LECTURE FIVE – PART FOUR

Inflation is the Cruelest Tax

- Suppose the inflation rate exceeds the rate of growth in our paycheck.
- That means our real income or purchasing power is declining – even though our wages are going up!
- BUT inflation that is unanticipated can benefit borrowers at the expense of lenders.

Two Kinds of Inflation

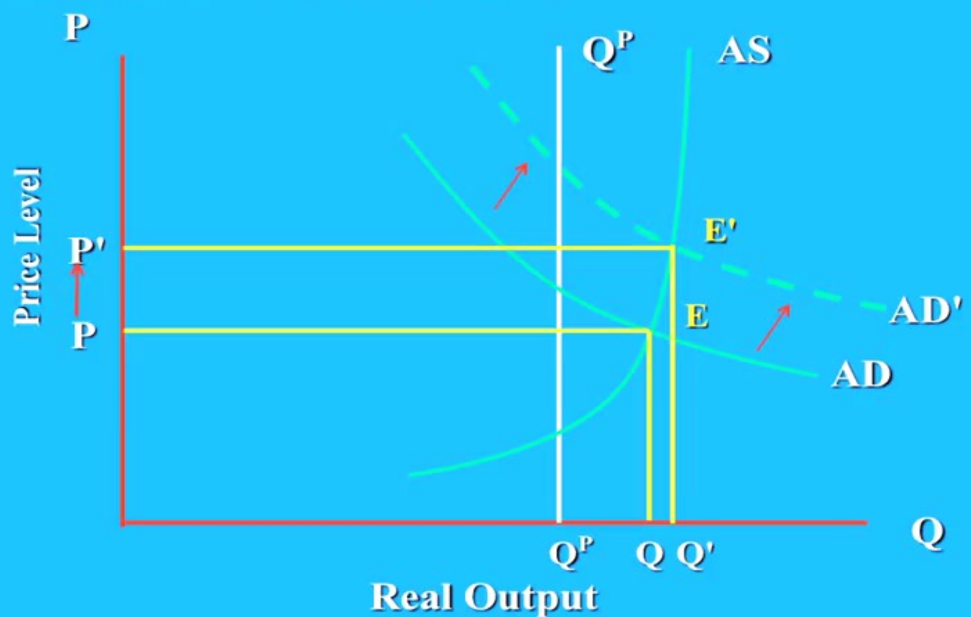
- Demand-Pull
- Cost-push

Demand-Pull Inflation

- "Too much money chasing too few goods"
- Example: The U.S. tried to finance both the Vietnam War and the Great Society.

Do you remember from Lecture One how to use the aggregate supply-aggregate demand framework to depict demand-pull inflation?

Demand Pull Inflation



Nixon's Price and Wage Controls

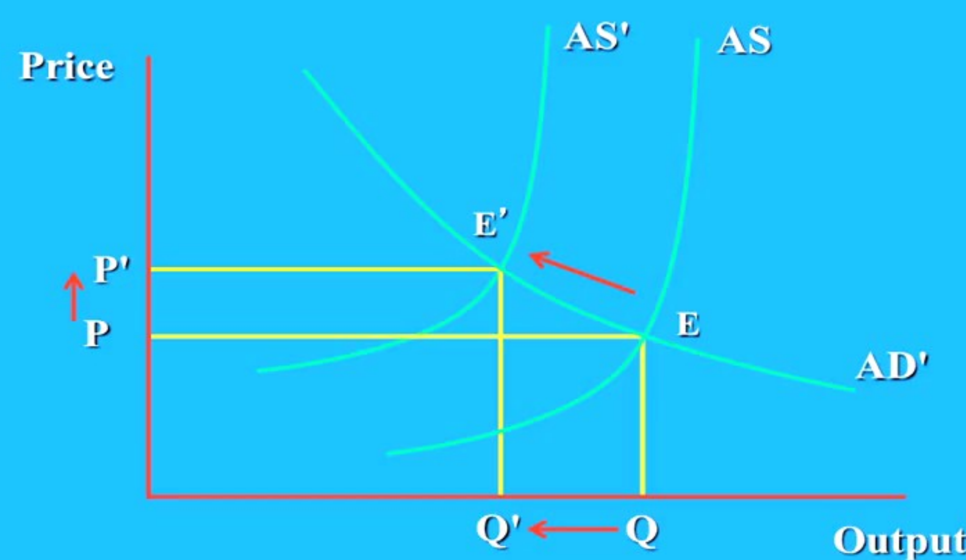
- In 1972, President Richard Nixon imposed price and wage controls.
- When the controls were lifted in 1973, inflation jumped back up to double digits.
- A new kind of inflation also emerged –"cost-push" or "supply side" inflation.

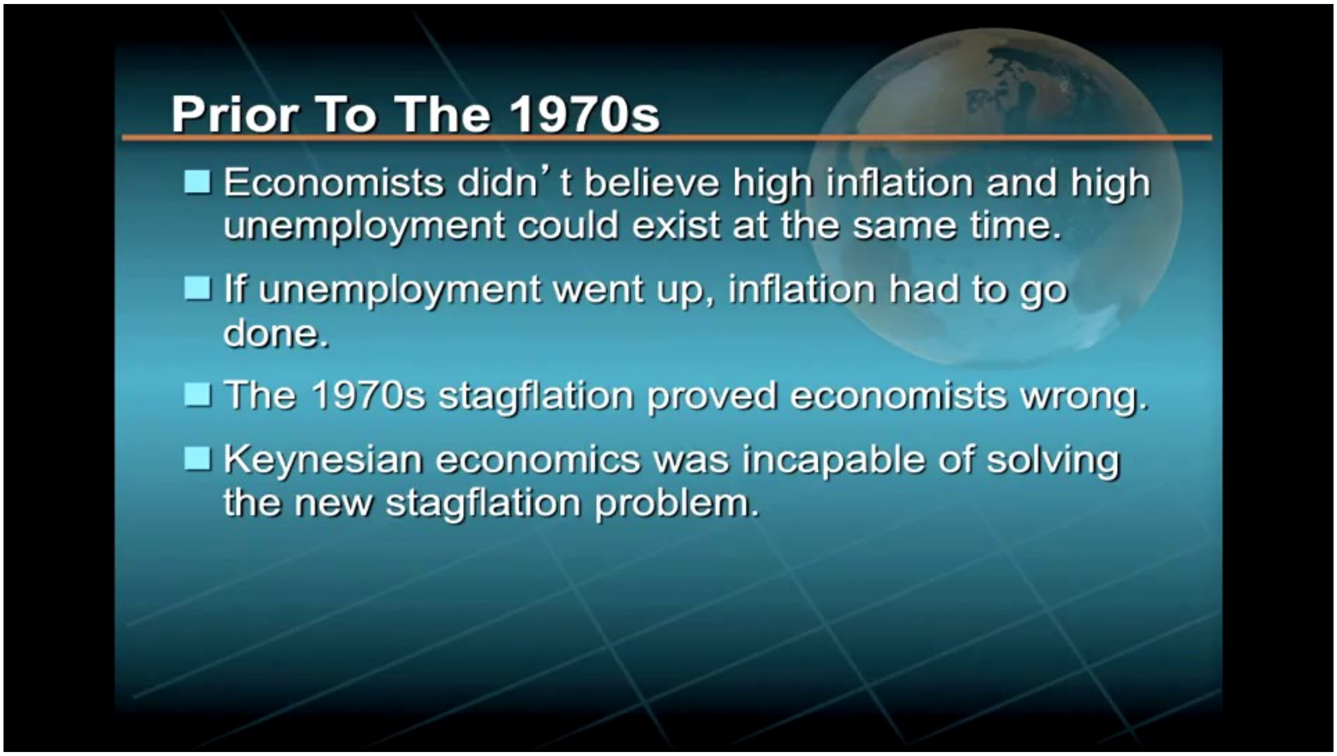
Cost Push Inflation

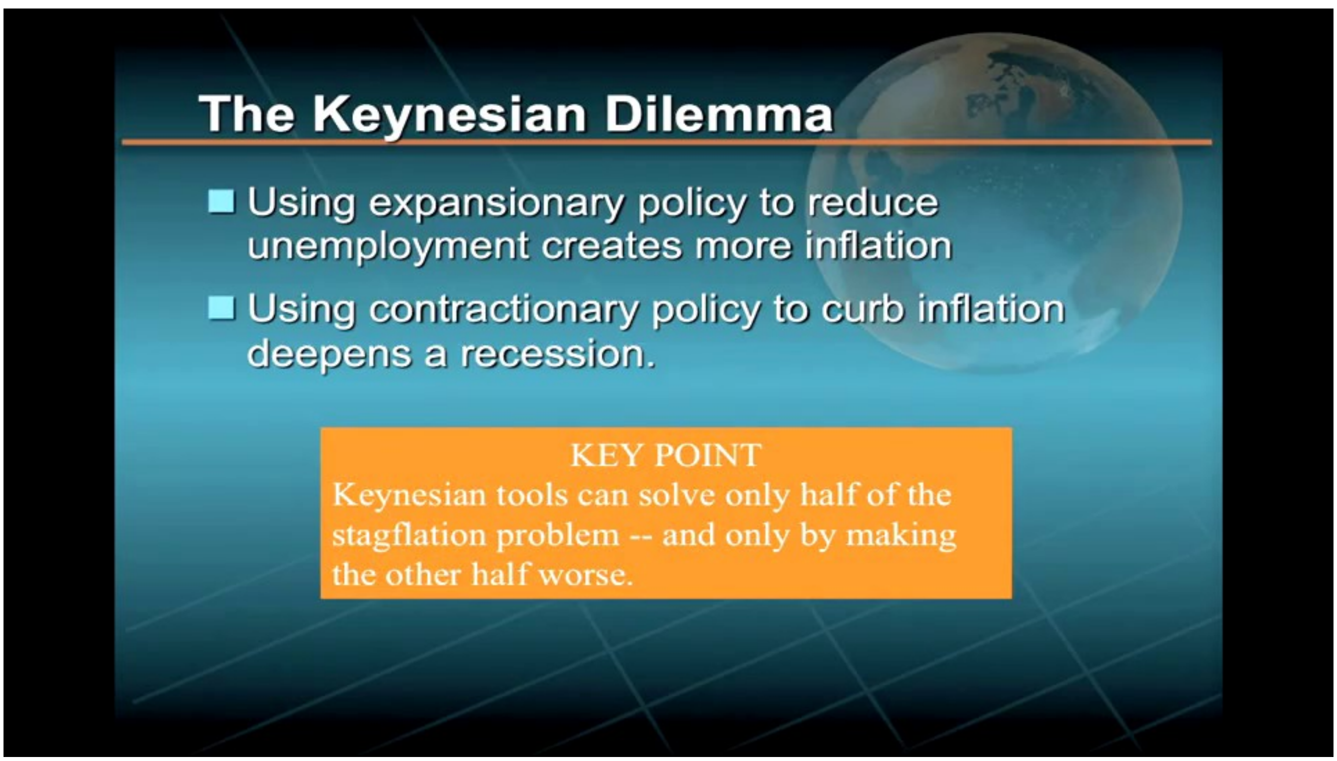
- Results when external shocks drive up production costs.
- "Supply shocks" can include crop failures and oil price spikes due to war or terrorism.

Do you remember from Lecture One how to use the aggregate supply-aggregate demand framework to depict cost-push inflation?

Cost Push Inflation

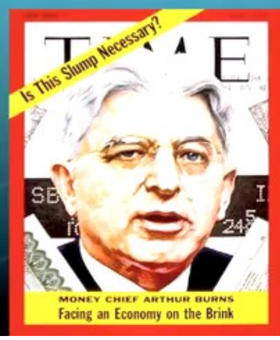



Prior To The 1970s
Economists didn't believe high inflation and high unemployment could exist at the same time.
If unemployment went up, inflation had to go done.
The 1970s stagflation proved economists wrong.
Keynesian economics was incapable of solving the new stagflation problem.


The Keynesian Dilemma
Using expansionary policy to reduce unemployment creates more inflation
Using contractionary policy to curb inflation deepens a recession.
KEY POINT
Keynesian tools can solve only half of the stagflation problem -- and only by making the other half worse.

A Failed Keynesian Response

- During 1973 and 1974, policymakers labeled inflation “public enemy number one.”
- Despite clear signs of recession, Fed Chairman Arthur Burns engaged in a sharply contractionary monetary policy.



President Ford’s 1974 WIN Campaign

- President Gerald Ford’s “Whip Inflation Now” included contractionary fiscal policy in the form of “fiscal restraint” and a tax surcharge.
- Contractionary policy by the Federal Reserve and White House drove economy deeper into recession.
- Meanwhile, oil price shocks drove the inflation rate higher.

Switching Strategies Didn't Help

- In 1975, recession became the number one policy worry.
- Congress passed a $23 billion Keynesian tax.
- The Fed switched to an expansionary Keynesian monetary policy.
- Stagflation blossomed!

Monetarist Perspective

- Stagflation set the stage for a Monetarist challenge to the Keynesian orthodoxy.
- To understand the Keynesian failure, we have to understand modern inflation theory and the Phillips Curve.