Alan S. Blinder

ECONOMIC POLICY and the GREAT STAGFLATION

STAGFLATION STAGFLATION STAGFLATION

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economic policy and the great stagflation

[student edition]

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preface

This is a book both about national economic policy and about economics as a policy-oriented science. (I trust the adjective does not contradict the noun.) Both experienced a kind of trial by fire during the Great Stagflation of the mid 1970s; and while neither escaped unscathed, it is my contention that economic policymaking fared much worse than did economic science.

It is simply not feasible to purge "political" issues from a book on economic policy, and I do not pretend to have done so. Rather than try to write in the style of a political eunuch, I have not hesitated to stake out positions on controversial issues where that seemed warranted. Though this is a book with a point of view, I think the positions taken here are not extreme ones. During the 3 years in which this book was taking shape, most of these positions were bounced off a number of my professional colleagues, and in the process of bouncing many of them were modified and moderated. In discussing these matters with colleagues both to my left and to my right, my own positions have doubtless become more centrist. I hope the outcome is not just milquetoast. I think it is not.

Why would an ivory tower economist like me write a down-to-earth book like this? I think I know the reason. In my judgment, the makers of national economic policy made several grievous errors during the years covered by this book (1971–1976). If we are not to repeat the same mistakes—a possibility that looks all too likely as this is penned—the story of this period needs to be told and retold, and the lessons learned.

Actually, I did not set out to write a book at all. This monograph had its origins in 1976 in a paper I agreed to prepare for a Brookings Institution conference on "Stabilization Policies in Industrialized Countries, 1972–1976," held in Rome from May 30 to June 3, 1977. It was Gardner Ackley, the organizer of that conference, who persuaded me, against my better judgment, to undertake an interpretive economic history of an episode so recent that the ink was not yet dry on the data. As it turned out, a book—not a paper—was necessary to do justice to the policy errors of the 1970s. As is, I suppose, inevitable in writing history with so brief a time perspective, many of the ideas—and certainly all of the data!—have changed considerably since the original paper prepared for that conference. But I think the basic message of this volume is the same as it was in the conference paper—that U.S. policymakers, faced with a difficult situation in 1973–1975, made a bad job of it.

Acknowledgments

Just as a stone gathers moss if it fails to roll, a manuscript like this gathers intellectual debts as it matures. My biggest one is certainly to Burton Malkiel who, first as a discussant at the Rome conference and second as a colleague back at Princeton, ignored the constitutional prohibition on double jeopardy and put himself through the rigors of two complete drafts of this work. While the two of us have not agreed on all issues, his good judgment was always welcome and his influence is manifested in many places throughout the book. I thank him sincerely.

At the Rome conference, a number of useful suggestions were offered by George Perry, and by Franco Modigliani, one of our profession's best discussants at large. While the overgrown "paper" was being transformed into a book, I benefited from a host of useful comments from Jeffrey Perloff and Albert Ando. The life cycle of a research assistant being what it is, quite a few Princeton students contributed to the preparation of this work. I hope I am not leaving anyone out when I name David Card, Suzanne Heller, Robin Lindsey, Robert Marshall, and especially William Newton, and thank them all. Phyllis Durepos did her usual fine job in typing the manuscript.

Mention should be made of Otto Eckstein's book, *The Great Recession* (North-Holland, 1978), which appeared after this monograph had gone through several drafts. The two books overlap considerably, though each takes up a number of topics not dealt with by the other. Where they overlap, they seem not to contradict one another. Several references to Eckstein's book will be found in the text; but I have not attempted a detailed point-by-point comparison.

Fortunately, economic researchers normally do not do their work while starving in a garret—romantic as that may seem. Several benefactors have supported this research, including the Ford Foundation, which financed the Rome conference; the Brookings Institution, which commissioned the original paper; the Institute for Advanced Studies in Jerusalem, where I worked on this project for half a year; and the National Science Foundation, which helped finance two econometric spinoffs of this project (reported in Chapters 6 and 7).

As it happened, during the 3-year gestation period of this book I was also working on a textbook. All praise is due my wife, Madeline, for putting up with this rare conjunction of events. She says it was not easy. My two sons, Scott and William, retarded progress on this book as only little boys can—thereby imbuing the work with the wisdom that only the passage of time can impart. By coincidence, I suppose, William's birth corresponded almost exactly with that of this manuscript. If only the latter had progressed as much as the former in the ensuing years!

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1 introduction

If a little knowledge is dangerous, where is the man who has so much as to be out of danger?
—Thomas Huxley

Stagflation is a term coined by our abbreviation-happy society to connote the simultaneous occurrence of economic *stag*nation and comparatively high rates of in*flation*. While the coexistence of these two maladies is in fact not quite as unique as was originally thought, there is no question that the virulence of the stagflation that afflicted us in the mid 1970s was unprecedented. This book aims to summarize what economists do and do not know about the inflation and recession that beset the U.S. economy during the years of the Great Stagflation, so that we may understand better what policymakers did, why they did it, and what effects their actions had.

1. Historical Perspective

At least by postwar historical standards, inflation was a rather new problem for American policymakers, while recession was not. Of all the years between 1948 and 1968, only 1951 would be considered "inflationary" by current standards. During the 11 years from 1953 to 1964, for example, the U.S. generally operated a low-pressure economy, and inflation (as measured by the GNP deflator) averaged only 1.9% per annum, exceeding 2% in only 4 years. Recessions and unemployment, however, are nothing new. During those same 11 years, there were recessions in 1953–1954, 1957–1958, and 1960–1961. According to the Council of Economic Advisers' (CEA) revised estimates of potential Gross National

Product, GNP was below potential in every year from 1954 through 1964 except 1955.[1] Similarly, unemployment averaged 5.4% during those years, and was below 5% only during 1955–1957. Even given the redefinition of the "full employment unemployment rate" to account for changes in the demographic composition of the labor force, unemployment was substantially above full employment in every year but these 3.[2]

A sea change in the nature of America's macroeconomic problems appears to have occurred around 1965 (see Figure 1-1), and has been widely attributed to the political decision to finance the Vietnam War without a tax increase. The 5 years from 1965 through 1969 saw a high-pressure economy with no recessions,[3] and an unemployment rate that averaged only 3.8%—substantially lower than the adjusted full employment target. Similarly, except for 1965 (when they were virtually identical) GNP consistently exceeded its potential. Inflation always exceeded 2% per annum during these 5 years, and averaged 3.6%—roughly double the average rate of 1954–1964.

The 1970s have been characterized by the worst of both worlds. High inflation and low levels of activity have become the norm. During the 8 years from 1969 to 1977, inflation averaged 6.4%, and was below 5% only under price controls in 1972. The gap between potential and actual GNP was positive in 7 of these 8 years, and averaged $41 billion (in 1972 dollars). The cumulative gap amounted to over 3 months' production at 1973 rates. Unemployment never fell below 4.9% (as a yearly average) during these years, and averaged 6.3%. The 9% overall unemployment rate recorded in May 1975 was the highest in the postwar period, and even after 2 years of recovery the rate remained above 7%.

2. Preview of Things to Come

This book chronicles the nature and causes of this dramatic worsening of the economic picture. But, to a much greater extent, it is about how policymakers responded to this adversity and whether their actions exacerbated or ameliorated the problems. While the study focuses on the events of 1973–1975, the story must begin in 1971, both because of the

[1] See *Economic Report of the President*, 1978, Table 10, p. 84. Potential and actual GNP were less than 1% apart in 1955 and 1956. It should be remarked that the measurement of potential GNP is a matter of some controversy these days.

[2] The estimates of the moving full employment target are also those of the CEA. The rate rises from 4.0% to 4.3% during this period.

[3] A very mild recession started in the last quarter of 1969.

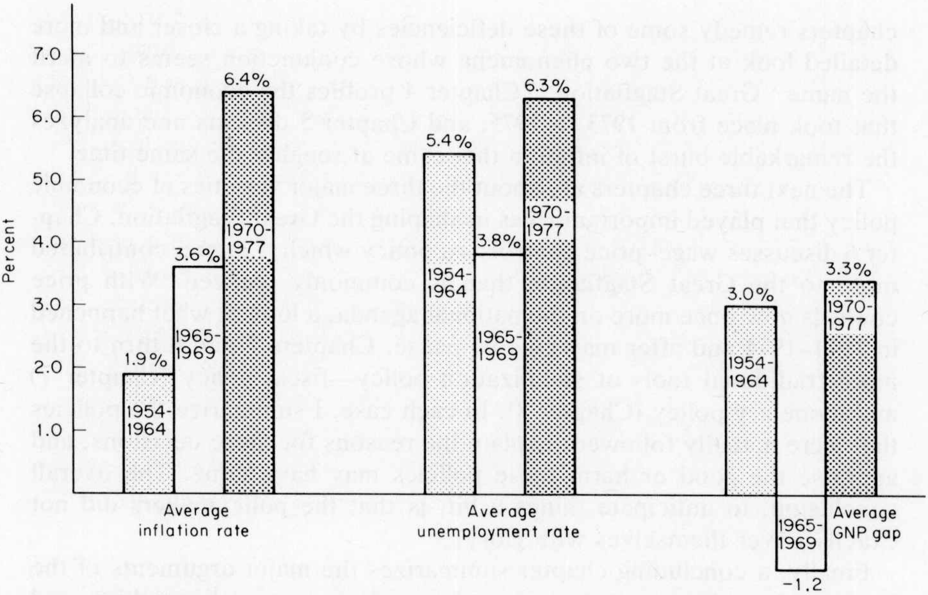

Figure 1-1. Indicators of inflation and recession. This figure shows the behavior of the inflation rate and two different indicators of recession—the unemployment rate and the GNP gap—during three different periods: 1954–1964, when both inflation and resource utilization were low; 1965–1969, when inflation was higher but resource utilization was much higher; 1970–1977, when inflation was very high but resource utilization was very low. The inflation rate is measured by the yearly average GNP deflator; the unemployment rate is measured by the yearly average overall unemployment rate; and the GNP gap by the gap between potential and actual GNP in 1972 dollars, expressed as a percentage of potential. (*Sources: Economic Report of the President,* 1978 and 1979, and *Survey of Current Business,* July 1978.)

lags in monetary and fiscal policy and because of the importance during this period of the New Economic Policy that President Richard M. Nixon inaugurated in August 1971.

Before getting into these important matters, however, the next chapter seeks to provide a conceptual framework for the entire book by presenting a fairly simple and general theory of stagflation. While this is the one chapter in the book that is "theoretical," the analysis to be found there certainly is not very technical.

Chapters 3–5 contain a rather interpretive, but I hope only slightly idiosyncratic, history of the Great Stagflation. The first of these chapters provides a fairly broad overview, treating some topics in reasonable detail, but necessarily moving rapidly over several aspects of the economic history of the 1970s that merit much closer scrutiny. The next two chapters remedy some of these deficiencies by taking a closer and more detailed look at the two phenomena whose conjunction seems to merit the name "Great Stagflation." Chapter 4 profiles the economic collapse that took place from 1973 to 1975; and Chapter 5 dissects and analyzes the remarkable burst of inflation that came at roughly the same time.

The next three chapters are about the three major varieties of economic policy that played important roles in shaping the Great Stagflation. Chapter 6 discusses wage-price controls—a policy which, I argue, contributed more to the Great Stagflation than is commonly realized. With price controls now once more on the national agenda, a look at what happened in 1971–1974 and after may give us pause. Chapters 7 and 8 turn to the more traditional tools of stabilization policy—fiscal policy (Chapter 7) and monetary policy (Chapter 8). In each case, I summarize the policies that were actually followed, explain the reasons for these decisions, and appraise the good or harm these policies may have done. The overall conclusion, to anticipate things a bit, is that the policymakers did not exactly cover themselves with glory.

Finally, a concluding chapter summarizes the major arguments of the book, seeks to ferret out the lessons for contemporary policymaking, and against this backdrop briefly discusses the economic events of 1977–1979.

The Great Stagflation, like the Great Depression, may with the passage of time prove to be *sui generis*—an unhappy episode caused by a rare conjunction of events. However, there is every reason to think that stagflation, which has been with us before, will be with us again. It is said that those who fail to learn from their mistakes are condemned to repeat them—a cliché, no doubt, but one that captures very well the reason for writing (or reading!) a book such as this.

2 understanding stagflation: some basic concepts

Everything should be made as simple as possible, but not more so.

—Albert Einstein

During and since the mid 1970s it has been widely claimed by journalists, politicians, and even by many economists that the phenomenon of stagflation perplexed economists, ran counter to all of our most cherished theories, and generally made the policy advice we offered at best useless and at worst downright dangerous. If repetition implied veracity, these claims would by now be beyond dispute.

Fortunately, however, though economists were certainly perplexed by the events of the mid 1970s, the puzzlement was mainly over what to do about stagflation, not about understanding why it was occurring. Nor, as will be seen in this chapter, does the existence of stagflation require that we jettison contemporary macroeconomic theory, for that theory can indeed explain what has happened. When it comes to policy recommendations, however, more circumspection is appropriate. No economist had then, or has now, a perfect or even a halfway decent cure for stagflation. But this does not imply that the performance of policymakers could not have been improved. After all, though it may be quite difficult to extricate oneself from 4 feet of quicksand, there is still something to be gained by going in feet first rather than head first.

A major theme of this book is that government policies coped rather poorly with the Great Stagflation—that while there was no way that things were going to be very good, they could have been a great deal better than they were. A wide variety of data, models, statistical methods, and documentary evidence will be used to buttress this view, but any counterfactual statement such as this ultimately relies on some theory. The principal purpose of this chapter is to make this theory explicit.

The chapter seeks to explode two widespread myths about stagflation: first, that stagflation is a mystery that economic theory cannot explain; and second, that because of stagflation policymakers no longer face a trade-off between inflation and unemployment. In the process, it will become clear why there is no remedy for stagflation, at least not within the conventional litany of policy tools.

This is the first and only chapter of the book that is mainly about economic theory. Readers who have little patience for such matters can proceed directly to the brief summary on page 23 where, however, they will have to accept the conclusions as bold-faced assertions, lacking the supporting arguments that are presented in the chapter.

1. Aggregate Supply and Demand Analysis

It may be helpful to begin by reviewing the basic organizing framework that most macroeconomists use nowadays in thinking about aggregative issues like inflation, unemployment, and stagflation. Borrowing the oldest tool of economic analysis, the economy as a whole is thought of as a giant market; and its various aspects are divided into those pertaining to "aggregate demand" and those pertaining to "aggregate supply."

AGGREGATE DEMAND

During the 1950s and 1960s, and continuing even into the early 1970s, the greatest controversies among macroeconomists revolved around the specification of aggregate demand; Keynesians and monetarists argued whether aggregate demand was more usefully obtained by *adding* consumption, investment, and government purchases or by *multiplying* the money stock times velocity. There was a long debate over whether monetary policy mattered (much?) for aggregate demand, followed by an equally long debate over whether fiscal policy mattered (much?).

By now this is largely behind us, and it is widely recognized that the same sort of aggregate demand curve—a downward sloping relationship between the volume of real demand and the price level—can be derived from either a monetarist or a Keynesian approach, and can be shifted by either fiscal or monetary policy.[1] Figure 2-1 depicts such a curve. It is

[1] The two approaches, while they differ in style, are essentially equivalent except in some extreme cases, which each side now disavows.

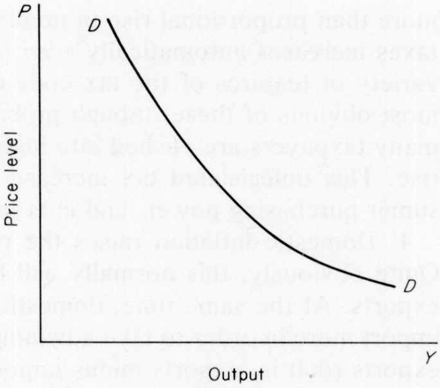

Figure 2-1. An aggregate demand curve.

worth briefly enumerating some of the reasons for its negative slope, because these reasons play a role in the analysis of stagflation that follows.

1. At higher price levels, research has shown, the demand for money is proportionately higher because the same number of transactions require more dollars to finance them. Thus, for a given supply of money, a higher price level brings forth a "tighter" situation in the money markets. Typically, this financial stringency manifests itself in higher interest rates, which have deleterious effects on business investment and, especially, on mortgage financing and residential construction.[2] In this respect, a higher price level acts much like a reduction in the money supply: it raises interest rates and, because of this, reduces aggregate demand.

2. Much consumer wealth is held in the form of assets whose values are fixed in money terms. The purchasing power of such assets declines as the price level rises. Money itself is the clearest example; but all of the many varieties of time and savings accounts share this attribute with money and are much more important quantitatively. Government and corporate bonds also decline in real value when prices rise. Finally, recent research has suggested that even common stocks, which used to be thought of as a hedge against inflation, can often behave much like nominal assets. For all these reasons the real wealth of consumers falls when prices rise, and this loss of purchasing power puts a damper on consumer spending.

3. Our personal income tax system is *progressive*, and tax liabilities are defined in *nominal* terms. In combination, these two features mean that during inflationary periods each rise in the price level leads to a

[2] Higher interest rates may also reduce consumption and state and local government spending, but these effects are likely to be minor.

more than proportional rise in nominal tax receipts, so the real value of taxes increases automatically *even if real incomes are not changing*. A variety of features of the tax code combine to produce this result; the most obvious of these, though probably not the most important, is that many taxpayers are pushed into higher tax brackets as nominal incomes rise. This unlegislated tax increase that inflation produces drains consumer purchasing power, and cuts into aggregate demand.

4. Domestic inflation raises the prices of the goods we sell abroad. Quite obviously, this normally will be damaging to the demand for our exports. At the same time, domestic inflation encourages Americans to import more in order to take advantage of lower foreign prices. Since *net* exports (that is, exports minus imports) are a component of U.S. aggregate demand, higher prices dampen demand on both counts.

AGGREGATE SUPPLY

As the controversies over aggregate demand subsided, monetarists and Keynesians regrouped for a new battle, and the most heated debates in macroeconomics these days are over the specification of *aggregate supply*. It would be foolhardy for me to try to present a consensus view of the aggregate supply mechanism, since no such consensus exists. Instead, I will offer one consistent—and not terribly partisan—view of aggregate supply, and hope that the eventual consensus bears a close resemblance to it.

The question here is this: How does the aggregate volume of production respond to changes in the price level? Since producers in the U.S. economy are mainly motivated by profit, it is at once clear that the answer depends largely on what is simultaneously happening to production costs. It is hardly a surprising notion that output will rise vigorously if costs are held constant while selling prices increase, but may not respond at all if every item of cost rises proportionately with prices. For this reason the analysis of aggregate supply is conducted in the market for factors of production and in particular in the market for the most important factor, labor.

In the very short run, labor and other inputs normally are available at constant costs. There are many reasons for this. Labor, like other factors, may be supplied under long-term contracts that stipulate fixed money wages. Failing this, firms and their workers may have entered into implicit agreements under which the firms are entitled to purchase whatever labor they want (within limits) at set wage rates. Or, when there is unemployment, there may be many available workers who can be hired at the going wage. Whatever the reason, the short-run stickiness of