

ECONOMICS U\$A

PROGRAM #22

STAGFLATION: WHY COULDN'T WE BEAT IT?

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 and macroeconomic principles. The subject of this edition is Stagflation. Our guest is Barry Bosworth, the former Director of the President's Council on Wage and Price Stability. I'm Frank Stasio.

MALE VOICE: "This boycott is a perfectly reasonable free enterprise tool to use when meat prices are the highest in history...."

GERRY FORD: "This Administration, I can assure you, is pledged to protect consumer buying power, or customer purchasing power. I don't care whether W-I-N spells "Whip Inflation Now," or "Work is Needed"....."

FRANK STASIO: Once inflation begins, it's difficult to control. Throughout the 1970s, policymakers and economists struggled to explain and correct a growing inflation rate that would top 15 percent. Before the '70s, economists looked at inflation as a demand phenomenon. That is, as unemployment fell to levels approaching full employment, demand would begin to outpace total economic production. Economists can see this sort of inflation coming by tracking the unemployment rate and measuring output. But there are other forces that can send prices soaring

without warning. Nature is one of them. In the early '70s, natural disasters and war devastated food production around the world. By 1972, millions of people were threatened with starvation. Relief efforts were taken up to ease the suffering. American relief efforts and exports depleted grain reserves by more than six million bushels in two years, and food prices rose 20 percent. The jump was sudden, and steep, and consumers were angry.

FEMALE VOICE: "We want to boycott meat. We don't want to eat it. We don't want to fill up our freezers with it. We want to not eat it, and we don't want to buy it."

FRANK STASIO: Still reeling from the shock of food price hikes, American consumers would face another blow in the early '70s.

MALE VOICE: "Violence erupted in the Mideast today, as armored tanks and troops belonging to the Egyptian army crossed the Israeli border and rapidly advanced on the Sinai. Confirmation of the attack, which began on the Jewish High Holiday of Yom Kippur, is...."

FRANK STASIO: Like food, oil is basic to the American economy. Nearly everybody depends on it. Like the food shortage, the Arab oil boycott and the energy crisis that followed was sudden, and its effects were profound. In six months, gasoline prices jumped 40 percent. Inflation neared 11 percent. People were stunned at first, but, once again, shock turned quickly to anger.

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: Clearly, the sudden shortfall in the supply of oil and food caused those prices to rise. But why did the overall inflation rate jump so high? Usually, when prices go too high, people buy less until the prices fall back to more affordable levels. It's true that food and oil are so basic that there is a limit to how much consumption can be reduced. But, in that case, economists expect to see a drop in the consumption of less vital products. The resulting decline in the prices of those goods should offset the food and oil price increases. These so-called relative price changes keep the overall inflation rate from rising much higher. Barry Bosworth is

former Director of the President's Council on Wage and Price Stability. He explains why this did not happen in the '70s.

BARRY BOSWORTH: "The real force in the economy is, when oil prices went up, and I had to pay more for gasoline, I wanted a wage increase to cover those higher costs. And uh, what you get is pressure for other wages and prices to go up, because people want to restore what they regard as a fair wage, a fair price, cover cost increases, just keeping up. Then, the response is that wages and prices of other industries, instead of falling, may, in fact, go up, as everybody in those other industries tries to catch up to the higher price of energy or food, or whatever it may be. So, in fact, we found, particularly in the 1970s where this phenomenon was very important, that things like, when oil prices go up, food prices go up, uh, those things do not reduce overall inflation of other goods. They tend to raise the rate of inflation of other goods, and, therefore, they add to the general inflationary pressures in the economy, rather than being offset as relative price changes."

FRANK STASIO: This was not the demand-pull inflation economists had become familiar with. Unemployment remained right around five percent. All the while, consumer prices were climbing into the double digits. If this were a demand-pull inflation, we would expect to see a steady drop in the unemployment rate. But this inflation, touched off by sudden shortages, was driven by expectations. Workers presumed that prices would continue to rise. Economists call this "cost-push inflation." Alan Blinder is a Professor of Economics at Princeton University.

ALAN BLINDER: "Typically, the major cause of inflation is an excessively rapid growth of aggregate demand, of the demand for goods and services, a growth rate that outstrips the rate at which the economy's productive capacity, uh, is increasing. This is sometimes put in the phrase, uh, "too much money chasing too few goods." But there's another kind of inflation often called, "cost-push"—or "supply-shock"—inflation, that is caused, not by demand growing very rapidly, but by supply growing very slowly, or even in some cases, contracting."

FRANK STASIO: The supply-shock of the '70s seemed to prove, once and for all, the instability of the Phillips Curve, and the relationship between unemployment and inflation that it implies. Remember that the Phillips Curve shows an inverse relationship between unemployment and wages. As unemployment falls, wages rise. As wages rise, demand

increases, and prices go up. Even before the sharp price increases of the early '70s, economists had begun to question the validity of these relationships. In the late 1960s, the economy had become over-stimulated by huge defense outlays for the Vietnam War. Because of President Lyndon Johnson's reluctance to raise taxes to pay for the war, inflation rose, unchecked. It wasn't long before workers began to build into their wage agreements the expectation of higher prices.

BARRY BOSWORTH: "Workers consensus was, 'not that I'm trying to get a wage increase bigger than everybody else, I'm just trying to keep up with price inflation.' So, the first group just gets it because they want compensation for higher prices. And, then, everybody else tries to catch up with their wage increase, and the whole thing is 'off to the races.' In fact, normally, when we look at the problem of inflation, 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, their 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."

FRANK STASIO: In 1968, inflation had risen to almost four and a half percent, while unemployment held steady at three point six percent. President Lyndon Johnson imposed an income tax surcharge to reduce demand, and bring down inflation. This is called, "a demand management policy." It's a simple remedy for inflation that can be inferred from the Phillips Curve. But the Johnson tax hike didn't work. There was a rise in unemployment, but it seemed to have no effect on inflation. Bosworth says a turning point in economic thinking came with the failure of the Johnson tax surcharge.

BARRY BOSWORTH: "That, then, the subsequent recession, was a major, uh, change in U.S. economic policy, in the sense that economists, at that point, thought all you had to do was let unemployment go up a little bit, and you'd get immediate benefits in terms of substantial rates of reduction and rate of inflation. And we didn't. Unemployment went up six and a half, uh, percent uh, during that period. We thought of that as a very high unemployment rate. Yet wage and price increases kept right on going. So, economists, I think, at that point realized that the old

view that there was a simple tradeoff between nominal wages and the unemployment rate was way too simplified.”

FRANK STASIO: Economists, like Milton Friedman and Edmund Phelps, tried to show that the Phillips Curve was a short-term phenomenon. These economists, sometimes known as “accelerationists,” argue that, in the long run, workers will come to expect ever higher prices, and they will insist on higher wages to keep pace. Businesses then pass on their increased cost to consumers. This can occur without an increase in demand for the product. In fact, the price increase is likely to reduce demand for the product, which might force the business to lay off workers. So, it’s possible that prices and unemployment may rise at the same time. The combination of stagnant economic growth and inflation has been dubbed “stagflation.” Stagflation can begin either with a cost- push or a demand-pull inflation. But Bosworth says, it’s important to determine which the driving force behind the price spiral is.

BARRY BOSWORTH: “ If you see an inflation that’s due to the fact that there are shortages in almost all markets, uh, shortages of skilled labor, skilled, uh, shortages of basic materials, you would identify that as one where, demand for the whole economy is clearly in excess of its ability to produce and it’s pulling up prices. The clear response to that has to be to reduce the level of demand. And that calls for fiscal and monetary policy with strengths of the traditional mechanisms the government has...has been using for the last fifty years in trying to control the economy. Then, someone comes along and says, ‘well, the real problem here is that we are facing upward pressures on...on cost, perhaps, from an industry, uh, where the union and the company together have excessive market power, and they’re pushing up their wages and their prices and adding to the cost of other industries.’ And somebody says, ‘well, should we, therefore, have unemployment in all other industries, trying to offset this? Or, should we go into that industry and try to strengthen competitive pressures, perhaps, by relaxing regulatory restrictions or something like that, inducing other firms to enter— opening up competition.’ Uh, that’s a different type of policy to deal with inflation.

FRANK STASIO: The key to controlling inflation seems to be keeping the wage-price spiral from gaining momentum. Even accelerationists like Friedman and Phelps admit that the Phillips Curve *is* a valid relationship in the short run, and that as unemployment is reduced to levels that

would drive the economy near full capacity, they would expect demand-pull inflation to set in. But this was a principle that policymakers and economists seemed to ignore in the 1960s.

BARRY BOSWORTH: "If we looked back now we would say that the economics profession was too optimistic about our ability to keep inflation under control at low rates of unemployment. There was a lot of discussion that we could have a four- percent unemployment rate in the U.S., and still not experience accelerating inflation. That turned out definitely to be too optimistic a view on the part of economists. But, second, even as we began to realize that, in the mid-'60s, uh, the economy overshot, more than any economist intended, because we had a tax reduction in 1964— we'd had one in '62 as well— both of them designed to get unemployment down in the United States, we had essentially achieved that goal at four percent by the middle and end of 1965. That would have been a time to, then to try to maintain that unemployment rate, but, certainly, not go further, because we didn't have much experience with what would happen at lower rates of unemployment. But, instead, that was the period when the Vietnam War accelerated, and government continued to be more expansionary than it was before in fueling economic growth, and pushed unemployment to lower levels. We did run into capacity shortages in many types of materials."

FRANK STASIO: Notice that Barry Bosworth said the expansionist policies of the 1960s were pushing unemployment too low. But how can unemployment be too low? Why is full employment set at a rate that is higher than zero? Well, there is, according to some economists, a "natural rate of unemployment." Since there will always be people between jobs, looking for new work, unemployment will never reach zero. As people grow more reluctant to take unpleasant or low-paying jobs, the natural unemployment rate would increase. Also, structural unemployment plays a part in determining the natural rate because changes in technology can have an impact on unemployment. Natural unemployment is fixed at the point where inflation starts to rise.

BARRY BOSWORTH: "So, that you have an unemployment rate that, now we would talk at... about it as an unemployment rate below which inflation begins to accelerate from whatever level it was at. And if you put unemployment rate higher than that, there's a tendency for inflation to decelerate. In the U.S., for example, today the best estimate is that, if we get an unemployment

rate down around six percent, we begin to see clear evidence of accelerating rates of inflation. If we keep unemployment above six percent, there is a...a tendency for the rate of inflation to steadily decelerate. Now, obviously, the further away you get from that, the more dramatic the difference is."

FRANK STASIO: Over the past several decades, the natural unemployment rate has crept up steadily. This is due, largely, to increases in the percentage of the workforce that is inexperienced. This expansion was especially rapid in the 1970s.

BARRY BOSWORTH: "Because it was a period where the postwar Baby Boom was coming into labor markets at a very rapid rate, they lacked much job experience. And so we had a very poorly-trained workforce on average in the '70s, very inexperienced. Employers are obviously reluctant to hire such workers, and, given a choice, would rather try to bid a worker away from another employer rather than hire some of the unemployed. So that you can think of, in from the demand side, as where those pressures come from. A...a proven worker in his thirties, forties and fifties, looks more attractive to an employer than a young inexperienced teenager. When the labor force was so heavily composed of teenagers, there was a tendency for that unemployment rate that we associated with price stability to steadily rise over time. Now, you can use job-training programs, education programs, uh, even things like trying to move workers from parts of the country where jobs are short, to areas where there are more jobs available, can, so-call..., shift this natural rate of unemployment, this point at which inflation starts to accelerate, to lower levels. So we try to use, uh, elimination of discrimination, for example, in job opportunities as one way to shift that level of unemployment down."

FRANK STASIO: The government has tried several programs aimed at reducing the natural rate of unemployment. The Job Corps, for instance, was designed to train poorly-educated teenagers in job skills so that they could enter the job market. The Job Corps takes in ninety thousand new applicants each year. Most don't complete the full two-year program, but, of those who do, 70 percent find work when they leave. Ken Koons teaches cement finishing at a Job Corps Center in Harper's Ferry, West Virginia.

KEN KOONS: "When a kid comes back here, all dressed up, and saying he's making twenty dollars an hour, and he got married now, and he's buying a house and all that, you know, that, it really makes you feel good. I had one young man that relocated from uh, Philly down to Houston and he calls me every now and then, and tellS me how he's doing down there, how well he's doing. He's been gone for six years or something like that. They're not all, you know, you don't get all uh, success stories, you know. Some of 'em just go and uh, get any kind of job, at McDonald's, or something like that. And they don't all become good cement finishers that you train. But I got a, I...I've, I've had a...a fair...fairly good ratio of success with them."

FRANK STASIO: Koons was interviewed by National Public Radio. The federal government spends about fifteen thousand dollars a year on the average Job Corps student. No one has yet measured the impact of programs like Job Corps on the natural unemployment rate. But they're generally supported as ways to bring that rate down. Republican Senator Orrin Hatch of Utah chairs the Senate Committee on Labor and Human Resources. He also spoke with NPR.

ORRIN HATCH: "We're talking about the greatest society in the world not writing off some of the greatest potentials it has, just because these kids are born in poverty or on the wrong side of the tracks. My father taught me his trade. I worked in the building and construction trade unions for ten years. And I want to make sure some of these kids that don't have fathers who can do that for them, have the opportunities that I had."

FRANK STASIO: A reduction in the rate of natural unemployment would mean that society could achieve lower rates of unemployment without the risk of inflation. But job training and reductions in discrimination take time, and time is short when prices rise faster than wages.

VICTOR GOTBAUM: "I represent workers."

FRANK STASIO: Victor Gotbaum is a representative of the American Federation of State, County, and Municipal Employees in New York.

VICTOR GOTBAUM: "If they're taking a beating, and they go into the supermarket, I hear about it. They don't make unfounded, or, you know, loud demands. If a Vinnie Perisi, who's a sewer worker, says, 'Hey, Mary goes into the market. Vic, it's killing me,' that's what I hear. If a hospital worker says, 'We, you know, it's...it's becoming awful,' that's what I hear.

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."

FRANK STASIO: In 1971, President Richard Nixon imposed wage and price controls, a mandatory cap on wages and prices. It's an extreme measure, not taken lightly in a free economy. But, by this time, economists had lost faith in the power of simple demand management to control inflation. They realized that the amount of spending cuts or tax increases necessary to stem inflation would be politically impossible to achieve. Besides, unemployment had already risen to six percent, and that was considered high. Traditional demand management remedies would only make unemployment worse. Unfortunately, wage and price controls weren't very effective, either. When Nixon lifted the lid, prices soared once again. Herbert Stein is a former member of the Council of Economic Advisors.

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 their expectation of inflation. And businesses were raising prices in their expectation of inflation and 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 uh, you could then resume a free market system, with a low rate of inflation. But that didn't happen. We didn't change their expectations. The only, we only created the expectation that, when the controls ended, the prices would zoom again.

FRANK STASIO: Along with the psychological reasons, there are a number of technical reasons why wage and price controls failed, and why economists generally have little faith in such programs. In the first place, wage and price controls can easily lead to bad choices in the way we use our resources."

BARRY BOSWORTH: "A standard that, if you don't want any inflation in the average level of prices, is that no one price can go up, or no one wage. It's just excessively rigi... uh, rigid to the economy. You are, experience, continual reallocations of resources from one industry to another. Even back, say, in 1960 to '65, when the U.S. really had essentially a zero rate of inflation, individual prices were changing a great deal, about that average. So, you have to have some mechanism that does allow, uh, resources to, uh, or prices to change at the relative level.

Otherwise, you're really talking about something like the Soviet Union's economy. Uh, here's the price of shoes, and the manufacturer says, 'Well, I can't make any money uh, pricing, producing shoes at that level, so I'm not gonna make any.' And then there's a shortage of shoes, and, then, consumers say... normally, what we would do is...is at that point, the price of the shoe would rise and that would induce somebody to come in and produce 'em. Uh, prices are a signal from consumers to producers to tell 'em what they want. And if you interrupt that whole mechanism, then, how are you gonna allocate goods in our society?"

FRANK STASIO: The very cost and complexity of administering wage and price controls makes them an unattractive option to most policymakers. As Bosworth has said, wage and price controls are never absolute.

BARRY BOSWORTH: "So, in fact, you end up trying to make a judgment instead about, some price increases are justified, usually, on the basis of cost increases, and some are not. That gets you into very complex economy arguments with firms over what's really been happening to their cost. It's not always easy to determine because they're producing a wide range of different products, with a wide range of different inputs. Some are going up. Some are going down. They bought 'em at different points in time at different prices. Uh, you get into very detailed calculations with firms. If you really want to do it, you end up with a huge staff, or else you have to accept their word for it. And, uh, when it gets down to money, people aren't always all that honest. So, that the experience that I've ever had with it, when we tried to run programs, uh, involving some form of price and wage controls, was that you end up in enormous hassles with firms and asking for continuously more data. And then they try to inundate you with data and information that you just don't know how to absorb because there's so much information."

FRANK STASIO: The failure of both demand management, and wage and price controls to hold down inflation led the Federal Reserve Board to take action. Late in 1973, the Fed, then chaired by Arthur Burns, raised the interest rate it charges member banks.

ARTHUR BURNS: "The policy of monetary restraint pursued by the Federal Reserve has helped to cool the economy by moderating the expansion of credit and disciplining inflationary psychology."

FRANK STASIO: Burns was half right. The economy did cool. In fact, it nearly froze. By 1974, a combination of tight money policy and extreme price shocks caused the sharpest drop in economic activity in sixteen years. But inflation was out of control, soaring to more than 13.5 percent. Stanley Fisher is a Professor of Economics at the Massachusetts Institute of Technology.

STANLEY FISHER: " "I don't think that the failure of policymakers in general or economists for that matter, understood well how the oil price shock, uh, affected the economy. I think there was some view that oil prices would go up, uh, without having much impact on...on the uh, level of unemployment or the rate of growth of the economy. It's easy to see now that when you get a shock of that type, it really can push the inflation rate up for a period of a year, or two years, even. But I don't think that's what people thought, at the time, was gonna happen."

BARRY BOSWORTH: "Our efforts to try to direct specific policies towards areas of what have sometimes been called "cost-push" have not been effective. Uh, we don't do 'em very well. We run into enormous political efforts to try to use 'em. Uh, we don't have a lot of ideas, in many cases, about how to deal with the problems."

FRANK STASIO: In 1984, after a severe recession, the inflation rate fell below three and a half percent. And many economists predicted that it would remain relatively low for much of the eighties. Barry Bosworth contends that the balance between unemployment and inflation has shifted with the new emphasis on controlling inflation.

BARRY BOSWORTH: "We've been through a decade, but we're very aware now, the public, of what the cost of sustained inflation is. We may not yet fully realize what the cost to sustained unemployment is. Uh, we may not, really, as a society sit back and think what it means to go on for several decades with teenage unemployment rates in the range of 25 percent, and what that's ultimately gonna mean to the structure of society. Uh, so I'm not sure this is a permanent balance that we've struck. Uh, we're learning more about what it means to have higher rates of unemployment. We'll accumulate, maybe in the '80s, a lot of information about that. Clearly, in the '30s the balance was the other way, but it was so extreme, uh, that it's not a much of a guide to where we'll go in the future."

FRANK STASIO: Let's review the main points in our study of stagflation. The Phillips Curve, which shows the relationship between a level of unemployment and the rate at which wages increase, also implies a relationship between unemployment and inflation. Since the Phillips Curve shows wages rising as unemployment falls, it follows that prices will also rise as unemployment falls. Some economists believe that the Phillips Curve is only valid in the short run, and that, in the long run, inflation may be driven higher by the expectation of further price increases. This sort of inflation is called "cost-push inflation." It may be touched off by prolonged demand-pull inflation, or by a sudden sharp increase in a basic commodity like oil or food. Traditional demand management policies, which try to reduce demand through tax increases or reduce government spending, are not likely to be effective in fighting cost-push inflation. This is because demand management policies always increase unemployment, and cost-push inflation unemployment is already rising along with inflation. The combination of rising inflation and increased unemployment is called "stagflation." Other ways to control inflation include monetary measures that restrict the money supply and dampen demand. This, too, results in higher unemployment. The government may also impose wage and price controls, but these are difficult to administer and lead to misallocation of resources. Inflations often begin when the level of unemployment falls below the natural unemployment rate. The natural unemployment rate includes those who are looking for work, or those who have lost their jobs due to technological innovations. The natural unemployment rate can be reduced somewhat through manpower programs which include job training, geographic relocation, and ways to reduce discrimination. The techniques for controlling cost-push inflation are not well-developed, and the ability of economists and policymakers to fine-tune the economy, and keep both inflation and unemployment under control, has yet to be demonstrated."

(MUSIC PLAYS)

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 Council on Wage and Price Stability. Economics U\$A has been produced by the Educational Film Center. I'm Frank Stasio.

(MUSIC ENDS)

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