

ECONOMICS U\$A
PROGRAM #19
INFLATION: HOW DID THE SPIRAL BEGIN?

AUDIO PROGRAM TRANSCRIPT

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(MUSIC PLAYS)

Announcer: Funding for this program was provided by Annenberg Learner.

FRANK STASIO: This program was originally recorded in 1985. Though times have changed, the basic economic principles presented here remain as relevant today as they were when the series was produced. Also, please note that individuals interviewed on this program may no longer hold the same titles they held when this program was recorded.

(MUSIC PLAYS)

FRANK STASIO: Economics U\$A. One of a series of programs designed to explore twentieth-century micro and macroeconomic principles. The subject of this edition is Inflation. Our guest is Barry Bosworth, the former Director of the President's Council on Wage and Price Stability.

I'm Frank Stasio

FEMALE VOICE: "Between the food, and the rent, and the clothing, and the cleaning and...and everything else, and you put it all together, you haven't got a dollar left."

FEMALE VOICE: "I don't see why the President doesn't do something about it. It's like, the gasoline, and the meat, and now, this. I was shocked when I heard on the radio that, now, oil is going up, cooking oil is going up, beef is going up. There's just too many things that are going up."

FRANK STASIO: The ever-increasing cost of living. It's called "inflation." And it means that the dollar doesn't buy what it used to. From houses, right down to the nails that hold them

together, the price of almost everything is higher today than it was years ago. Consumers don't need to measure inflation to feel its effects, but economists and policymakers want to know just how fast prices are rising.

BARRY BOSWORTH: "By inflation, we just mean an increase in the average price level."

FRANK STASIO: Barry Bosworth is an economist at the Brookings Institution, and former Director of the President's Council on Wage and Price Stability.

BARRY BOSWORTH: "Individuals, I think, going out to the store, tend to think of a price...of inflation as just when the price of something they want to buy goes up. But, continually, in an economy all the time, some prices are rising, some prices are falling."

MALE VOICE: "According to information released today by the Bureau of Labor Statistics, the consumer price index took another giant leap upwards this month, as food and energy costs continue to soar. A spokesman for OPEC said that a meeting...."

FRANK STASIO: The Consumer Price Index, or CPI, is the most familiar measure of inflation. It represents the percentage of price change of a wide range of consumer goods and services compared with a base year. The CPI is released each month by the U.S. Department of Labor. The Labor Department selects a market basket of goods and services for comparison based on studies of the buying habits of American consumers. Before 1968, Americans paid scant attention to the Consumer Price Index. Inflation wasn't much of a concern. Perhaps, because of the profound impact of the Great Depression, Americans in the '40s, '50s, and early '60s seemed more anxious about rising unemployment than rising prices.

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."

FRANK STASIO: When John Kennedy took office in 1961, unemployment was on the rise and the country demanded he do something about it. By now, the lessons of John Maynard Keynes were commonly accepted in the economics profession. To reduce unemployment, the government should stimulate demand by cutting taxes, or raising spending. Kennedy chose a tax cut, and that did the trick.

WALTER HELLER: “*Business Week*, which is not exactly a liberal pro-Kennedy publication, said that it probably was the most successful tax cut in history.”

FRANK STASIO: Walter Heller was Chairman of the Council of Economic Advisors under Presidents Kennedy and Johnson.

WALTER HELLER: “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, uh, that was a tax cut that worked.”

FRANK STASIO: At first, unemployment fell and demand rose without much effect on prices. But in 1965 demand shot up, driven by more than the Kennedy tax cut. By the mid-'60s America was at war on two fronts: One, at home...

LYNDON B. JOHNSON: “This Administration, today, here and now, declares unconditional war on poverty in America.”

FRANK STASIO: ...and another, halfway around the world, in a country called Vietnam. Spending on the Great Society and the war in Vietnam had begun to over-stimulate the economy. By 1965, demand was rising at a rate of eight percent a year, straining the limits of existing production capacity. When people want more goods and services than the economy can produce, there are likely to be shortages, and prices are bound to go up. This is known as “demand-pull inflation.” With production pushed to the limit, and demand rising, some economists, by the end of '65, began to suspect that inflation was near, and urged President Johnson to raise taxes. It

was simply the other side of the Keynesian equation. If a tax cut could stimulate demand, then a tax increase would cool demand, and reduce the risk of inflation. But, as Barry Bosworth points out, it's easier to cut taxes than to raise them.

BARRY BOSWORTH: "The problem that we faced was, there was a political judgment made that the American public wouldn't support that. They were already having trouble getting public support for the war. Uh, would it be, it would be even more difficult if you tried to ask people to pay for it?"

FRANK STASIO: The Vietnam War was costing tens of billions of dollars a year, far more than the Great Society programs, but Johnson was afraid that taxing Americans to pay for the war might cost him support for his social agenda. So, the mere threat of inflation would not be enough to force higher taxes.

BARRY BOSWORTH: "I think politicians took an attitude, as they still do today--when you try to warn about the dangers of some economic policy, you can be wrong and this is not anywhere near an exact enough science to be able to predict exactly when the problems will show up--politicians take the attitude, 'show me.' But, I think, to give them credit, so, too, does the American public. And all, during this period, they reflected nothing more than the standard view of an American citizen. He was unwilling to pay higher taxes to finance the war in Vietnam because he didn't see any evidence that it was causing inflation."

FRANK STASIO: By 1968, inflation had risen to almost four and a half percent, enough to convince the American public that the time had come to swallow a bitter pill. Lyndon Johnson imposed an income tax surcharge in 1968, meant to reduce inflation, but it came too late. Americans had been fighting their own battle against inflation for a couple of years. They found they weren't keeping up. Prices were rising faster than wages. It's true that the tax surcharge took money out of the hands of consumers, but only for one year. Because consumers knew the surtax was only temporary, they didn't bother to change their spending habits. So, inflation continued, unabated.

BARRY BOSWORTH: "Once it...once it goes on, so long it gets into people's expectations, then, you gotta find a way to reverse their expectations. You have to have very depressed economic conditions for a period of time to really reduce the actual rate of inflation, to change their expectations of what it will be in the future."

FRANK STASIO: By 1969, most Americans had begun to protect themselves against rising prices. The more surely they expected inflation to continue, the harder it became to hold it in check. Bosworth says that, in some ways, the consumer price index itself helped to drive inflation.

BARRY BOSWORTH: "The people have gotten very used to having the statistic available. It's subject to widespread commentary, and, uh, the media, and probably, to some extent, people now do respond to the availability of that information in deciding in their own mind, what's a reasonable wage increase for me to seek?" And, so, it begins to influence the rate of inflation.

FRANK STASIO: A low unemployment rate means that labor is in demand. This gives workers the bargaining power they need to gain higher wages.

BARRY BOSWORTH: "If we have an expansion of the economy, and we drive unemployment down to very low levels, one of the consequences of that is, that people think they have good employment opportunities, uh, alternative jobs available. If you're not worried about losing your job, you're obviously gonna become much more militant in asking for wage increases."

FRANK STASIO: If, on the other hand, unemployment rises, demand for labor drops off, reducing pressure on wages. This simple relationship between the level of unemployment and the rate of wage increases is called the "Phillips Curve."

BARRY BOSWORTH: "Similarly, in product markets, when a whole industry is operating close to full capacity, individual firms are much more likely to raise their profit margins because they're less worried that customers can go to other firms. So, you see that, both in product

markets and in labor markets, as capacity utilization of the overall economy increases you're gonna get to see some acceleration of wages and prices."

FRANK STASIO: The Phillips Curve implies a relationship between unemployment and inflation. Low unemployment drives up prices because it gives workers the leverage to win higher wages. So, why, when workers have the bargaining power to keep pace with inflation should they worry about inflation at all? Why not just automatically adjust or index everybody's salary to match the rate of inflation?

BARRY BOSWORTH: "Because, I think, the basic battle that people are going through is not that they just want a wage increase that keeps up with inflation; they want a wage increase that's greater than the rate of inflation. I think, in fact, most of us look at it is, 'the wage increase I got is too small, and it ought to be larger. And, uh, if I get a large wage increase, that's a reward for hard work and effort, and it's about time they recognize my value.' Then, it's those other people out there who went out and got inflationary wage and price increases, uh, that are responsible for our problems. When I was in the government, dealing with this issue, I never once had a labor union come in and want to talk about their own inflationary wage increases. And you never had a company that wanted to come in and say, 'we're having inflationary price increases.' Uh, inflation's always the fault of other people. If you index it that does not eliminate the battle that everybody wants to go through: I want a wage that's higher than yours."

FRANK STASIO: And the fact is that indexing does nothing to stop inflation. It can only help consumers keep pace. But inflation may have more subtle effects than its impact on purchasing power. Inflation creates uncertainty about the long-term economic future.

BARRY BOSWORTH: "It begins to distort seriously investment decisions that get made in the economy because people don't know what the future's gonna look like. Yet, the whole basis of an investment decision in an asset that's gonna last for a period of time, is having on... some expectation about what the economy will look like in future years. So, I think in that way, inflation has become very distortionary of resource use. It makes long-term planning look very

risky— you better concentrate on the short-run; don’t worry about the long-run because you don’t know what’s gonna happen anyway— it leads people to invest in short-lived assets rather than making long-term investments. Uh, in the ‘70s, for example, there was quite a bit of decline in research and development expenditures by business firms because the payoff period looked so far in the future. And the future looked so uncertain to them, that they were reluctant to do it. I think inflation contributed to those expectations.”

FRANK STASIO: During inflationary times, the longer a consumer waits to make a purchase, the more the item is likely to cost. This encourages people to spend more, and save less. It’s also an incentive for them to go into debt, not only because the product they wish to buy will cost more if they wait until they have more cash, but also because interest rates for borrowing are often fixed at the time of purchase. If the rate of inflation climbs above the interest rate, the buyer pays back the loan with dollars that are worth less than when the terms were settled, effectively lowering the total cost of the product. In this way, inflation tends to hurt lenders and benefit borrowers. As Barry Bosworth points out, inflation is more damaging when the rates vary unpredictably. Economists make the distinction between anticipated and unanticipated inflation.

BARRY BOSWORTH: “When you get into people’s contracting— in particular, an economy like ours has very large amounts of contracting over long periods of time, labor contracts that may extend as far as three years in the future—business firms that are making investment decisions have to look out, five to ten years over the life of that asset. And, so, what we’re really interested in the formation of those contracts is, not what the actual rate of inflation is at any point in time, but what that does to their expectations of what they think inflation’s gonna be over the period for which they’re signing the contract. I mean, a worker would think, for example, a five-percent wage increase was a great increase if he was expecting zero inflation over the future period. On the other hand, it’s not nearly enough if he thinks inflation was going to be 10 percent. Just an area of where you can see the influence on people’s investment decisions. Look at housing. I think, back in the early 1970s, and even in the mid-‘70s, a lot of Americans thought that a 10-percent interest rate was an outrageous price to have to pay for...to borrow money, for a mortgage. Then they came to realize, well, if inflation’s 10 percent, a 10-

percent interest rate's really pretty cheap, and we had a big boom in housing. Well, in the 1980s, uh, I think that expectation of the '70s was carried over. What they learned was, go buy a house that appears to be more than you can afford, but inflation is going to raise your own income, the mortgage payments are gonna stay constant, and you're gonna end up after a few years able to afford it – you're gonna have a big capital gain. Uh, without understanding the full mechanism, I think a lot of Americans thought, well, that was just the way housing was. Now, we go into the 1980s, we have very high interest rates, still, but we have very low rates of inflation, and home prices are not going up at 10 percent a year, and wages are not going up at 10 percent a year. But, without understanding that, people entered into contracts again to buy a house, expecting, well, if everybody else could do it in the '70s, why can't I do it in the '80s? And finding out, three and four and five years later, that that mortgage is still an enormous burden. And a lot of people are having more and more trouble trying to meet these mortgage payments. You see it; for example, in, uh... defaults on mortgages are much higher in the 1980s than they were in the 1970s."

FRANK STASIO: It is possible to benefit by inflation through shrewd investments, or by having been lucky enough to own resources, say, land or precious metals, before the prices skyrocketed. But, according to Bosworth, it's sometimes hard to tell the winners from the losers.

BARRY BOSWORTH: "Inflation is something, on the one hand, you're likely to be gaining, and, on the other hand, you're likely to be losing. Uh, people would say, 'inflation—I lost because I had to pay these tremendous mortgage interest rates during a period of high inflation.' Of course, on the other side, the value of your home was rising in value very rapidly. Uh, so inflation is much more a situation where we can't identify specific groups of people who are clear-cut losers, or gainers. Everyone is to some extent a winner and to some extent a loser, and, in balancing it out, you don't come up with a nice well-identified group. Like, certainly, the elderly— which used to be the popular example in the '50s and '60s, retired people clearly were the big losers from inflation. In the '70s, Social Security was indexed for inflation. That was their major source of income. All of a sudden, they didn't care, so to speak, about inflation anymore. Private pension funds, uh, were not, and if you had, a big share of your retirement income came from a private pension fund; in general, you were a loser. But many of the private

pension funds did adjust their benefit payments during the period, even though, maybe, by law, they weren't required to, because the fund was earning more, because interest rates were higher, and, so, they were able to pay, during a period of inflation, somewhat higher benefit payments. I think one of the problems, in fact, we have with inflation is, no one wants to recognize that any of their gains came from inflation. They always want to allege that it's due to their own, uh, brilliance, investment decisions, or their own hard work. It's always deserved. The losses are always perceived as not their fault, and due to inflation."

FRANK STASIO: What Bosworth is suggesting is that. whatever the real effect of inflation, people don't seem to like it very much. Businesses, for example, don't jump for joy at having to charge higher prices. Richard Rahn is the Chief Economist for the U.S. Chamber of Commerce.

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...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."

FRANK STASIO: Barry Bosworth recalls his efforts to try to talk with both labor and management about controlling wages and prices when inflation was running high, in the 1970s. He says that, while there is some justification to charges that unions help fuel inflation by demanding costly wage settlements, workers never believed they were winning the battle against inflation. He uses auto workers as an example.

BARRY BOSWORTH: "Automobile workers always were paid more than the average of other factory workers –about a 25-percent wage premium if you were in autos—maybe, in part, because it was unionized...variety of explanations for it. But the remarkable thing in the 1970s was that

their relative wage, which used to be 25 percent greater than the average, by the end of the decade was 75 percent greater than the average. Yet, if you tried to talk to an automobile worker, it was not his perception that he had done real well in the 1970s. Uh, one of the things, I think, that does happen when you have rapid rates of inflation is, people become very confused about what's happened to their own real situation. Uh, trying to keep track of the growth in your own income accurately to stack up against prices is hard."

FRANK STASIO: Bosworth says that unions are not to blame for starting inflation. Higher wage demands are usually the result of increased prices.

BARRY BOSWORTH: "It's hard to see that very many inflations were initiated by excess wage pressures. They're far more likely to start with excess price increases due to shortages. And, then, what the function of the wage negotiation process is, once an inflation gets started, it's the wage negotiations that keep it going. Nobody wants to back off. Everyone just keeps saying, I'm trying to keep up with my neighbor. I'm not causing inflation; I'm responding to inflation. And it's, it's, uh, an analogy that can be made sort of as, like, if you go to a football game and an exciting play occurs, and somebody in the front row stands up, then everybody behind him stands up. And, then, you say, well, if only everybody would sit down at the same time, you'd all be more comfortable. And you try to figure out who's going to go first."

FRANK STASIO: Mistrust and an unwillingness, both on the part of business and labor, to be the shock troops in the fight against inflation make it almost impossible for voluntary efforts to succeed. That was something President Nixon realized when he took office in 1969

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

FRANK STASIO: Nixon may have felt responsible for cutting inflation, but his options were limited, and almost all of them meant higher unemployment. Politically, he was in an awkward

position. He could either raise unemployment or let inflation spiral upward. The American public couldn't decide which was worse.

BARRY BOSWORTH: "The '70s, then, became nothing but a period of absolute frustration in trying to deal with this problem. But, I think, it should be kept in perspective, again. It was never a debate that economic restraints, or restricted monetary policies, or restricted budget policy could not stop inflation. I mean, the Great Depression of the 1930s, when the price level fell, convinces any economist that you can stop inflation if you're willing to pursue these policies. The problem was, was it worth it? How much cost are we willing to pay in terms of unemployment? Our earlier experience of debt-- the moment the unemployment rate started to rise, public opinion turned around completely—didn't seem to care at all about inflation anymore, and put pressure on government to do something about the unemployment. Uh, that went on throughout the 1970s. These, uh, recurrent—uh, turns in policy. We would become very exp...uh, upset about inflation, adopt a restrictive policy to deal with it. It would start to come down, but, unfortunately, the rate of unemployment would begin to rise, and then we'd swing back the other way, and say, we gotta do something about unemployment. We'd stimulate the economy, it would go down, but inflation would start to rise again. Our economy began to look like a roller coaster."

FRANK STASIO: In future editions, we'll see how economists and policymakers cope with the twin problems of inflation, and high unemployment. Let's look back, now, at some of the key points in our discussion about inflation. Inflation is the general upward movement of prices across the whole economy. It is measured by the Consumer Price Index, which is published monthly by the U.S. Department of Labor. The Consumer Price Index uses a carefully selected group of consumer items called a market basket of goods and services to compare prices from month to month. Inflation that is caused when aggregate demand rises faster than economic output at full employment is called demand-pull inflation. The relationship between the level of unemployment and the rate of wage increases is called the Phillips Curve. As unemployment falls, wages tend to rise, since labor is in short supply. There is, therefore, a relationship between unemployment and inflation. A simple view of this relationship shows that inflation falls as unemployment rises, and inflation rises as the economy draws nearer to full employment. While

there may be some who gain by inflation, a steady escalation of prices is generally seen as damaging to the economy. During inflation, people tend to base investment decisions and long-term agreements on expectations of higher prices. This can distort investment planning and lead to speculation rather than more productive investments. The results may mean less efficient use of resources. The biggest losers during inflation are people whose incomes are fixed and cannot keep pace with rising prices. Savers are also hurt because their money loses buying power over time. Long-term loans made at fixed interest rates can be costly to lenders because inflation erodes the value of money that is used to pay back the loan. Borrowers under these circumstances can be considered the beneficiaries of inflation. Given this simple view of the relationship between inflation and unemployment, a view which held through the fifties and sixties, economists believe that inflation could be controlled by reducing demand. This could be done by raising taxes, or reducing federal spending. Both are unpopular, and, therefore, politically difficult, and both result in higher unemployment. Workers and individuals negotiating long-term agreements during inflation may try to tie the terms of their contract to the rate of inflation. This is called "indexation." As we've said, the simple relationship between unemployment and inflation seemed adequate to explain the economic trends of the '50s and '60s, but when inflation was allowed to spiral for too long, psychological factors had to be added to the equation, creating new problems for economists in the '70s. More on that in future editions of Economics U\$A.

(MUSIC PLAYS)

FRANK STASIO: You've been listening to Economics U\$A, one of a series of programs on micro and macroeconomic principles. Our guest has been Barry Bosworth, former Director of the President's Council on Wage and Price Stability. Economics U\$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio

(MUSIC ENDS)

ANNOUNCER: Funding for this program was provided by Annenberg Learner.