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Prices and Wages (1)

p2 - why the world changed?
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Burns presents his view of why there is high inflation and weak business activity at the same time, drawing largely from the Gramley memo (6/8/71), immediately preceding. He then proposes a "strong wage and price policy," including a six-month wage and price freeze.

June 22, 1971

Dear Mr. President:

Last week, at the Quadriad meeting, I presented a set of statistical tables that give a rather comprehensive view of price and wage developments since the beginning of 1969.

I drew one conclusion from this evidence, namely, that it is doubtful whether we have made any progress in moderating the pace of inflation. The figures on the behavior of consumer prices in May reinforce my fears.

I realize that more optimistic interpretations have been made--and are still being made, by others--both within and outside the Administration. I have tried hard to read the evidence their way; I find that I cannot do so.

In my judgment, some of us are continuing to interpret the economic world on the model of the 1940's and 1950's. In fact, the structure of the economy has changed profoundly since then.

There was a time when the onset of a business recession was typically followed in a few months by a decline in the price level and in wage rates, or at least by a moderation of the rise. That is no longer the case. The business cycle is still alive, indeed too much so; but its inner response mechanism, which has never stood still, is now very different from what it was even ten or twenty years ago.

Failure to perceive this may be responsible for some shortcomings in our national economic policy. I doubt if we will bring inflation under control, or even get a satisfactory expansion going, without a major shift in economic policy.

Let me turn, first, to the question: Why are the old rules not working? Why is inflation continuing at a virtually undiminished rate in the face of substantial unemployment of men, machinery, plant and equipment?

The answer is to be found in the changed character of our labor and product markets. Here are a few of them:

I. Our success in moderating downturns in economic activity during the postwar period has reduced the concern of workers over the possibility of prolonged unemployment and the fears of businessmen of a protracted slump in sales. Wage and price decisions are now being made on the assumption that governmental policy will move promptly to check a sluggish economy.

2. The past decade has witnessed a vast growth of trade unionism in the public sector--mainly among State and local employees but also Federal employees. We have had innumerable illegal strikes of public employees, among them the postal strike. These strikes have been preponderantly successful, in the sense that the employees got pretty much what they asked for. In this environment, both the trade union leaders and the rank and file have come to believe that the government lacks either the power or the will to resist their demands. They have therefore become progressively bolder in pushing wage and other demands.

3. During the past decade, we have also had a vast expansion of welfare programs. When subsidies are provided by government to strikers--and this is what we have been doing more and more--workers on strike can hold out longer. Business managers are fully aware of this, and they are therefore less inclined to take a strike than was the case ten or twenty years ago.

4. The Landrum-Griffin Act has weakened the power of trade union leaders relative to the rank and file membership. As a result, when the leaders have sought moderate wage settlements, they have frequently been thwarted by a rebellious membership.

5. Non-union enterprises have always been influenced in their wage policies by what the unionized establishments were doing. With trade unions becoming stronger and more influential, nonunion businesses now adjust more quickly to--or even anticipate--the wages being set in the unionized sector.

6. The persistence of inflation, which has been running a mad course since 1964, has by now made practically every participant in the economic process inflation-minded.

   (a) Workers seek wage increases that will compensate for past effects of inflation on their real incomes and provide some insurance against future price advances, besides providing for some improvement in their living standard.

(b) Businessmen mark up their prices even when demand is weak, partly because they expect their costs to go up, partly because they fear further erosion of their shrunken profit margins, and partly because they expect that their competitors--facing similar problems--will behave similarly.

(c) Buyers, whether in the consumer or the business sector, have become accustomed to paying higher prices, and therefore offer less resistance to price advances than they would in an environment of stable price expectations.

(d) Businessmen, expecting to pay back in cheaper dollars, have become more inclined to borrow. Lenders, having similar expectations with regard to inflation, tend to hold out for higher interest rates. Every sign that inflation may be quickening leads to expectations of higher interest rates and thus reinforces these tendencies.

(e) In short, every part of the decision-making process in the business and financial world is now being shaped by inflationary expectations, even in the face of heavy unemployment.

We thus face an entirely new economic problem--one that our nation has never before had to face: namely, an inflation feeding on itself at a time of substantial unemployment.

Much of our economic thinking and economic policy has not yet caught up with the changes that have taken place in the structure of our economy. We continue to rely on monetary and fiscal policies that worked reasonably well ten or twenty years ago, unmindful of the profound changes in our economic environment.

The first requirement of a new economic policy is recognition of the uneasiness that characterizes the economic world--an uneasiness that is slowing the business recovery and which may continue to impede it this year and next.

Consumers are saving at a high rate, partly because of existing unemployment and partly because of concern about what inflation is doing to their incomes and savings.

There is also a mood of hesitation among businessmen. They see their wage costs accelerating, they fear that they will be unable to raise their prices sufficiently to cover their higher costs, and--with profits already sharply eroded and interest rates high--many hesitate about undertaking new investments. It is important to note that business capital investment, in real terms, has been declining in the present economic recovery; this is very unusual for this stage of the business cycle.

As you already know, I have reluctantly come to the conclusion that our monetary and fiscal policies have not been working as expected; they have not broken the back of inflation, nor are they stimulating economic activity as expected.

What the economy basically lacks is sufficient confidence in the future. There is a widespread feeling that we are drifting, that inflation may be getting out of control. Worried, unhappy people will not act to enlarge their activity in the economic arena or any other.

I am convinced that the restoration of confidence requires, above everything else, a firm governmental policy with regard to inflation. With this achieved, our economy can move forward towards full employment. Without it, we may stumble--perhaps stumble all the more if we try a more expansive monetary or fiscal policy.

The recent nervousness of financial markets supplies a warning that we must not overlook: every time we more, or appear to move, in a more stimulative direction, interest rates rise. Needless to say, this disconcerting behavior could frustrate our hopes with regard to residential building and State and local construction.

What I recommend, as a way out of the present economic malaise, is a strong wage and price policy.

I have already outlined to you a possible path for such a policy--emphatic and pointed jawboning, followed by a wage and price review board (preferably through the instrumentality of the Cabinet Committee on Economic Policy); and in the event of insufficient success (which is now more probable than it would have been a year or two ago), followed--perhaps no later than next January--by a six-month wage and price freeze.

Some such plan as this is, I believe, essential to come to grips with the twin problems of inflation and unemployment.

A firm wage and price policy will not get at the basic problem--the abuse of economic power. But the kind of legislation that would be needed will not be passed in the next year or two.

Also, a firm wage and price policy such as I'm suggesting may not restore full price stability. But it will at least clear the air, dampen inflationary psychology, bolster confidence, and perhaps leave elbow room for a more stimulative fiscal policy to hasten the decline of unemployment.

Let me say, finally, that my omission of any reference to a more stimulative monetary policy is deliberate. Monetary policy, I feel, has done its job fully.

The issues that I've touched on in this letter are clearly of the greatest importance. If you should want me to clarify any part of my thesis, do let me know.

Sincerely yours,

Arthur F. Burns

The Honorable Richard Nixon
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