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STABILIZATION GOALS: BALANCING INFLATION AND UNEMPLOYMENT

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the session on

"The Goals of Stabilization Policy"

at the 1977 Annual Meetings of the

Allied Social Science Associations

New York City

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Unemployment and inflation are grave social ills, both capable, unless resolved, of changing our economic and perhaps political system. Between the two ills, moreover, there is only a very limited trade-off. In the longer run, there is no trade-off; indeed, they may tend to move in the same direction if not at exactly the same time.

This last proposition is easier to defend today than it was twenty and even ten years ago when I first tried to argue it. That period spans the life and, as some might say, the death of the Phillips

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curve, probably the most important innovation in macro-economics since Keynes. Today, the defense of the proposition that there is very little trade-off -- and that only transitory -- between unemployment and inflation can fall back upon the theoretical framework surrounding the "natural rate of unemployment," upon "rational expectations," and on a growing body of empirical research. It can fall back also upon the living experience of the last dozen years. This experience has refuted the formerly widespread view that accelerating inflation is unlikely to occur without a continuously declining unemployment rate and would do little real damage if it did.

If ever there existed a meaningful trade-off, it rested on workers' and employers' expectation that higher inflation would soon be reversed. Once experience ceased to validate that expectation, money illusion was bound to vanish quickly. With money illusion dissipating, any trade-off will occur only along a Phillips curve shifting nearly concomitantly with changes in the rate of inflation.

Even a Phillips curve that is vertical in the long run does not adequately explain present high and apparently stubborn levels of both unemployment and inflation. For most industrial countries, unemployment today seems to be above what one might suppose to be its natural rate. Yet inflation has moved to extraordinarily high levels and is coming down very slowly if at all. Many special reasons can be adduced -- oil price increases, food shortages, raw material scrambles, errors of monetary and fiscal policy, uncompetitive wage and price behavior, exchange rate fluctuations. But I believe that a more systematic pattern is discernible.

Inflation and unemployment have moved up together because a short-run Phillips curve that shifts over time in response to variations in inflation rates implies realized trade-offs that change in accordance with the stage of the business cycle. When the economy expands, the curve traced out by unemployment and inflation becomes steep -- much inflation must be accepted for a given reduction in unemployment. When the economy contracts, the curve traced out becomes flat -- little reduction in inflation is accomplished for a given rise in unemployment. Where previously we recognized downward inflexibility of the level of wages and prices, today we are beginning to recognize diminishing downward flexibility of the rate of wage and price increases. Movements on the short-run Phillips curve, in other words, are not reversible.

The upward zigzagging of inflation and unemployment has been aggravated by the stop-go character of anticyclical policy. In the United States as in various other countries, policy has moved back and forth between fighting inflation while ignoring mounting unemployment and fighting unemployment while ignoring mounting inflation. It is only of late that a more moderate approach has gained ground which seeks to reduce both evils simultaneously.

The net result has been the tracing out of a positively sloping relation between unemployment and inflation. The rough contours of this path for the United States are visible in the following table showing periods of increasing and decreasing rates of unemployment and inflation.

The cyclical movements outlined in the table on the following page are the result, in considerable degree, of policy measures, even though the precise consequences of those measures may not always have been adequately foreseen. This at least seems true of the United States, although not necessarily of other countries, where cyclical fluctuations often are imported. Could it then be argued that if no measures ever were taken to halt inflation, unemployment would never have to rise?

This is tantamount to saying that continuously accelerating inflation might be indefinitely sustainable. Historical evidence indicates that it is not, and that hyperinflation in any event produces recession and unemployment. But even in the absence of acceleration, with inflation simply fluctuating around a high level, mounting unemployment ultimately seems unavoidable on present evidence. The reason is that inflation has shown itself to be adverse to investment and hence threatens a mounting imbalance between capital stock and labor force. In the United States, the growth of the capital stock clearly has not kept pace with that of the labor force. Full employment, by almost any definition, today would require operating the

Table

Periods of Increasing and Decreasing

Rates of Inflation and Unemployment

(Four Quarter Moving-Averages)

Rate of Inflation*		Rate of Unemployment	
Decreasing	Increasing	Decreasing	Increasing
1960(I)-1961(I) 2.1 0.6			1960(I)-1961(III) 5.4 6.5
	1961(I)-1962(IV) 0.6 2.1	1961(III)-1962(IV) 6.5 5.3	
1962(IV)-1964(I) 2.1 1.3			1962(IV)-1963(IV) 5.3 5.4
	1964(I)-1966(IV) 1.3 3.7	1963(IV)-1967(II) 5.4 3.6	
1966(IV)-1967(II) 3.7 2.5			1967(II)-1967(IV) 3.6 3.7
	1967(II)-1970(I) 2.5 5.6	1967(IV)-1969(II) 3.7 3.3	
1970(I)-1972(II) 5.6 3.8			1969(II)-1971(IV) 3.3 5.8
	1972(II)-1975(I) 3.8 11.1	1971(IV)-1973(IV) 5.8 4.7	
1975(I)-1976(IV) 11.1 4.7			1973(IV)-1975(IV) 4.7 8.3
	1976(IV)-1977(III) 4.7 5.6	1975(IV)-1977(III) 8.3 7.2	

* The rate of inflation is a four quarter moving-average of the annualized per cent change in the GNP deflator.

economy at rates of capacity utilization far in excess of historically non-inflationary limits.

Thus, there seem to be three causal sequences through which inflation ultimately raises rather than reduces unemployment: (1) Policy measures designed to curb inflation, (2) acceleration toward hyperinflation in the absence of such less than accommodative policy measures, and (3) disincentives to investment and reduction in the capital stock relative to the labor force.

In recent years, the economics profession seems to have modified its evaluation of the relative welfare loss from inflation and unemployment. In other words, in economists' perception, the indifference curve relating inflation and unemployment became flatter as the Phillips curve became steeper. Estimates of the loss from inflation have been raised while those of the loss from unemployment have been lowered. In the higher estimate of the loss from inflation, abandonment of the assumption of perfectly anticipated inflation has played a role. This useful analytical tool, like other forms of perfect foresight, has no reliable counterpart in the real world. The evidence so far seems to indicate that inflation will not be correctly anticipated.

Moreover, even in a world where inflation is correctly anticipated, making the correct adjustment to inflation could prove to be very difficult. Governments, indeed, will make every effort to prevent correct adjustment, by insisting on original cost depreciation, on capital gains taxes based on nominal rather than inflation corrected values, on tardy adjustment of tax brackets, on interest rate ceilings, and on treating the inflation premium in interest rates as if it were income or an expense item, just to name a few of the roadblocks thrown up on the road to adjustment to inflation. Official statements of the need and intention to bring down inflation have a similar effect.

Inflation therefore does affect real variables -- the level and distributions of income and wealth, relative prices, investment, growth, and employment.

Furthermore, even in the unlikely event that rational expectations were to lead to unbiased anticipations of inflation, this does not guarantee systematic avoidance of real effects. Markets and institutions may not permit wealthholders to obtain the inflation premia they would like to have. Borrowers may not want to pay a nominal rate equal to the real rate plus the inflation premium. Alternative assets may not be available that would provide an adequate inflation-adjusted return. It then does not help the wealthholder who correctly perceives future inflation to "demand" such a return. The same could happen in the labor market.

Moreover, the contracting parties -- employers and employees, lenders and borrowers -- may not feel completely sure of their expectations. Each may therefore want to charge their counterpart a risk premium. This means that supply and demand functions, adjusted for the respective risk premia, will be shifted inward and will intersect only at a lower volume of transactions than they otherwise would.

Finally, any change in the rate of inflation, even if correctly anticipated for the future after it has become effective, will leave a residue of old contracts that cannot be adjusted and that give rise to redistributive gains and losses. One has to mount to a dizzying level of abstraction to lose sight of these individual consequences of inflation.

But it is fanciful to discuss inflation in terms of perfect anticipations, however qualified. The fact that the U.S. Government issues 30-year bonds callable only after 25 years at about 8 per cent does not imply that the Government expects 25 years of inflation at about 5 per cent -- it is simply a sensible act of risk diversification on the part of a debtor. If inflation were firmly expected by government or the private sector to continue at some constant rate, forces would come into being causing it to accelerate. That, I fear, is our prospect today. The essence of inflation is uncertainty.

This means that, under conditions of inflation, the ordinary uncertainties attaching to individuals' income and wealth are greatly increased. The variance or risk term in utility functions rises. Since the variability of inflation has been shown to be positively related to its rate, risk rises with inflation and utility falls.

While the costs of inflation have been accorded increasing weight in professional opinion, the opposite has been the case with respect to unemployment. The costs of unemployment generally have been evaluated at two levels: the macroeconomic loss of total output, and the microeconomic financial and morale loss to those experiencing unemployment. The macroeconomic loss presumably exceeds the sum of the micro losses thanks to the various compensation schemes that redistribute the impact.

The perception of loss of potential output attributable to unemployment is being reduced by the shift that has been taking place in the definition of the full employment level of unemployment. At one time, a plausible definition of full employment seemed to be the equality of unemployment and job vacancies. Today, the natural rate of unemployment seems to find increasing acceptance as the measure of full employment. The latter definition obviously leads to a lower level of potential output and hence a lower loss attributable to a given level of unemployment.

Additional doubts can be raised, moreover, about the concept of "potential output" as such. It rests heavily upon arbitrary institutional limitations, such as the 40-hour week and mandatory retirement at age 65. Today we seem to be in the process, with a minimum of fanfare, of raising the retirement age limit. Should we recompute past potential and compute the loss from not removing the limit earlier? Some dissatisfaction with the 8-hour day, too, seems to be indicated by the heavy movement of women into the labor force, some of which may reflect dissatisfaction with the earnings that husbands bring home from their 8-hour stint. What would potential be, and how much output would we be losing, if the workweek were 42 or 45 hours?

At the microlevel, too, the cost of unemployment is coming to be seen in a more measured perspective. A considerable part of it today is viewed as search activity, i.e., as voluntary unemployment. Although far from painless, the benefits from search must be weighed against the micro costs of unemployment. Insofar as job search leads to better matching of skills and jobs, it produces gains also at the macro level.

The economic cost of unemployment to the unemployed individual is perceived to be less disastrous than it has often been presented to be. Much unemployment is that of secondary earners in a household. Compensation is more adequate. Together with food stamps, tax deductibility of the benefits, savings on transportation, on meals away from home, and on clothing, unemployment "income" may come close, in many cases, to offsetting the wages lost to the individual. Any induced extension of unemployed status must then also be viewed as voluntary.

The transient character of much unemployment is more clearly perceived. "The unemployed," for the most part, are not a fixed group like "the aged," but more nearly like "the sick." The composition of the unemployed part of the labor force is more clearly seen: unemployment is much lower among heads of households and particularly married males than among women and particularly teenagers. This fact, incidentally, also limits potential output from a given unemployed labor force -- during an expansion, markets for skilled labor will tighten faster than labor markets in general.

All told, unemployment, in liberal discourse, is losing its role as a successor to sex among the Victorians -- as an utterly obscene and unacceptable part of the human condition.

If inflation were thought to be costly mainly because it causes unemployment, and if unemployment itself were judged to be less costly than had earlier been thought, the issue of balancing the two would lose much of its portentousness. Such a misconception could arise from defining the respective "costs" in too narrowly economic terms. There is more to an economic system than the production of GNP. Indeed it can be argued that the most significant impacts of unemployment and inflation fall outside the area of determination of income and wealth.

In particular it is easy to overrate the importance of any loss of aggregate income and growth resulting from the joint and several impacts of unemployment and inflation. Income per capita has tended almost to double in each generation. Does anyone argue seriously that earlier generations were substantially less happy than ours? That the 1950's or 1920's were periods of widespread distress? That 100 years ago, at an income per capita about one-tenth of today's in real terms, American lived in misery?

There have been enormous gains, of course. But they have principally consisted in the elimination, or at least reduction, of extreme conditions of poverty, and hardly from major gains in the sense of well-being of the average household. Growth has brought satisfaction probably because it has given income receivers a rising rather than simply a higher living standard. And growth, of course, has not resolved the dissatisfaction arising from the iron law of rank: for everyone who gains satisfaction by rising in the scale of income, wealth, or other forms of prominence, there must be another who has lost satisfaction by moving down.

If unemployment and inflation were to continue at high levels, the principal individual and social welfare losses would not come from income foregone. Nor need they come from diminishing satisfaction through a slower rate of growth, since it is at least conceivable that growth might continue about the rate of the past, albeit on a lower path. The principal loss, it would seem to me, would take the form of a lowered quality of life, in the form of heightened uncertainty, sharper social conflicts, great injury to some individual life patterns, and mounting hostility to the economic and political institutions that would be held responsible. Persistent unemployment and inflation are forms of pollution of the social environment.

Unemployment directly affects a relatively small number, but with considerable intensity. High turnover increases this number and softens the impact, as does improved compensation. But in certain groups -- not so much regional or occupational as principally age and racial, such as black teenagers -- the condition with all its consequences is becoming endemic. Affected individuals and groups are in danger of moving outside the mainstream of society and becoming altogether alienated.

Little seems to be known about the consequences of this condition for the attitudes of those affected. A good deal has been said about the views and feelings of the unemployed, much of it derived primarily, one must assume, from introspection by overemployed economists. Given the paucity of objective studies, one may guess that plain hostility to the system must be at least as frequent a reaction as loss of personal dignity, frustration, and functional disturbances.

Inflation hits directly a much larger number than does unemployment, but generally far less severely and in many cases indeed with positive effects on income and wealth. Uncertainty, however, is bound to be pervasive under inflation. Partial indexation merely raises the risk of the unindexed remainder. The ability to provide for the future, an essential attribute of a civilized society, evaporates. Inflation, which early on had been thought to discourage saving, does nothing of the sort -- in all major countries savings rates rose as inflation accelerated. But full protection of these savings can be offered only by government, to the extent it chooses to do so through indexation of social security, civil service pensions, and at some future point perhaps indexed bonds.

Some concluding remarks on policy seem in order. The standard prescription against inflation derived from the natural rate of unemployment analysis is to allow the unemployment rate to remain above the natural rate for some time. To the extent that, by design or default, it has been employed it has so far given poor results. This experience reflects the view expressed earlier, that when inflation is on the way down, the short-run Phillips curve becomes quite flat.

The type of action that would simultaneously reduce unemployment and inflation is represented by the family of tax-oriented incomes policies (TIP). Numerous versions of TIP have been proposed. Restraint can be exerted through tax penalties, or through tax bonuses. It can be exerted against wages only, on the well validated assumption that prices are closely tied to wages, or against both wages and prices. Applicability can be compulsory or voluntary. The taxes used can be the corporate income tax, or a payroll or sales tax. The principle is always the same. There are no mandatory controls. Market forces continue to govern. If a firm wants to concede a high wage increase, for whatever reason, it is free to do so, provided the tax is paid. Only the balance of bargaining power is shifted in favor of restraint.

The principle of TIP, as Abba Lerner has pointed out, is to internalize to the wage and price setter the inflationary externalities he creates. The effect would be to break into the present spiral in which inflation moves forward mainly by its own momentum. The result should be not only a decline of inflation, but also an opportunity for lower unemployment. The Phillips curve or, if one prefers, the natural rate of unemployment, would have been moved toward lower levels of unemployment.

There are difficulties to be overcome, both technical and political. In the light of the high social costs of unemployment and inflation, I regard the effort as eminently worthwhile. Those who do not share the view expressed here that these are the principal costs of those twin evils but are primarily concerned about their economic cost, or who continue to believe in the existence of a meaningful tradeoff between them, should find the proposal no less convincing.

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