

ECONOMICS U\$A LESSON #7

(MUSIC PLAYS)

Announcer: Funding for this program was provided by the Annenberg CPB Project.

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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.

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 affects, but economists and policymakers want to know just how fast prices are rising.

Bosworth: By inflation we just mean an increase in the average price level.

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

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: 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...

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 Nineteen Sixty-eight, 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 Forties, Fifties and Early Sixties seemed more anxious about rising unemployment than rising prices.

Kennedy: I'm not satisfied to have fifty 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.

Stasio: When John Kennedy took office in Nineteen Sixty-one, 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.

Heller: Business Week which is not exactly a liberal pro-Kennedy, uh, publication said that it probably was the most successful tax cut in history.

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

Heller: In a sense, you know, it came out of the textbooks and in a sense it went back into the textbooks as the, uh, 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.

Stasio: At first, unemployment fell and demand rose without much affect on prices. But in Nineteen Sixty-five demand shot up, driven by more than the Kennedy tax cut. By the Mid Sixties, America was at war on two fronts: One at home...

Johnson: This Administration, today here and now, declares unconditional war on poverty in America.

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 Nineteen Sixty-five, 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-pulled inflation. With production pushed to the limit and demand rising, some economists by the end of Sixty-five 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.

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, wouldn't it be even more difficult if you tried to ask people to pay for it?

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.

Bosworth: I think politicians took an attitude as they still do today. When you try to warn about the dangers of some economic policy, uh, you can be wrong. And, uh, 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.

Stasio: By Nineteen Sixty-eight, 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 Nineteen Sixty-eight 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.

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.

Stasio: By Nineteen Sixty-nine, 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.

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.

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

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 be gonna become much more militant in asking for wage increases.

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.

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

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?

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 as 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.

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.

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 Seventies, 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.

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.

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 ten percent. Just a area of where you can see the influence on people's investment decisions look at housing. I think back in the Early Nineteen Seventies and even in the Mid Seventies a lot of Americans thought that a ten 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 ten percent, a ten percent interest rate's really pretty cheap, and we had a big boom in housing. Well in the Nineteen Eighties, uh, I think that expectation of the Seventies 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 Nineteen Eighties, we have very high interest rates still but we have very low rates of inflation and home prices are not going up at ten percent a year and wages are not going up at ten percent a year. But without understanding that, people entered in to contracts again to buy a house expecting well if everybody else could do it in the Seventies, why can't I do it in the Eighties? 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 Nineteen Eighties than they were in the Nineteen Seventies.

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.

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 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 Fifties and Sixties retired people clearly were the big losers from inflation. In the Seventies, 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 do to inflation.

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.

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.

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 Nineteen Seventies. 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 autoworkers as an example.

Bosworth: Automobile workers always were paid more than the average of other factory workers – about a twenty-five 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

Nineteen Seventies was that their relative wage which used to be twenty-five percent greater than the average by the end of the decade was seventy-five 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 Nineteen Seventies. 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.

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

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 ver—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.

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 Nineteen Sixty-nine.

Nixon: The primary responsibility for controlling inflation, uh, rests with the National Administration and its handling of fiscal and monetary affairs.

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.

Bosworth: The Seventies 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 Nineteen Thirties when the price level fell convinces any economist 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 Nineteen Seventies. 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.

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-pulled 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 Fifties and Sixties 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 Seventies. 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.

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