Keynesian Economics and Inflation

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A first and essential step in the development of Keynesian economics took place in the 1920's when several economists, both in England and in the U.S., succeeded in clarifying how our modern monetary system works, i.e., how the banking system operates to create money in the process of making loans and investments.

What we use for money is an abstraction—deposits, we call them, in banks. Actually, nothing has been deposited. They are simply credits that are chalked up on the books when the banks expand their loans and investments. The intricacy of the banks' relation to each other obscures the way in which this is done, so that each bank thinks it is only lending out what has been deposited with it. If you look at the banking system as a whole, however, that is not what happens.

The process of expanding the money supply through the lending and investing mechanism is controlled by the central bank—the Federal Reserve in the case of the U.S.—through its control of the total amount of reserves. The banks are required to keep reserves equal to a certain percentage of their deposits. That sets a ceiling on the total expansion of deposits that it is possible to undertake.

The intricacies of this system require about three weeks in an introductory economics course, and I'll assume you are willing to take it on faith that it really works. Incidentally, I believe all modern economists are agreed that this is the way the banking system works to create money.

I suppose what is really important about this is that you don't need to worry about money. If it seems like a good idea to create money, we'll create it. So if you at any point along the way have a sort of hesitant feeling about where the money will come from, just forget it.

The second major step occurred in the early 1930's, when Keynes and several of his associates succeeded in getting rid of the prejudices that had up to that time attached to the concept of spending, and achieved an objective analysis of the spending process in the economy. I can well remember in the early 1930's, in debates about how we could get out of the Depression, it was popular to say that you could no more spend your way into prosperity than you could drink yourself sober. Spending was almost always coupled with some such adjective as "wild," "loose," "excessive"—and the general atmosphere that surrounded it was nothing good could be associated with spending.

An objective analysis of the economy makes it clear that spending is necessary in a market economy for the successful functioning of the production and employment system. What we have, in effect, is a flow of goods and services in one direction against the flow of spending in the other. Unless the flow of spending is adequate, the flow of goods and services drops off, and you have unused production capacity and unemployment.

It follows from this general conception of the economy that in the case of inadequate spending—which causes a fall in production and in employment—the government can do something about it. There are two major ways in which government policy can influence the flow of spending. One is through monetary policy, making money cheaper and easier to get through the operation of the Federal Reserve and the banking system, which has the tendency to stimulate private spending on investments, on residential building, and perhaps on consumer borrowing. The other way is for the government itself either to cut taxes or to increase its own spending. If it cuts taxes, it releases some of the money that would otherwise be taken away from private spenders—it gives them more to spend. If it increases its own spending, obviously this adds to the total stream. That is, it adds if the government does not at the same time take action which counteracts the beneficial effect of the tax cut or the spending increase.

There was a great deal of confusion about this in the 1930's, and I'm interested to see that there seems to be, even today, a certain amount of the same type of confusion. It won't do any good to cut taxes if at the same time you cut spending. The one will roughly offset the other. In the early days of the New Deal this wasn't clearly seen, and those of you who are of my generation may remember that at the same time the Roosevelt administration appropriated money for an expanded public works program they cut government salaries. Now I admit that building bridges or dams or roads is much more glamorous than doing clerical work, and the notion that somehow or other it would be better for the economy is one that I can understand, but it has no foundation in fact. The people—the lowly clerks whose salaries were cut—spent the money just as much as the construction workers who were employed on the public works. So that to the extent that government salaries were cut at the same time that public works were increased, the benefit of the second step was nullified. Fortunately it wasn't to a very large extent, and fortunately also, the President, being flexible, being empirically oriented, was not insistent in sticking to his orthodox notions.

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At the present time, as you've noticed, the President's budget has something of this same contradiction in it; it is proposed we should cut taxes, but it's also proposed that we should cut various types of spending—unfortunately, and particularly, those types of spending which are least suitable for cutting right now: Social Security, food stamps, and other welfare payments. This indicates either confusion about the policy or, possibly, the better explanation that a committe drew up the policy. In any case, we must remember that we are not going to stimulate the economy if we take away with one hand what we give with the other.

What this means is that for spending to be effective, either via the tax-cut or the spending-increase route, it has to be deficit spending. I suppose that still sounds bad. Every time I read a newspaper there's something about the gloomy budget, the big deficit, and how dreadful it is that we're going to have a deficit. Actually, deficits aren't bad. In a period in which we need to stimulate the economy, they are good. We *should* say, "Hurray, there's a big deficit coming up."

Friends of mine coined a phrase in the 1930's which put this whole thing very neatly. Instead of talking about the government deficit, they talked about the government's net contribution to buying power. As you think about it, you'll see that puts a different light on matters. It is a net contribution to buying power that's needed; and if we increase spending without raising taxes we will have it.

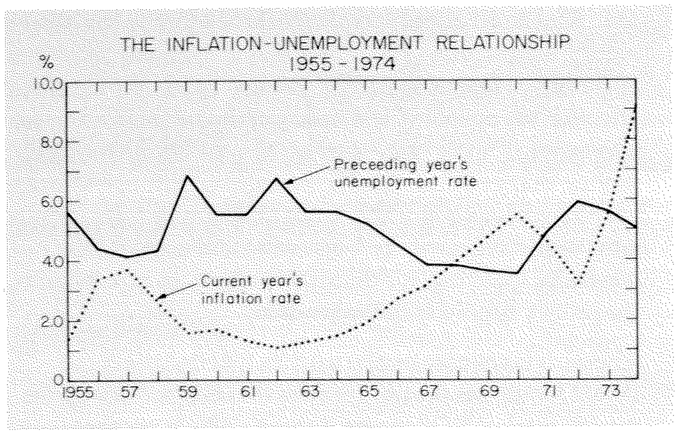
One final word about spending before I turn to the other side of the picture—the inflation side. Not only must the spending be deficit spending, but for maximum beneficial effect on the economy it should usually be financed by an expansion of the money supply. This will mean that the money that goes into the income stream through increased spending or tax reduction is not taken away from somebody who would otherwise be borrowing and using it. So, generally speaking, it's desirable to have an expansion in the money supply at the same time.

This also takes care of any worries that financing the deficit would, as the phrase runs these days, "dry up the capital market." Of course if there's only a certain amount of capital and the government borrows it, that will dry up the capital market and other would-be borrowers will not be able to get as much as they want, and the beneficial effect of the government action will be largely nullified again. But that's not necessary. The sensible thing to do is to expand the money supply to the extent that the government is going to call on the market for funds.

Now what about the other side of the picture? I've talked so far only about the danger of inadequate spending and the policies the government can pursue to offset that danger. The other extreme, of course, is excessive spending, and here's where things have gotten complicated.

Let's start with the simplest Keynesian model. As output and employment increase, prices remain stable until a magical point we call full employment is reached. At this point, since it is impossible in the short run to increase output any further, the result of any further increase in demand—whether public or private—will be inflation. Prices, in other words, don't rise at all as demand increases up to the limit of the economy's capacity to produce, and then pure inflation sets in. The policy conclusion is as simple as the model: Increase demand up to the point of full employment and then stop. If private demand goes on increasing, use restrictive monetary and fiscal measures to keep total demand within the limits of the economy's capacity to produce.

Now, this is too simple, as Keynes saw very clearly, and he later described the main sets of factors that will begin to influence prices before full employment is reached. One is that as employment increases, various inefficiencies creep into the operation of the system. Some bottlenecks will probably be reached in special industries or special occupations. Labor that is not as efficient as the labor already employed will be added to the work force, and for these and related reasons, marginal costs will tend to rise. The second factor, which in the modern world is even more important than the first, is that as we move toward higher levels of employment and lower levels of unemployment, the bargaining power of unions increases and the ability of large corporations to pass on the higher wages



likewise improves, so that we get a tendency to what is now called "cost-push" inflation as we move toward more satisfactory levels of operation for the economy. We could depict this by saying that instead of simply going along until we hit full employment and then having straight-out inflation, that at some stage—maybe at 90 percent of full employment—we begin to get price rises and that those will become more marked as employment increases still further.

One final element has to be added to this—an element that is related to the bargaining power of unions but goes beyond it. It is a kind of automatic wage-price spiral which becomes particularly difficult to cope with when it is the result, as the one we now have, of an attempt to catch up after an external shock has hit the system, leaving labor short of its goals in terms of real earnings. And that element has now come prominently into the system.

A simple little chart, shown here above, demonstrates the inflation-*un*employment trade-off. The broken line is the current year's inflation rate. The solid line is the preceding year's unemployment rate, which assumes there is some lag in the effect of changes in the unemployment situation on inflation. You can see two things. One, that in the 1950's and up to the middle 1960's the inverse relation between unemployment and inflation was rather neat.

When unemployment was high—in the 5½ to 6½ percent range—the inflation rate was low. (That's 1 percent down there. In the memory of living people we actually had a time when we were only having a 1-percent-a-year inflation rate.) Then, in the late 1960's, things began to change.

Let me say a bit more first, however, about the period of the early and middle 1960's. That now seems in some ways to have been a golden age, except that of course it didn't strike people then as a golden age, and I really would be reluctant to say that we should be willing to settle permanently for conditions as they were then. Unemployment was what was then considered to be undesirably high —over 5 percent most of the time. The target unemployment rate in that time was 4 percent. We weren't willing to accept 5½ or 6 percent as the norm for the economy, and some of you will remember there was great emphasis on the part of the Kennedy administration in getting the economy going and bringing the unemployment rate down to what would be a more acceptable figure.

In addition to the relatively high unemployment rate, there were two other things in this period that helped to give us the low inflation rate. One was that farm prices tended to sag. Remember when we used to complain about farm surpluses? Do you think we could get along without complaining if we had some nice big farm surpluses hanging over the market to keep prices from rising, and there was never anybody starving anywhere, and we were sure we could send X millions tons to keep them alive? But such is our perversity that we used to curse our fate and say how dreadful it was to have this big surplus. Actually it was a very useful thing and I hope, although I don't expect, that we will again see something like that develop.

The other thing we had was the wage-price guideposts which operated on a so-called voluntary basis—a good deal of pressure from the White House and from the government generally on corporations and on unions to keep their demands within the limits of moderation. This was greatly facilitated, of course, by the relatively high unemployment rate. Then came the Vietnam War and the rapid acceleration of expansion. The unemployment rate dropped below 4 percent, in and of itself not a bad thing, but it may be that it dropped a little too fast. The unions decided the chance was too good to break the guideposts and they did it, and the guideposts became ineffective along about 1966-67.

So, as we moved into the latter part of the 1960's we found that inflation was beginning to pick up strength, both on the price front, and even more on the wage front. Wages were rising at an increasingly rapid rate and in fact so much so that it was not possible to offset the increase in wages with rising productivity, which—to make things even worse —slowed down at this particular point. So we find at the end of the 1960's that the trade-off is much worse.

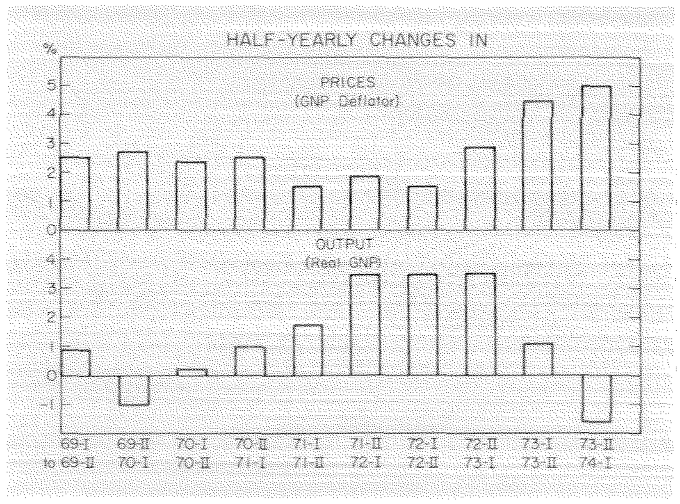
We had an unemployment rate going into 1970-71-72 which would have been associated with a relatively low inflation rate back a few years earlier. It was at this time that the Nixon administration decided to try a restrictive monetary and fiscal policy in order to counteract the inflation. The war spending had leveled off, and it became possible to experiment with the traditional methods of policy. They tightened up on monetary policy, and fiscal policy became also mildly restrictive. The consequence wasn't what you'd expect—it did slow the economy down, but it didn't do much to stop inflation. By the middle of 1971, the discontent in the country in general with the level of unemployment and with the slowdown in production and the economy had become such that the administration decided to shift its policy.

The trouble with a restrictive policy as a method of counteracting inflation was very well described by Art Buchwald in a column in February 1970 entitled, "It's *Hard to Be a Hero in the War Against Inflation.*" He has a government official talking to a freshly unemployed worker. He starts off by saying:

"I beg your pardon, is that a pink slip in your hand?"
"Yeh."
"Well, congratulations. You can consider yourself a front-line soldier in the President's fight against inflation."
"I can?"
"Yes sir . . . Incidentally, you will be happy to know that your being laid off came as no surprise to us."
"It didn't?"
"No sir! Your government predicted that, given high interest rates and a tight money situation, you would be out of work by February. Here it is, right on the graph."
"I'll be darned. You guys really know your stuff. But what do I tell my family?"
"You can tell them that although they will have to put up with a certain amount of inconvenience, the upward spiral in unemployment—to which I might say you've made such a valuable contribution—will have a very definite effect on the stabilization of prices."
"They'll be happy to hear that."
"If it weren't for people like you, I'm afraid the economy would have kept overheating and your dollars would have lost their purchasing power . . . "
"But why me?"
"Everyone says 'why me?' It has to be somebody. If we are to take strong anti-inflation measures, we have to have a citizenry ready to make financial sacrifices. All we're asking of you is to stay unemployed until the economy cools off."
"How long will that be?"
"Well, we're projecting 18 months, but I'd count on two years to be on the safe side."
"What am I supposed to do in the meantime?"
"This is a Certificate of Unemployment which you can hang on the wall. It attests to the fact that your government appreciates all you are doing to keep the economy from spiraling sky-high."
"Gosh, it's beautiful!"

Well, I haven't yet seen a better description of the essential weakness of the tight-money-policy cure for inflation.

The Nixon administration shifted completely in the summer of 1971, and instead of restrictive monetary and fiscal policy, adopted a strongly stimulative policy, along with controls. What was the result? Well, unfortunately there are many difficulties about making controls work—particularly in a democracy. And we certainly experienced those difficulties in plentiful measure—so much so that many people will now tell you that controls were a complete failure. That's not quite true, however. Controls had plenty of problems connected with them, but there were also some strong pluses. The main thing was that the controls enabled us to reverse the tendency toward increased unemployment and increased slack in the economy and to move in the direction of higher employment, a better rate of operation, and at the same time to moderate the degree of inflation.



The chart above, which brings out this relation very nicely, shows half-yearly changes from 1969 to 1974. The top of the chart shows the percentage change in prices in each half-year period, and the bottom shows the change in output again from each half-year period to the next one. As you can see, the change in output from early 1969 until the beginning of 1970 was either negligible or actually negative. There was no strong increase until the second half of 1971 and then in 1972 and 1973 we see output moving ahead at a greatly increased rate. Now if we had not had controls, I think it is highly likely that the effect would have been to accentuate the inflation problem. Actually, though, the controls—while not completely effective—were sufficiently effective so that rather than accentuating the inflation problem, the problem was modified. You can see that it was precisely in the controls period there that the rise of prices subsided significantly. Inflation didn't disappear, but it did moderate.

I would like to give you one other fact on what was happening to wages. Wage increases had been picking up speed. A good index of not only what was happening but what was likely to happen in the near future is the size of the first-year wage increases in collective bargaining agreements covering a thousand or more workers. Here is the way those figures changed from 1968 to 1974.

AVERAGE FIRST-YEAR WAGE INCREASE

1968	1969	1970	1971	1972	1973	1974-3rd Q.
7.4%	9.2%	11.9%	11.6%	7.3%	5.8%	11.0%

You can see that they reinforce the picture of a swing from an increasing to a moderating inflation rate. The increase goes from 7 percent in 1968 to 11.9 percent in 1970. Then with controls in 1972 it drops to 7.3 percent and in 1973 to 5.8 percent. I submit that this is really a significant achievement for the wage control mechanism in that period to have moderated the increase in new union contracts from an average of 12 percent in 1970 to just below 6 percent—half as large—in 1973. Incidentally, I'm sorry to say, we're now back up to 11 percent.

So I think that controls were not a failure. But then you say, why didn't we keep them? And there I think the story is very sad. It's partly that the controllers weren't enthusiastic about them, and of course in a democracy, as I said, we have a great deal of difficulty with them. Controls in a sense really have to be voluntary, since nobody is strong enough to just issue orders. You have to have at least a large measure of consent on the part of the people who are being controlled, and they are—in our type of society—all very avid to see that somebody else doesn't get better treatment than they do. So there are these real problems—the lack of enthusiasm of the controllers, and the avid interest that each of the groups being controlled showed in making sure they didn't get short-changed compared to the other groups.

Those probably would have been enough to bring the controls to grief, but then they received a body-blow from the outside with the fuel and food crises in the summer of 1973. Food prices, which had been such a stabilizing influence on our economy through the 1950's and 1960's suddenly became an explosive element. To expect unions to simply accept this increase in the cost of living from the outside, without trying to make up for it with higher wages, is perhaps expecting more than we should in our type of society at this stage of its development—although I would like to submit that this may be a problem for the future that we somehow will have to learn to cope with.

I don't think we can assume any longer that it will always be true that our gross national product will increase from year to year, and that it will be possible for everybody to always have more than they had before.

But whatever the reasons, controls have been discredited, and in the middle of 1974 the administration again turned to a restrictive monetary and fiscal policy as a method of combating inflation. This worked awfully well again in terms of moderating inflation. It worked so well in terms of depressing the economy that I think it has even scared the people who were sponsoring it and they have reluctantly shifted to a policy of at least half-way stimulation.

In reading recent editorials I have noticed three different positions on what should be done. *Fortune* in its December issue came out flatly in favor of continuing to fight inflation by allowing the economy to remain depressed. "Only a few months into a declared war on inflation the U.S., or at least many of its visible spokesmen, seems to have lost sight of the goal and to have become transfixed instead by the recession that is now upon us. This recession was not unexpected. It was deemed by many students of the economy to be a necessary evil—a burden that must somehow be shouldered—probably for an extended period if we are to bring inflation under control." That is obviously the Spartan view of the thing. It's always a little easier to take that position if it's somebody else who is out of a job.

The *London Economist* reaches a completely different conclusion as to the proper policy on the basis of a basically similar analysis of the economic situation. "There are only two ways to deal with inflation. Effective wage and price controls, or the pursuit of financial rectitude to a point that will cause unemployment to soar." The *Economist's* view is that we should have controls, the sooner the better.

The third position is based on the assumption that we can have it both ways—both stimulate the economy to overcome recession and at the same time experience a declining inflation rate. In its February 10 issue *Business Week* criticizes the President's program as "unrealistic because it ignores the need for more government spending in a recession. The demand for new programs or expanded programs to ease the impact of unemployment and increase the purchasing power of bottom-bracket incomes simply cannot be denied." But although recession is the most urgent immediate issue, "uncontrollable inflation remains the chronic threat to the U.S. system." We must therefore have a program "that offers the greatest possible stimulation with the least inflationary side effects." How, without using controls, we are going to be able to stimulate the economy without at the same time reviving the threat of inflation *Business Week* unfortunately fails to explain. This is the more surprising in view of the fact that in its news columns *Business Week* has emphasized the stubborn character of our present wage-push inflation and the slow, grinding way in which recession, if it continues long enough, may be expected to sap the vigor of the inflationary process.

> "The economy is slipping deeper into recession . . . Though there will be a lag, wage demands should begin to moderate as 1975 wears on. That will be the key to winding down inflation. Workers want to catch up on past price increases, but now they are worried about their jobs. The quit rate has come down sharply since last summer. Workers will soon become even more worried as the unemployment rate climbs . . . That is bound to take some of the edge off demands, even though the unions are still shooting for double digit wage gains." (Dec. 21, 1974, p. 19)

That's a clear-cut statement of what the connection is. It runs through weak markets, unemployment, people clamoring for jobs, all of this eroding, undermining the strength of wage demands. Maybe it would work in a year, two years, if we were willing to put up with that kind of an economy. It's everyone's choice, I suppose, as to what you consider really important. Personally, I would much prefer the problems connected with the renewal of controls (which could be limited to the key collective bargaining and the key corporation price sectors)—to the dragging unemployment, low production, and the discouragement of people's hopes and ambitions that would be involved in a continued policy of attrition. □