

Chapter 14: Unemployment vs. Inflation

John Petroff

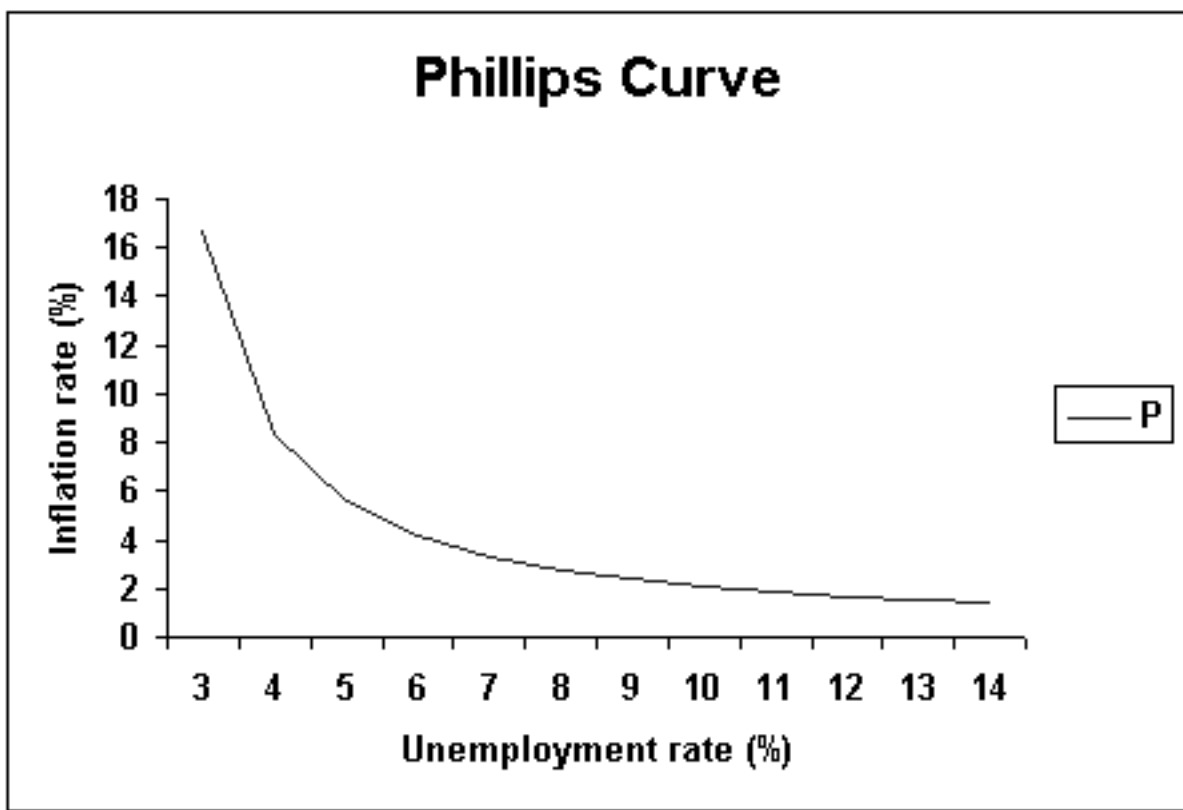
INTRODUCTION

The purpose of this topic is to look at recent changes in economic conditions and study alternative policies for the age old problems of unemployment and inflation.

PHILLIPS CURVE

The Phillips curve shows that historically a trade-off has existed between a high rate of inflation and a high rate of unemployment. The trade-off has been used for policy purpose in the 1960's to seek an acceptable combination.

Graph G-MAC14.1



Under the Johnson administration, economists believed that the economy could be "fine tuned". Between 1964 and 1968, the government used policies to reduce the unemployment rate from 5% to 3.8% at a cost of an additional inflation of only 3%.

PHILLIPS CURVE SHIFT

The observations for the 1970's did not conform to the trade-off shown in previous Phillips curve statistics. This suggests that the Phillips curve had shifted.

Graph G-MAC14.2

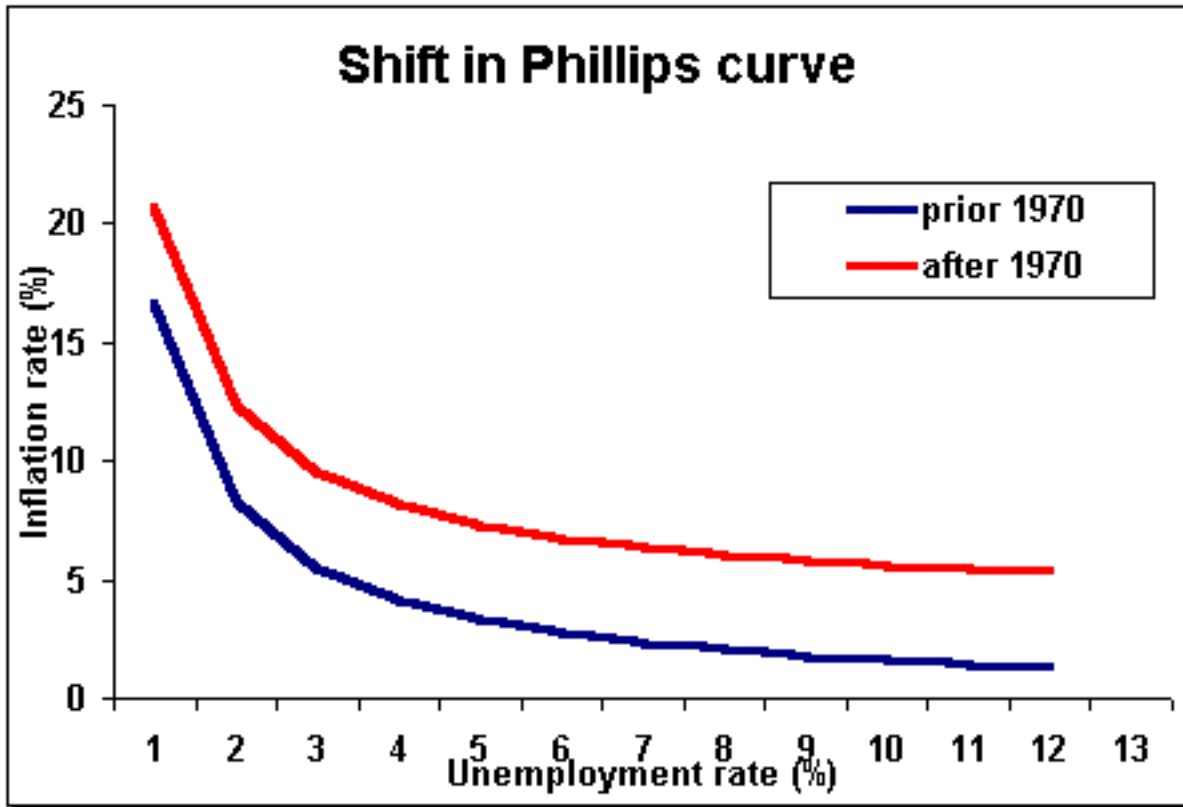
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STAGFLATION

The 1970's experienced a simultaneous excessive rate of unemployment and a high rate of inflation. This combination is referred to as stagflation. Various explanations were offered for this new phenomenon such as commodity price rises, oil crisis, inflation expectations, changes in labor force composition and reliance on recurring Keynesian aggregate demand policies.

The very high unemployment rate of 8.3% and inflation of 9% experienced in 1975 exemplifies an economy plagued by the two undesirable conditions at the same time.

INFLATION EXPECTATIONS

The period of stagflation was longer and the inflation was more entrenched than expected because of inflation expectations. Inflation was expected to continue and measures were taken to overcome its effects with cost of living adjustment clause in employment contracts and indexing of interest rates.

Before the 1970's, indexed interest rates or wages did not exist in the United States. Variable mortgage rates are common since then (and even in 2002 when inflation is practically non-existent), and are

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used in half of the mortgages. In variable mortgage rates, the interest rate is recalculated at different agreed upon times to be so many percentage points above some chosen average (such as that of Treasury Bill's yield for the year). Thus, inflation is built into the interest rate.

ACCELERATION HYPOTHESIS

One explanation of stagflation is that the use of expansionary fiscal policies may succeed in reducing unemployment only for a while. But the reemployed workers find out that the increase in inflation has eroded the purchasing power of their income and return to being unemployed. Successive use of expansionary policy results in further increasing inflation as increases in interest rates are passed on in costs and price increases.

During the 1970's, the economy seemed to be returning after each period of recession to an ever higher rate of natural unemployment (natural unemployment being due to new entrants to the labor force and people changing jobs). The higher rate of natural unemployment was explained by demographic changes, such as the increasing women participation in the labor force.

RATIONAL EXPECTATION

The rational expectation theory suggests that individuals and firms will not take corrective actions in periods of difficulty, but wait for the government to stimulate the economy with appropriate policies.

The successive American administrations of the 1970's did use expansionary fiscal policy on a recurring basis. People got used to expect such actions to be taken.

LABOR COST AND PRODUCTIVITY

Another explanation of stagflation is tied to the decline in productivity gain in the 1970's. Indeed, if wage rates increase (dW) at the same rate as productivity gains ($dProd$), then labor cost increase (dLC) will be null: $dLC = dW - dProd = 0$ But, a decline in productivity gains (which occurred in the 1970's) will produce higher labor costs and a cost push inflation.

Increase in productivity gains (which occurred in the 1990's) allowed increases in incomes without inflation.

Since 1900, the rate of productivity gain has been about 2.7% per year. It compensated wage increases and resulted in virtually no cost push inflation. In the 1970's, productivity gain rate fell by more than

half. As a result, businesses had to pass any wage increases to consumers in order to stay in business.

MARKET POLICIES

Traditional methods of dealing with inflation have been in part aimed at improving the functioning of markets. For instance, the labor market bottlenecks can be avoided by increasing information, providing retraining and facilitating mobility, as well as reducing discrimination. Another strategy is to limit potential monopoly power.

Several American programs have been enacted since the 1960's, which are intended to increase the efficiency of labor markets and permit workers to use their skills more fully. For instance, the Comprehensive Employment and Training Act (CETA) was passed in 1973. The Job Training Partnership Act was passed in 1983. Some programs facilitate apprenticeship: for instance, the Job Corps and the Work Incentive Program.

INCOMES POLICIES

These traditional anti-inflation policies consist in preserving the purchasing power of incomes by restricting price and wage increases. They take the form of price guidelines (used during the Johnson administration) or price and wage controls (used during WW II and the Nixon administration). Controls have not been very effective because of expectations and because they are contrary to freedom.

Price controls are more common in other countries than the United States. Except for war time (World War II and Korean war), the only price controls imposed during peacetime in the United States were those under the Nixon administration between 1971 and 1974. The most drastic was a price and wage freeze where prices and wages were not allowed to exceed their level of the previous year. The wage freeze was most unpopular.

SUPPLY SIDE ECONOMICS

In early 1980's in the United States, a novel strategy to deal with stagflation offered to approach inflation by cutting cost of production: specifically, the cost imposed on businesses by government in the form of taxes and regulations. The Reagan administration sought to cut taxes and regulations for that purpose. The policies appear to have been successful but they have resulted in large budget deficits.

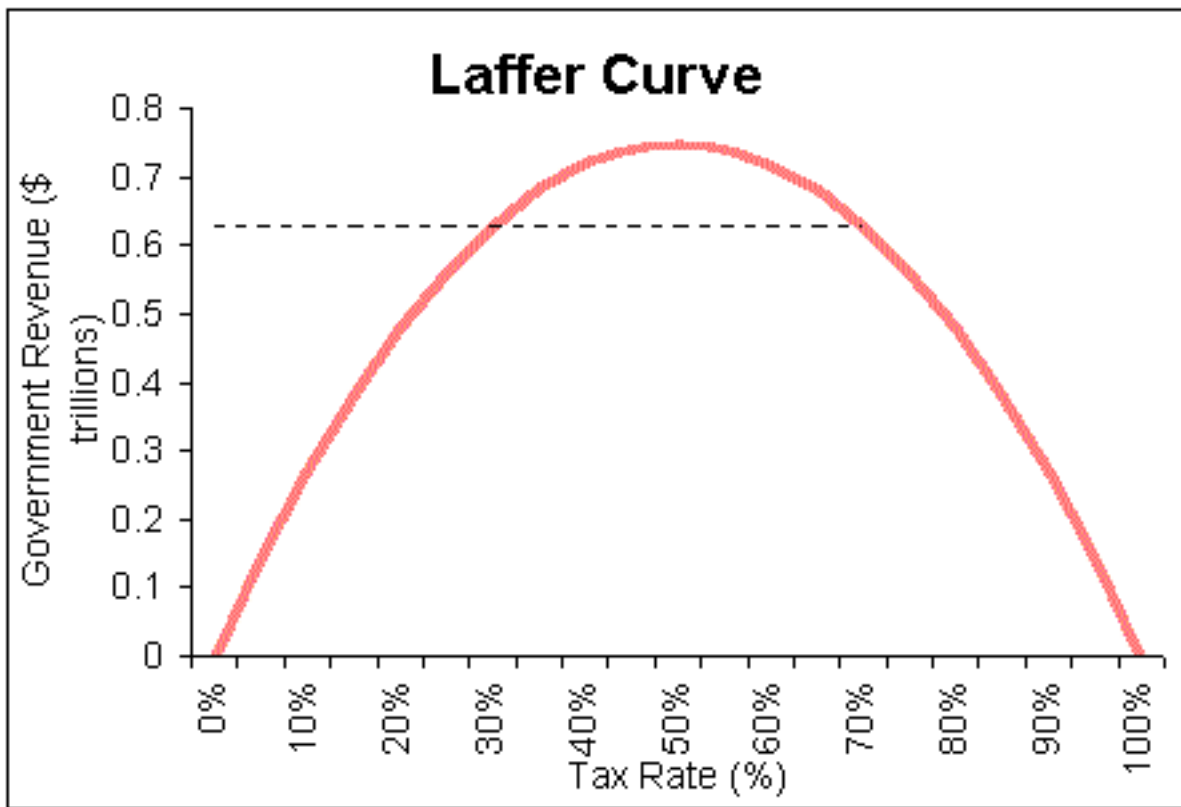
The Civil Aeronautics Board was responsible in assigning routes to airlines and set fares airlines could charge. The Civil Aeronautics Board was terminated in 1984 as mandated by the Airline

Deregulation Act of 1977. The result of the deregulation has been an increase in competition among airlines and a decrease of many air fares by more than half in some instances. In the 1990's, increased concentration of the airline industry has pushed airline fares back up.

Laffer Curve

The Laffer curve shows that government revenues increase if tax rates are either increased from 0% or reduced from 100%. A hypothetical reduction of tax rates from very high rates may result in increased revenues. Thus, the tax cut of supply side economics was defended. The increasing budget deficits do not seem to have fully verified the Laffer curve proposition.

Graph G-MAC14.3



The Economic Recovery Act of 1981 cut the marginal tax rate on personal income taxes by 23%. The fact that the revenues from personal income taxes hardly decreased at all seems to confirm the Laffer curve argument. However, the tax brackets were not adjusted for inflation (i.e. "bracket creep") until 1985, and that may be the reason why revenues did not decrease.

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