

DEALING WITH WORLD STAGFLATION:  
WHAT HAVE WE LEARNED?

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RESERVE BANK OF CHICAGO AT BERGENSTOCK, SWITZERLAND

IN THE RECENT PAST, THE WORLD ECONOMY HAS PASSED THROUGH THE MOST DIFFICULT PERIOD SINCE WORLD WAR II. VIRTUALLY NO NATION WAS SPARED THE DOUBLE CURSE OF INFLATION AND RECESSION THAT HAS PROFOUNDLY INFLUENCED THE FORTUNES AND LIVES OF BUSINESSMEN, WAGE EARNERS AND ALL CITIZENS. TODAY, THAT EXPERIENCE IS LARGELY AN UNPLEASANT MEMORY. SIGNIFICANT PROGRESS HAS BEEN MADE THROUGHOUT THE WORLD IN RESTORING ECONOMIC GROWTH AND REDUCING INFLATION. WE STILL HAVE A WAY TO GO, SOME NATIONS MORE THAN OTHERS, IN RESTORING THE NATIONAL ECONOMIES TO THEIR FULL POTENTIAL IN A NON-INFLATIONARY ENVIRONMENT. BUT THE SIGNS ARE CLEAR. THE WORLD ECONOMY HAS "TURNED THE CORNER." IN THE IMMEDIATE FUTURE, IMPROVEMENTS WILL OCCUR IN VIRTUALLY ALL COUNTRIES ON BOTH FRONTS.

IT IS TEMPTING FOR THOSE OF US IN EACH OF OUR COUNTRIES WHO SHARE THE RESPONSIBILITY FOR FORMULATION OF NATIONAL ECONOMIC POLICIES THAT POSSIBLY CONTRIBUTED TO THIS TURNAROUND, TO PAUSE AFTER THE TRYING PERIOD JUST BEHIND US, AND TO REST ON THE LAURELS OF THIS ENCOURAGING EVIDENCE. IT WOULD BE TEMPTING FOR ME TODAY FOR EXAMPLE TO USE MY TIME TO EXTOL THE SPIRIT OF INTERNATIONAL COOPERATION THAT PREVENTED NATIONS FROM DEALING WITH ADVERSITIES THROUGH THE ADOPTION OF NARROWLY CONCEIVED NATIONAL POLICIES THAT, AS IN THE THIRTIES, WOULD HAVE PLUNGED THE WORLD ECONOMY IN AN

UNCONTROLLABLE TAILSPIN. I SHALL RESIST THAT TEMPTATION. FOR, TO SUCCUMB TO IT WOULD SUGGEST A FLAGRANT DISREGARD FOR THE VEXING PROBLEMS THAT LIE AHEAD FOR ALL OF US IN THIS GREAT FAMILY OF NATIONS. TO PUT IT BLUNTLY, WHILE WE HAVE "TURNED THE CORNER," WE ARE NOT "OUT OF THE WOODS" BY ANY MEANS. INDEED, IT CAN BE SAID THAT THE DEVELOPMENTS OF THE RECENT PAST HAVE BROUGHT TO THE SURFACE AND INTO SHARPER FOCUS NEW PROBLEMS THAT, MORE THAN EVER, CLOUD THE LONG-TERM OUTLOOK FOR THE WORLD ECONOMY. THUS, I SHOULD LIKE TO USE MY TIME TO SHARE WITH YOU SOME OF MY THOUGHTS ON THE PROBLEMS THAT LIE AHEAD, AND ON THE LESSONS WE MAY HAVE LEARNED FROM THE MOST RECENT EXPERIENCES IN DEALING WITH THEM.

FROM THE ECONOMIC POLICY VIEWPOINT, THE MOST VEXING PROBLEM THAT SURFACED IN THE PAST PERIOD--AND THAT HAS IMPORTANT IMPLICATIONS FOR THE FUTURE COURSE OF EVENTS--HAS BEEN THE COEXISTENCE OF VIRULENT INFLATION AND RECESSION--OR "STAGFLATION"--IN VIRTUALLY EVERY INDUSTRIAL COUNTRY. ALTHOUGH WE IN THE UNITED STATES HAD ENCOUNTERED A MODERATE MANIFESTATION OF THIS PHENOMENON IN THE LATE 1950'S, ITS UBIQUITY AMONG INDUSTRIAL NATIONS, AND ITS INTENSITY, WERE UNPRECEDENTED. THIS PHENOMENON, OSTENSIBLY, FLEW IN THE FACE OF THE CONVENTIONAL ECONOMIC WISDOM AND THE TRADITIONAL ECONOMIC POLICIES BASED ON IT. IN A SUBTLE YET DECISIVE WAY, THE PHENOMENON BROUGHT INTO QUESTION THE VALIDITY AND/OR RELEVANCE OF A LARGE BODY OF ECONOMIC THEORY WHICH, SUMMARIZED VERY CRUDELY, TAUGHT US THAT: (1) A REGIME OF FLOATING EXCHANGE IN A COUNTRY'S CURRENCY INSULATES THAT COUNTRY FROM THE TRANSMISSION TO ITS ECONOMY OF ADVERSE ECONOMIC DEVELOPMENTS FROM ABROAD, AND PERMITS THE AUTHORITIES TO PURSUE MORE INDEPENDENT ECONOMIC POLICIES TO ACHIEVE

THE UNIVERSALLY DESIRED ECONOMIC GOALS OF PRICE STABILITY AND PROSPERITY; (2) THESE GOALS CAN BE FURTHERED THROUGH APPLICATION OF BROAD ECONOMIC POLICIES BY DEALING WITH INCIPIENT INFLATION BY "TIGHTENING" EFFECTIVE DEMAND IN THE ECONOMY THROUGH RESTRICTIVE MONETARY AND FISCAL POLICIES, AND BY DEALING WITH INCIPIENT RECESSION BY "INFLATING" EFFECTIVE DEMAND THROUGH EXPANSIONARY POLICIES--IMPLICITLY TREATING THESE TWO ALTERNATIVES AS MUTUALLY EXCLUSIVE.

THE APPARENT UNDERMINING OF A LARGE BODY OF CONVENTIONAL ECONOMIC WISDOM LEFT POLICY MAKERS AROUND THE WORLD WITHOUT CLEARLY OUTLINED CONCEPTUAL GUIDELINES FOR BROAD POLICY ACTION AND FORCED A SOMETIMES PAINFUL REEXAMINATION OF ALTERNATIVES AND OF THE BASIC PREMISES OF ACTIONS. THIS PROCESS, IMPLICITLY OR EXPLICITLY, EVOLVED ON TWO PLANES: ON ONE PLANE, DECISIONS HAD TO BE MADE BETWEEN THE ALTERNATIVE OBJECTIVES IN APPLICATION OF THE CONVENTIONAL MACRO-ECONOMIC POLICIES. IN OTHER WORDS, TO THE EXTENT THAT THE CONVENTIONAL MONETARY AND FISCAL POLICIES CAN BE USED EITHER TO STIMULATE A LAGGING ECONOMY OR TO COOL AN OVERHEATING ONE, A DECISION HAD TO BE MADE AS TO THE PRIORITY OF OBJECTIVES TO BE ACCOMPLISHED IN THE NEW STAGFLATIONARY ENVIRONMENT. ON THE SECOND PLANE, THE PROCESS INVOLVED AN ANALYSIS OF THE GENERAL PHENOMENON OF STAGFLATION TO DETERMINE ITS INDIVIDUAL COMPONENTS, AND, WHERE AMENABLE TO SUCH ACTION, TO DEVELOP SPECIFIC, NARROWLY AIMED POLICIES TO DEAL WITH THESE COMPONENTS.

THAT WHICH POLICY MAKERS THROUGHOUT THE WORLD LEARNED IN THIS PROCESS INFLUENCED THE COURSE OF EVENTS IN THE WORLD ECONOMY IN THE PAST AND, OBVIOUSLY, WILL INFLUENCE THE COURSE OF EVENTS IN

THE FUTURE. LET ME BRIEFLY TOUCH UPON SOME OF THE EVIDENCE THAT, IS EMERGING. FIRST, LET'S LOOK AT THE AREA OF BROAD AGGREGATE POLICIES. WHILE MAJOR COUNTRIES EXHIBITED UNDERSTANDABLE RELUCTANCE TO ADOPT FLOATING EXCHANGE RATE, THE EXPERIENCE SO FAR SUGGESTS THAT, AS A PRINCIPLE, THE SYSTEM HAS SERVED THE COMMUNITY OF NATIONS RATHER WELL. INDEED, IN THIS AREA, ORTHODOX ECONOMIC THEORY SUSTAINED THE "LEAST DAMAGE" TO ITS FUNDAMENTAL PREMISES. WHILE IT IS CONTROVERSIAL WHETHER, AND TO WHAT EXTENT, THE OLD FIXED EXCHANGE RATE SYSTEM CONTRIBUTED TO THE SPREAD OF INFLATION AMONG COUNTRIES, IT APPEARS CLEAR THAT THE FLOATING RATES SYSTEM HAS PROVIDED FOR A REASONABLY SMOOTH ADJUSTMENT OF EXCHANGE RATES (THAT IN THE FINAL ANALYSIS MUST REFLECT FUNDAMENTAL ECONOMIC REALITIES) TO WIDELY DIVERGENT AND RAPIDLY CHANGING CONDITIONS IN INDIVIDUAL COUNTRIES. RECENT AGREEMENTS AMONG MAJOR COUNTRIES FOR MODERATION OF ERRATIC FLUCTUATIONS IN EXCHANGE RATES HAVE REMOVED SOME OF THE MORE OBVIOUSLY OBJECTIONABLE FEATURES OF THE SYSTEM. IN ITS MODIFIED FORM, THE SYSTEM IS WITH US TO STAY FOR THE FORESEEABLE FUTURE.

IN THE AREA OF APPLICATION OF AGGREGATE DEMAND MANAGEMENT POLICIES, THE PREVAILING EMPHASIS AMONG INDIVIDUAL NATIONAL POLICIES HAS BEEN TOWARD CONTAINMENT OF INFLATION RATHER THAN TOWARD A UNILATERAL FOCUS ON UNEMPLOYMENT AND ECONOMIC GROWTH. THIS, I THINK, OCCURRED FOR TWO REASONS. FIRST, COUNTRIES HAVE COME TO RECOGNIZE THE ALL-PERVASIVE EVILS OF INFLATION--AND THE VIRTUAL IMPOSSIBILITY OF ACHIEVING SOUNDLY BASED, LONG-TERM ECONOMIC GROWTH IN AN INFLATIONARY ENVIRONMENT. THE SECOND REASON HAS BEEN THE INCREASING DOUBTS OF THE POLICY MAKERS, IN THE FACE OF ACCUMULATED

EVIDENCE REGARDING THE VALIDITY OF THE SO-CALLED PHILLIPS CURVE THEORY ON WHICH, IN LARGE MEASURE, PAST ECONOMIC POLICY HAS BEEN BASED. EVIDENCE INDICATES THAT THE TRADE-OFF BETWEEN UNEMPLOYMENT AND INFLATION IS MORE ILLUSORY THAN ESTABLISHED THEORY WOULD HAVE US BELIEVE. FOR THESE REASONS, I BELIEVE THE POLICY FOCUS ON INFLATION WILL CONTINUE, INHIBITING SOMEWHAT THE AUTHORITIES' RESOLVE TO DEAL WITH UNEMPLOYMENT BY DIRECT GOVERNMENT ACTIONS.

IT IS, HOWEVER, ON WHAT I HAVE CALLED THE "SECOND PLANE" OF ANALYSIS, THE ANALYSIS OF THE STAGFLATIONARY PHENOMENON, THAT THE MOST SIGNIFICANT EVIDENCE IS SURFACING. IN PART, THE ANALYSIS HAS BROUGHT INTO FOCUS SEVERAL ELEMENTS, MOSTLY ON THE SUPPLY SIDE OF THE EQUATION THAT I WOULD CALL "EXOGENOUS," THAT CONTRIBUTED TO THE EMERGENCE OF THE PHENOMENON. AMONG THESE THE MOST IMPORTANT, OF COURSE, HAS BEEN THE FOUR-FOLD INCREASE IN THE PRICE OF OIL. THE ALL-PERVASIVE IMPACT OF THIS DEVELOPMENT ON CRITICAL BUT INTANGIBLE FACTORS SUCH AS BUSINESS AND CONSUMER CONFIDENCE, ON MORE TANGIBLE FACTORS SUCH AS THE PRICES OF CHEMICALS, FERTILIZER, TRANSPORTATION, CONSTRUCTION, ETC., ON FINANCIAL FLOWS, INTERNATIONAL BALANCE OF PAYMENTS, INVESTMENT POLICIES, ECONOMIC DEVELOPMENT POLICIES, THE INDEBTEDNESS STRUCTURE OF DEVELOPING COUNTRIES--AND ON MANY, MANY OTHER RELATIONSHIPS--CONTINUES TO BE FELT THROUGHOUT THE WORLD ECONOMY. THE WORLD-WIDE DISRUPTION OF FOOD PRODUCTION,--AND THE CONCOMITANT RISE IN THE WORLD'S FOOD PRICES,--AND RESTRUCTURING OF THE PRIORITIES OF NATIONAL POLICIES ETC., HAVE BEEN ANOTHER "EXOGENOUS" ELEMENT. ANOTHER FACTOR WAS THE COINCIDENCE OF THE EXPANSIONARY PHASE OF THE BUSINESS CYCLE IN VIRTUALLY ALL MAJOR COUNTRIES IN THE 1972-73 PERIOD THAT

STRAINED THE WORLD'S RAW MATERIALS MARKETS, LEADING TO SKYROCKETING PRICES. AND ONE COULD, I AM SURE, ADD A NUMBER OF OTHERS TO THIS LIST OF EXOGENOUS, ALMOST ACCIDENTAL FACTORS. WHILE SUCH AN ANALYSIS HELPS US TO BETTER UNDERSTAND WHAT HAPPENED, IT HAS, HOPEFULLY ONLY A LIMITED RELEVANCE FOR THE FUTURE--BARRING, OF COURSE, RECURRENCES OF THESE EVENTS.

IT IS IN THE AREA OF ANALYSIS OF WHAT I WOULD CALL THE "ENDOGENOUS" FACTORS WHERE THE SYSTEMATIZATION OF EVIDENCE GLEANED FROM THE PAST EXPERIENCE APPEARS TO HAVE MOST PROFOUND IMPLICATION FOR THE FUTURE LONG-TERM OUTLOOK FOR THE WORLD ECONOMY. THIS ANALYSIS OF THE INTERNAL DYNAMICS OF THE INDUSTRIAL SOCIETIES, UNDERTAKEN IN A SEARCH FOR AN EXPLANATION OF THE STAGFLATIONARY PHENOMENON, APPEARS TO BE LEADING US INTO A REEXAMINATION OF SOME OF THE FUNDAMENTAL PREMISES ON WHICH THESE SOCIETIES TYPICALLY FUNCTION. ON ONE END OF THE SPECTRUM OF THIS REEXAMINATION PROCESS EMERGES SERIOUS QUESTIONING OF A PROPOSITION WHICH, AFTER BEING NURTURED ON A GROWING BODY OF ECONOMIC THEORY OVER THE POSTWAR YEARS, ACQUIRED THE QUALITY OF A WIDELY-ACCEPTED PREMISE--NAMELY, THAT GOVERNMENT ECONOMIC POLICIES ARE CAPABLE OF ASSURING VIRTUALLY UNINTERRUPTED PROGRESS TOWARD ELIMINATION OF CONDITIONS OF MATERIAL INSUFFICIENCY AND THE SOCIAL DISCONTENT THAT IS PRESUMABLY DERIVED FROM IT. ON THE OTHER END OF THE SPECTRUM WE FIND INCREASING QUESTIONING OF THE FUTURE OF THE FREE ENTERPRISE SOCIETY, MANIFESTING ITSELF IN THE RENEWED INTEREST IN THE WORK OF THAT STAUNCH ADMIRER BUT GLOOMY PROPHET OF THAT SYSTEM, JOSEPH SCHUMPETER, AND, ON A MORE RADICAL PLANE, MARX HIMSELF. I HAVE NO INTENTION TO EXAMINE WITH YOU THIS WHOLE SPECTRUM OF THOUGHT THAT I DETECT EMERGING IN THE "POST-MORTEM" OF RECENT EXPERIENCE. I HOPE YOU

WON'T MIND IF I PLEAD TIME CONSTRAINT AS AN EXCUSE, BUT HASTENING TO STATE--MY OWN SCEPTICISM ABOUT THE VALIDITY AND RELEVANCY OF A GOOD PART OF ALL THIS. BUT I WOULD LIKE TO SHARE WITH YOU A FEW OF MY THOUGHTS ON SOME OF THE ELEMENTS OF THAT SPECTRUM, PARTICULARLY AS IT RELATES TO THE ROLE OF GOVERNMENT IN THE ECONOMIC PROCESSES IN INDUSTRIAL COUNTRIES.

IT HAS BEEN ENDEMIC IN THE VERY NATURE OF DEMOCRATIC POLITICAL PROCESSES THAT POLITICAL LEADERS SEEKING REELECTION HAVE, IMPLICITLY OR EXPLICITLY, CREATED A MYTH IN THE ELECTORATES OF INDIVIDUAL NATIONS THAT CENTRAL GOVERNMENT CAN IDENTIFY, SOLVE--AND PAY FOR ALL PROBLEMS OF THE SOCIETY. OUT OF THAT MYTH SPRANG CLAIMS ON THE TOTAL PRODUCTION CAPACITY OF INDIVIDUAL ECONOMIES BY LABOR, CONSUMERS, BUSINESS--AND GOVERNMENT ITSELF--FAR IN EXCESS OF THE CAPACITY OF THE ECONOMIES TO SATISFY THEM. THE DEMOCRATIC GOVERNMENTS AROUND THE WORLD, IN TRYING TO LIVE UP TO THEIR PROMISES, HAVE TYPICALLY SOUGHT SOLUTION TO THESE EXCESSES THROUGH TWO CHANNELS: WE HAVE SEEN GOVERNMENTS RESORT TO PROGRAMS AND REGULATORY MEASURES DESIGNED OSTENSIBLY TO ADJUDICATE THESE CLAIMS MORE "JUSTLY" THAN WOULD HAVE BEEN DONE BY THE IMPERSONAL FORCES OF THE MARKET PLACE. THEN THE GOVERNMENTS, UNABLE TO ADJUDICATE, TRIED TO VALIDATE THESE EXCESSIVE CLAIMS BY "PRINTING MONEY"--EITHER LITERALLY, OR BY MEANS OF DIRECT OR INDIRECT PRESSURES ON THEIR AT TIMES NOMINALLY "INDEPENDENT" CENTRAL BANKS. THE RESULT OF THESE TENDENCIES HAVE BEEN--DEPENDING UPON THE EMPHASIS PLACED ON EITHER ONE OR BOTH OF THESE TENDENCIES--INFLATION AND A GRADUAL EROSION OF THE EFFICACY OF THE FREE MARKET.

WHAT ARE THE LESSONS FOR THE FUTURE TO BE DRAWN FROM THIS EXPERIENCE? I DISAGREE WITH THOSE WHO, BY EXTRAPOLATING THESE TRENDS AND TENDENCIES, DRAW THE CONCLUSIONS OF CHRONIC, EVER RISING INFLATION AND INEVITABLE DOOM FOR CAPITALIST, MARKET ORIENTED SYSTEMS. I REJECT THESE CONCLUSIONS BECAUSE I HAVE COMPLETE CONFIDENCE IN THE RESILIENCY OF OUR SYSTEM OF GOVERNMENT AND IN THE DYNAMISM OF THE ECONOMIC ORDER TO REVERSE THESE TRENDS ONCE THEIR MALIGNANCY BECOMES GENERALLY RECOGNIZED.

TO ANSWER THE FINAL QUESTION I HAVE POSED IN THE TITLE OF MY REMARKS: I THINK WE HAVE LEARNED TO RECOGNIZE THE PROBLEMS. I AM ENCOURAGED IN THAT CONCLUSION BY CERTAIN DEVELOPMENTS IN OUR COUNTRY AND ELSEWHERE--FOR EXAMPLE, IN THE UNITED KINGDOM. BUT JUST AS THESE TRENDS TOOK YEARS, INDEED GENERATIONS, TO DEVELOP, SO IT WILL TAKE TIME TO REVERSE THEM. IN THE MEANTIME WE ALL MUST LIVE WITH THE CONSEQUENCES OF OUR PAST FOLLIES AND MOVE VERY CAUTIOUSLY BUT CONFIDENTLY ON THE ROAD AHEAD.