

ECONOMICS U\$A LESSON #10

(MUSIC PLAYS)

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Stasio: Economics U\$A. One of a series of programs designed to explore Twentieth Century micro and macro economic principle. 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.

Stasio: Once inflation begins it's difficult to control. Throughout the nineteen seventies policymakers and economists struggled to explain and correct the growing inflation rate that would top fifteen percent. Before the seventies, 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 seventies, natural disasters and war devastated food production around the world. By nineteen seventy-two 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 twenty 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 to fill up our freezers with it. We want to not eat it and we don't want to buy it.

Stasio: Still reeling from the shock of food price hikes, American consumers would face another blow in the early seventies.

Male Voice: Violence erupted in the Mid-East today. 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

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 crises that followed was sudden and its effects were profound. In six months gasoline prices jumped forty percent. Inflation neared eleven 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.

Stasio: Clearly the sudden short fall 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 seventies.

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. Uh, 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 nineteen seventies 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.

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 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.

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 economists’ 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.

Stasio: The supply shock of the seventies 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 in 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 seventies, economists have begun to question the validity of these relationships. In the late nineteen sixties the economy had become overstimulated 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.

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 waves negotiation process is once an inflation gets started, it's the waves negotiations that keep it going. Nobody wants to back off. Everyone just keeps saying, "I'm trying to keep up with my neighbor."

Stasio: In nineteen sixty-eight 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."

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.

Stasio: Economists like Milton Friedman and Edmond 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 is the driving force behind the price spiral.”

Bosworth: If you see an inflation that’s new 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 word, 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 and try to control the economy. Then someone comes along and says, “well, the real problem at the end of the year, 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.

Stasio: The key to controlling inflation seems to be keeping the wage price spiral from gaining momentum. Even acceleration just 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 nineteen sixties.

Bosworth: If we looked back now, we would say that the economics profession was too optimistic about our ability to keep inflation under control and 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-sixties uh, the economy overshot more than any economist intended because we had a tax reduction in nineteen sixty-four. We’d had one in sixty-two 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 nineteen sixty-five. That would have been a time to then pause, 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 and many types of materials.

Stasio: Notice that Bosworth said the expansionist policies of the nineteen sixties 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.

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.

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

Bosworth: Because it was a period where the post-war 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 seventies, 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.

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 if those who do, seventy percent find work when they leave. Ken Koons teaches cement finishing at a Job Corps Center in Harper's Ferry, West Virginia.

Koons: When a kid comes back here all dressed up and saying he's making twenty dollars an hour, 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 tell 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.

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 Orin Hatch of Utah chairs the Senate Committee on Labor and Human Resources. He also spoke with NPR.

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.

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.

Hatch: I represent workers.

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

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 civil labor's aide, or Mary goes into that 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.

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.

Stasio: In nineteen seventy-one 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.

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 inflationary 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.

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.

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 rigid uh, rigid to the economy. You experience continual reallocations of the sources from one industry to another. Even back say in nineteen sixty to sixty-five when 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 the 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?

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

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 the, 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.

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 nineteen seventy-

three, the Fed, then chaired by Arthur Burns raised the interest rates charged member banks.

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.

Stasio: Burns was half right. The economy did cool. In fact it nearly froze. By nineteen seventy-four 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 thirteen and a half percent. Stanley Fisher is a Professor of Economics at the Massachusetts Institute of Technology.

Fisher: I don't think that the failure to policymakers in general or economists for that matter, understood well how the oil price shock uh, effected 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 (unclear) 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.

Bosworth: Our efforts to try to direct specific policies towards areas of what have sometimes been called...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.

Stasio: In nineteen eighty-four 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. Bosworth contends that the balance between unemployment and inflation has shifted with the new emphasis on controlling inflation.

Bosworth: We've been through a decade, but we're very aware now, the public, of what the cost of uh, sustained inflation is. Uh, we may not yet fully realize what the cost to sustain 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 twenty-five percent and what that's ultimately gonna mean to the structure in 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 eighties a lot of information about that. Clearly in the thirties 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.

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 increased, 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 that 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. Inflation often begins 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.

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You’ve been listening to Economics U\$A, one of a series of programs on micro and macro economic principle. Our guest has been Barry Bosworth, former director of the Council on Wage and Price Stability. Economics U\$A has produced by the Educational Film Center in Annandale, Virginia. I’m Frank Stasio.

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