

ECONOMICS U\$A
21st Century Edition

PROGRAM #19

INFLATION: HOW DID THE SPIRAL BEGIN?

AIRSCRIPT

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Final Transcript

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DAVID SCHOUMACHER: The 1960s, a time of great prosperity and growth. In a period characterized by success in managing the economy, how did we let inflation get out of control? We think of an inflationary period as a time when everybody suffers from a loss of purchasing power. Yet, when prices rise there are those who benefit. Who are the winners and losers from inflation?

RICHARD NIXON: "The primary responsibility for controlling inflation rests with the national administration."

DAVID SCHOUMACHER: Finally, in the 1970s, the government was pushed to take drastic action. What was the result?

No one likes rising prices, and in the first part of the 21st Century, inflation has not been a major factor in the economic well being of the nation. Yet in the 1970s inflation became a fact of life despite all the clamor to do something about it. Inflation...How did the spiral begin? With economic analyst Richard Gill we'll explore that question on this 21st-Century edition of Economics U\$A. I'm David Schoumacher:

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PART I

DAVID SCHOUMACHER: What is inflation? Well, here at the Bureau of Labor Statistics, they measure inflation, in a sense, with the consumer price index...totaling the cost of goods and services and then comparing them from month to month and year to year. We've all felt the effect of inflation. There are those among us who can look back nostalgically on the days of the 3-cent postage stamp and the 25-cent movies. When prices go up just a little we're not surprised, but when they get out of hand, well then we sit up and take notice, as we did in the late 1960s when prices began spiraling upward. What caused that spiral? And how did inflation get out of control? As the country grew and expanded in the 1950's no one was very worried about inflation. Then late in the decade the economy began to cool down, and that became a factor in the 1960 elections.

JOHN F. KENNEDY: "I'm not satisfied to have 50 percent of our steel mill capacity unused...I'm not satisfied when the United States had last year the lowest rate of economic growth of any major industrialized society in the world."

DAVID SCHOUMACHER: President John F. Kennedy called for a "new frontier"...a new era of energy and spirit.

JOHN F. KENNEDY: "The election may have been a close one but I think there is here general agreement by all of our citizens that a supreme national effort will be needed in the years ahead to move this country safely through the 1960s."

DAVID SCHOUMACHER: This new activist approach was to be reflected in economic policy. Walter Heller chaired the Council of Economic Advisors in the Kennedy administration.

WALTER HELLER: "Kennedy was our first Keynesian president. It isn't that others hadn't done some Keynesian things in terms of the way they managed the economy but

Kennedy did it in an avowed and in a perceptive way. He was very cautious at first, and it took a while for him to see that a more liberal approach was needed to stimulate the economy.”

DAVID SCHOUMACHER: It took the form of a massive tax cut proposed in 1962.

JOHN F. KENNEDY: “This net reduction in tax liabilities of 10 billion dollars will increase the purchasing power of American families and business enterprises in every tax bracket.”

DAVID SCHOUMACHER: But John F. Kennedy didn’t live to see his programs enacted. Instead, on that fateful day in November, Lyndon Baines Johnson was sworn in as the 36th President of the United States. Johnson pursued Kennedy’s economic proposals and pushed the passage of the tax plan through Congress. How well did it work?

WALTER HELLER: “Perfectly...*Business Week*, which is not exactly a liberal pro-Kennedy publication, said that it probably was the most successful tax cut in history. In a sense, you know, it came out of the textbooks, and in a sense it went back into the textbooks as the fiscal measure that came closer to carrying out what people had projected for it. In terms of the economics of it...that was a tax cut that worked.”

DAVID SCHOUMACHER: The economic policies of the Kennedy/Johnson administration had succeeded in stimulating demand, creating growth in the economy... Business was booming...jobs were plentiful...and unemployment was near an all-time low. But many observers, including the President’s Council of Economic Advisors, were now concerned about the appearance of inflation as the economy heated up. James Duesenberry recalls...

JAMES DUESENBERRY: “But in 1965 the real aggregate demand was rising at an annual rate of nearly eight percent and it was continuing to rise into 1966. And that is what produced the high capacity utilization, the rising raw materials prices and the decline in unemployment accompanied by labor shortages.”

DAVID SCHOUUMACHER: Many economists felt a tax increase would take money out of the hands of the consumers and business...Spending would drop...inflationary pressures would retreat..but even as the tax measure was debated, new inflationary forces were about to be unleashed by the White House. Lyndon Johnson didn't want to be bothered by warnings about inflation. Lyndon Johnson had a dream of a "Great Society."

LYNDON B. JOHNSON: "This administration today, here and now, declares unconditional war on poverty in America."

DAVID SCHOUUMACHER: LBJ began to build his "Great Society." But the big ticket item in the federal budget was not war on poverty...it was the war in Vietnam. The Defense Department told the public it was spending about a billion dollars a month. We were to find out later it was costing more...in fact between two and three times more!

WALTER HELLER: "We were not really fully aware...not even as economic advisors in Washington, let alone those of us who were outside consultants, were not aware of how much Vietnam was going to cost. So we were taken unawares for several months, but by December of 1965, still early in the game, when the President had me come down to the ranch, I urged him to go for a sizable tax increase and he said, 'Walter, I've checked on both sides of the aisle and both houses of Congress' and he said, 'I don't think I could get a dozen votes.' "

MYRA MACPHERSON: "The whole problem stemmed from the kind of war this war was. It was a war that was never declared a war and one of the main problems about it from the beginning was the idea that we would sort of run it on the cheap. That was one of Lyndon Johnson's great points was, 'let's try to run this war without letting people know we're at war.' He wanted a silent, invisible war and so, therefore, he did not want to raise taxes...that was just a total anathema to him. He wanted to do the guns and butter...he wanted to have the domestic programs and he wanted to be able to run the war as well."

DAVID SCHOUUMACHER: The stage was set for the surge of inflation. In the absence of a tax increase or any other effective restraint, consumers and businesses kept

spending...at the same time the government kept spending, so businesses operated close to capacity and labor approached full-employment. To meet the demands of the marketplace, expensive new factories had to be built and competition for workers bid up wages. In short, the demand exceeded the economy's ability to supply...and everything began to cost more. Finally, the President declared a one-year 10 percent surtax. But was it enough...Was it in time?

WALTER HELLER: "I don't think he wanted to fight for a tax increase on the backs of an unpopular war in Vietnam and so that was held off until 1967...not enacted until 1968...and the horse was out of the barn."

DAVID SCHOUUMACHER: In the 1960s we had a classic go-go economy. Consumer demand ran at a feverish pitch as did government spending.....and that began a cycle of inflationary pressures that would be with us for a long long time. But does it have to be that way? Does a booming economy necessarily go hand in hand with inflation? That's the question we put to economic analyst Richard Gill...

(MUSIC PLAYS - COMMENT & ANALYSIS I)
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RICHARD GILL: In the 1960s, most economists would have said: inflation occurs when the total -- the aggregate -- demand for goods and services in the economy is expanding faster than the aggregate supply. Everybody wants more goods...more goods aren't available... prices go up. Mind you, this was the period when Keynesian analysis was at its height. These are simplified Keynesian-style aggregate demand and supply curves...similar to, but, of course, not exactly the same as the curves we might draw for a particular product, say, refrigerators. A major difference is that here we are dealing with supply and demand for the total output of the nation, its GNP. And on the vertical axis, we are now measuring not the price of refrigerators but the price of output in general, that is the price level. Let's concentrate on one feature of these curves...the shape of this simplified Keynesian-style aggregate supply curve. You'll notice it is drawn quite flat through most of its range, until we approach this line which represents full employment

GNP, and then suddenly it goes up quite sharply. Suppose we start here...far from the full employment line. Our level of GNP is quite low, our price level here. We now try to increase aggregate demand. The tax-cut of 1964 giving more income to consumers would be a perfect example. What is the result? GNP now goes up, meaning more production and jobs for everybody. But the price level remains the same. We have growth without inflation. But now look at what happens when we start over here. This is what we were facing in the late 1960s. Demand was already high. The "Great Society" programs of Lyndon Johnson had been launched, and now along comes the Vietnam War, and suddenly demand is given a big shot in the arm. Our aggregate demand curve shifts up here. And look at the difference: all the effect of the increasing demand goes into higher prices. We are already producing at the economy's capacity. Supply does not increase. We have entered the world of demand-pull inflation. Now Keynesians felt that the economic cure was simple. Lower demand by raising taxes. If a tax cut can raise demand, a tax increase can reduce demand. How well this Keynesian style remedy could have worked we can never know for certain – it wasn't tried. What is certain is that inflation was to become, in the years following, a much more complex - and painful - phenomenon.

PART II

DAVID SCHOUMACHER: Inflation...a source of anguish and despair for many as it undermines purchasing power and eats away at savings. It's hard to plan for inflation, and when it spreads rapidly many are unprotected...particularly those like these people on fixed incomes. But, as destructive as inflation can be, there are those who benefit from unexpected rising prices. Just who are they? One answer may surprise you. People in debt can gain from inflation...and the great middle class traditionally goes into debt to buy a house...so when interest rates on existing mortgages are lower than the rate of inflation, homeowners win. They pay back their loans with cheaper, inflated dollars. At the same time, their property values rise. Along with millions of other homeowners, Mr. and Mrs. Lawson found they had a windfall from inflation.

DAVID LAWSON: “I realize that inflation has been a serious problem for many people, but it really hasn’t affected us too much, with our house payments remaining essentially constant, the interest rate...it was an FHA loan of five and one quarter percent...we are just fortunate that inflation really hasn’t bothered us very much.”

DAVID SCHOUMACHER: And there were other winners as well. This wave of inflation coincided with the “credit boom” of the late ‘60s. Consumers were urged to buy on credit. An inflationary psychology emerged. “Buy now before prices go up...pay later with cheaper dollars.” Consumers were spending money...and the increased demand was creating lots of jobs. So, businesses would seem to be winning, but many soon had second thoughts.

RICHARD RAHN: “Well, business does not fare well overall during periods of inflation. At the initial stages of inflation, when it’s increasing, some businesses think they are better off because profits seem to rise. What you have is a situation where your inventory cost is low, where you have purchased goods at some previous time period... Then, suddenly, inflation comes along and you’re able to raise your prices, so it looks like you get a bigger profit. But all of a sudden your costs then begin to soar... You have all this uncertainty which comes along, and suddenly most businesses find themselves far worse off. And that often leads us to recessions.”

DAVID SCHOUMACHER: Among those clearly worse off from inflation were senior citizens. For the most part, they lived on fixed incomes. They had no extra money to cover even a small price increase. How could they meet raises in rents, heating bills or food?

WALTER JONES: “It seemed that when you became old, if you had not been fortunate enough to put aside or prepare to take care of yourself when you were aging, that you didn’t deserve any better. And that was a common feeling.”

DAVID SCHOUMACHER: But the “seniors” had the power to organize and to make their voices heard.

WILLIAM HUTTON: "In those marches we achieved recognition that social security was still inadequate. Our long goal was to try to secure a way in which we could link the consumer price index to regular increases, so we wouldn't have to go and beg Congress, and beg an administration which maybe was conservative and didn't want to give us anything. We felt that if that was automatic with the consumer price index increases, that would be much better...it would be less political...and we finally achieved that."

DAVID SCHOUMACHER: Others hit hard by inflation were the working poor and the unemployed. Most of the little money they had went for the necessities of life and the prices of those basics...of food, fuel and housing and health...all were rising the fastest. Like the seniors, the poor attempted to organize to keep pace with inflation, but their efforts were not as successful.

MICHAEL HARRINGTON: "The "senior citizen" movement, in terms of participation, has been a much more effective movement than the poor. One of the problems with the poor is precisely that they're not organized...that they vote less than anybody else...that they join groups less than anyone else. The poor are not like the organized workers."

DAVID SCHOUMACHER: Even the "organized worker" was having problems keeping up. New York was only one city knocked on its heels as first the sanitation workers struck for higher pay. Shortly afterwards, firemen and police went out on job actions. Then came the transit strike and the teachers' strike...each group, like so many other Americans, fighting to hold on to a decent living. We asked Victor Gotbaum, who represents public employees in New York, to recall those turbulent days.

VICTOR GOTBAUM: "I represent workers. If they're taking a beating when they go into the supermarket, I hear about it. They don't make unfounded or loud demands. If Vinny Perissi, who is a sewer laborer says, 'Hey, Mary goes into that market, Vic, it's killing me'...that's what I hear. If a hospital worker says, 'You know it's becoming awful'...that's what I hear."

DAVID SCHOUMACHER: Workers won higher settlements, but that raised costs and boosted prices. In all sectors of the economy...in all parts of the country...inflation had

become entrenched. It was hard to keep up. It was harder to feel sure about who was winning. The cry to do something about inflation was coming from more quarters and it was growing louder and louder. Was there any real hope that the inflation momentum would run out of steam...or were we just victims of our own expectations that inflation would continue? We asked economic analyst Richard Gill...

(MUSIC PLAYS - COMMENT & ANALYSIS II)
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RICHARD GILL: I would say that there was relatively little hope at this time that the inflationary momentum would run out of steam. You see, one thing that happens when inflation gets going is that all groups feel that they are losers. Sanitation workers, teachers, senior citizens, rich man, poor man, you name it...everybody faces these higher prices, and thinks, my God, I'm being ruined. Now, in one sense, this perception that everyone is losing is unjustified. If prices are going up, incomes are going up too. Not everybody is losing all the time. There have to be winners too! Still, when this uncertainty about the future becomes contagious...things can get bad for everybody. It's extremely difficult to run an efficient, productive economy when prices are changing all the time. But whether justified or not, this fear of falling behind can unquestionably be a major factor causing inflation to increase. The sanitation workers feel they are falling behind. They strike and get a higher wage. But now other public employees see that they really are falling behind. They demand even higher increases. But now other workers...coal-miners, assembly-line workers, sales clerks...see that they are falling behind. Up, up we go. Wages, prices, wages, prices. The spiral is upon us. How on earth can it be stopped? By the end of the 1960's, the question was not only real but urgent.

PART III

DAVID SCHOUMACHER: President Johnson had been able to shrug off the importance of inflation, but by early 1969 when the inflation rate climbed to over five

percent, it could no longer be ignored. Both the business community and consumer groups demanded that something be done. The responsibility was left to the White House and its new occupant...Richard Milhous Nixon.

RICHARD NIXON: "The primary responsibility for controlling inflation rests with the national administration and its handling of fiscal and monetary affairs."

DAVID SCHOUMACHER: But would this President be more willing than his predecessor to accept the traditional Keynesian approach ...to reduce demand by increasing taxes? Chief Economic Advisor, Paul McCracken, explains Nixon's reluctance...

PAUL MCCRACKEN: "I don't know of any political situation...short of a war...where there isn't enormous hesitancy about increasing taxes. That's about the least popular thing that the political system wants to hear."

DAVID SCHOUMACHER: And increased taxes, after all, were likely not only to cut inflation but also to slow the economy. That was a sore point for Nixon's past. He believed the economic "slowdown" in 1960 had cost him the Presidency...and his eye was now on the 1972 elections. Also Nixon was a laissez faire conservative. He feared that increased tax revenues would increase the size and the role of government. But if taxes were not to be raised...why not cut back on federal spending?

PAUL MCCRACKEN: "It would have been irresponsible to start out with a meat cleaver slashing everything...partly because I'm sure that a year or so later government would be hard at work trying to increase everything they could increase...Better to stay in the middle of the stream."

DAVID SCHOUMACHER: If increasing taxes or cutting the budget were unpalatable to Richard Nixon, perhaps the Federal Reserve could be enlisted to combat inflation. In theory, the rate of inflation is a function of the money supply. By restricting the money supply, inflation should also contract. The Fed cooperated. The result...

PAUL MCCRACKEN: “One thing that was expected then by economists was that the price level would respond to restraint...monetary and fiscal restraint...much more rapidly than in fact it did. And so there was a tendency to say, ‘well the policies are failing.’ ”

DAVID SCHOUMACHER: Then, as the Feds’ restrictive policies did take hold, the economy slowed down...Unemployment mounted. There was an outcry against this “made in Washington” recession. But inflation was barely affected. It was so entrenched that people expected it to continue, and it did. Could stronger medicine contain it? Critical economists and politicians called for the government to directly freeze prices and wages. Those controls had worked during wartime to stifle inflation, but they had never before been seriously considered in times of peace. Controlled wage and price ceilings interfered with the “free market” and the laissez faire traditions of the country. On the other hand, elections were just eighteen months away and something had to be done. But could a conservative president like Richard Nixon come to accept price controls?

RICHARD NIXON: “The time has come for decisive action...action that will break the vicious circle of spiraling prices and costs. I am today ordering a freeze on all prices and wages throughout the United States for a period of ninety days.”

HERBERT STEIN: “We were having an inflation, before the controls, which was the result of the expectation that inflation would go on...so people were asking for wage increases in the expectation of inflation...and businesses were raising prices in the expectation of inflation in their costs...and the theory was that if you could just stop this process for a while...people would get over that expectation of inflation and you could then resume a “free market” system with a low rate of inflation. But that didn’t happen...We didn’t change the expectations...We only created the expectation that when the controls ended the prices would zoom again.”

DAVID SCHOUMACHER: And prices did zoom up again when controls were lifted...Price and wage controls proved ineffective, in the long run, in stopping this spiral of inflation. And even when we did take inflation seriously, controlling it was more easily said than done. Was there anything that could have worked? Economic analyst Richard Gill offers his commentary...

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RICHARD GILL: The basic reason that wage and price controls were adopted was that the traditional Keynesian remedy for inflation -- cutting back aggregate demand -- suddenly seemed inadequate to our new situation. A Keynesian-style inflation, we recall, looks like this. Demand is too high. So we cut back...say, by raising taxes...and we lower prices, without having any real effect on GNP or employment. But suppose our aggregate supply curve is different from the Keynesian. Suppose that, instead of this little upward curvature here, the whole supply curve looks like this. Suddenly we are in a new world. Our prices are too high up here. So we cut back aggregate demand to here. Prices do fall, but...and this is a huge but...so also does our GNP. In simple words, to lower inflation we have had to plunge the economy into a recession. We have had to trade off some of our employment to bring inflation down. Of course, these diagrams present an oversimplified picture of what was going on at the time. In a general way, however, we can say that by the early 1970s, prices had a tendency to rise well before full employment in the economy was reached. Inflationary pressures were being felt even when there was substantial unemployment in the economy. No wonder economists turned from Keynesian to other remedies. And, sad to say, our problems were just beginning.

DAVID SCHOUUMACHER: We learned the hard way that inflation can't be taken lightly. The boom of the late '60s may have had its positive aspects...lots of jobs and a growing economy...but the continuing demand pulled up prices. The spiral of inflation began and there was no quick fix. Once started, it perpetuated itself. We all learned to live with inflation, and for some of us that meant learning to live with less...and as we were learning to cope with inflation...it was becoming more complex. It's hard, in this 21st Century to imagine that time when inflation was continuing to grow but demand fell off, and the economy stagnated. We called it Stagflation...a new problem and a problem

we'll explore in a future 21st-Century edition of Economics U\$A. This is David Schoumacher.

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