

CURRENT ECONOMIC POLICY DILEMMAS

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I wish to concentrate on today's major dilemmas of inflation and unemployment. This will lead us into several related dilemmas.

THE TRADE-OFF FRAMEWORK

Almost everyone is now familiar with the Phillips Curve trade-off between inflation and unemployment. This curve can be envisioned by drawing a line through the most densely dotted areas in Figure 1, for example, through the dots representing 1969, 1967, 1964, and 1963. This curve shows that high unemployment has been associated with low inflation rates and, conversely, that low unemployment has been associated with high inflation rates. According to this widely accepted postulate, one goal can be achieved on a sustained basis only by sacrificing some of the other one. In this framework, the dilemma confronting the policy maker is to weigh the benefits from reduced unemployment against the

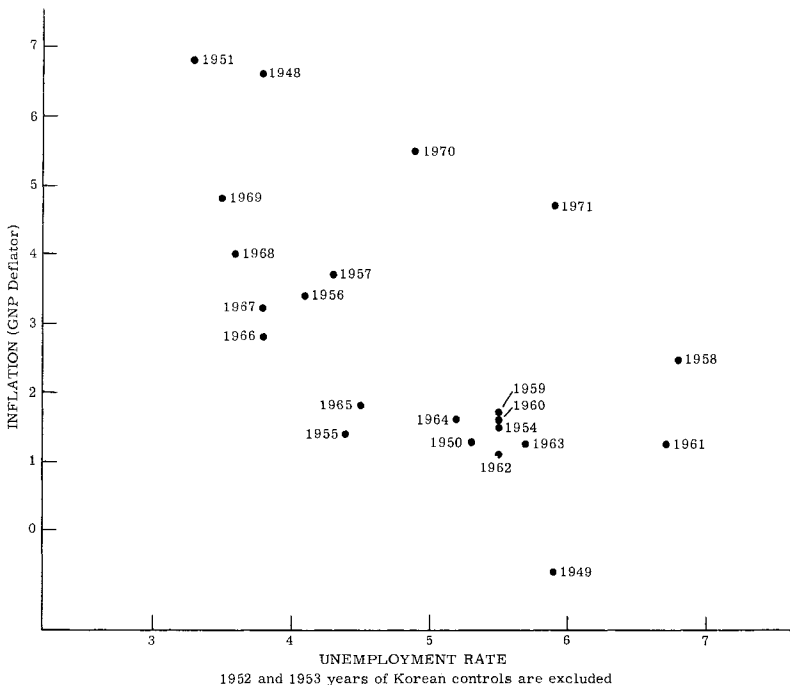


FIGURE 1. Relationship between rates of unemployment and inflation.

costs of faster inflation, and vice versa. The political process must balance these costs and benefits and arrive at the “optimum” combination. The political process must also manage fiscal and monetary policies to achieve the objectives.

In any one period, the trade-off may be temporarily worse or better than the average. Recent performance of the economy, inflationary expectations, and structural changes can all move the curve and alter the trade-off. Such factors make the curve unstable and its position uncertain, which points up the pitfalls in placing too much emphasis on a two-dimensional view of the economy.

It is the job of economic advisers to identify the achievable combinations in any given period, and to recommend the best set of policies to achieve the objectives. But in the absence of agreed upon social preferences between inflation and unemployment, it is the job of the political process to pick the objectives. Economists can contribute to the selection by clarifying the costs of inflation, and the costs of unemployment, and it is not at all uncommon for economists to place their own values on the costs and state their own preferences. In the end policy makers must weigh the economic, psychic, and distributional costs of inflation and unemployment. Since there are many policy makers, and they weigh each cost differently, serious conflicts emerge in the political process.

The difficulty of obtaining less inflation and less unemployment at the same time has rarely permitted the economy to achieve a satisfactory balance. This has given rise to manpower programs, particularly when unemployment was high. It was thought that such programs could improve the matching of skills of unemployed workers with the requirements of vacant jobs, and that they could improve access of the hard-core unemployed to the mainstream of productive work. In periods when inflation was high, the search turned to incomes policies and even compulsory controls. Policy makers still faced a dilemma. Neither manpower policies nor incomes policies can be implemented without costs. Manpower programs require resources to operate, and their effectiveness in altering the relationship shown on the Phillips Curve is open to debate. Incomes policies on a voluntary basis are of questionable effectiveness, and compulsory controls diminish individual freedom and can lead to serious maladjustments in the economy.

Economists could identify other measures to improve the trade-off such as concentrations of economic power, import quotas, minimum wage laws, and a whole set of protective policies and regulations in transportation, maritime activities, energy, agricul-

ture, and other sectors. Many of these proposals would reduce the level of prices (in contrast to the rate of change) and make better use of resources, but they would also improve the trade-off between inflation and unemployment on an interim basis. Altering such policies, however, presented another dilemma because of the large political costs that policy makers often decided were too heavy to bear.

THE 1970-1971 EXPERIENCE

The combinations of unemployment and inflation that emerged in 1970 and 1971 raised another dilemma that was more serious than the ones already mentioned. The trade-off became worse than the economy had experienced for some time. This raised the prospect that the Phillips Curve had shifted, perhaps permanently, to an unacceptable position (both high unemployment and high rates of inflation), or even that the relationship no longer could be depended upon at all.

Needless to say, this experience confronted policy makers and their advisers with new and challenging dilemmas. What has been done is well known. The Economic Stabilization Program was adopted to reduce cost-push inflation, and expenditures on manpower programs have risen from \$2.3 billion in fiscal 1969 to over \$5 billion this year. These were attempts to get back toward more acceptable levels of inflation and unemployment.

But several questions still remain. Is there any such thing as a Phillips Curve? If there is, has its position changed? What can be done to improve the trade-off? These are questions that are under careful study by groups inside and outside government.

Two explanations of the apparent Phillips Curve shift are currently popular. First, inflationary expectations have become ingrained in economic behavior so that any given unemployment rate corresponds to faster inflation. Second, there is evidence that changes in the composition of the labor force have caused any given inflation rate to correspond to a higher overall unemployment rate. Today's labor force contains a higher proportion of women and teen-agers who typically have much higher rates of unemployment. As a consequence the same overall unemployment rate would correspond to more tightness in labor markets and greater inflation. Also the proportion of the labor force employed in the public sector is growing (although not in federal jobs), and along with substantial wage increases this may have affected behavior in private labor markets.

Another school of thought argues that there is no permanent

trade-off. Instead there is a natural rate of unemployment which depends on structural impediments in the economy and the behavior of job seekers. Policies to expand aggregate demand will only temporarily reduce the unemployment rate, and will lead to a higher rate of inflation at the natural rate of unemployment.

IS THE PHILLIPS CURVE USEFUL?

A promising line of work now under way is the effort to better understand the behavior of micro labor markets. This will help provide a theoretical basis for the Phillips Curve, if a stable one exists, and at the same time identify labor policies to improve the trade-off. It may well turn out, for instance, that manpower programs are most productive in periods of high employment and should be aimed at tight labor markets rather than at the hard-core unemployed.

Another question should be asked: Is the Phillips Curve a useful guide to policy? Here there are two problems. First, the Phillips Curve is clearly unstable in the short term, and therefore it is an uncertain guide to what the economy can achieve in any given period. Second, it places the emphasis on unemployment, not employment. Year-to-year policy management might be better designed by a guideline that stresses expanding employment, but without increasing demand so rapidly that the economy becomes overheated. Critical sectors where supply restraints loom as inflationary threats could be treated on an ad hoc basis. In this approach there may be particular periods like the mid-1960's when the sensible policy would be to curtail the growth of aggregate demand so that full employment is approached more gradually to avoid generating demand-pull inflation. In other historic contexts like the recent past, temporary controls may be the appropriate remedy.

THE DILEMMA OF CONTROLS

This brings me to the "controls dilemma." While prognostications about their future differ widely, there is general agreement about certain elements that gave rise to the controls. This agreement focuses on the following sequence of events. First, fiscal-monetary policy in 1966-1968 seriously expanded the economy beyond its limits to produce and generated genuine demand-pull inflation. Second, a few highly visible wage settlements triggered a sequence of catch-up wage settlements. Third, rapid inflation became anticipated and was built into behavior throughout the economy. This propelled the rapid rise of wages and prices even after excess aggregate demand had subsided. Moreover, this dynamic process was compounded by structural factors such as

protective institutions for organized labor and a host of government-sanctioned protections for particular sectors of the economy. The popular proposition that concentrations of economic power caused inflation has much less support, largely because this is not a new element in the economy. There is, nevertheless, some support for the view that concentrated groups were more prone to use their position than in the past.

If this is an accurate characterization of what happened, we can draw several conclusions about future economic policy. First, aggregate demand policy should not expand the economy so fast that full employment is exceeded, or even approached too rapidly. This will require new restraint in financing federal programs. The current annual appropriations decisions are made one by one and usually add up to more than was originally envisioned as desirable. And new programs are enacted without any systematic review of their budgetary implications for future years. As a consequence, the uncontrolled element in the federal budget grows almost without limit.

Second, there may well be a place for a permanent pre-emptive mechanism for dealing with excessive wage settlements and price increases in the private sector, and perhaps even in the public sector.

Finally, inflationary expectations have to be reduced to achieve greater price stability, and this will itself require a period of price stability. The current "food price dilemma" demonstrates the enormity of dealing with inflationary expectations. Perhaps more than in any other sector, market forces determine the price of food. In the past nine months these forces, with some restraint from the controls program, have generated food price increases at slightly higher than a 4 percent annual rate. This is not exorbitant, although it is faster than nonfood items. Historically food prices have increased at about the same rate as overall consumer prices, and I would expect food price increases to taper off within the next year.

In the meantime, food prices seem to be a major irritant to consumers. Somehow consumers perceive a 4 percent rate to be runaway inflation. The gap between reality and belief is immense. This problem is magnified by the tendency of people to give considerably more weight to food prices in forming inflationary expectations than their actual expenditures warrant. There is one bright spot in this dilemma. Food prices typically level off after a period of increases, and if consumers perceive this when it occurs, inflationary expectations will probably begin to ease.

SUMMARY

Let me summarize by mentioning four major policy issues that the next administration will need to grapple with, no matter which political party sits in the White House.

1. Demand management. Principles and procedures need to be developed for fiscal and monetary policy that will prevent demand from growing too rapidly. Discipline in the budgetary process will be the key element.

2. Unwinding the controls. The administration will need to decide what form the next phase will take and when to drop or modify the current control system which was intended to deal with a unique cost-push situation.

3. Government programs. In the past, government programs and regulations have been more oriented to the interests of producers than consumers. In the future, more attention should be given to the price effects of government decisions.

4. The unemployment objective. It will be necessary to decide what level of unemployment is consistent with price stability. At present we do not know what level of unemployment is consistent with price-stable demand management. Clearly some level of unemployment is voluntary, but the government has a responsibility to improve choices of job seekers so they can find work more easily.

PART II

*Who Will Control
Agriculture?*

