In this environment we shall find that collective claims for wage increases will be advanced at the renewance of every wage contract, almost regardless of the state of the labour market. The contracts will normally either be rather short-term or contain provisions for conditional termination of the contract or automatic cost of living clauses (4).

(a) *The influence of the degree of employment.*

However, to demand higher wages is not equal to obtaining them. If the government (including the central bank) is in the habit of controlling the balance of payments by means of changes in the level of employment or if a government has adopted the policy of combatting inflation (defining inflation as a rise in P), for whatever reason, by so-called monetary policy, i.e. credit policy, and thus creating unemployment, the employers will resist wage claims when employment is subnormal, and the more firmly the lower is the degree of employment. The leaders of the unions will yield somewhat to this resistance, because they feel that the result of forcing through a greater rise will lead to too great unemployment.

If, on the other hand, the government follows a policy of full employment, the resistance of the employers to wage claims may be very weak, but just for this reason the trade union leaders will be comparatively moderate in their claims, realizing that an increase in W promptly leads to higher P . However, the experience of the

(4) Some evidence of this thesis could be found in my book: *Arbejdslønnen i Danmark under skiftende Konjunkturer i Perioden ca. 1850-1913*, København, 1930. It is remarkable that there seems to have been very little rise in wages in U.S.A. during the period 1924-29, which is considered to be a boom period. This indicates that the bottle-neck stage had not been reached. The behaviour of W under the New Deal corresponds to the thesis, with the reservation that the organisations were politically supported.

post-war period is that some concessions to wage claims are always made, even during depression, and automatic adjustment provided for in the collective agreements has led to further rise in W (5).

It must be admitted that the depressions experienced after World-War II have been mild by a pre-war standard. We do not know whether it is possible to stop increases in W by unemployment or at what level unemployment has to be in order to prevent a rise in W . In Denmark the trade unions succeeded in obtaining substantial rises in W every year from 1934 to the outbreak of World-War II, in spite of the fact that the yearly average of unemployment never fell below 8 per cent; after the war wage increases have been negotiated at every renewal of the agreements, amounting to 2 per cent as a minimum and as a rule considerably more. In addition, there has been provisions for conditional automatic rises, and this has occurred in spite of the fact that the monetary policy has degenerated into the gold-standard model and that the margin of unemployment has never been below a yearly average of 8 per cent.

In conclusion, all the available evidence indicates that it may not be possible to prevent the continual rise in W by keeping a low degree of employment and that in terms of employment it may be a very costly affair, to keep the average annual rise in W below, say, 5 per cent.

(b) The next question is how much W can be expected to accelerate when demand enters what we may term the "bottle-neck-area". In this area two forces are at work, viz. union pressure, which we have found to be a function of the degree of employment, and partial excess demand, which according to Keynes was the only source of rise in W before the attainment of full employment. The evidence available is not sufficiently clear for any except a tentative answer to the question (6).

There has been a considerable difference between countries with respect to the degree of employment. During the whole post-war period until 1958, the U.K., Sweden, Norway, The Netherlands and Switzerland have maintained a level of employment over long

(5) A. J. BROWN, *The Great Inflation 1939-51*, Oxford University Press, 1955, Chapt. 4. Cf. A. W. PHILIPS, "The Relation between Unemployment and the Rate of Change of Money Wage Rates in the United Kingdom, 1861-1957", *Economica*, 1958.

(6) BENT HANSEN and GÖSTA REHN: "On Wage-Drift. A Problem of Money-Wage Dynamics", in *25 Economic Essays in Honour of Erik Lindahl*, 21st November 1956.

periods, bordering on full employment in the literal sense of the term. At times there has perhaps even been a genuine excess demand for labour. Other countries of a similar cultural pattern, such as Denmark, Belgium, W. Germany, Italy and the U.S.A., have periodically maintained a very high margin of unemployment and have never attained anything near full employment for any sustained period.

Unfortunately it is difficult, if not impossible, to make a comparative study of wage rates, because the employers to an increasing extent pay part of the wages into so-called welfare funds (fringe benefits, social security contributions, etc.) so that the rates currently published, representing that part of wages which is paid in cash to the workers, to a diminishing and varying degree, represent the cost of labour to the employer. There are other reasons, too, which make a comparison difficult.

It is, however, possible to establish that wage rates in countries having an extremely tight labour market have not risen much faster than in countries with a considerable margin of unemployment, and particularly that there is no sign of extreme acceleration of wage rates seriously endangering the monetary system in the former group of countries.

2. *The efficiency of measures affecting total demand* (Credit and fiscal policy).

It follows from what has been said above that as long as total demand for labour does not exceed total supply retardation of the rate of increase in W must be bought by sacrificing employment and real income. On the other hand, in the case of excess demand (apart from direct control of investment), credit and fiscal policy are the only means of preventing an unlimited rise in W and thus preventing a deterioration of the monetary system.

However, experience seems to indicate that it is possible for short periods to balance on the edge of excess demand, without the appearance of a strong acceleration in the rise in W , and that "bottle-necks" are dissolved by an automatic acceleration of the mobility of labour in a period of rising demand for labour short of general excess demand.

3. *Retarding the rise in W through persuasion*

Although it is still the prevalent opinion among bankers and politicians that prices are determined by the quantity of money, the concept of "cost-push-inflation" is gaining ground increasingly. As a consequence politicians and economists issue appeals to organised labour, in the interest of general welfare, to moderate their wage claims. At the same time firms and corporations are exhorted to refrain from passing on the wage increases to prices. Could such admonitions be expected to be worth the effort or should they be considered as merely empty words?

As far as the firms are concerned, it ought to be obvious that unless they are charging prices which exceed long term average cost, there is no alternative than to pass on the wage increase in full or to see employment reduced. If, in fact, excessive prices have been charged, their removal must necessarily be a one-time measure; having once been performed, it could not prevent or retard the passing on of wage increases. It is not possible to ascertain in how far, if at all, the degree of monopoly has been affected by the above mentioned admonitions. I submit that it has not been affected at all.

Concerning the behaviour of organised labour, the matter has to be left undecided too. My own view is that government declarations have been futile.

There are, however, other forms of persuasion. The trade union leaders and the more enlightened part of the trade union membership may, themselves, have realized that without sacrificing employment it is impossible to increase real wages by increasing W . The majority of the membership, supported perhaps by candidates for leadership, fail to see the connection between wages, prices and employment. They hold that a rise in wages could be paid out of the profits of employers and therefore insist on continuous wage claims.

Here the leaders have a great task of persuasion and education. I believe that in many cases they are working very hard on this problem and not always without success. This is, I think, one of the most important explanations why wages have not risen more than has been the case in those countries where the labour-market has been extremely tight and why the emergence of bottle-necks has not led to an explosive rise in W .

It is an extremely interesting question whether a policy of combatting inflation by means of restrictive credit and fiscal policy, thus creating fluctuations in activity and keeping a considerable margin of unemployment, is in the long run more effective in curbing inflation than maintaining full employment and leaving inflation to run its course.

In the latter case, we might perhaps temporarily get a faster rate of inflation, but the trade union leaders and their members could hardly fail to realize, that they do not gain anything by pushing up W . In the first mentioned case, this is not so clear, for the reason that the fall in the level of employment does, in fact, make a higher W/P possible, especially during depressions, for those workers remaining in employment.

4. *Government control of wages*

We have seen that the control of money is equal to the control of W . So far we have discussed measures for exercising this control. Those measures have had in common that they were of an indirect nature. It would, however, seem more rational to fix W directly by government decree.

During many decades governments fixed the price of a commodity, gold. This was an indirect way of fixing W and it proved to be a very irrational method, leading to numerous serious repercussions, detrimental to human welfare and finally resulting in the collapse of the whole system. Why not fix the price of a certain quality of labour and thus adopt a wage standard instead of a gold standard?

It is generally agreed that the general level of W does not affect relative prices or the allocation of productive factors and that, in the absence of further interference, prices readily and without friction adapt themselves to changes in W . A "wage-standard", therefore, would seem to be the ideal method of controlling the monetary system.

However, apart from the difficulties involved in defining a definite quality of labour, it will prove technically difficult, if not impossible, to carry out such a policy. The main reason for this is that the structure of wages has to be continually adapted to market conditions for the various qualities of labour. Fixing the price of a definite quality, therefore would imply that the price of some

qualities would have to rise and others would have to fall, and such a reduction in wages would be very difficult to effect.

For administrative reasons, therefore, the program has to be somewhat modified. The adaptation of relative wages to market conditions should be allowed to take place solely by a rise in wages for the qualities to which demand has shifted, leaving wages constant for the qualities subject to decreased demand. At the same time demand for labour should be kept equal to supply as nearly as practically possible by means of credit and fiscal policies.

If such a modified "wage-standard" were adopted by the whole international system, it would require that exchange rates were adapted to changes in relative labour productivity. If, on the other hand, the system was limited to a single country, exchange rates would also have to be adapted to changes in the relative wage level between countries. This would not cause difficulties; determination of exchange rates could be left to market forces. Wage rates being under control, speculation would keep the fluctuations of exchange rates within narrow limits (7).

The system would also overcome what some economists consider a difficulty, viz. a falling price trend. For the rising trend of wages, due to the adaptation of relative wages, might very well compensate for the general increase in productivity.

In principle there could hardly be any objections to such a system. It may, however, encounter serious political or administrative difficulties. To my knowledge there is only one Western country in which wages are subject to government control, viz. The Netherlands. In that country the system enjoys the support of the leading trade unions, which realize that W/P could not be raised by raising W if full employment is to be maintained (8).

In other countries neither the trade unions nor the people in general are so enlightened, and it is obvious that the system could not be forced through against the will of such a large section as the wage earning population. Therefore, until such enlightenment

(7) It should be added that if full employment, equilibrium of the balance of payments, constant duties and export subsidies and absence of quantitative control of trade is to be maintained, exchange rates must be left free to adjust themselves, too. This will prove a very real problem in connection with the so-called European Economic Community.

(8) Cf. BERT ZOETWEIJ, "National Wage Policy: The Experience of the Netherlands", *International Labour Review*, Vol. LXXI, 1955.

has become general, the system of governmentally controlled wage rates could not become general. In the meantime it would be necessary to live with a considerable amount of inflation.

5. *Inflation and unemployment*

It has been argued that, taking maximum real income as the supreme goal, inflation, at least when it exceeds a rate of 2 or 3 per cent per year, is an evil. Experience indicates that the rate of inflation could be somewhat curtailed by creating periodical depressions and by keeping a margin of unemployment even at the peak of economic activity. As unemployment from the point of view of maximizing real income is also an evil, this leaves us with a choice of two evils, and the objective, therefore, must be to find the combination of the two that minimizes the total evil.

Now, as I read the experience available, virtually full employment could be maintained within a rate of inflation which is so moderate that it does not seriously hamper production. Moreover, the distributive effects, which are often cited as a great evil, would be very small if the authorities refrain from interfering with the price system in order to keep interest rates or prices down. At the same time, the chance is that the absence of such interference may have a healthy effect on the interest labour may have in raising wage rates, at least in the longer run. For it would serve to educate even the dullest to realise that nothing could be gained by increasing W .

My conclusion is, therefore, that it does not pay to sacrifice employment in order to curb inflation. Governments should concentrate their efforts on maintaining full employment, see to it that excess demand for labour which may develop is speedily removed, mainly by means of credit policy, and leave the degree of inflation to the state of education of the people, which of course should be promoted by every means available.

Aarhus

JØRGEN PEDERSEN