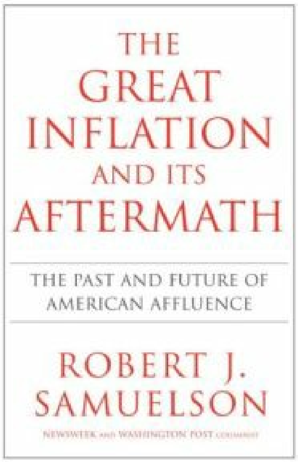

Book The Great Inflation and Its Aftermath

The Past and Future of American Affluence

Robert J. Samuelson
Random House, 2008
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Recommendation

Recessionary times have led many people to re-evaluate their long-held beliefs about the financial system. His history-based economic analysis makes journalist Robert Samuelson's fresh investigation of the insidious effects of inflation especially interesting. He covers the advent of inflation in the U.S. in the 1960s, and explains how it changed the nation's economic thought and vision. Like a mutated gene, inflation assumed a life of its own and spawned the "new economy." Samuelson presents a provocative, if debatable, argument about economics and prosperity. *BooksInShort* recommends this detailed, advanced economics report and assures readers who stick with it that it will reward them with deeper understanding and fresh insights.

Take-Aways

- The Great Inflation of the 1960s and 1970s was an unintended byproduct of an attempt to control business cycles and cut unemployment.
- This persistent inflation, which started under John F. Kennedy, was an ambitious intellectual effort to improve Keynesian economic theory by fostering growth.
- Every president from JFK through Jimmy Carter failed to control inflation or (except Gerald Ford) to identify it as the economy's greatest problem.
- "Double-digit inflation" caused four recessions: 1969–70, 1973–75, 1980 and 1981–82.
- Ronald Reagan and Fed Chair Paul Volcker used unpopular tactics to control inflation.
- Their actions produced the longest peacetime economic expansion, from 1983 to 1990.
- The "old economy" was stable; the growth-driven "new economy" is in constant flux.
- It creates more jobs, choices, innovative products and higher living standards, but it also leads to shorter job tenures, more bankruptcies and weakened industries.
- Globalization generates prosperity, competition, job migration and bigger markets.
- Studies find no direct correlation between wealth and happiness, though economic growth tends to breed democracy and optimism.

Summary

The Inflationary Cycle

Almost 50 years have elapsed since the United States experienced the start of an inflation-dominated economic cycle. From 1960 to 1979, U.S. inflation grew from 1.4% to 13.3%. By 2001, it had fallen to 1.6%, almost its 1960 level. The "Great Inflation" from the mid-1960s to the early 1980s could be considered the U.S.'s "greatest domestic policy blunder" since the end of World War II. These decades of inflation had a huge impact on prices, politics, business, employer-employee relations, global trade and the evolution of American society.

> "It's impossible to decipher our era, or to think sensibly about the future, without understanding the Great Inflation and its aftermath."

People take price stability for granted, but when prices increased in the 1970s, food and housing costs became uncertain, and savings declined. Worse, Americans did not know who could regain control of the situation. Ronald Reagan won the 1980 U.S. presidential election due to public discontent over "double-digit inflation," which caused four recessions: from 1969 to 1970, 1973 to 1975, 1980, and 1981 to 1982. Late in 1982, inflation rose again, unemployment hit 10.8% and the U.S. standard of living fell. The Dow Jones Industrial Average "was no higher in 1982 than in 1965." The Great Inflation was an unintended byproduct of the U.S. government's attempt to control business cycles and cut unemployment. Policymakers based their actions on "collective hopefulness and intellectual overconfidence," but their decisions undermined daily American life.

> "The inflationary episode was a deeply disturbing and disillusioning experience that eroded Americans' confidence in their future and in their leaders."

Americans believe they control their own destinies and they love progress. They do not think outside forces shape their lives. Yet, as prices rose, Americans saw their living standards erode – just one of the cascading effects of high inflation. Inflation-driven interest rates contributed to the 1980s savings and loan crisis, costing taxpayers about $160 billion. High inflation and loose lending wreaked havoc on farmers, who borrowed heavily while commodity and farmland prices were inflated. But when interest rates rose and commodity prices plunged in the 1980s, farm foreclosures soared. Inflation, increasing interest rates and falling commodity prices led to the Third World debt crisis of the early 1980s and fed U.S. public anger toward the stock market.

> "The very belief in the permanence of economic growth undid economic growth."

After 1982, "inflation broke," though few commentators give enough credit to the power of controlling it. Inflation's decline produced disinflation and lower interest rates, which helped fuel the home-buying frenzy. The public mistakenly assumed disinflation would continue forever, pushing home prices higher. This environment also generated the drive for globalization. Historically, when inflation is quiescent, the U.S. economy gets stronger. Reagan and Bill Clinton both made overstated claims about their budget reductions, better tax policies and lower deficits when, in fact, low inflation was the major factor behind their economic successes. This oversight is part of a larger problem: Historians do not analyze economic events, too many people find economics boring and journalists primarily cover current events. As a result, major economic forces, such as inflation, get omitted from history.

America's Greatest Domestic Policy Blunder

The inflation of the 1960s resulted from an ambitious intellectual effort to increase growth. This Keynesian thinking was labeled "new economics." Academic economists – Walter Heller, James Tobin, Robert Solow and Paul Samuelson – believed the U.S. could control its business cycle and achieve "full employment" (about 4% unemployment). They fostered consumer demand and higher costs, breaking "the self-restraint that had silently kept prices and wages in check." Heller, Solow, Samuelson and other economists said the public should abandon its old economic myths, "including belief in the positive benefits of public debt and slight inflation." Such changes would introduce a new equilibrium, they said, giving workers power to bargain for higher salaries.

> "Through its history, the Fed has made many small errors but only two blunders. The first was permitting the Great Depression; the second was fostering the Great Inflation."

These ideas, plus a tax cut proposed by John F. Kennedy and implemented by Lyndon Johnson, helped the U.S. achieve 4% unemployment in 1965, when the economy expanded by 5.9%. The public embraced the new economics. John Maynard Keynes made the cover of *Time* as a symbol of contained inflation and widespread prosperity. Yet, new economics had a dark side: a negative impact on the business cycle, blamed on the politicians. Richard Nixon made unemployment the worst alternative to inflation. He told his Fed Chairman Arthur Burns, "I'm counting on you to keep us out of recession." This mindset stood until the 1980s as inflationary forces simmered.

> "The lesson from the Great Inflation is that inflation ought to be nipped in the bud: The longer we wait; the harder it becomes."

In practice, the "wage-price spiral" (the cycle by which prices increase when employees demand higher wages) produced inflationary expectations, which begat price jumps. When inflation re-emerged, people blamed Vietnam War spending and oil price increases. One of Jimmy Carter's policy makers later said that Carter's financial administrators had misjudged pent-up inflationary pressures and focused, instead, on growth and low unemployment. They weren't the only ones. Every president from Kennedy through Carter (except Ford) made the same mistake of relying on a combination of monetary policy and price controls. These presidents misidentified the real problem: the prevailing doctrine of seeking growth by pursuing new economics despite inflation.

> "The real budgetary threats lie in the future, when the costs of the retiring baby boom generation could produce much higher taxes, deficits or both."

To break the new economics doctrine, Reagan and Fed Chairman Paul Volcker attacked inflation with political and monetary policy. In the fall of 1980, inflation was 11%. By 1981, interest rates on the 30-year U.S. Treasury bond averaged 13.5%, highlighting investors' lack of confidence in the government's ability to manage inflation. With Reagan's approval, Volcker raised rates and restricted credit, aiming to create a recession to break the inflationary cycle. Production declined and small business bankruptcies rose. In 1982, unemployment hit 11%, wholesale prices dived and previous wage gains fell. From 1979 to 1982, economic output was flat. The recession did cut inflation. This bitter economic medicine worked due to Reagan and Volcker's determination.

> "Though often arcane, high finance serves a simple purpose: to channel a society's savings into productive investment."

As a result of this very unpopular political step, the U.S. economy enjoyed the longest peacetime expansion in its history to date, from early 1983 to late 1990. As inflation fell, the dollar strengthened. This changed international trading. America's trade deficit encouraged imports and reduced exports. While the Volcker-Reagan policy proved that the Fed could, indeed, control inflation, it also introduced the idea of "price stability" (low inflation that does not raise prices). The policies Volcker and Reagan used to contain inflation had painful side effects, but they fulfilled their purpose and restored public confidence in federal financial institutions. The conquest of inflation was a historic economic milestone. The parallel "restoration of capitalism" provoked disinflation, which nurtured competition and globalization, a two-edged sword.

Globalization's New Economy

By the 1980s, non-American companies worldwide were challenging the invincibility of U.S. corporations. As competition increased, the concept of lifelong employment eroded. The vocabulary of "downsizing," "restructuring" and "outsourcing" emerged. As global capitalism spread, U.S. workers and companies had to compete on a world stage where jobs, technology and capital flowed to the countries that offered the best opportunities and prices.

> "A capitalist system must permit private property, must tolerate relatively free markets and must endorse the social value of risk taking – meaning that people who take greater risks or who work harder can earn greater rewards."

This transition from the old domestic economy to the new internationally involved economy required social and intellectual changes. World War II-era executives believed in solving social problems with stability and growth. They applied business solutions to society's nagging problems. The next generation of business leaders was more combative. Focused on key corporate stock metrics (share prices, market share, earnings), they soon demonstrated that they would jettison workers to remain competitive, society's problems notwithstanding. This made U.S. companies more prosperous, but at the cost of more wage inequality, and more volatile incomes and financial markets. Employment stability dwindled and layoffs became common. In 1982, half of employed men aged 45-54 had been with the same company at least 13 years. By 2006, it was eight years.

> "After insecurity, inequality is the other great indictment of the new economic order."

This economic evolution was a direct result of deficiencies in the old economic order, particularly inflation, despite current nostalgia for the way things used to be. In reality, the new economy creates more jobs, more products, more choices and higher living standards. The old economy was static (but stable); the new economy is based on continuous change. You cannot have both. The new economy has both benefits and inherent problems, such as wage gaps between executives and workers, income gaps between households, and 401(k) plans instead of pensions. To the good, modern economics smoothed business cycles and fostered expansion, job creation and higher living standards, while reducing societal discontent. This period of "Great Moderation" produced positive effects in the 1990s and launched the 2000s, but it remains unclear if its gains are permanent. Capitalism's business cycles tend to fluctuate based on spending patterns and other changes. A breakdown in the financial system disconnects saving, investing, borrowing and lending from each other, thus creating losses and investment bubbles.

> "Being middle class is a moving target."

This places ordinary Americans in a precarious position. They are culturally conditioned to expect that if they get educated, work hard and act like good citizens, they will enter the middle class. That belief is based on the assumption that politicians can control the economy. The Great Moderation demonstrated that no one knows if a destabilized economy can regain balance, with or without government intervention. This creates tension between economic stability and the average person's quest for more income. Former Federal Reserve Chairman Alan Greenspan saw the "flexible" economy as a sign of strength, but it has meant job losses and weaker industries.

> "Inflation helped transform the entire financial system – and not just the stock market."

From 1982 to 2006, the Great Moderation ushered in rising living standards, higher median incomes and 46 million new jobs. Yet Americans now face job insecurity, job migration and income disparities. The Social Security Administration says annual growth will fall to 2% by 2020. Indicators also project less growth, largely due to growing numbers of retirees. Trends like globalization, increased credit and more government-paid welfare also could hamper growth.

> "What Americans generally want from their economic system are higher incomes and ample security in their everyday lives."

Is growth still a valid measure of societal progress? If growth froze today, Americans still would have history's best living standard. And, how are people using this prosperity? Economist Robert Frank warns that "obsessive" consumption "spawns discontent while starving the public sector." Lendol Calder adds that this "consumption treadmill" serves no social purpose and does not make people happier. Studies find no direct correlation between wealth and happiness. Instead, people report that good relationships, fulfilling jobs, spiritual meaning and stable moods make them happy, not wealth. Yet, economic growth builds social cohesion and optimism. An expanding middle class strengthens democracy and fosters economic success.

> "We Americans are progress junkies."

Many powerful constituencies urge economic growth, at any rate, despite these three pervasive issues:

1. **The welfare state** – The U.S. must contain its welfare costs, perhaps by raising eligibility requirements or reducing benefits. Citizens take Medicare, Medicaid and Social Security for granted, but the government cannot guarantee all of these entitlements forever.
2. **Debt and growth** – The U.S. should hold inflation to 2% a year. The Fed must balance its role as the "lender of last resort," with its obligation to provide enough liquidity for banks to do business. Globalization and the changing financial system make this harder.
3. **Globalization** – The global financial system is increasingly interconnected. Many countries invest in the U.S., and use U.S. dollars to stabilize their currencies and their trading positions. Globalization has positive and negative effects, and receives far too much of the blame for America's problems. In reality, other nations' economies are getting stronger and they are competing with America for raw materials, goods and services. The U.S. must learn to manage economic nationalism and economic reliance on other nations. Globalization produces prosperity (since 1950, average annual incomes have gone up six times in Spain and 11 times in Japan), but it also breeds job and trade imbalances and, thus, political dissent. The U.S. dominated the world economy after WWII, but other nations (notably Russia, China, Japan, Brazil and India) with different political interests and priorities now have growing influence.

> "Historians don't do economics, and economists don't do history."

A separate issue has the potential to trump the others: global warming. Climate change will place more burdens on developed nations than developing ones. Managing this issue requires more research and prompt action. Governments must introduce environmental legislation to control greenhouse gas emissions. Like efforts to address inflation, domestic policies on global warming will probably have to survive great unpopularity if they are ever to become effective.

About the Author

Robert J. Samuelson is a *Newsweek* and *Washington Post* columnist. He wrote *The Good Life and Its Discontents* and *Untruth,* a collection of his columns.