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# Inflation And Unemployment: A Dilemma Of Economic Policy

**Inflation and unemployment have simultaneously hit the U.S. economy, posing a severe policy dilemma. This issue of the Minnesota Agricultural Economist examines some of the forces causing this situation and suggests a direction for future policymaking.**

**By John D. Helmberger and John J. Waelti**

## A policy dilemma

Unemployment and inflation have long concerned workers, consumers, and policymakers. The American economy has had unemployment and inflation before, but not at the same time. With unemployment, we have had stable or falling prices in some economic sectors. In turn, prices have tended to rise as the employment level reached 95-96 percent of the working force.

Now, however, we have over 8 percent unemployed, and 1975 prices have been rising at an annual rate of over 7 percent. Between April and May, this increase slowed to 4.8 percent—only to accelerate again in June. Why is this, and what policies can deal with the problem?

This issue of *Minnesota Agricultural Economist* will explain some of the factors involved in this complex economic situation.

## Total spending and GNP

To understand the problems of unemployment and inflation, one must first understand what determines total output or GNP.[1]

Every expenditure is also a receipt. Each person's income results from someone else's spending. In other words, total spending equals total income.

[1]GNP is the total market value of all final goods and services produced in the nation's economy in 1 year.

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Three categories of spending exist:

1. Consumers' spending for goods and services (C), motivated by the desire to satisfy wants.
2. Investors' spending for capital goods (including net foreign investment) (I), motivated by the hope for profit.
3. Governments' (federal, state, and local) spending on goods and services (G), motivated by the public's desire for government services.

The sum $C + I + G$ equals aggregate income (GNP) or aggregate (total) demand. If total spending is of appropriate size, the demand for goods and services will provide full employment. With enough competition in the economy, a full employment level of spending would be compatible with a stable price level.

### Inflation caused by excess demand

While production is limited by the productive capacity of the economy, the level of spending is not. If spenders (consumers, investors, and governments) try to buy more than the fully employed economy can produce, the result is rising prices—inflation. Collectively, when full employment is reached, *we cannot buy more goods and services—only more costly goods and services.*

This is "demand pull" inflation. Excess demand for a limited supply of goods tends to "pull" prices up. Before World War II, such inflation was generally associated with increased governmental expenditures (G) during wartime. Under these conditions, demand can only be reduced by reducing consumption (C), investment (I), or nondefense government spending.

Reduction in private spending (C or I) can be achieved by fiscal policy (increasing taxes, thereby reducing take-home pay) or monetary policy (reducing or eliminating credit, thereby allowing fewer dollars in the hands of consumers and investors).[2]

These "contractionary" policies are designed to compensate for excess demand. Such policies (increased taxes and reduced credit) are needed during wartime to prevent inflation brought about by excess demand.

### Unemployment caused by insufficient demand

If total spending is too small to buy all the goods and services a fully employed economy can produce, unemployment results. Such unemployment can be cured by "expansionary" policies which increase private spending (C or I), government spending (G), or both.

Private spending can be increased by cutting taxes (leaving more money in the hands of consumers and investors) or by making access to credit easier (increasing purchasing power). This is the rationale for cutting taxes or making credit more available during periods of unemployment.

### The rationale for governmental policy

The historical pattern (before World War II) had been that prices and employment levels increased during wartime (because of in-

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[2]Changing the levels of government spending or taxes to stimulate or dampen total demand (depending on whether we are fighting unemployment or inflation) is called *fiscal policy.* Changing the cost and availability of credit to stimulate or dampen demand is called *monetary policy.*

creased G). Then, at the war's end, aggregate demand decreased sharply. Competition caused prices to drop—ending inflation and then some.

This did not occur because of policy, but rather from a postwar decline in G spending. During such periods, unemployment resulted. The economy was "left to the elements."

Eventually, business inventories would become depleted and capital goods would wear out. Then, investment would increase again and unemployment would decrease. The depressed economy "cured itself," but only after unnecessarily large and prolonged unemployment.

## The Employment Act of 1946

The rise of macro (or Keynesian) economics during the 1930's taught that specific public policies could combat inflation or unemployment. Policies necessary to deal with inflation (without unemployment) or with unemployment (without inflation) were developed in John M. Keynes' *The General Theory of Employment, Interest and Money*, published in 1936.

The depression of the 1930's, together with the knowledge that public policies could minimize the severity of unemployment, led to passage of the Employment Act of 1946.

> "The Congress hereby declares that it is the continuing policy and responsibility of the federal government to use all practical means consistent with . . . other essential considerations of national policy . . . in a manner calculated to foster and provide free competitive enterprise—*to promote maximum employment*, production and purchasing power." (Italics added.)

When Congress passed this bill, it opened "Pandora's box." However, it was a box that had to be opened to cope with inflation and unemployment.

For a while after 1946, macro policies to dampen demand fought inflation fairly well. As aggregate demand was reduced by reducing government spending, raising taxes, or reducing availability of credit, competition resulted in widespread price reductions. This was because sellers, fearful of depression, would attempt to reduce inventories. Similarly, reverse policies to stimulate demand worked fairly well to combat unemployment. Then, competition led to increased production by putting unused resources to work. Although some prices increased, the major effect of increased demand was to increase production rather than prices. (Table 1 shows very modest price level increases from 1948-1965.)

## Recent problems

After postwar recessions failed to develop, become very deep, or last very long because of the implementation of the Employment Act, increasing numbers of businesses and labor unions with monopoly power[3] acted as though we would never have any more depressions or significant recessions.

They apparently believed that, with even a small threat of recession and increased unemployment, the government would stimulate demand enough to prevent a recession. If so, it would no longer be necessary to cut prices to move goods, or even to stop increasing prices. The government would "validate" current or higher prices by increasing aggregate demand. *The economy was not (and is not) competitive enough to permit stimulating demand to increase employment without permitting inflation.*

Thus, certain noncompetitive elements in the economy appear basically responsible for price increases in the face of substantial unemployment.

During 1965-67, prices were relatively stable, and unemployment was low (table 1). Accelerated American involvement in the Vietnam War increased government spending (G) without compensating restraint of consumption or investment expenditures (C or I). Wartime expenditures were made using peacetime fiscal and monetary policies. The inevitable result was inflation.

The government attempted to fight this inflation primarily by monetary policy (restricting access to credit) and, belatedly, by fiscal policy (limiting government spending (G) while increasing taxes). In spite of these policies, prices rose in monopolistic sectors of the private economy (autos, oil, steel, etc.), and unemployment increased (table 1, 1969-1970). The economy is not competitive enough to permit fighting inflation without causing unemployment.

The effort made the first 2 years of the Nixon administration to dampen demand by tight fiscal and monetary policies failed to stop inflation. Instead, it caused unemployment (table 1, 1970). Because Americans do not tolerate much unemployment, the administration switched from dampening demand to stimulating demand in August 1971, while recognizing that we would get more inflation with more employment. To prevent resultant inflation, the administration imposed price controls at that time (table 1, 1971, 1972). In January 1973, the administration junked the price controls, and monetary policy was tightened to dampen demand to check inflation.

Many, if not most, people apparently still believe that the government, faced with the public's unwillingness to accept a deep recession, will give up dampening demand, stimulating it instead. Given the Ford administration's avowed determination to check inflation and the President's resistance (through the veto) to Congressional attempts to stimulate demand, the public may give up this belief—business and labor may stop increasing prices. If so, our demand-dampening monetary and fiscal policies may check inflation. However with policy restrictive enough to check inflation, the cost in terms of lost production and unemployment will be great.

From January through May 1975, inflation was abated. The 9.2 percent unemployment may have shaken the beliefs of some business and labor leaders that there would not be any more depressions. If so, shaking their beliefs was costly. We are currently without more than $200 billion worth of goods and services we could just as well be producing. And we still have too much inflation—it has accelerated again in June.

The administration apparently believes that inflation can be checked if the administration refuses to stimulate demand. Perhaps it can, but we cannot be sure, and, given this policy, the price of checking inflation is very high.

Other factors contributing to recent inflation were bad weather in the 1972 crop year in many parts of the world, resulting in shortages of agricultural commodities.

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[3]Monopoly power is interpreted here to mean having sufficiently few economic units that each has some power to set prices.

This, together with rising income abroad, contributed to increased demand for American food and feed grains at a time when the U.S. policy was to eliminate public storage. The oil embargo and the aggressive policies of the Organization of Petroleum Exporting Countries (OPEC), together with the economic power of the multinational oil companies, contributed to rising energy costs (price of oil at the Persian Gulf quadrupled), causing further price increases. Shortage and high prices of raw materials in the economy created "bottlenecks" in the economy and contributed to higher prices.

*While the energy, raw materials, and agricultural situation have played a role in recent inflation, it would be a grave error to assume that falling raw material and agricultural commodity prices and stable oil prices would bring about an end to general inflation.* For example, falling farm prices are not necessarily followed, in full measure, by falling retail prices. A major reason inflation may continue to occur is that there are monopolistic elements in the economy which increase prices and wages—even during recession—restricting output and employment rather than prices and wages.

### An alternative approach

Current inflation is not caused by excess demand. On the contrary, demand is deficient, which results in the high unemployment rate. C, I, and G together are too small to buy what we can produce at full employment. We could stimulate demand substantially to increase employment and to prevent the additional demand being dissipated on higher prices. This could be accomplished by using persuasive wage and price guidelines and/or coercive wage and price controls for strategic goods to the extent necessary to increase employment while checking inflation.

Few economists favor long term price controls. However, short term controls on strategic items (oil, steel, chemicals, nonferrous metals, etc.) may be useful—if we make use of the time to make the economy more competitive.

Responsible economists in both political parties recognize this. Arthur F. Burns[4] in an address to a joint meeting of the American Economic Association and the American Finance Association in December 1972 (when we still had price controls) said:

"*The hard fact is that market forces no longer can be counted on to check the upward course of wages and prices even when the aggregate demand for goods and services declines in the course of a business recession.* During the recession of 1970 and the weak recovery of early 1971, the pace of wage increases did not at all abate as unemployment rose, and there was only fragmentary evidence of a slowing in price increases. . . .

"There are those who believe that the time is at hand to abandon the experiment with controls and to rely entirely on monetary and fiscal restraint to restore a stable price level. This prescription has great intellectual appeal; unfortunately, it is impractical.

"If some form of effective control over wages and prices were not retained in 1973, major collective-bargaining settlements and business efforts to increase profits could reinforce the pressures on costs and prices that normally come into play when the economy is advancing briskly, and thus generate a new wave of inflation. *If monetary and fiscal policies become sufficiently restrictive to deal with the situation by choking off growth in aggregate demand, the cost in terms of rising unemployment, lost output and shattered confidence would be enormous . . .*

"We need to reassess the adequacy of our laws directed against monopolistic practices of business, the enforcement of these laws, the power of trade-unions at the bargaining table, restrictions on entry into business or the professions, the restrictive practices of trade-unions, the subsidies to farmers, the federal minimum wage—particularly for teen-agers—restrictions on the activities of financial institutions, the welfare system, import quotas, tariffs, and other legislation that impedes the competitive process.

"We need also to re-evaluate our extensive manpower-training programs and the feeble effort to establish computerized job banks, for it is clear that our labor-market policies have thus far failed to contribute sufficiently to the objective of expanding employment and yet avoiding the inflationary effects that monetary and fiscal policies so often tend to generate.

"There is no quick or easy path to meaningful structural reform [making the economy more competitive]. But I see no real alternative if our national aspiration for prosperity without inflation is to be realized, while free enterprise and individual choice are being preserved." (Italics and parenthetical phrase added.)

Walter W. Heller and George L. Perry[5] wrote in *The U.S. Economic Outlook*, published by the National City Bank of Minneapolis on Oct. 8, 1974:

"The 'old-time religion' has generated, not a benign 'levelling off' of inflationary demand pressures, but a full-fledged recession beset with fierce cost-push pressures. Continued overreliance on tight money and budget-cutting as inflation antidotes would be self-defeating. It would destroy jobs, output, and profits and undercut the very capital expansion and productivity advances that are vital to the longer-run battle against inflation . . .

"*Monetary-fiscal restraint must not only be moderated but flanked by a broad spectrum of other measures to boost productivity and avert future shortages, improve the allocation of credit, remove government restrictions that*

[4]Source: U.S. News and World Report, Jan. 15, 1973. Burns was longtime head of the National Bureau of Economic Research, Chairman of the Council of Economic Advisors under President Eisenhower, and Economic Consultant to President Nixon who appointed him to his current position, Chairman of the Board of Governors of the Federal Reserve System.

[5]Walter W. Heller, professor of economics at the University of Minnesota, was the Chairman of the Council of Economic Advisors under Presidents Kennedy and Johnson, and George L. Perry, a former professor of economics at the University of Minnesota, is a researcher for The Brookings Institution. The Brookings Institution and the Burns' National Bureau are the leading economic research organizations in the United States—if not the world.

**Table 1. Inflation and unemployment**

| Year | CPI 1967=100* | Annual percent change in CPI | Unemployment | Percent of work force unemployed |
|---|---|---|---|---|
| 1929 | 51.3 | — | 1,550,000 | 3.2 |
| 1933 | 38.8 | −6.75 | 12,830,000 | 24.9 |
| 1939 | 41.6 | 1.17 | 9,480,000 | 17.2 |
| 1940 | 42.0 | 1.0 | 8,120,000 | 14.6 |
| 1941 | 44.1 | 5.0 | 5,560,000 | 9.9 |
| 1942 | 48.8 | 10.7 | 2,660,000 | 4.7 |
| 1943 | 51.8 | 6.2** | 1,070,000 | 1.9 |
| 1944 | 52.7 | 1.7** | 670,000 | 1.2 |
| 1945 | 53.9 | 2.3** | 1,040,000 | 1.9 |
| 1946 | 58.5 | 8.5 | 2,270,000 | 3.9 |
| 1947 | 66.9 | 14.4 | 2,356,000 | 3.9 |
| 1948 | 72.1 | 7.8 | 2,276,000 | 3.8 |
| 1949 | 71.4 | −1.0 | 3,637,000 | 5.9 |
| 1950 | 72.1 | 1.0 | 3,288,000 | 5.3 |
| 1951 | 77.8 | 7.9 | 2,055,000 | 3.3 |
| 1952 | 79.5 | 2.2** | 1,883,000 | 3.0 |
| 1953 | 80.1 | 0.8** | 1,834,000 | 2.9 |
| 1954 | 80.5 | 0.5 | 3,532,000 | 5.5 |
| 1955 | 80.2 | −0.4 | 2,852,000 | 4.4 |
| 1956 | 81.4 | 1.5 | 2,750,000 | 4.1 |
| 1957 | 84.3 | 3.6 | 2,859,000 | 4.3 |
| 1958 | 86.6 | 2.7 | 4,602,000 | 6.8 |
| 1959 | 87.3 | 0.8 | 3,740,000 | 5.5 |
| 1960 | 88.7 | 1.6 | 3,853,000 | 5.5 |
| 1961 | 89.6 | 1.0 | 4,714,000 | 6.7 |
| 1962 | 90.6 | 1.1 | 3,911,000 | 5.5 |
| 1963 | 91.7 | 1.2 | 4,070,000 | 5.7 |
| 1964 | 92.9 | 1.3 | 3,786,000 | 5.2 |
| 1965 | 94.5 | 1.7 | 3,366,000 | 4.5 |
| 1966 | 97.2 | 2.9 | 2,875,000 | 3.8 |
| 1967 | 100.0 | 2.9 | 2,975,000 | 3.8 |
| 1968 | 104.2 | 4.2 | 2,817,000 | 3.6 |
| 1969 | 109.8 | 5.4 | 2,832,000 | 3.5 |
| 1970 | 116.3 | 5.9 | 4,088,000 | 4.9 |
| 1971 | 121.3 | 4.3** | 4,993,000 | 5.9 |
| 1972 | 125.3 | 3.3** | 4,840,000 | 5.6 |
| 1973 | 133.1 | 6.2 | 4,304,000 | 4.9 |
| 1974 | 147.7 | 11.0 | 5,076,000 | 5.6 |
| Dec 1974 | 155.4 | | | |
| July 1975 | 162.3 | | 8,538,000 | 8.7 (8.4 seasonally adj) |
| Annual rate of change Dec 1974 to July 1975 | | 7.61 | | |

*Index from 1929-1974 are annual averages
**Price Control

Source: *Economic Report of the President*, 1975, p. 300 and p. 276 except for July, 1975 data which comes from BLS and Economic Indicators, Aug 1975, p. 10.

*prop up prices and costs, and develop meaningful wage price restraint.*

"The President will be buffeted by conflicting counsels in preparing both his immediate and his longer-term program to deal with an inflationary recession. We would underscore three points that policymakers should bear in mind in coping with 'stagflation'.

"First it would be at their peril—and the country's that they would shun the need for an *effective program of price-wage restraint. Granted, labor and business opposition is formidable, and wage-price controls remain in disrepute after their thorough discrediting by the Nixon Administration.* But if we fail to short-

circuit the new price-wage spiral that is growing out of the 1973-74 explosion in the cost of living, the battle against inflation cannot be won for years to come. Nor will the public patiently wait for severe recession to cure double-digit inflation.

"So as a matter of both economic and political reality, it is essential to equip the new Council on Wage and Price Stability with the weapons of subpoena, suspension, and rollback—*powers to be used sparingly but unhesitantly where powerful labor unions and big business defy the public interest.*" (Italics added.)

Even under the best circumstances, the amount of inflation we consider acceptable in the future will have to be larger than we considered acceptable in the past. Reasons include:

*If we wish to have a cleaner environment or keep it from deteriorating further, we must pay for clean-up. This cost will have to be included in prices of final products. However, studies show that environmental cleanup would add an extremely small amount to inflation (less than 1 percent per year).

*As the world uses up its depletable resources, we have to dig deeper and process lower grade resources. Both increase costs of production and, therefore, prices. Technology can mitigate, but cannot permanently permit us to escape these increased costs. We are increasingly dependent on foreign sources for many of these resources. OPEC policy aggravates the problem, but even in the absence of OPEC, we would be faced with higher energy costs than was the case previously.

*The American economy is increasingly tied to the world economy, most of which has an inflation rate higher than ours. Factors such as exchange rates, trade policies, and changes in demand for American exports and supply of American imports can affect the domestic price level.

Although we must face inflationary pressures generated by environmental costs, energy costs, and in some cases, rising costs of key raw materials, we do not have to accept the inflation caused by monopoly power.

## Summary

Income is determined by aggregate spending in the economy. Too much spending generates inflation. Too little spending generates unemployment. In the absence of governmental policy, the "right" amount of spending to generate full employment without inflation will not automatically occur without government policy.

During the 1950's and early 1960's, the United States enjoyed a generally high level of employment and prices which, though rising, were held to modest increases. During the late 1960's and 1970's, several forces contributed to both unemployment and severe inflation. A major force frustrating government economic policy is monopoly power in key sectors of the economy. For the government to successfully pursue policies to bring about the level of spending consistent with full employment and stable prices, there is the need for short term wage-price guidelines and/or control while measures are taken to *reduce* the power of large firms in key economic sectors and strong labor unions to raise prices and wages at will.

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