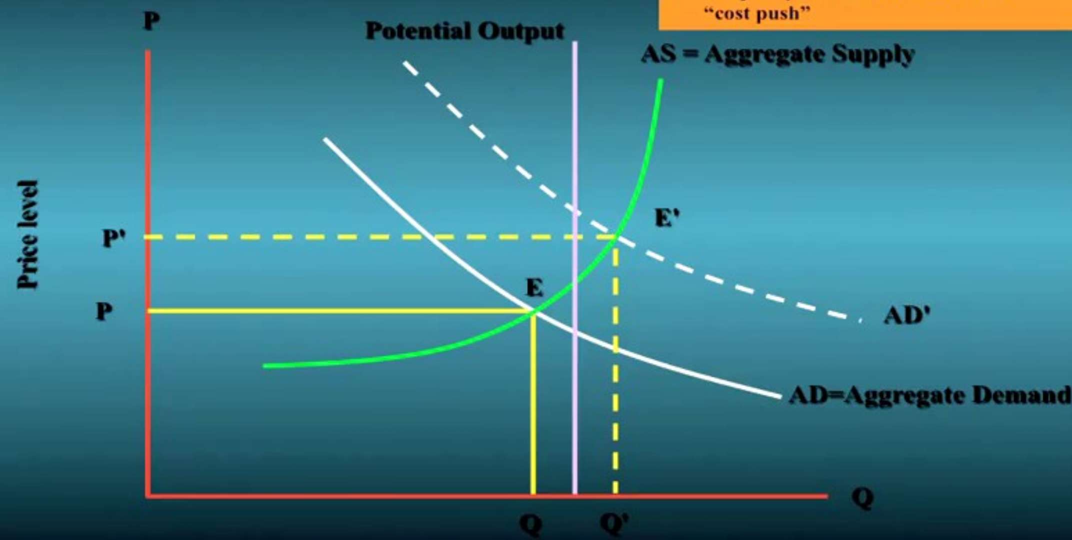
LECTURE ONE - PART FIVE

Demand-Pull Inflation

- "Too much money chasing too few goods."
- When America tried to finance both the Vietnam War and the Great Society, severe demand pull inflation resulted.

Demand-Pull Inflation

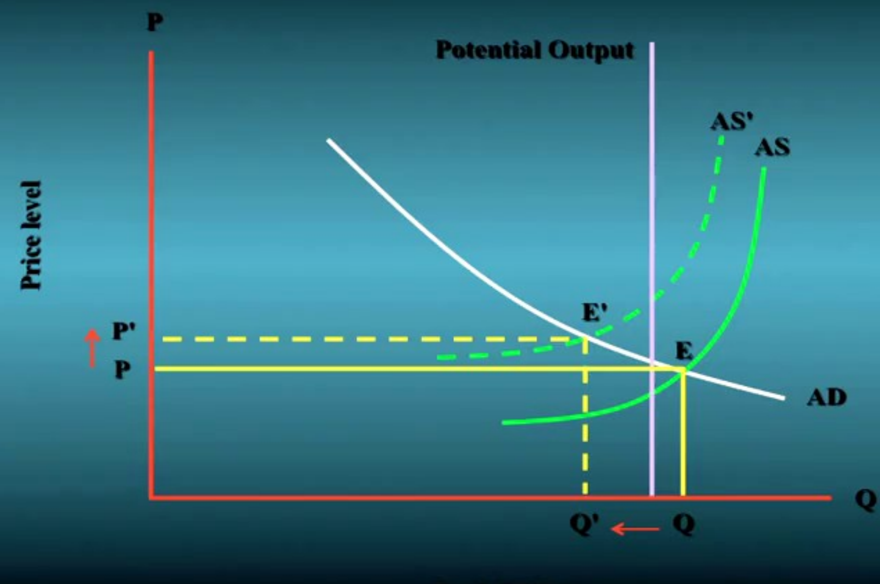
- President Nixon imposes price and wage controls in 1972
- When controls lifted in 1973, inflation jumps!
- It's partly a new kind of inflation – "cost push"



Cost-Push Inflation

- Rapid increases in raw material prices or wage increases drive up production costs.
- This can happen as a result of so-called "supply shocks."
- 1970s shocks included crop failures, a worldwide drought, and a quadrupling of the world price of crude oil.

Cost-Push Inflation



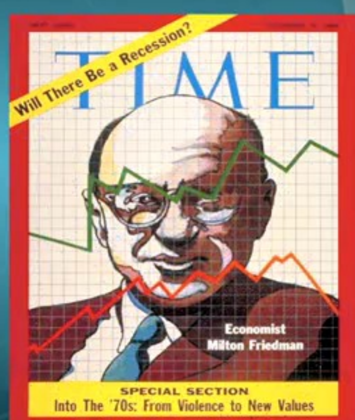
A Budding Keynesian Paradox

- Prior to the 1970s, economists didn't believe you could have simultaneous high inflation and high unemployment.
- If inflation went up, unemployment had to go down – and vice versa.
- Keynesian economics turned out to be incapable of solving the new stagflation problem.

The Keynesian Dilemma

- If expansionary policy were used to stimulate the economy to reduce unemployment, it would exacerbate inflation.
- If contractionary policy were used to fight inflation, it would increase unemployment.
- Ergo, traditional Keynesian tools could solve only half of the stagflation problem at any one time -- and only by making the other half worse.

The Rise of Monetarism



Friedman's Monetarist School

- The problems of both inflation and recession may be traced to one thing -- the rate of growth of the money supply.
- Inflation happens when the government prints too much money.
- Recessions happen when it prints too little money.

The Monetarist Perspective

- Stagflation is the inevitable result of activist fiscal and monetary policies.
- Activist Keynesians try to push the economy beyond its so-called "natural rate of unemployment."
- The "natural rate of unemployment" is also called the "lowest sustainable unemployment rate" or LSUR.

The LSUR or Natural Rate

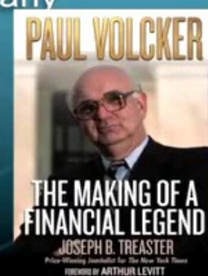
- The lowest level of unemployment that can be attained without upward pressure on inflation.
- Expansionary attempts to go beyond the LSUR may result in short run spurts of growth.
- After each growth spurt, prices and wages inevitably rise and drag the economy back to its LSUR-- at a higher rate of inflation!

Some Bitter Medicine

- Attempts to push the economy beyond its natural rate are futile.
  - They lead to an upward inflationary spiral.
- Monetarists believe that the only way to wring inflation and inflationary expectations out of the economy is to push the actual unemployment rate rise <u>above</u> the LSUR.
- That means inducing a recession!!!!!!

Inducing a Recession

- This is one interpretation of what the Federal Reserve did in 1979 under the Monetarist banner of setting monetary growth targets.
- Under Chairman Paul Volcker, the Fed adopted a sharply contractionary monetary policy
- Interest rates soared to over 20%!!
  - Interest rate-sensitive sectors were particularly hard hit.



A Sweeter Economic Cure

- The Fed's bitter medicine worked to wring inflation out of the economy.
- But after three years of hard economic times, Americans wanted a sweeter cure.
- Enter stage right: supply side economics.