The Problem of Stagflation

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THE PROBLEM OF STAGFLATION

We are deep into the era of relatively high measured unemployment rates and high rates of inflation that is described by that inelegant term "stagflation." Growth rates of real output fell in Western Europe and the U.S. just at the time that the growth rates of the labor forces increased. The rate of increase in productivity has fallen, so real incomes have either fallen or risen more slowly than in the sixties. Inflation and progressive tax rates financed further increases in the relative size of the public sector with the result that current and prospective taxes have grown more than incomes.

The combined effect of rising prices, higher unemployment, higher taxes and slower growth in real income produced the dissatisfaction and malaise that makes "stagflation" a widely discussed problem. Governments appear unable to reduce inflation without increasing unemployment or to reduce unemployment without, sooner or later, increasing inflation. Nowhere does this outcome seem more apparent than in the United States where the rates of inflation and unemployment rise with each succeeding round of expansion and recession and where measured productivity growth in the private sector has remained close to zero, on average, for the past two years. The appearance of a positive relation between the cyclical average rate of unemployment and the cyclical average rate of price change is misleading. There is no necessary relation between the two, and any existing long-term relation between the two in the United States could be eliminated by a decision to index the tax system.

Stagflation appears to have two distinct meanings. One is the apparent longer-term relation between the average unemployment rate and the average
rate of inflation, just mentioned. The other is the very limited reduction in inflation -- and relatively large increase in unemployment -- that occurs in the first year or two following a shift in political priorities from reducing unemployment to reducing inflation. The reason that unemployment responds to policy change more quickly than prices is very different from the reason that average unemployment and inflation are higher than in the past. One concerns the level of the averages, the other their rates of change. I discuss the two separately.

Long-term Stagflation

Although stagflation is a relatively new problem, some of its principal features can be found in earlier periods. Two periods are of special interest. The interwar experience of Britain helped to shape many of the beliefs now commonly held about unemployment. The depression of the 1930's seemed to show that the interwar experience of Britain was a general phenomenon applicable to many countries. Counter cyclical fiscal and monetary policies were used on a much larger scale than ever before, and the groundwork for postwar economic policies was laid.

In Britain during the years 1925 to 1929, measured unemployment rates remained remarkably stable at about 10%. Prices were stable also; the relatively high rate of unemployment leaves no imprint on either the rate of change of prices or the rate of change of money wages. The failure of real wages to fall in the face of persistent unemployment was puzzling. Recent work by two economists at the University of Washington, Levis Kochin and Daniel Benjamin, helps to resolve the puzzle. Kochin and Benjamin present evidence suggesting strongly that the introduction of unemployment compensation in the 1920's raised the rate of measured unemployment. Unemployment
compensation, and other benefits to the unemployed, were low by current standards but high relative to the wages at which many of the idle would have been paid for work. The evidence suggests that much of the increase in unemployment that occurred in Britain during the twenties can be explained in this way.

In the 1930's, budget deficits and monetary expansion were used as part of a policy designed to move the economy from recession to prosperity. The economy recovered from 1933 to 1937 but did not surpass the previous peak in real output despite four years of Federal budget deficits that were rarely less, and often more, than total Federal government spending at the 1929 peak. After the recession of 1937-38, the economy moved forward sluggishly, even though the budget remained between 17% and 35% of Federal spending. As is well-known, the unemployment rate remained above 15% through much of the decade and did not decline until wartime increases in production and in the armed forces absorbed large numbers of persons into the military and civilian labor force.

The lesson from the experiences of Britain in the 1920's and in the U.S. during the thirties is that high rates of unemployment coexist with rising prices, falling prices and stable prices. There is no reason to expect an association between the average unemployment rate and the average rate of price change, and none is found.

The average rate of measured unemployment during a decade depends on a large number of factors. Demographic factors -- as reflected in age, marital status or the like -- affect the supply of labor and the rate at which the labor force turns over. Political and social decisions reinforce or offset the demographic factors by changing the real wages at which
workers choose between labor and idleness and the prices at which potential investors choose between consumption and the accumulation of capital. Spending and transfers by government have increased relative to output in all western countries during the past quarter century. Taxes, whether paid directly or through inflation, must rise faster than output to pay for the increased spending, so after-tax returns from work and after-tax returns from investment are held down. Transfer payments to welfare recipients, food stamps, medical programs, and higher unemployment compensation lower the cost of unemployment to the worker. Together higher taxes and increased transfers lower the return from work and the cost of idleness. Many of the idle are counted as unemployed. Clarkson and Meiners have noted that, under the food stamp program, some recipients must register for employment to maintain their benefits. Legislation of this kind increases the average rate of measured unemployment, so we could expect some of the unemployment to vanish if the law were repealed.

Reducing real tax burdens, slowing the growth of government spending to the rate of growth of output or lower, reducing the size of transfer payments or their rate of increase, and lowering the minimum wage relative to the average wage rate are all means of reducing the average rate of measured unemployment and the number of discouraged workers. The decision to take these steps is the responsibility of the Congress. If they are taken, the average rate of measured unemployment will decline.

Failure to reduce the relative size of the government sector by permanently lowering tax rates, or to reduce unemployment benefits relative to wages, or to take other steps that increase the after-tax returns to labor and capital raises unemployment rates. If we can remember that the higher
average unemployment rates and slower growth of output are, in part, a result of our tax and transfer policies, we will avoid one of the major mistakes of economic policy in this decade -- using fiscal and monetary policies to pump up spending with the aim of reducing the average unemployment rate or eliminating some arbitrary measure of the output gap.

This committee heard testimony in 1977 and 1978 about idle resources and output gaps that were to be removed by expansive economic policy. The amount of idle capacity was overestimated because of an error in assessing the effects on the economy of the 1974 oil shock and the effect of tax and transfer policies on unemployment and potential output. The gap between actual and potential output vanished without being filled, but the attempt to close the gap by using expansive policies left us with high inflation, a devalued dollar, a large budget deficit and a high rate of inflation. I believe that the rate of inflation would be lower, the dollar would not have been devalued in foreign exchange markets in 1977 and 1978 and the unemployment rate would be little different if we had avoided the excessively expansive policies of 1976, 1977 and 1978.

Let me restate a previous conclusion in a different way. One reason we now have high inflation is that we used excessive fiscal and monetary expansion to reduce the average rate of unemployment and increase the growth of output. Moderate policies throughout the decade would have left us with about the same average rate of unemployment for the decade, possibly less, and less inflation. The average rate of unemployment and the average rate of inflation are best regarded as unrelated. The failure of policymakers to accept this conclusion is one of the principal reasons we have long-term stagflation.
A brief comparison of changes in prices and in industrial production in major countries for the current decade shows, as expected, that there is little relation between the two. Percentage increases in industrial production are listed in descending order and are compared to percentage increases in consumer prices. Rankings are shown in parentheses. A cursory examination shows that high or low rates of increase in industrial production, used to measure the growth of employment opportunities, occur with relatively high and relatively low rates of increase in consumer prices.

TABLE 1

Rates of Increase in Industrial Production and Prices, 1969 to Autumn 1978

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage Increase Industrial Production</th>
<th>Percentage Increase Consumer Prices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>54 (1)</td>
<td>131 (3)</td>
</tr>
<tr>
<td>Canada</td>
<td>44 (2)</td>
<td>89 (5)</td>
</tr>
<tr>
<td>France</td>
<td>38 (3)</td>
<td>114 (4)</td>
</tr>
<tr>
<td>U.S.</td>
<td>33 (4)</td>
<td>81 (6)</td>
</tr>
<tr>
<td>Italy</td>
<td>32 (5)</td>
<td>181 (2)</td>
</tr>
<tr>
<td>Germany</td>
<td>29 (6)</td>
<td>55 (7)</td>
</tr>
<tr>
<td>U.K.</td>
<td>14 (7)</td>
<td>191 (1)</td>
</tr>
</tbody>
</table>

The longer-term problem of stagflation for the United States is that the relatively modest average growth of industrial production occurred during a period in which the growth of the labor force increased. Increases in output provided mainly by growth of the labor force leave little room for rising standards of living. To raise standards of living, we must have increases in capital per worker and increased productivity. Since 1973, both of these traditional sources of growth in living standards have been
modest. Productivity growth has averaged less than 1% a year since the previous peak in 1973.

I believe that the most effective programs that the Congress can enact to increase long-term productivity growth are: (1) permanent tax reductions for individual and corporate taxpayers, accompanied by (2) permanent reduction in the growth of public spending and transfer payments and a combination of (3) deregulation and (4) the establishment of rules for regulatory agencies that are as clear, definite and long-lasting as the Congress can provide.

We have built a system in which very high rewards go to those who find ways to circumvent regulation or to reduce its burden on firms or groups. Firms often have a greater opportunity to reduce costs by reducing the burden of regulation than by improving production techniques. Skilled personnel, our most talented individuals, are attracted to fields or endeavors that are much more valuable to firms or groups than to society as a whole. One step in a program to restore productivity growth is to reduce the social cost of regulation. The other main step is to slow the relative growth of government and the anticipated growth of taxes.

Cyclical Stagflation

Whenever political priorities change from stimulus to restraint, the size of the budget deficit, or the public sector borrowing requirement, and the growth rate of money change. The first affect of the shift toward less expansive economic policies is on employment. Inflation starts to fall only after restraint has been maintained for some time. Sometimes, a year or more passes before the policy of restraint has any noticeable effect on the rate of inflation. The converse is also true. A policy shift
toward greater stimulus first affects output, then employment and later prices.

Were it not for this pattern of delayed response in prices, cyclical fluctuations would not have their well-known pattern. If the price level, interest rates and wage rates adjusted instantly to changes in tastes, productivity and government policy, we would not have the fluctuations in output and employment known as business cycles. Instantaneous adjustment of prices to changes in the demand for or supply of output would eliminate the effectiveness of economic policies but would also eliminate any need for stabilization policies.

Contemporary economic policies are based on a Keynesian view of fluctuations. Money wages and prices are assumed to be rigid, or slow to change, so policies that increase spending raise output first and the rate of change of prices and money wages later. Policies to slow an inflating economy work through the same mechanism. Output falls and, later, the rate of change of prices and wages falls.

Policymakers who follow this approach, as many have, regard most cyclical changes in employment as "involuntary," the result of insufficient spending by the private sector. Even if the unemployed receive compensation equal to their real incomes, it is believed that society loses all of the output that the unemployed do not produce. Hence government policies to eliminate unemployment are regarded as policies that have low cost and large social benefits. Because the rate of inflation is regarded as slow to adjust, policymakers believe, or are advised, that there is no reason to expect inflation to increase until full employment is reached.
Repeated attempts to use fiscal and monetary policies to stimulate output first and slow inflation later have left a residue of higher inflation. Widespread public dislike of inflation forces policymakers to respond and often to overreact, thereby creating another recession, another attempt at stimulus and another round of stop and go. We may be, once again, in the process of shifting from excessive expansion to excessive contraction.

The problem with the types of policies on which we have relied is that they have not worked as promised. Whatever confidence people may have had about the ability of fiscal and monetary authorities to keep the economy near full employment without inflation eroded long ago. The policies failed because they were based on incorrect beliefs about the way in which the economy works.

There are two principal, and I believe, fundamental errors in the theory of inflation and employment or unemployment that guides policymakers. One is the failure to recognize that workers in cyclically-sensitive industries expect periods of unemployment. The other is that workers, on average, choose to accept unemployment in preference to wage cuts as long as they believe that unemployment is temporary. Recent work with my collaborators, Karl Brunner and Alex Cukierman, has explored these issues in detail, but the basic idea can be summarized readily.

Workers in cyclically-sensitive industries know that fluctuations in employment have occurred in the past and will occur in the future. They are uncertain about the timing and duration of recessions but not about their occurrence. No one knows precisely when a recession will start, how long it will last or how severe it will be. However, few of us are unaware that there have been recessions, and few doubt that there will be
future recessions. At the start of a recession, workers who are "laid off" regard the experience as consistent with their belief that the layoff is temporary. They do not, in most cases, search for new jobs at lower wages but instead use their time to take a vacation, to fix up their houses, to do odd jobs. They wait to be recalled. If, on average, a worker experienced layoffs or unemployment of this kind for periods of six or eight weeks every three or four years, he is not surprised to be layed off when recession occurs. He does not start to look for permanent employment elsewhere at lower real wages. He waits.

It is true, as many economists have noted, that workers could offer to reduce their real wages in periods of low demand to maintain their jobs. Workers agree to reduce real wages, as many examples show, when they believe that the alternatives are a permanent loss of employment or search for a different job at lower pay. The response to a permanent loss of employment resulting from changes in tastes, technology, or international competition is very different from the response to the temporary changes in employment that occur during recessions. Employees more readily agree to cut wages when the alternative is a plant closing.

Unfortunately, changes in employment do not come with neatly typed labels indicating that they are permanent changes. Workers and employers -- people in general -- must repeatedly solve a complex inference problem to decide on the proper course of action. Offering to supply labor at lower real wages represents a loss of lifetime income if the reduction in demand is temporary. Failing to cut real wages when the reduction in demand is permanent also means a loss of lifetime income. The proper choice is not always clear at the time. This is one reason that workers and firms are slow to adjust prices and money wages up or down.
Suppose that a government of good intentions responds to every recession by pushing up spending to stimulate the economy. Each time this is done, output recovers, employment rises, but the rate of inflation is higher at each trough than at the previous trough and higher at each peak than at the previous peak.

Experience of this kind, and it is our experience, teaches the public two lessons. First, whether the decline is temporary or permanent, the average rate of price and wage change rises from cycle to cycle. Resistance to relative wage and price reduction increases in recessions. The other side of the coin is that anticipated inflation increases and the demand for higher wages rises. Second, all temporary recessions are expected to be offset by stimulative government policies, and the costs of unemployment are expected to be reduced by unemployment compensation benefits. There are fewer reasons to look for employment at lower real wages and more reasons to wait for stimulative policies to restore employment at the old job once these policies are anticipated.

The use of variable monetary and fiscal policies adds an additional dimension to the already complex inference problem. Uncertainty about the future course of monetary and fiscal policies adds to uncertainty about present and future tax rates and inflation. People who want to know whether tax rates will rise or fall in the future must guess, or infer, whether the bulge in government spending during a recession is a portent of permanently higher spending and tax rates or temporarily higher spending. Past experience gives some guidance, but it is very imperfect guidance. Yet, differences in anticipated tax rates often are the deciding factor in decisions to invest in durable capital, to invest in land or other tax-sheltered capital or to consume.
With hindsight, it is easy to identify the sustained change in money growth that lead to higher or lower inflation. I assure you that there is much less certainty when the turning points occur. Our current uncertainty about the rate of monetary growth is an extreme but nevertheless useful, example.

We have been through four or five cycles in which governments have made explicit commitments to end inflation. Is it unwise for the public to treat such commitments skeptically? I believe not. After four or five cycles in which promises to end inflation were followed by higher average rates of inflation, credibility is strained.

The experience of 1966-67 is informative. The six-month average rate of change of wholesale prices fell from 4% to minus 2% in one year and a similar average for consumer prices fell from 3.8% to 1.8%. The retardation of the economy was so brief that the episode is not recorded as a recession. The anti-inflation policy worked quickly because inflation was a relatively new phenomenon, and government had not reduced its credibility by promising to end inflation while acting to increase it or by abandoning policies that slow inflation when unemployment increases.

Some Suggestions for Change

I have suggested some explanations of long-term and cyclical stagflation. Earlier, I proposed some policies to increase long-term growth and stability. I will conclude with recommendations to lower the cost of ending inflation.

The principal recommendation is, by now, familiar. My colleagues on the Shadow Open Market Committee and I have asked repeatedly for a commitment from government to a pre-announced policy of sustained, gradual reductions in the growth of money by 1% per year until a non-inflationary
rate of money growth is achieved. A similar recommendation has now been made, unanimously, by the House Committee on Banking, Currency and Urban Affairs. Chairman Miller has recognized on many occasions that inflation cannot be ended in less than three to five years.

Recognition of the problem is not enough. The Congress should require the Federal Reserve to adopt a policy of this kind, and the Congress should endorse the policy. If a commitment of this kind by the Federal Reserve, the Congress, and the administration is followed by implementation, beliefs about future inflation will erode more rapidly and the cost of ending inflation will decline.

To supplement monetary policy and make it credible, other steps must be taken. A commitment by Congress and the administration to hold the growth of public spending below the growth of output implies that the average tax rate will fall in the future. But the commitment also implies that the Federal Reserve will not be called upon to finance larger government deficits by raising money growth. A commitment to slower growth of government reinforces and complements the commitment to maintain a monetary policy that ends inflation.

There are many policy changes that can help to reduce the problem of cyclical stagflation. I would like to conclude, however, by pointing to two current risks that cannot be avoided without Congressional action. I refer to the risks of a major error in monetary policy and the risk of a financial panic following a run on one of the non-insured financial intermediaries that now hold assets that formerly were held in insured commercial banks and thrift institutions.
The risk of a major error in monetary policy arises because the numbers now added together to form M1, M2 or any other M do not have the same meaning that they had before the development of ATS, NOW accounts, overnight repurchase agreements, money market funds and many other assets. Currently, money growth may be pushing the economy toward substantially higher inflation or deeper recession than we know or believe.

The risk of an error in interpretation cannot be reduced, at current rates of inflation, unless Congress agrees to repeal regulation §, to repeal the prohibition against interest payments on demand deposits and to permit interest payments on required reserves. The Congress has heard testimony on these proposals for more than a decade, but it has not acted. The failure to act now to lower the risk of a potential crisis is inexcusable and costly.

Suppose some large seller of commercial paper, Euro-dollars or other financial instrument defaults. These instruments are held indirectly by individuals and small firms through their participation in some of the substitutes for demand and time deposits that are now held by many people. The substitutes are not insured. Here we have the ingredients for the type of financial panic that we have not experienced since deposit insurance started more than forty years ago. This risk can be reduced by removing controls on interest rates at banks and thrift institutions or by a clear statement from the Federal Reserve that it will serve as lender of last resort to the entire financial system.

The probability of a panic is small, but it is larger than it need be. And the probability is increased by the failure of Congress to remove regulations and restrictions.