

The Real Issues of Inflation and Unemployment

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ARTHUR F. BURNS

The Real Issues of Inflation and Unemployment

Conventional thinking about stabilization policies is inadequate and out of date. We must now seek ways of bringing unemployment down without becoming engulfed by a new wave of inflation.

Our country is now engaged in a fateful debate. There are many who declare that unemployment is a far more serious problem than inflation, and that monetary and fiscal policies must become more stimulative during the coming year even if inflation quickens in the process. I embrace the goal of full employment, and I shall suggest ways to achieve it. But I totally reject the argument of those who keep urging faster creation of money and still larger governmental deficits. Such policies would only bring us additional trouble; they cannot take us to the desired goal.

The American economy has recently begun to emerge from the deepest decline of business activity in the postwar period. During the course of the recession, which began in late 1973, the physical volume of our total output of goods and services declined

by 8 percent. The production of factories, mines, and power plants fell even more—by 14 percent. As the overall level of economic activity receded, the demand for labor rapidly diminished and unemployment doubled, reaching an intolerable 9 percent of the labor force last May.

The basic cause of the recession was our nation's failure to deal effectively with the inflation that got under way in the mid-sixties and soon became a dominant feature of our economic life. As wage and price increases quickened, seeds of trouble were sown across the economy. With abundant credit readily available, the construction of new homes, condominiums, and office buildings proceeded on a scale that exceeded the underlying demand. Rapidly rising prices eroded the purchasing power of workers' incomes and savings. Managerial practices of business

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enterprises became lax and productivity languished, while corporate profits—properly reckoned—kept falling. Inventories of raw materials and other supplies piled up as businessmen reacted to fears of shortages and still higher prices. Credit demands, both public and private, soared and interest rates rose to unprecedented heights. The banking system became overextended, the quality of loans tended to deteriorate, and the capital position of many banks was weakened.

Emerging from the recession

During the past year many of these basic maladjustments have been worked out of the economic system by a painful process that could have been avoided if inflation had not gotten out of control. As the demand for goods and services slackened last winter, business managers began to focus more attention on efficiency and cost controls. Prices of industrial materials fell substantially, price increases at later stages of processing became less extensive, and in many instances business firms offered price concessions to clear their shelves. With the rate of inflation moderating, the confidence of the general public was bolstered, and consumer spending strengthened. Business firms were thus able to liquidate a good part of their excess inventories in a rather brief period. Meanwhile, as the demand for credit diminished, tensions in financial markets were relieved, and the liquidity position of both banks and business firms generally improved.

These self-corrective forces internal to the business cycle were aided by fiscal and monetary policies that sought to cushion the effects of economic adversity and to provide some stimulus to economic recovery. On the fiscal side, public employment programs were expanded, unemployment insurance was liberalized, and both personal and corporate income taxes were reduced. On the monetary side, easier credit conditions were fostered, resulting in lower interest rates and a rebuilding of liquidity across the economy.

With the base for economic recovery thus established, business activity has recently begun to improve. Production of goods and services turned up during the second quarter and is continuing to advance. The demand for labor has also improved. Both the number of individuals at work and the length of the work week are rising again, and unemployment has declined three months in a row. Retail

sales have risen further, and of late residential construction has joined the recovery process.

Along with these favorable developments, however, some ominous signs have emerged. Despite an occasional pause, inflation once again may be accelerating. By the second quarter of 1975, the annual rate of increase in the general price level was down to 5.5 percent—about half the rate of inflation registered in the same period a year earlier. But over the summer, prices began to rise more briskly.

This behavior of prices is particularly worrisome in view of the large degree of slack that now exists in most of our nation's industries. Price increases in various depressed industries—aluminum, steel, autos, and industrial chemicals, among others—are a clear warning that our long-range problem of inflation is unsolved and therefore remains a threat to sustained economic recovery.

History suggests that at this early stage of a business upturn, confidence in the economic future should be strengthening steadily. A significant revival of confidence is indeed under way, but it is being hampered by widespread concern that a fresh outburst of double-digit inflation may before long bring on another recession. By now, thoughtful Americans are well aware of the profoundly disruptive consequences of inflation for our economy. They also recognize that these consequences are not solely of an economic character. Inflation has capricious effects on the income and wealth of a nation's families, and this inevitably causes disillusionment and discontent. Social and political frictions tend to multiply, and the very foundations of a society may be endangered. This has become evident in other nations around the world, where governments have toppled as a result of the social havoc wrought by inflation.

If we in the United States wish to enjoy the fruits of a prosperous economy and to preserve our democratic institutions, we must come to grips squarely with the inflation that has been troubling our nation throughout much of the postwar period, and most grievously during the past decade.

The bias toward inflation

A first step in this process is to recognize the true character of the problem. Our long-run problem of inflation has its roots in the structure of our economic institutions and in the financial policies of our government. All too frequently, this basic fact is

clouded by external events that influence the rate of inflation—such as a crop shortfall that results in higher farm prices, or the action of a foreign cartel that raises oil prices. The truth is that, for many years now, the economies of the United States and many other countries have developed a serious underlying bias toward inflation. This tendency has simply been magnified by the special influences that occasionally arise.

A major cause of this inflationary bias is the relative success that modern industrial nations have had in moderating the swings of the business cycle. Before World War II, cyclical declines of business activity in our country were typically longer and more severe than they have been during the past thirty years. In the environment then prevailing, the price level typically declined in the course of a business recession, and many months or years elapsed before prices returned to their previous peak.

In recent decades, a new pattern of wage and price behavior has emerged. Prices of many individual commodities still demonstrate a tendency to decline when demand weakens. The average level of prices, however, hardly ever declines. Wage rates have become even more inflexible. Wage reductions are rare nowadays even in severely depressed industries, and the average level of wage rates continues to rise inexorably in the face of widespread unemployment.

These developments have profoundly altered the economic environment. When prices are pulled up by expanding demand in time of prosperity and are also pushed up by rising costs during a slack period, the decisions of the economic community are sure to be influenced, and may in fact be dominated, by expectations of continuing inflation.

Thus, many businessmen have come to believe that the trend of production costs will be inevitably upward, and their resistance to higher prices—whether of labor, materials, or equipment—has therefore diminished. Labor leaders and workers now tend to reason that in order to achieve a gain in real income, they must bargain for wage increases that allow for advances in the price level as well as for such improvements as may occur in productivity. Lenders, in their turn, expect to be paid back in cheaper dollars, and therefore tend to hold out for higher interest rates. They are able to do so because the resistance of borrowers to high interest rates is weakened by their anticipation of rising prices.

Moving toward the welfare state

These patterns of thought are closely linked to the emphasis that governments everywhere have placed on rapid economic growth throughout the postwar period. Western democracies, including our own, have tended to move promptly to check economic recession, but they have moved hesitantly in checking inflation. Western governments have also become more diligent in seeking ways to relieve the burdens of adversity facing their peoples. In the process they have all moved a considerable distance toward the welfare state.

In the United States, for example, the unemployment insurance system has been greatly liberalized. Benefits now run to as many as sixty-five weeks, and in some cases provide individuals with after-tax incomes almost as large as their earnings from prior employment. Social Security benefits too have been expanded materially, thus facilitating retirement or easing the burden of job loss for older workers. Welfare programs have been established for a large part of the population, and now include food stamps, school lunches, Medicare and Medicaid, public housing, and many other forms of assistance.

Protection from economic hardship has been extended by our government to business firms as well. The rigors of competitive enterprise are nowadays eased by import quotas, tariffs, price maintenance laws, and other forms of governmental regulation. Farmers, homebuilders, small businesses, and other groups are provided special credit facilities and other assistance. And even large firms of national reputation look to the federal government for sustenance when they get into trouble.

Many, perhaps most, of these governmental programs have highly commendable objectives, but they have been pursued without adequate regard for their cost or method of financing. Governmental budgets—at the federal, state, and local level—have mounted and at times, as in the case of New York City, have literally gotten out of control. In the past ten years, federal expenditures have increased by 175 percent and the fiscal deficit of the federal government, including government-sponsored enterprises, has totaled over \$200 billion. In the current fiscal year alone, we are likely to add another \$80 billion or more to that total. In financing these deficits, pressure has been placed on our credit mecha-

nisms, and the supply of money has frequently grown at a rate inconsistent with general price stability.

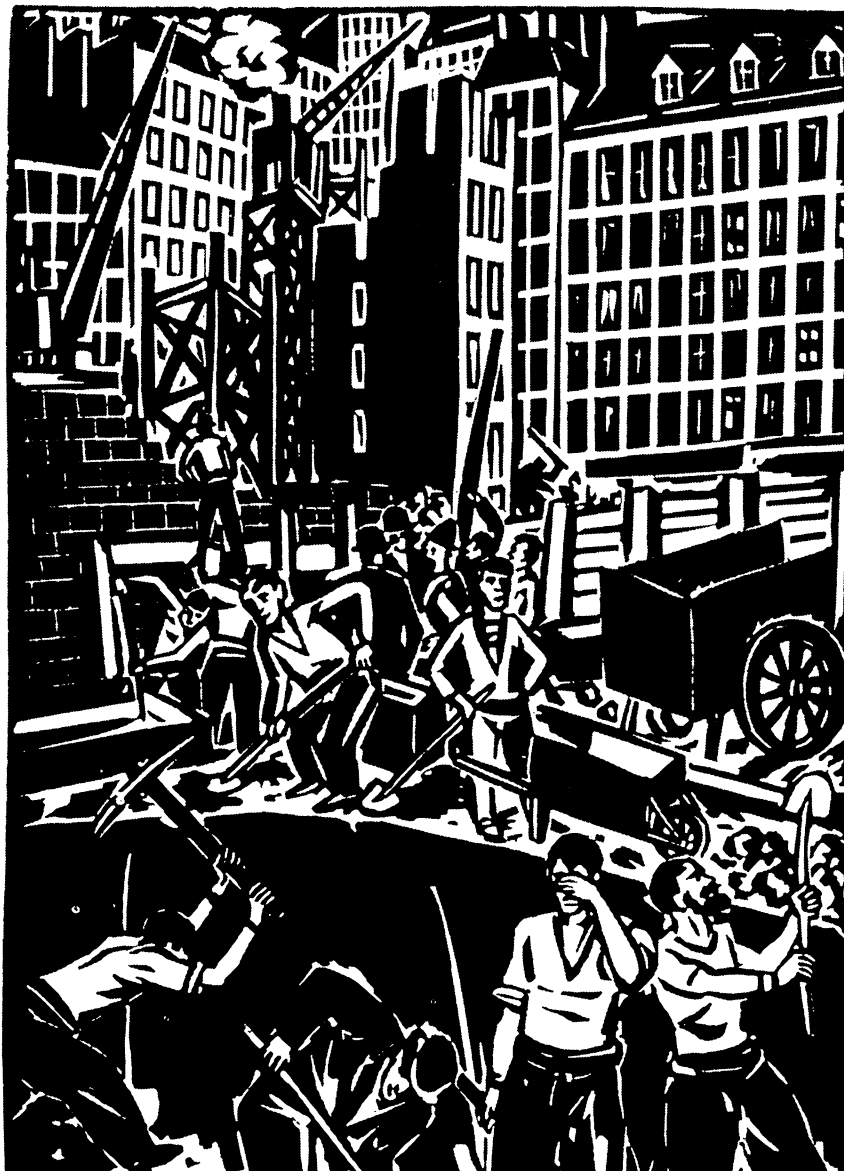
Other spurs to inflation

Changes in market behavior have contributed to the inflationary bias of our economy. In many businesses, price competition has given way to other forms of rivalry—advertising, changes in product design, and hard-sell salesmanship. In labor markets, when an excessive wage increase occurs, it is apt to spread faster and more widely than before, partly because workmen have become more sensitive to wage developments elsewhere, partly also because many employers have found that a stable work force can be best maintained by emulating wage settlements in unionized industries. For their part, trade unions at times seem to attach higher priority to wage increases than to the jobs of their members. Moreover, the

spread of trade unions to the rapidly expanding public sector has during recent years fostered numerous strikes, some of them clearly illegal, and they have often resulted in acceptance of union demands—however extreme. Needless to say, the apparent helplessness of governments to deal with this problem has encouraged other trade unions to exercise their latent market power more boldly.

The growth of our foreign trade and of capital movements to and from the United States has also increased the susceptibility of the American economy to inflationary trends. National economies around the world are now more closely interrelated, so that inflationary developments in one country are quickly communicated to others and become mutually reinforcing. Moreover, the adoption of a flexible exchange rate system—though beneficial in dealing with large-scale adjustments of international payments, such as those arising from the sharp rise in oil

From *The City*



Frans Masereel

prices—may have made the Western world more prone to inflation by weakening the discipline of the balance of payments. Furthermore, since prices nowadays are more flexible upward than downward, any sizable decline in the foreign exchange value of the dollar is apt to have larger and more lasting effects on our price level than any offsetting appreciation of the dollar.

The long-run upward trend of prices in this country thus stems fundamentally from the financial policies of our government and the changing character of our economic institutions. This trend has been accentuated by new cultural values and standards, as is evidenced by pressures for wage increases every year, more holidays, longer vacations, and more liberal coffee breaks. The upward trend of prices has also been accentuated by the failure of business firms to invest sufficiently in the modernization and improvement of industrial plant. In recent years, the United States has been devoting a smaller part of its economic resources to business capital expenditures than any other major industrial nation in the world. All things considered, we should not be surprised that the rate of improvement in output per man-hour has weakened over the past fifteen years, or that rapidly rising money wages have overwhelmed productivity gains and boosted unit labor costs of production.

Whatever may have been true in the past, there is no longer a meaningful trade-off between unemployment and inflation. In the current environment, a rapidly rising level of consumer prices will not lead to the creation of new jobs. On the contrary, it will lead to hesitation and sluggish buying, as is indicated by the increase of the personal savings rate in practically every industrial nation during these recent years of rapid inflation. In general, stimulative financial policies have considerable merit when unemployment is extensive and inflation weak or absent; but such policies do not work well once inflation has come to dominate the thinking of a nation's consumers and businessmen. To be sure, highly expansionary monetary and fiscal policies might, for a short time, provide some additional thrust to economic activity. But inflation would inevitably accelerate—a development that would create even more difficult economic problems than we have encountered over the past year.

Conventional thinking about stabilization policies is inadequate and out of date. We must now seek

ways of bringing unemployment down without becoming engulfed by a new wave of inflation. The areas that need to be explored are many and difficult, and we may not find quickly the answers we seek. But if we are to have any chance of ridding our economy of its inflationary bias, we must at least be willing to reopen our economic minds. I shall briefly sketch several broad lines of attack on the dual problem of unemployment and inflation that seem promising to me.

How to achieve more employment, less inflation

First, governmental efforts are long overdue to encourage improvements in productivity through larger investment in modern plant and equipment. This objective would be promoted by overhauling the structure of federal taxation, so as to increase incentives for business capital spending and for equity investments in American enterprises.

Second, we must face up to the fact that environmental and safety regulations have in recent years played a troublesome role in escalating costs and prices and in holding up industrial construction across our land. I am concerned, as are all thoughtful citizens, with the need to protect the environment and to improve the quality of life in other ways. I am also concerned, however, about the dampening effect of excessive governmental regulations on business activity. Progress toward full employment and price stability would be measurably improved, I believe, by stretching out the timetables for achieving our environmental and safety goals.

Third, a vigorous search should be made for ways to enhance price competition among our nation's business enterprises. We need to gather the courage to reassess laws directed against restraint of trade by business firms and to improve the enforcement of these laws. We also need to reassess the highly complex governmental regulations affecting transportation, the effects on consumer prices of remaining fair trade laws, the monopoly of first-class mail by the Postal Service, and the many other laws and practices that impede the competitive process.

Fourth, in any serious search for noninflationary measures to reduce unemployment, governmental policies that affect labor markets have to be reviewed. For example, the federal minimum wage law is still pricing many teenagers out of the job market. The

Davis-Bacon Act continues to escalate construction costs and damage the depressed construction industry. Programs for unemployment compensation now provide benefits on such a generous scale that they may be blunting incentives to work. Even in today's environment, with about 8 percent of the labor force unemployed, there are numerous job vacancies—perhaps because job seekers are unaware of the opportunities, or because the skills of the unemployed are not suitable, or for other reasons. Surely, better results could be achieved with more effective job banks, more realistic training programs, and other labor market policies.

Public employment

I believe that the ultimate objective of labor market policies should be to eliminate all involuntary unemployment. This is not a radical or impractical goal. It rests on the simple but often neglected fact that work is far better than the dole, both for the jobless individual and for the nation. A wise government will always strive to create an environment that is conducive to high employment in the private sector. Nevertheless, there may be no way to reach the goal of full employment short of making the government an employer of last resort. This could be done by offering public employment—for example, in hospitals, schools, public parks, or the like—to anyone who is willing to work at a rate of pay somewhat below the federal minimum wage.

With proper administration, these public service workers would be engaged in productive labor, not leaf raking or other make-work. To be sure, such a program would not reach those who are voluntarily unemployed, but there is also no compelling reason why it should do so. What it would do is to make jobs available for those who need to earn some money.

It is highly important, of course, that such a program should not become a vehicle for expanding public jobs at the expense of private industry. Those employed at the special public jobs will need to be encouraged to seek more remunerative and more attractive work. This could be accomplished by building into the program certain safeguards—perhaps through a constitutional amendment—that would limit upward adjustment in the rate of pay for these special public jobs. With such safeguards, the budgetary cost of eliminating unemployment need not be

burdensome. I say this, first, because the number of individuals accepting the public service jobs would be much smaller than the number now counted as unemployed; second, because the availability of public jobs would permit sharp reduction in the scope of unemployment insurance and other governmental programs to alleviate income loss. To permit active searching for a regular job, however, unemployment insurance for a brief period—perhaps thirteen weeks or so—would still serve a useful function.

Incomes policy

Finally, we also need to rethink the appropriate role of an incomes policy in the present environment. Lasting benefits cannot be expected from a mandatory wage and price control program, as recent experience indicates. It might actually be helpful if the Congress renounced any intention to return to mandatory controls, so that businesses and trade unions could look forward with confidence to the continuance of free markets. I still believe, however, that a modest form of incomes policy, in some cases relying on quiet governmental intervention, in others on public hearings and the mobilization of public opinion, may yet be of significant benefit in reducing abuses of private economic power and moving our nation toward the goal of full employment and a stable price level.

Structural reforms of our economy, along some lines such as I have sketched, deserve more attention this critical year from members of the Congress and from academic students of public policy than they are receiving. Economists, in particular, have tended to concentrate excessively on overall fiscal and monetary policies of economic stimulation. These traditional tools remain useful and even essential; but once inflationary expectations have become widespread, they must be used with great care and moderation.

This, then, is the basic message: our nation cannot now achieve the goal of full employment by pursuing fiscal and monetary policies that rekindle inflationary expectations. Inflation has weakened our economy; it is also endangering our economic and political system based on freedom. America has become enmeshed in an inflationary web, and we need to gather our moral strength and intellectual courage to extricate ourselves from it. I hope that all of you will join in this struggle for America's future.