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Faculty Working Papers

THE GREAT STAGFLATION:
TWO RECENT BOOKS ON IT

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Summary

This is a joint review, written for the *Journal of Economic Literature*, of two recent books by Blinder and Eckstein on the Great Stagflation. The review compares the approaches, the theory bases, and the policy conclusions of the two books and examines the extent to which the policy conclusions reflect the theory bases.

Economic Policy and the Great Stagflation. By ALAN S. BLINDER. New York, London, Toronto, Sydney, and San Francisco: Academic Press, 1979, Pp. xiii, 229.

The Great Recession. With a Postscript on Stagflation. By OTTO ECKSTEIN. Data Resources Series, Vol. 3. Amsterdam, New York, and Oxford: North Holland Publishing Co., 1978, Pp. ii, 213.

These two eminently readable books were published almost simultaneously and deal with the same subject, the 1972-1977 cycle. Successful historiography must be factual as well as counterfactual, and both books are successful. Blinder writes with color and verve,

using intuition, *ad hoc* econometrics, or the full MIT-Penn-SSRC model as he sees fit. Eckstein writes austerely, using a single model throughout, his Data Resources model programmed to simulate the eight histories of the real gross national product and the rates of inflation, interest, and unemployment as they would have unfolded *if* there had been no war, *if* the war had been financed by higher income taxes, *if* there had been no price and wage controls, *if* a full-employment balanced budget had prevailed, *if* bank reserves had been growing smoothly and moderately, *if* the rate of interest had never exceeded 6 per cent, and *if* food or oil price growth had never exceeded 3 and 6 per cent per annum, respectively. The very success of the Data Resources model in predicting what did happen lends credence to its simulation of what did

not happen and to its finding that the food and oil shocks contributed 2.8 percentage points to the 1975 unemployment rate of 8.5 and 3.2 percentage points to the 1974 inflation rate of 10.3. Here is modern quantitative economics at its best!

What are the theory bases and the policy conclusions of the two books? To what extent do the policy conclusions reflect the theory bases?

Eckstein offers no succinct statement of his theory basis——perhaps none is feasible. He does offer a most readable twenty-two page overview of the economic content of three generations of large-scale macroeconomic computer models.

Blinder' Chapter 2 offers a succinct statement of his theory basis under the Einstein motto that everything should be made as simple as possible, but

not more so. Diagrams of static aggregate demand and supply curves show that whereas an upward shift of the demand curve will raise both price and output, an upward shift of the supply curve will raise price but *reduce* output. It is concluded that the supply shift fits the Great Stagflation better than does the demand shift.

Would Einstein have thought of this as being simpler than possible? Blinder is always shifting one curve while leaving the other in place. If, like Marshall's plasterers, a trade or industry is small, its demand and supply curves can be independent. But aggregate ones cannot be, consequently the economy cannot do what it does in Blinder's diagram: end up in the intersection point between a new supply curve and the old demand curve.

Next, Einstein might have observed, it is one thing to tell how high price will be, quite a different thing to tell how rapidly it will be changing. Shifting static curves is an arbitrary act of the investigator——is exogenous and one-shot. Exactly what we need!, Blinder would say, emphasizing his distinction between an exogenous one-shot inflation, caused by energy or food shocks, and sustained inflation, caused by excessive growth of the money supply. The distinction is used to pass judgment on the performance of economic theory in the 'seventies and allows Blinder to "drive the final nails into the coffin" of the monetarist model: Its simulation misses the energy, food, and decontrol shocks. Keynesian models fare better: "...it was not the adherence to 'Keynesian' policies that got us in trouble

in the 1970s." Two pages earlier, however, Blinder does take the public debate to task for having ignored the supply side. Are Keynesians really less guilty than monetarists of having taught the public to ignore the supply side?

Einstein might have been pleased, had Blinder softened his supply-side statics into a supply-side dynamics. Less than the 900 equations of the Data Resources model might do. For a quarter century we have possessed a simple and powerful piece of supply-side dynamics, Solow's (1956) neoclassical growth model. Unemployment, a Phillips curve, and natural resources could be put into it [Brems (1980)] and would show the rate of inflation to be the higher, the more rapidly natural resources are dwindling.

Blinder and Eckstein draw quite different policy

conclusions and do it with quite different biases of optimism. Towards the end of his book, Blinder tells three histories of 1971-1976. The first is the actual one; the second is what might have happened under a hands-off economic policy; the third is what might have happened under an economic policy to Blinder's liking.

In 1972 a wise economic policy would have been a hands-off policy rather than the heavy monetary and fiscal stimulus under price and wage controls actually pursued. In 1974 the actual policy *was* a hands-off policy: It failed to accommodate the food and oil shocks and even added a shock of its own, i. e., the decontrol shock. Blinder's neat distinction between one-shot and sustained inflation allows him to think optimistically of the supply shocks as one-shot

events which the Ford administration should have "accommodated" by one-shot monetary and fiscal stimuli.

But were the supply shocks one-shot events? At the end of his book Blinder looks at the next stagflation, that of 1977-1979, and observes that the new food and oil shocks were almost exact parallels to the old ones. If so, we would have had *four* major supply shocks within a seven-year period —on an average one every twenty-two months! If such supply shocks are perceived as part of a regular pattern emerging in a new, smaller, and more dangerous world, Ford-Carter nonaccommodation becomes more understandable.

Nonaccommodation is indeed one of Eckstein's two Drastic Approaches to end stagflation. Let us

take a closer look at them. Use Solow (1956) and Eckstein (1978) notation: $g \equiv$ growth rate; $K \equiv$ capital stock; $L \equiv$ employment; $p \equiv$ price; $u \equiv$ unemployment rate; $w \equiv$ money wage rate; $Y \equiv$ output. Let A be a growing parameter, α , f , and ϕ stationary ones. Find a price equation by assuming a production function $Y = AK^\alpha L^{1-\alpha}$. Profit-maximizing firms will then hire labor until the real wage rate equals the marginal productivity of labor: $w/p = (1 - \alpha)Y/L$ or $p = wL/[Y(1 - \alpha)]$, in other words, until price exceeds per-unit labor cost in the proportion $1/(1 - \alpha)$. Now differentiate logarithmically and find the price equation $g_p = g_w - g_{(Y/L)}$: The rate of growth of price equals the rate of growth of the money wage rate *minus* the rate of growth of labor productivity. The wage equation is easier, it is simply a Phillips function incorporating labor's inflationary

expectations: $g_w = f/u + \phi g_p$. Does a price-wage equilibrium exist? Is there a set of solutions (g_p, g_w) which, if expected, will come true and satisfy both the price and the wage equation? There is:

$$(1) \quad g_p = [f/u - g_{(Y/L)}] / (1 - \phi)$$

$$(2) \quad g_w = [f/u - \phi g_{(Y/L)}] / (1 - \phi)$$

which are mathematically meaningful if $\phi \leq 1$ and economically meaningful in the sense of yielding a stable equilibrium if $\phi < 1$.

The first one of Eckstein's Drastic Approaches is three to four years of rigid price and wage controls, tantamount to suppressing our equilibrium solutions (1) and (2) for a time. This will, in Eckstein's words, "accomplish the change in price expectations that is

necessary." Will it? How can the new expectations thus accomplished come true and at the same time satisfy both the price and the wage equation? If, given the unemployment rate u , productivity growth $g_{(Y/L)}$, and the structural parameters f and ϕ of the Phillips function, solutions (1) and (2) are unique, then how can price-and-wage-control values of g_p and g_w prevail once controls are lifted? Eckstein's own simulation (pp. 54-59) and that of Blinder (pp. 126-129) agree that they did not prevail: by the second half of 1974 the benefits of controls were lost.

Now for Eckstein's version of nonaccommodation. His second Drastic Approach is five to seven years of unemployment and is tantamount to adhering to equilibrium solutions (1) and (2) while maintaining a high value of u .

This is called "the other feasible strategy for ending stagflation." But how can it be? According to solutions (1) and (2) will not g_p and g_w return to normal once u does? Elsewhere in the volume Eckstein agrees that they will: "The American economy does not possess a Phillips curve which reconciles reasonable full employment with reasonable price stability." (p. 142). Elsewhere, Eckstein-Girola (1978, 332) were numerically specific: "Deriving the Phillips curve from the postwar record 1947-77 the unemployment required for perfect price stability seems to have risen to about $7\frac{1}{2}\%$, while the point where it becomes nearly vertical has remained near 4%." Unlike Blinder's optimistic bias, that of Eckstein is present only in his conclusions, not in his premises.

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