Inflation, Recession – What's a Policymaker To Do?

A Presentation by DARRYL R. FRANCIS, President, Federal Reserve Bank of St. Louis,
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IT IS good to have this opportunity to discuss with you some of the problems confronting policymakers during these troubled economic times. Early last year the pace of real growth in the U.S. economy started to slow, and in the first three quarters of 1974 the nation's output of goods and services declined. At about the same time that output started to slow, the pace of inflation accelerated.

From the standpoint of a policymaker trying to formulate a strategy for stabilization policy, these two developments appear to be in direct conflict with one another. The slowdown in real growth, carrying with it a threat of rising unemployment, suggests that monetary and fiscal policies should be stimulative. The quickening and persistence of inflation, on the other hand, seems to call for monetary and fiscal restraint. This conjunction of developments, which is called "stagflation" by some, thus poses a dilemma for policymakers.

The basis for the dilemma is the common belief that inflation and unemployment can, in some sense, be viewed as symmetrical problems. By symmetrical, I mean opposite sides of the policy coin — when economic policy is too stimulative, you get inflation; when policy is too restrictive, you get increased unemployment. In many policy discussions this dilemma is couched in terms of the so-called Phillips curve.

During the course of my remarks I will point out what I consider to be some major deficiencies underlying the notion of the Phillips curve, that is, an apparent trade-off between inflation and unemployment. Recent economic experience along with recent research results suggest that we need to modify our thinking about this relation. These recent developments in economic thinking carry important implications for stabilization strategy.

Before turning to these problems of policy formulation, I would like to review briefly our recent economic experience. As we are all painfully aware, the U.S. economy is currently undergoing some uncomfortable adjustments. To provide some perspective on recent developments I would like you to examine with me the first chart among the set that has been distributed to you.

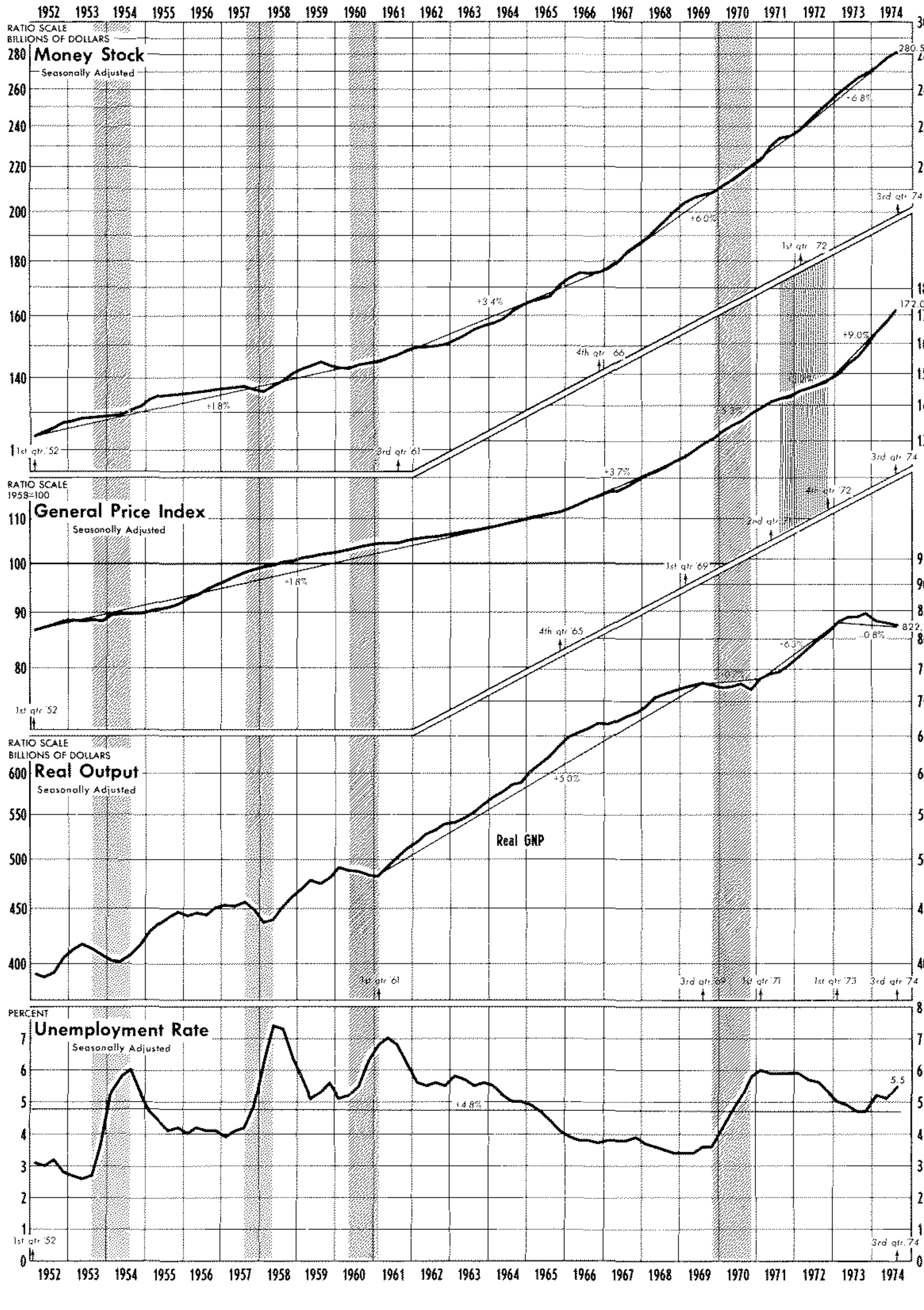
By way of introductory comment, I want to emphasize the importance of keeping our perspective as we attempt to analyze and understand our recent economic experiences. I find charts of this type very useful in this respect — providing a visual summary of the U.S. economy over the last two decades. I will return to this point later, but I feel that our current state of economic disarray is related in large measure to a lack of perspective in the formulation of economic policy, both now and in the past.

Let me begin by reviewing recent trends in the growth of the money stock, which are shown in the top tier of Chart I. Since early 1972, the nation's money stock has increased at a 6.8 percent annual rate. This rate of expansion represents a step-up from the 6 percent average rate of increase from late 1966 to early 1972. These average rates of money expansion for the last eight years compare with a 3.4 percent average rate of increase during the early 1960s and a 1.8 percent average rate of expansion during most of the decade of the 1950s.

Look now at the second tier in Chart I, which shows the general movement of prices over the last two decades. I feel that the top two tiers of this chart provide support for the proposition that inflation is a monetary phenomenon. The general movement of prices is closely related to the trend rate of monetary expansion.

Chart I

Influence of Money on Prices, Output, and Unemployment



Latest data plotted: 3rd quarter

To understand better the recent acceleration of prices, a shaded area has been included representing the period when the price-wage control program was in effect. In retrospect, it appears that controls had the effect of keeping reported prices down in late 1971 and throughout 1972; but it should be clear that such measures have only temporary effects, especially when the rate of monetary expansion is left unchecked. Consequently, I think the very rapid 9.0 percent rate of price advance since late 1972 is in large part a catch-up phenomenon following the period of controls.

Some analysts attribute the recent outburst of inflation to the operation of special factors — the oil embargo, the Russian wheat deal, two devaluations of the dollar, and so on. These events are labeled as special factors because they appear to be beyond the control of our monetary and fiscal authorities. I find it impossible to swallow this "special factor" explanation of inflation. If we maintain our perspective, we note that, in part, these special factors occurred in response to conditions created by previous mistakes in economic policy.

Our current energy problems are not completely unrelated to the increased demand for energy associated with the rapid pace of economic expansion in 1972 and 1973, an expansion fueled by very stimulative monetary and fiscal actions. The supply of domestic energy, on the other hand, was discouraged by implementing an economic policy of wage and price controls. Furthermore, the worldwide inflation should not be considered a special factor since it is related to the rapid monetary expansion in the United States. With a system of fixed exchange rates where the dollar serves as a reserve currency, the rapid monetary expansion in the United States resulted in a rapid accumulation of worldwide reserves, which, in turn, led to monetary expansion and inflation in other countries.

I am not willing to accept the special factor explanation of inflation because that explanation removes the focus from inflation as a monetary phenomenon. By losing such a focus I think we are abdicating our responsibilities as policymakers. Pretending that the bulk of our inflation is caused by factors other than excessive monetary expansion runs a great risk that the rate of monetary expansion will be stepped up further in an attempt to avoid possible reductions in real output growth currently.

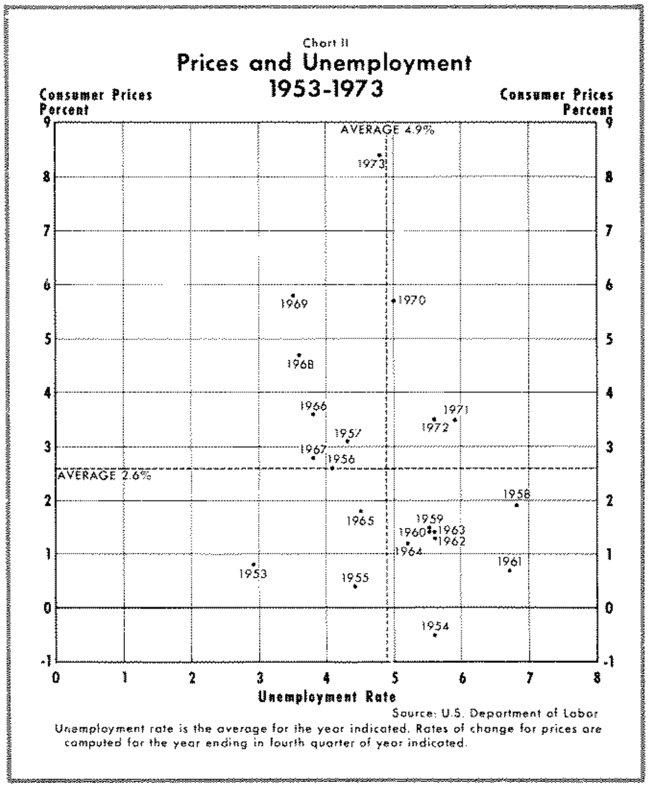
An examination of recent trends in output and unemployment (third and fourth tiers of Chart I) suggests that current economic activity is very sluggish. Real output remains below the level of early 1973, and since late last year unemployment has been rising. However, if we maintain our perspective, we note that output is still up at a 3.1 percent average annual rate from the end of the 1969-70 recession, and total civilian employment has increased at a 2.5 percent average rate during the same period.

Let me now turn to the issue that I raised earlier — is it appropriate to treat inflation and unemployment as symmetrical problems in policy discussions? The result of such discussions is that stabilization policy should attempt to walk a tightrope between these two problems, providing just the right growth of total demand so that neither inflation nor unemployment occurs.

Recent experience is again reminding us, however, that inflation and unemployment can emerge simultaneously, as we have just seen in Chart I. Inflation persisting in the face of rising unemployment currently runs counter to predictions based on the Phillips curve. In other words, the Phillips curve does not provide an adequate explanation for events as they seem to be evolving now. At the present time there does not seem to be a "right" amount of total demand that will permit the achievement of *both* full employment and price stability.

To understand better the nature of the relationship between inflation and unemployment, let us now turn to the rest of the charts that have been distributed to you. Chart II is a scatter diagram of the inflation-unemployment experience of the United States from 1953 through 1973. Each dot represents a year in that period. The unemployment rate has ranged from a low of 2.9 percent of the labor force in 1953 to a high of 6.8 percent in 1958, and the average for the entire period was 4.9 percent. The inflation rate, as measured by the annual rate of change in the consumer price index, has varied between minus 0.5 and plus 8.4 percent for the 1953-73 period, averaging 2.6 percent per year. Indications are that 1974 will record about a 5.5 percent average rate of unemployment and almost a 12 percent advance in prices.

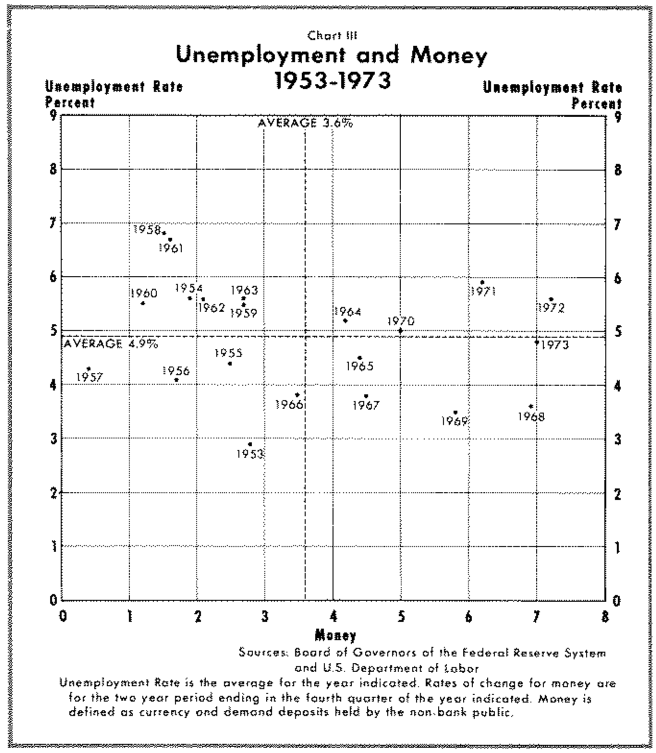
Examination of Chart II clearly demonstrates that there does not exist any systematic relationship between inflation and unemployment. What we do observe is a greater tendency for the unemployment rate to cluster about its mean than does the inflation rate. Association of dates with the dots also indicates that the inflation rate has moved progressively higher since the mid-1960s. For all years since 1966, the inflation rate has been above the average for the 1953-73 period, but the unemployment rate has not remained



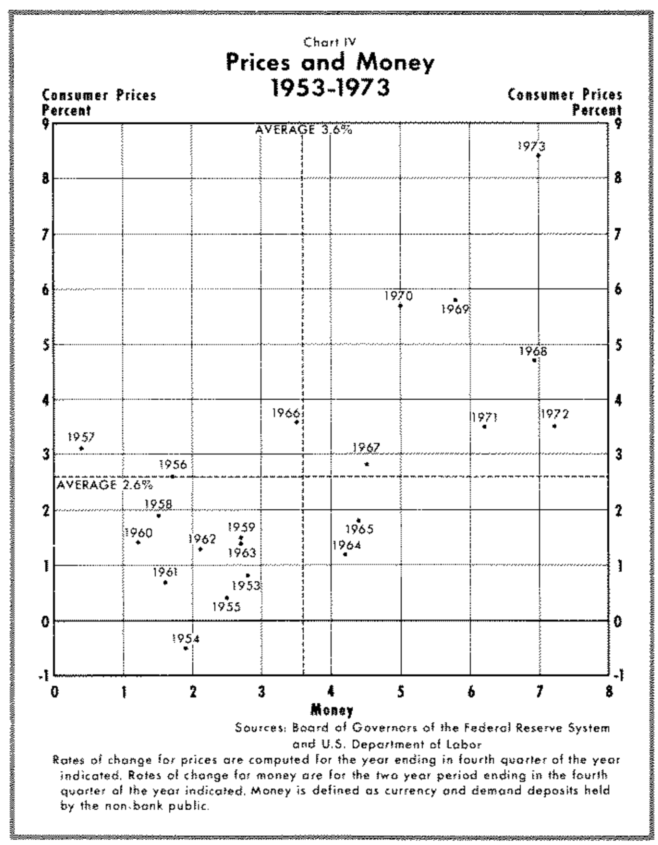
below the average, as followers of the Phillips curve would lead us to believe.

Charts III and IV allow us to examine the relationships between inflation and unemployment relative to the key determinant of growth in total demand — the rate of monetary expansion. Consider first the relationship between monetary growth and unemployment presented in Chart III. Examination of this chart fails to indicate any systematic relationship between the two variables. In other words, the level of unemployment does not appear to bear a directly observable relationship to the trend rate of monetary expansion as measured by a two-year average rate of change. What Chart III does imply is that over the last twenty years the *level* of the unemployment rate in the U.S. economy has taken on values quite independently of the trend rate of monetary growth. Based on this cursory examination of the data, I conclude that the trend rate of monetary expansion over a period as long as two years contributes little to the explanation of movements in the unemployment rate. I might add, however, that this conclusion does not deny any transitory effects of short-run monetary accelerations and decelerations on employment and unemployment.

Consider now the relationship between inflation and monetary growth presented in Chart IV. The relationship is closer than that between unemployment and money. Nineteen of the twenty-three ob-



servations fall in either the lower left or upper right quadrant. The relatively loose fit does indicate other factors have an influence on the movement of prices



in a given year. But when we talk about the "problem of inflation", I think it is safe to say that the fundamental cause is excessive money growth, and the cure is to slow down the rate of money expansion.

After examining these three charts I conclude that a sustainable low level of unemployment *cannot* be obtained for the "purchase price" of a higher rate of inflation. It should be pointed out, however, that for short periods a relationship between inflation and unemployment may exist, but the experience of the last four or five years has provided evidence casting serious doubt on the validity of the Phillips curve relation over the longer run.

Whether or not there is a systematic and lasting trade-off between unemployment and inflation is not just an academic question. The presence or absence of such a trade-off carries important implications for stabilization policy. If there is no trade-off, but policymakers act as if one exists, any attempt to use aggregate demand policies to achieve unemployment below the rate dictated by the forces of supply and demand will result in accelerating inflation.

On the basis of evidence presented in these charts, the implication is that monetary policy should be formulated with an eye toward controlling inflation, for this is the variable that is systematically related to the rate of monetary growth. The trend growth of money, in turn, is subject to control by the monetary authorities.

Monetary actions do have an effect on unemployment, but this effect is transitory in nature. From early 1952 to the fall of 1962, when monetary growth averaged 1.8 percent, unemployment averaged 4.9 percent of the labor force; from the fall of 1962 to the end of 1966, when money accelerated to a 3.8 percent rate of growth, unemployment also averaged 4.9 percent. Since 1966, with money rising in excess of 6 percent per year, unemployment has averaged 4.7 percent. On the other hand, accelerating money growth was accompanied by accelerating inflation. This experience leads me to conclude that the unemployment rate should not serve as a guide to monetary policy.

If aggregate demand policies are to be formulated with a primary focus on the price level, other policy tools are required to deal with the problems of unemployment. I think that the sooner we realize the limitations of conventional macroeconomic policy in reducing unemployment, the better off we will be. And this realization also implies that we must look to employment policies, rather than aggregate demand policies, as a means of dealing with the problems of unemployment.

By employment policies I mean Federal government actions geared toward improving the efficiency of operation of labor markets. The government can take steps to encourage improved job skills and can assist in the dissemination of information relating to job openings. Certain structural impediments to the efficient operation of our labor markets should be removed or modified, such as minimum wage laws and restrictions on occupational mobility. Furthermore, I feel that our whole system of unemployment compensation deserves closer study to see if the system actually diminishes the incentive to work while encouraging seasonal fluctuations in the demand for labor.

By way of summary, I have raised some questions about the symmetrical treatment of unemployment and inflation in the formulation of stabilization policy. When there appears to be a conflict of goals, the policymaker has to choose more of one to get less of the other. That, at least, is the advice that flows from the tradition of the Phillips curve. And, I might add, experience shows economic policy has been formulated in that way, with varying emphasis on unemployment and inflation, depending on prevailing circumstances.

If unemployment over the longer run is recognized as depending primarily on the real forces of supply and demand in labor markets, and inflation is recognized as depending primarily on the trend growth of money, then our policy strategy has to be modified accordingly. I feel the evidence supports the conclusion that monetary policy should be formulated with a longer-term focus. Such a focus implies that inflation, rather than unemployment, should serve as the primary guideline for aggregate demand policy. This is not to say that we as policymakers should ignore unemployment; rather, long-term benefits to society will be greater if we hold to a relatively stable path of monetary growth than if we react to every wiggle of the unemployment rate. The chief contribution that aggregate demand policies can make to our employment goals is the avoidance of sharp shifts in policy. The past mistakes of aggregate demand policy in this regard are all too familiar.