Inflation and Depression in the Seventies

1. Inflation and Excess Demand

I am no friend of inflation. It hits me, a university professor, harder than it hits most. But in a world suffering from war, racism, tribalism, poverty, crime, drugs, violence, alienation, decaying cities and the pollution of our air, water and soil, it is nothing less than shocking to hear inflation honored as our number one problem. And by this exaggeration we are being pushed into far greater evils, as was the boy who cried "wolf".

Thus President Nixon, in his State of the Union Message of January 1970, said: "When I speak of actions that would be beneficial to the

American people I can think of none more important than for Congress to join this administration in the battle to stop the rise in the cost of living." In an apparent attempt to give this more precision he went on to say: "In the decade of the sixties the Federal Government spent $57 billion more than it took in taxes. In that same decade the American people paid the bill for that deficit in price increases which raised the cost of living for the average family of four by $200 per month in America."

If we take this seriously enough to apply a pencil to the back of an envelope, we see that the $57 billion government deficit cost the American families some $600 billion in higher prices or about ten times what it would have cost them to pay the additional taxes needed to avoid the deficit.[1] The president consequently promised, "I shall recommend a balanced budget for 1971."

What is wrong with this kind of rhetoric, which is not peculiar to our President, is that it is based on the assumption, believe it or not, that while everybody buys all sorts of things, *nobody ever sells anything in America*! This assumption permits the evil of inflation to be measured by simply counting the price increases paid by the buyers – at least until some innocent child asks *from whom* they are buying everything. Since the *sellers,* who are also Americans, *received* the very same price increases, one could no less cogently argue that the American people have enjoyed a *gain* of $600 billion from the glorious inflation of the 1960's – and all achieved by a mere $57 billion deficit!

It is of course the special duty of economists to try to get people to reach economic or rational decisions by looking at both sides of such arguments. When this is done, the $600 billion is found to be neither a net gain nor a net loss but only a transfer from buyers to seller. A great part of this gross transfer cancels out because almost everybody is a seller as well as a buyer. The fraction of the gross transfer that constitutes the remaining *net* transfer is as likely to improve the distribution of wealth as to worsen it. A significant fraction of the *net* transfer fraction of the gross transfer does, however, impose serious hardships on poor pensioners and the like and these victims should be helped by some form of compensation. Such compensations for people in distress are

[1] In round numbers: $100 (the *average* increase during the decade) × 50 (million families) × 12 (months in the year) × 10 (years in the decade) = $600 billion.

indeed being developed in all relatively well to do countries. And these compensations in turn constitute no social *loss* but again only a *compensatory transfer.*

Carrying out this compensatory transfer does involve some true social loss in the form of the using up of resources (including the time of administrators needed to see that it is done properly)). But that would amount to only a fraction of a fraction of a fraction of the total ($600 billion) transfer – probably much less than 1% of it.

Much more serious than the rather childish (or naked emperorish?) error of looking only at the *buyer's* end of inflation is the policy of trying to cure it by a *deflation* which works by bringing about depression and unemployment. This *cure* is many times worse than the disease. We have already seen that the actual loss in national output (or national income) from inflation is only a very small fraction of the gross increase in the prices paid (and received). An additional 1% of inflation entails an actual loss of perhaps one hundredth of 1% of the national income. A 1% increase in unemployment, on the other hand, entails a loss of output of about *3%* of the national income. This is because when output is reduced 3 percent because of a decrease in demand for the products, it is only 3% of those workers who are engaged in the direct processing of the final output that are immediately threatened whit being laid off; and some even of these are kept on as a reserve or for morale or other reasons. Those whose work is less directly related to current output, and whose employment comes under the heading of fixed costs, stay on. There may even be an increase in the employment of some of these – as when greater sales efforts are undertaken because of the falling off of sales. The percentage decrease in *total* employment has been found to be about a third of the percentage decrease in output. The 3 percent loss in output associated with a 1 percent increase in unemployment is thus at least a hundred times as much as the tiny fraction of 1 percent loss in output from a 1 percent increase in the rate of inflation (allowing generously for the roughness of the calculation). In this we are not counting the psychological frustrations and the social dangers of the unemployed feeling that society has no place for them.

That such a *cure* should even be considered at all can be explained by a widespread belief that inflation can be due only to "excess demand" or "too much money chasing too few goods". If prices rose only because

buyers were bidding up the prices by trying to buy more goods and services than the economy was able to provide (even when running at full capacity) then a policy of decreasing total spending – the aggregate volume of expenditure in the whole economy – would be exactly what is called for. Reduced spending by the government (or indeed by anybody else), increased taxes, and tight money could all be used to remove excess demand without causing any depression or unemployment.

2. Inflation and Costs

But our current inflation is taking place even though we are working *well below* our capacity output. There is much more unemployment than the minimum at which we have seen it possible for the economy to operate. Almost all producers would be only too happy to sell additional output at the *current* prices. This would enable them to put unemployed men to work with underutilised capacity to increase output, wages, *and* profits. Buyers are not trying to buy more than it is possible for the economy to produce. There is no general excess demand. The cause of the inflation must be sought elsewhere.

Nor do we have to look very far to find the cause. The inflation is due, in the first place, to workers obtaining wage increases greater than the continuing increase in productivity, so that the cost of production goes up. (It does not make any difference whether the wage increases come *through* the trade unions, or by unofficial wildcat strikes mounted *in spite of* the union leaders.)

The inflation is due, in the second place, to the employers passing on the cost increases in price increases. In the absence of their ability to do this, they would not agree to the cost-raising wage increases.

The inflation is due in the third place to the increase in the aggregate volume of spending in the economy, made possible by the government's monetary and fiscal policy. In the absence of this increase in total spending, the quantity of goods and services would have to fall in proportion to the price increase. This would bring about a corresponding fall in employment below the politically tolerable (or socially justifiable) level.

The cause of the inflation thus lies in the interaction of these three increases – the increase in wages, the increase in prices, and the increase in spending. It is a tripartite *administered inflation,* engineered by the

respective *administrators* representing the workers, the employers, and the government, regulating the increase in wages, in prices and in total spending. Each increase depends on the others and each party to the increases puts the blame on the others. The workers claim that they must have the wage increases because prices are rising; the employers claim that they must raise prices because their costs are rising; and the government claims that it must provide the increase in aggregate spending if intolerable unemployment is to be avoided.

3. The Shocking Therapy

An adamant refusal by the government to provide the increase in total spending could break this vicious circle – by bringing about a state of unemployment severe enough to force the average wage to rise no more rapidly than the overall increase in productivity of about 3% per annum. It would have to create an *administered depression* powerful enough to force about half the workers to agree to wage increases of less than 3% per annum (while many would have to agree to actual reductions) to balance other wages that would still be rising at more than 3%. The severity and the duration of unemployment and depression required to achieve this cure would have to parallel the catastrophe of the 1930's and this is more than any government is willing to be responsible for – even in countries where it does not have its eye on a forthcoming election.

Our government, apparently working on the theory that the inflation is due only to excess demand, is indeed trying to cure it by a deflationary policy of holding down total spending through monetary and fiscal measures, while blandly (or blindly?) declaring that they hope to stop the inflation without creating unemployment.

The theory that inflation can be caused only by excess demand derives from an economic model of a perfectly competitive economy in which the laws of supply and demand determine prices without any hindrance from any pressure group or from the government itself (which is primarilly the resultant of all the pressure groups). In this model: a) *prices rise only if there is an excess of demand over supply* (i.e., only if buyers are unable to buy as much as they want at the current prices because they are trying to buy more than the economy is able to provide) and b) *prices fall whenever there is an excess of supply over demand*

(i.e., whenever sellers are unable to sell as much as they would like to sell at the current price).

Nowadays condition *b* – that prices fall whenever there is an excess of supply over demand – is hardly ever assumed to be in operation. Some time ago there were economists who recommended that the authorities keep total spending unchanged. If increases in population or productivity resulted in an increased output of goods and services, we should rely on the resulting excess of supply over demand to make prices, profits, wages and salaries fall to the level where the same total money expenditure would buy the increased output. This argument perished in the Keynesian revolution. We are *all Keynesians now* in agreeing that a *stickiness downward* of wages and prices makes it necessary for total spending to increase as output increases so that the output can all be sold at the *current prices.*

Condition *a,* however – that prices rise only if there is an excess of demand over supply – is still given lip service in many quarters and is implied in the pronouncements of the government that they expect to be able to cure the inflation without bringing about any serious unemployment – a trick that is possible if the inflation is caused only by an excess demand. It is only lip service because as soon as the holding down of the increase in total spending threatens to bring about serious unemployment we back off and allow total spending to increase. This increase is clearly an accommodation not only to the increase in physical output but also to the increase in prices resulting from the tripartite administered inflation described above.

There is an even stranger source of the frequent declarations that our policy will cure the inflation without causing unemployment. This is the combination of a recognition that the deflation does involve a decrease in economic activity with a notion that the essence of our inflation is that the economy is *overheated* in the sense of *producing too much.* A reduction in *output* is then welcomed as a reduction in *inflation!*

This aberration is due in part to the government's attempts to reduce total spending having been frustrated for a considerable time, by unexpected increases in private spending. When aggregate spending finally began to slow down *output* stopped increasing. This signaled the beginning of the unemployment, the *means* toward the *end* of stopping the price increase, and the *means* was hailed as if it were the *end.* But unprecedently

high future wage and salary increases are being won all along the line, so that costs are rising faster than ever and future prices will have to reflect these rising costs. One is reminded of how, in the depression of the '30's, prosperity was declared to be "just around the corner" when increases in the quantity of money, the *means* which it was hoped would lead to increased aggregate spending, output and employment, were hailed as if the *end* of returned prosperity had been sighted. (Some even denounced the increase in the quantity of money as if the inflation, which they identified with the increase in the quantity of money, was upon us.)

But whatever the explanation of the origins and the persistence of the theory that inflation can be cured by merely removing some *excess demand* and without causing serious unemployment, this feat is impossible because our inflation is not an *excess demand* inflation but an *administered inflation*. The deflationary policy creates unemployment long before it stops the price increases, and when the government sees the increase in unemployment – even while trying to deny responsibility for it – it calls off its deflation. It brings about as much unemployment as it dares, but not enough to stope the inflation, and so we find ourselves suffering from unemployment and inflation at the same time.

This is exactly where we are now (June, 1970). Unemployment has risen from 3.6% to 5.0%. There are a million more unemployed than a year ago. The number of those unemployed for more than 15 weeks is almost 50% above the average for last year. Yet there is so far no slowdown in the rise of prices, while new wage contracts are being signed for record future wage increases that indicate *greater* future cost and therefore price increases than ever. Thus, our present policy of trying to stop the inflation by holding down total spending does not succeed because it cannot really be applied.

4. The Gradual Process

Before we can develop an *applicable* policy, we must have a better diagnosis of our trouble. We must begin by understanding that the Keynesian diplomatic recognition of *stickiness downwards* of wages and prices is not enough. To say that prices and wages do not fall as soon as there is an excess of supply over demand because they are *sticky downward* is to say no more than that they do not fall because they do not fall.

Wages do not fall even when there is serious unemployment (which is what is meant by an excess of supply of labor over the demand) because wages are determined not by the market (or *supply and demand*) but by the *wage administrators* – the various parties to the collective bargaining that settles the industrial wage contracts. When there is an excess supply of labor the market (alias supply and demand) says that wages should fall. *Stickiness downward* of wages means that the *wage administrators* say *no* – and it is their say that *sticks.*

With this explanation of *stickiness downward* we see at once that the same administrators may not be limited to saying *no.* Their vocabulary and their power may extend to saying that wages should rise, and how rapidly they should rise.

In the ancient legend of Scylla and Charibdis, the mariners could hope, by adroit maneuvering, to get through between the Rock and the Whirlpool. Here we apparently have to suffer *both* evils – inflation *and* unemployment – and to be limited to choosing only whether we shall suffer more inflation or more unemployment. Furthermore, in the choice between more unemployment or more inflation, I would expect the government to continue to exaggerate the evils of inflation as compared with the evils of unemployment and so to accept too much unemployment and there – by to cause much more suffering than is needed. But even the best combination of unemployment and inflation – i.e., the least painful combination – promises to be extremely unpleasant and even dangerous. Is there a less painful treatment for the malady of inflation?

Such a treatment – indeed a cure – is suggested by our diagnosis. If the cause of the inflation is not excess demand but the displacement of the market mechanism (supply and demand) by wage and price administrators (who then enforce the cooperation of the money administrators under penalty of severe unemployment), the cure can consist only of protecting the market mechanism from the administrators or of reforming and improving our administrative institutions so that they will operate on wages and prices in such a manner as to avoid the inflation-employment trade-off.

The restoration of perfectly competitive markets throughout the economy (or their new establishment, since it is by no means certain that competition ever was perfect) is recommended only by a very few unrealistic dreamers who live in a distant and perhaps imaginary past. The only possi-

bility that has any practicability at all is to develop institutions which, even if very crudely, could perform the market's two main tasks in this area:

1. It must keep wages *on the average* increasing at something close to the rate of increase of productivity, say 3% per annum, so that costs on the average would be stable. Prices, which cannot depart widely from costs, would then also be stable; 2. It must arrange for wages in different parts of the economy to vary *relatively to each other* so as to induce movement of workers (in response to the continuing changes in tastes, techniques and other conditions in the economy) from where they are needed less to where they are needed more.

The late wage-price guideposts were an attempt at just such an institutional development in the form of directives to the wage and price administrators. A figure of 3.2% per annum was established as the estimated rate of increase in productivity so that this was the permissible average rate of increase in wages that would yield price level stability.

One trouble that led to the undoing of the guideposts was the overplaying of this magic number. Instead of being used to indicate only the required *average* rate of wage increase, it was taken as a universal guide for *all* wages. Every wage increase greater than 3.2% seemed to be disapproved of, and every wage seemed to be entitled to a 3.2% increase. There was no clear indication as to when the wage should rise by more, and when it should rise by less, than the 3.2%. In a word, the wage price guideposts seemed to deal only with the first of the two tasks.

By not allowing for those wages which would have to rise by much more than the average to meet the requirements of changes in the economy, the guideposts made the grievous mistake of *interfering* not only with the administrators' interferences with the market but with *the market itself.* Where the administrators were telling prices to rise by more than the market would have told them to (including the cases where the market would have told them not to rise at all and even to fall), the guideposts were properly doing their thing. They were restraining the administrators from interfering with the market. But where there was a relative scarcity of a kind of labor and the *market* was telling a wage to rise relatively to the average wage (so that it would have had to rise by more than 3.2%), the guideposts (as understood by all except some

economic specialists that had read all the technical literature) seemed to say that it should *not* rise by more than the 3.2%. The guideposts were *themselves* interfering with the market in trying to stop some wages and prices from rising in the face of excess demand. In such cases, the guideposts degenerated into crude *price controls* which cannot for long withstand excess demand. As such wages and prices, backed by excess demand, broke out of these *price controls,* others followed and the guideposts collapsed. They broke down for lack of dealing with the second task – arranging for wages to vary *relatively to each other* in response to changing conditions. Hence our present problem.

It is possible to amend the guideposts so that they *would* be able to deal with the second task. The basic 3.2% – 3% would do as least as well – would have to be recognized for what it is – only the *average* wage rate increase aimed at. Wages of sufficient importance in the economy would have to be examined to see whether market conditions in its area were normal or whether there was an extreme sellers market (labor very hard to get) or an extreme buyers market (labor in unusually great oversupply) as indicated by, say, the percentage of unemployed. If conditions were normal, the wage should rise at the basic 3%. If there was an extreme sellers market (indicated by, say, an unemployment less than half the national average), which means that more labor should be attracted to this market and employers (and consumers of the product) induced to see substitutes, then the wage should rise at a higher rate, say 6% per annum. And if there was an extreme buyers market (indicated by, say, an unemployment more than twice the national average) which means that workers should be encouraged to go elsewhere and employers (and consumers of the product) induced to substitute this labor (and its products) for others, then wage should rise by less than the basic 3%, perhaps not at all, until conditions change.

Proposals like this have been made before but never put into operation. One reason was that it was understood as a simple *price control* that interferes with the market whereas it is in reality only *a corrective interference with the interferences* with the market (by the wage and price administrators). Another reason was that the threat of inflation did not seem serious enough to warrant the resort to experimenting with our market and administrative institutions.

Now in 1970 the inflation is seen as a much greater threat, partly because of its direct evils and partly because of the greater evils of the *administered recession* – the unemployment administered as a cure for the inflation. As a consequence we now often hear suggestions for another try at guideposts. But they could be successful only if reformed on the lines suggested above and enabled to deal with *both* the average increase and the relative variations of wages and prices.

Unfortunately the progress of the inflation in the last few years has made things even more difficult. An *inflationary psychology* has been established and it will not go away (as has been suggested) if we refuse to utter those painful words. There is a widespread *expectation* of further inflation – and the reality of this expectation can be seen in the unprecedented wage increases currently – being demanded and granted. (These expectations are of course also self-fulfilling. The wage increases to which they give rise will bring about the very increases in costs and thus in prices from which they are intended to protect the workers.) The recognition of the inflationary psychology has even lead Mr. Robert Roosa, the former under secretary of the treasury for monetary affairs, and Mr. Arthur Goldberg, the former secretary of labor, to propose a six month wage and price freeze in hopes of breaking it (or perhaps of *something turning up* which would prevent the explosion at the end of the six months).

In such an atmosphere, with an expectation of prices rising at 6% per annum or more, it would be quite futile to expect agreement to wage guideposts which offered an average wage increase of 3% per annum. Such an offer would look like a proposed 3% *cut* in real wages. If prices are expected to rise at 6% per annum, $103 next year for each current $100 is equivalent to $97. And this would certainly not be acceptable since increasing productikity should enable workers to enjoy a *real* wage increase of 3% per annum.

Economists would indeed insist that if there was a general acceptance of such a proposal, prices would not rise at all, so that there *would* in fact be a real 3% increase; and if some steps were taken at the same time to reduce the degree of monopoly, prices would actually *fall* and the real wage would rise by more than the 3% increase in productivity. But

it would be most unrealistic to expect workers and their trade union leaders to take the word of the economists. They would want some guarantee, or at the very least, for the price increase to slow down *before* the wages followed suit; while employers would naturally want the cost increase to relax first.

This looks like an impasse but there is a way out. It *is* possible to give the workers a guarantee that they would not be shortchanged by the guideposts. The guarantee can take the form of a cost of living allowance – based on an agreed index, say the consumer price index.

The refined wage-price guideposts, instead of being based on the 3% average productivity increase (with the greater and smaller increases in tight and weak labor markets respectively), would then be based on an average 2% per annum productivity increase (with corresponding greater and smaller increases in tight and weak labor markets respectively) *on top of* a cost of living wage adjustment, based on the rise in the consumer price index during the immediately preceding period (of say 3 or 6 months), to guarantee protection against inflation. Each period would then bring the workers a pleasant surprise, in the form of their getting a *real* average wage increase of not 2% but 3%. With productivity rising by 3%, costs and prices would rise by 3 percentage points less than the average money wage.

This is how it would work. Suppose that when the scheme is started inflation has been proceeding at 6% per annum and is expected to continue at that rate. Then the average current wage increase would be 2% above this or 8% per annum. With productivity increasing at 3%, costs would rise by only 5% (the 8% increase in wages being offset to the extent of 3% by the increase in productivity). The same rate of markup over costs would cause prices and gross profits to rise in the same proportion as costs, namely by 5%. The 6% cost of living allowance would thus give the worker 1% windfall so that his *real* wage would rise by the full 3% made possible by the increase in productivity. In the next period prices would rise by only 4% and so on, as shown in the chart until the inflation had been conquered. At that point, when the cost of living allowance falls to zero, the basic money wage increase can be raised from 2% to 3%.

	Rate of increase (% per annum) of:				
	Money wage $\dot{w}$ $(=\dot{p}_{t-1} + 2)$	Productivity $\dot{e}$	Costs $\dot{c}$ $(=\dot{w} - \dot{e})$	Prices $\dot{p}$ $(=\dot{c})$	Real Wage $\dot{w} - \dot{p}$
Period 0	—	—	—	6	—
1	8	3	5	5	3
2	7	3	4	4	3
3	6	3	3	3	3
4	5	3	2	2	3
5	4	3	1	1	3
6	3	3	0	3	3
7* etc.	3*	3	0	0	3

In period 7 the inflation has come to an end and the increase in the wage ($\dot{w}$) con be raised from $\dot{p}_{t-1} + 2$ to $_{-1} + 3$ which $= 0 + 3$, the price increase in the previous plus the full 3% increase in productivity).

It will undoubtedly be a long time before the revised guideposts, incorporating the device for dealing with established inflationary expectations, will be developed and put into effective operation. Meanwhile we will continue to try to cure administered inflation by further doses of deflation. The unemployment induced by the attempted deflation of prices will continue to fall most heavily on racial and other minorities that lack saleable skills because of past discrimination against them and their ancestors, on the young who lack training and experience, and on displaced older men and women who need retraining and relocation. Recognizing these evils, we will continue to engage in various measures to alleviate them, but all these endeavors will continue to be hampered by the destruction of job opportunities by our administered *recession*. In every corner of the body politic we will see the innumerable manifestations of the poisonous effects of an innappropirate medication.

But if by the revised guidelines or by any other means we should succeed in curing our administered inflation without resorting to the greater evil of administered *recession,* we will be able to continue the regime of secular prosperity of the 60's which was interrupted only by the way we set about stopping the inflation. An even greater blessing from such continued secular prosperity than the additional tens of billions of dollars of national income would be the greater possibility of dealing effectively with the special problems of our underprivileged and alienated minorities of color, age and culture.

5. The Case in Brazil

This article was written before I had any direct and hardly any indirect knowledge about Brazil. The proposal for the gradual liquidation of the US inflation in a series of steps seemed a purely theoretical construction put forward hesitantly and treated most roughly by the few people who read the manuscript. It was generally declared to be eminently unpractical on all grounds, political, administrative and psychological, ingenious and logical as it might be.

Before going to Brazil I was asked by many friends, with different degrees of seriousness, to find out how the Brazilians managed to live with high inflation. But what I found after a few weeks was that in down to earth practice they had actually reduced their inflation in several years from a rate of 90 percent per annum to a rate of 25 percent per annum, and that they seem to have done this by what was very nearly the same as the theoretical extravaganza I had concocted for this article. The main difference was that while I had suggested as a guide for the overall movement of the wage level a complete offsetting of the cost of living increase combined with a partial adjustment for increasing productivity, the Brazilians had used a partial offsetting of the cost of living with a full (and perhaps even exaggerated) adjustment for increased productivity. However I am just as diffident of this unanticipated *sucess* of the formula as I was about its original submission and I am looking forward to comments by Brazilian economists who may know what has really happened.

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