

ECONOMICS USA
PROGRAM #10
STAGFLATION: WHY COULDN'T WE BEAT IT?

Learning Objectives

PURPOSE:

To discuss how rising inflation and rising unemployment can occur simultaneously when there is a supply shock; and how demand management policies can fight cost-push inflation only by causing extremely high unemployment.

OBJECTIVES:

1. Inflation can come about because of increases in aggregate demand pressures. This demand-pull inflation can result from expansionary fiscal and monetary policies pushing the economy up to its capacity limits.
2. Inflation can also be caused by sudden changes in aggregate supply (such as oil embargoes and crop failures). Rapid inflation in necessary goods can cause people to cut back on postponable expenditures such as durable goods. Cost-push inflation can be a major factor behind stagflation.
3. There is general agreement that, in the short run, there is a tradeoff between the rate of inflation and the amount of slack in the economy (the unemployment rate). However, the tradeoff is much worse when there are supply shocks and when wages are indexed to inflation.
4. In the early stages of demand-pull inflation, demand management policies may be able to reduce inflation without causing unemployment to rise to high levels. But in order to fight inflation that is entrenched or inflation that is due to supply shocks, the government would have to reduce aggregate demand significantly, causing a high level of unemployment.

KEY ECONOMIC CONCEPTS:

stagflation	Phillips curve (long-run and short-run)
demand pull inflation	natural rate of unemployment
cost-push inflation	expectations
wage determination	supply shocks
indexing (COLA's)	demand management policies

ILLUSTRATIVE EVENTS:

1. The inflation and unemployment caused by the agriculture and petroleum supply shocks of 1972, 1973.
2. The increase in wages in the auto industry due to COLA's in 1974, increase that took place as unemployment in the industry was increasing.
3. The attempt to fight cost-push inflation with demand management policies in 1974 and the ensuing recession.

Final Transcript
(Revised 5/3/02)
Annenberg CPB Project (Logo and Music)

TEASER

DAVID SCHOUMACHER: In the early 1970's, battles raged in the Middle East, and, throughout the world, disastrous weather caused crop failures of immense proportions. Why did these two events affect inflation and unemployment in the American economy? U.S. society was besieged by the twin assaults of inflation and unemployment in the 1970's. Why couldn't the government achieve significant success against the ravages of stagflation? In the late 1990's the economy was booming. Unemployment was at a thirty year low, and inflation was also at a thirty year low. Did that mean that inflation was dead?

During the 1970's, the American dream threatened to become the American nightmare. For the first time we were faced with skyrocketing prices and exploding unemployment. Stagflation, why couldn't we beat it? With economic analyst Richard Gill, we'll explore that question on this edition of Economics USA. I'm David Shoumacher.

(MUSIC PLAYS -- OPENING TITLES)

(STAGFLATION: WHY COULDN'T WE BEAT IT? appears on screen.)

PART I

DAVID SCHOUMACHER: Since the passage of the Employment Act in 1946, it has been accepted policy for the government to fight unemployment by stimulating total demand. Often, inflation resulted. When that happened, the government shifted gears and clamped down on demand in order to decrease inflation. For five administrations the government more or less successfully practiced the delicate art of balancing off unemployment and inflation. The experience of the 1950's and 1960's indicated that when unemployment went up, inflation would correspondingly fall. By the time Richard Nixon was in the office though, this classic relationship was showing signs of strain. By 1972, inflation was at a level of 4% and unemployment was at 5 1/2%. A year later, unemployment was holding at 5%, but inflation had skyrocketed to 8 1/2%. Why weren't the old predictable trade-offs working? What had happened to change the economic rules? Nature, suddenly violent, rampaged over the entire globe. In 1972 there were crop failures worldwide. What was the result? Under the intense heat of worldwide demand, U.S. grain reserves nearly evaporated. Within two years, reserves fell from 863 million bushels to 265 million bushels. The average price of all food in the United States rose 20%. This shock to the food supply caused an inflationary surge. But it was a different kind of inflation than we previously experienced. What made it different? Alan Blinder, Professor of Economics at Princeton University, comments.

BLINDER: Well, 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 is

increasing. This is sometimes put in the phrase, “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.

DAVID SCHOUMACHER: And so America was faced with this new kind of inflation, one based on supply and not demand. Consumers were furious and protested vigorously.

FIRST PROTESTOR: 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.

SECOND PROTESTOR: I think we’ll be affected...

DAVID SCHOUMACHER: But all of this anger...this frustration...was merely a prelude for the storm to come. On October 6, 1973, the Middle East exploded in conflict. The Arab nations retaliated against the U.S. support of Israel with the most potent weapon in their arsenal--an oil embargo. America had come to rely on cheap and plentiful oil and had structured its economy on this basic resource. Suddenly, oil was scarce and expensive. Prices for gasoline soared 40% in just six months. Prices on virtually everything shot upward. Inflation hit 10.8% and the nation reeled from its second supply-shock.

INTERVIEWEE: 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, it’s just too many things are going up. By the fall of 1974, prices were ballooning upwards at over 13% annually. In the past, inflation occurred during an expanding economy marked by high employment, but this was different. The economy had slowed down. Unemployment was rising, yet there was still inflation. Why?

BLINDER: The inflation the economy was witnessing in the fall of 1974 was the legacy of the food price increases that had happened in ’72 and ’73 and, more recently than that, the oil price increases that had happened in the closing months of ’73 and the early months of 1974. These kind of supply shocks first of all raised the prices of the products to which they apply...in the very obvious way...the food prices went up and energy prices went up. Beyond that, these agricultural and energy products...and especially the energy products...are inputs to other productive processes, so other manufacturers have to use these things to produce other goods, and therefore, because they were suffering cost increases, the prices of these other manufactured goods went up.

DAVID SCHOUMACHER: The American economy was like a great fighter that had been stunned by an unexpected one-two punch, the food and energy supply shocks. This economic combination created something new: supply shock inflation and recession. People called it stagflation and it was to hammer at the American economy for years to come. Why did it so confound the economists of the day? We put that question to economist analyst Richard Gill.

(MUSIC PLAYS)

(COMMENT & ANALYSIS I; ECONOMICS USA LOGO appears on screen)

RICHARD GILL: In the old days, you used to be able to divide economists into two groups: Those who worried about stagnation and those who worried about inflation. What the food and energy shocks of the early 1970's proved was that both were right. Economics can be a bit unsettling that way. Everybody's worries can come true.

Technically speaking, what was happening was a shift of focus from the demand side of the economy to the supply side. Here we have aggregate supply and demand curves for the economy as a whole. We measure total output, GNP, along the horizontal axis, and the price level along the vertical axis.

Now, roughly speaking, we can think of "stagnation" as occurring whenever the economy moves toward lower GNP...that is, to the left here along the horizontal axis. But by contrast, inflation occurs when we move upwards here along the vertical or "price" axis. Now in the days before the supply shocks, people tended to focus on changes on the demand side only. If demand went up to here, for example, we'd get a new equilibrium of the economy with a higher price level. The change would be inflationary. But we wouldn't then have to worry about stagnation. GNP, you see, has also increased with this shift. But now look at what happens when you get an unfavorable shift in the supply curve. Food and energy shortages drive up prices and businesses' costs of production. The supply curve shifts upward. And notice what happens. We have more inflation, as in the case of the demand shift, but we now have a lowering of GNP. We have moved both up...more inflation...and to the left...more stagnation. This is the world of stagflation. And, unfortunately, when we tried to adjust to this world, we sometimes did things that made our problems even worse.

PART II

DAVID SCHOUMACHER: In 1973, food shocks and oil shocks battered the economy...and stagflation settled over the land. Was the federal government any better prepared to face the tough challenges ahead than business or labor had been? Coming out of the 1960's, inflation was the nation's number one economic problem. President Nixon and his economic advisors grappled with this vexing puzzle...unsuccessfully. Finally, they instituted an extreme measure: wage and price controls. But when the economy was shaken by the food and oil shocks, the wage and price program fell apart and inflation continued its upward spiral. For most of 1973, employment remained relatively high, and it was natural for government leaders and economists to think that the problem of inflation was due to excessive demand. Why were the signs misleading? Stanley Fischer, Professor of Economics at the Massachusetts Institute of Technology:

FISCHER: At the end of 1973, it really wasn't clear what was happening in the economy. I think that there are two main reasons for that. The first is that the data were actually bad. The early data on GNP in 1973 showed a faster growth than we now know actually happened. The second reason was that unemployment was

still very low at that time...under 5%...so that for both reasons it wasn't obvious that the economy was heading for a recession.

BURNS: The rise that we had in interest...

DAVID SCHOUMACHER: So the Federal Reserve, under the leadership of Chairman Arthur Burns, sought to fight inflation by restricting the money supply. In late 1973, the Fed raised the interest rates charged to member banks. Chairman Burns believed a restrictive monetary policy was necessary...not for weeks or months, but for years to come.

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.

DAVID SCHOUMACHER: But by the beginning of 1974, the economy stalled and inflation shot up to a staggering annual rate of 13.6%. Why didn't the Fed's actions halt the inflationary spiral?

FISCHER: I don't think that the Fed or policy-makers in general...or economists for that matter...understood well how the oil price shock affected the economy. I think there was some view that oil prices would go up without having much impact on the 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 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 going to happen.

DAVID SCHOUMACHER: As late as mid-1974, even as unemployment hit 6%, Congress, businesses and consumers were virtually united in the view that inflation was a worse problem than unemployment.

SHOPPER: Between the food and the clothing and the cleaning and everything else...and you put it all together...you haven't got a dollar left.

DAVID SCHOUMACHER: In an attempt to further cool the economy, in the fall of 1974, the Fed again raised the interest rate. At the same time, an economic summit conference was convened by the administration. The majority of economists present spoke out about the deepening recession and wanted to stimulate the sagging economy. But President Ford continued to call for a battle plan against inflation.

FORD: From this summit we're going to start going up.

DAVID SCHOUMACHER: But still, despite the signs of worsening stagflation, despite the message from the economic summit, neither President Ford nor Arthur Burns, at the time, could bring themselves to alter the policy of fighting inflation above all else. In October, the President offered his anti-inflationary program to a joint session of Congress. It relied on the old formulas, a tight ceiling on federal spending, and a tax surcharge. And for the public...

FORD: It bears the single word..."win"

DAVID SCHOUMACHER: Participation in a special campaign.

FORD: I will call upon every American to join in this massive mobilization and stick with it until we do win as a nation and as a people.

DAVID SCHOUMACHER: While government concentrated on fighting inflation GNP continued to fall. Unemployment continued to rise. Why was it so difficult for the government to adapt to the signs of the developing recession?

BLINDER: The first was the tremendous fear of inflation that was all over the country...it wasn't only in Washington, but all over the country...which really effectively paralyzed those arms of government policy that might fight recession, because those very same arms also tend to propel inflation. And so that was effectively eliminated by the fear of inflation. The second reason is that this unusual event, the supply shock, the series of supply shocks that had happened in 1973 and into 1974...was a kind of foreign event that people didn't really know how to think about. There wasn't a conceptual framework, and lacking this conceptual framework, it was that much less clear what a policy-maker ought to do about it. And these policy-makers were not at all sure what to do about it.

DAVID SCHOUMACHER: Finally, soaring unemployment figures convinced the administration that a policy change was due. At the beginning of the year, President Ford bowed to the inevitable.

FORD: The new and disturbing element in the economic picture is our worsening recession and the unemployment that goes with it. We have made some progress in slowing the upward spiral of inflation, in getting interest rates started down. And we have suffered sudden and serious setbacks in sales and unemployment. Therefore, we must shift our emphasis from inflation to recession.

DAVID SCHOUMACHER: In March, Congress responded to President Ford's call and passed a tax-relief bill of almost 23 billion dollars. And the Fed? Did it continue its restrictive monetary policies? At just about the same time that Congress was passing the tax-relief bill the Fed also changed course, and increased the rate of growth of the money supply. And so, after months and years of struggle by men and women of vast knowledge and power, what was the outcome in the government's war against stagflation? Was the beast finally overcome? For the rest of 1975, inflation would average over 9% and unemployment over 8%. At best it was a holding action, and the dilemma of fighting both inflation and unemployment at the same time remained. We asked economic analyst Richard Gill why the government wasn't more successful...

COMMENT AND ANALYSIS:

RICHARD GILL: Well, the reason the government was running into difficulty...at least, the reason that many economists would give...was that we were trying to

deal with the problem too exclusively from the demand side. If we look back at our aggregate supply and demand curves again, we can see this problem very clearly. Suppose we are not down here, but way up here, as we clearly were in the early and mid-1970's. Prices are high, but GNP is pretty far to the left. That is to say, unemployment is also quite high. Now if you decrease demand to fight inflation, bringing prices down to here, you lower more GNP to here, causing more unemployment. But if you increase demand to raise GNP to here, you're likely to cause prices to go up even higher, to here. Neither policy is satisfactory. And shifting back and forth between the two, as we did, may be the very worst policy of all. Now not all economists...then or now...would agree with this particular analysis. But one thing is clear. A great many economists, who had previously looked only at the demand side of the economic equation, now began thinking that perhaps the supply side could also use some attention.

PART III

DAVID SCHOUMACHER: Just as the stagflation of the 1970's saw weak growth and strong inflation, the period of the 1990's saw the reverse – strong growth, low unemployment, and low inflation, a phenomenon that had not been seen in the United States for many decades. Over the years the Federal Reserve came to assume that the economy could not experience prolonged growth above two and a half percent a year without insighting inflation. And yet in the 1990's, growth was double that. Unemployment was at a thirty-year low, and all without waking the sleeping giant of inflation.

PAUL VOLCKER: What was extraordinary about the 1990's is that at the end of that long expansion, expansion is now over, the inflation rate was as low as when it began. That is very uncharacteristic of expansions because generally, when you have an economic expansion, you are putting more pressure on productive capacity, more pressure on the labor force, and prices tend to go up. And interest rates tend to go up, and that tends, among other things, to bring the expansion to an end. It didn't happen in the 1990's. Why didn't it happen in the 1990's?

DAVID SCHOUMACHER: Why didn't this happen? What were the factors that kept inflation down despite all the economic indicators to the contrary? A major factor was the revolution in information technology. The digitization of all information created new companies and new industries. In Silicon Valley alone, eleven new companies were created every week. A new economy had come into being and its product was intellectual property. A growing debate started among economists over whether the new economy had changed the rules.

PRESENTER:

Ladies and Gentlemen, it's my honor and deep privilege to introduce to you the Chairman of the Federal Reserve Board, Dr. Alan Greenspan.

DAVID SCHOUMACHER:

To Chairman Alan Greenspan the rules had changed. He doubted whether inflation could be adequately measured in the new economy using current techniques to trace price trends over time.

PAUL VOLCKER: When electricity was developed, that was a new economy. When automobiles became prevalent, that was a new economy. Now we have a new economy that's the Electronic Age. I think it has contributed as those earlier new economies contributed to an increase in productivity.

ALICE RIVLIN: There was a time when economists thought that when the unemployment rate got below six percent or five and a half or five, something like that, that we would inevitably have inflation. We found out in the 1990's that with a very productive economy we don't necessarily get inflation when unemployment drops.

DAVID SCHOUMACHER: Productivity was a key factor in keeping inflation down, but another factor was the globalization of business. The introduction of market forces, freer trade, and widespread deregulation, meant that international trade and investment played a much larger role in our economy than before.

PAUL VOLCKER: Japan's been almost flat on its back. Europe's been growing very slowly until recently particularly with a high level of unemployment. So if you look at the world as a whole, while we were expanding, there was very ready availability of goods.

ALICE RIVLIN: When inflation rises in one country those citizens have the option of buying from abroad.

PAUL VOLCKER: There was a lot of emphasis on expenditure restraint, and that was particularly strong during the 1990's. There was a great debate at the beginning of the Clinton administration about how to deal with what was perceived as a relatively small recession, but none the less a recession. What to do? There were those who wanted to spend their way out. And others said "No, let's have budgetary restraint. That will be better for the economy. That will keep interest rates down. It will tend to restrain inflationary pressures. And in the long run we'll be better off." And that was, I think fortunately, the approach that was adopted. And, lo and behold, the economy did so well, and we got some productivity increases, the revenues increased faster than expected, budget expenditures were held down, and for the first time in decades we had budgetary surpluses.

DAVID SCHOUMACHER: There was no inflation when it came to goods and services but there was a sharp rise in the price of stocks. Was this a problem?

ALICE RIVLIN: Alan Greenspan coined the term "irrational exuberance," meaning the people were buying stocks without regard to the future earnings, just because they thought that the stock market values would continue to go up and up. We now know of course that they didn't.

DAVID SCHOUMACHER: The Fed. Played a key role in holding down inflation in the 1990's but after the terrorist attacks of September 11th, the Fed opened the monetary floodgates. Was that an overreaction? And could it lead to higher inflation?

ALICE RIVLIN: The fear that people have of more terrorism has thrown the economy into a downturn. In a downturn, one doesn't worry about inflation. That's the least of the worries because a downturn means people aren't buying. People aren't demanding goods and services and therefore there's no upward pressure of prices.

RUDOLPH PENNER: There's always a danger that we will overreact to events such as September 11th. There are always a danger that we'll get sloppy and let the money supply drift up. Especially when we've had a long period of very little inflation. You get complacent and you start taking risks on the other side of the equation. So I think it would be very very foolish to say, "Inflation is dead."

PAUL VOCKER: Inflation is never dead. That's, we have a lot of human history going back to the, I suppose, the dawn of civilization but certainly back to the creation of money. They had inflation in Roman times. Some people think that inflation contributed to the downfall of the Roman Empire. But we certainly have had periods in history of decades, or even centuries of price stability or declines but in general, inflation has been a recurrent characteristic of modern capitalism.

DAVID SCHOUMACHER: We asked economic analyst Nariman Behravesch for his thoughts on inflation in the 1990's and beyond.

COMMENT AND ANALYSIS:

NARIMAN BEHRAVESH: One way to understand what happened in the late 1990's, during the so-called "new economy boom," is to look at the aggregate supply and aggregate demand curves. The productivity boom allowed the aggregate supply curve to move to the right faster than the aggregate demand curve. This allowed both the unemployment rate and the inflation rate to fall simultaneously to thirty-year lows. The experience of the late 1990's is exactly the opposite of what happened in the 1970's and early 1980's, when the aggregate supply curve moved to the left because of wheat productivity growth and supply shortages. This resulted in stagflation with both the unemployment rate and the inflation rate rising simultaneously. Any assertion about inflation being dead must be backed up by the assumption that productivity growth will remain strong. Unfortunately as the experience the 1970's showed us, there is no guarantee that productivity growth will continue to be robust. Thus the Fed has to remain vigilant against the possibility that inflation will be resurrected once again.

CLOSING STAND-UP

DAVID SCHOUMACHER: The classic business cycle has not come to an end. Recession has not been banned and inflation could always rear its ugly head. Nevertheless, the business cycle of the 1990's was different, driven more by technology and trade and that could enable us to grow faster than before without the danger of inflation. For Economics USA, I'm David Schoumacher.

(Music plays -CLOSING CREDITS)