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INFLATION DECLINE: GOOD NEWS OR FOREBODING SIGNAL?

by Teresa Ghilarducci

Mid April's announcement of a third consecutive decline in the monthly inflation rate was coupled by the dismal news that one million fewer people were employed last year than in 1980. At least nine million people wanting work can't find jobs.

Fighting inflation with high rates of unemployment is a vital part of the President's economic policy. In his first State of the Union address, President Reagan attributed the price decline to the success of his economic policies. Six weeks later Budget Director David Stockman greeted the recession as "part of the cure and not the problem." A record rate of unemployment is, in this view, bitter but beneficial anti-inflation medicine.

Such economic doctoring rests on the assumption that the recession will change producers' and workers' expectations about future price increases, and that firms and workers will accordingly soften their price increases and wage demands. Lower expected inflation will also cause interest rates to go down, which supposedly causes business confidence to increase, which in turn hopefully spurs investment growth.

Although these beneficial side effects haven't occurred, Reagan's policies to fight inflation with unemployment have been helped by other factors he doesn't control. Henry S. Reuss, D-Wis. points out that "declining prices of energy attributed to a world oil glut, and lower food prices resulting from a big harvest, accounted for most of the decline"--rather than changes in inflationary expectations.

Inflation Erodes Purchasing Power. Americans polled during the last few years considered inflation to be the most important economic issue. However families don't necessarily benefit from an inflation decline. In fact the Wall Street Journal noted, ". . . for many people, gains against inflation are costly."

Many unionized workers responded to inflation by demanding cost-of-living increases at the collective bargaining table. But such wage adjustments come only after inflation has eroded real incomes, so that even the best COLAs (i.e., Social Security, federal pensions, and some union clauses) recoup only about 50-70% of the inflation losses. Therefore many workers who lost purchasing power during the last period of inflation borrowed money at record high interest rates to buy consumer goods.

During a period of decline in inflation anyone who borrowed money and expected the interest rate and inflation to rise or stabilize will be paying a higher real rate of interest. For example an 18% auto loan is actually 8% is both inflation and wage growth are 10% (you pay the loan back with cheaper dollars). So, one takes out the loan expecting prices and wages to increase. When inflation and wage growth fall, the real interest rate increases; you end up paying back the loan in more valuable dollars.

Inflation erodes buying power yet deflation can raise the interest costs of items bought on time during a period of high interest rates. Thus debtors are adversely affected during a deflation.

Who is Unemployed in the Current Recession. To the extent the inflation decline signals the presence of a severe recession, the high unemployment rates will spread to all occupations. Groups of workers who weren't seriously threatened during a recession are now targets of ailing businesses seeking cost controls and relief from production slowdowns. White collar professionals and middle management who are predominately white men (in both the private and public sector) are now readily laid-off.

Such layoffs constitute a significant change in business practice during an economic downturn. Traditionally firms lay off production workers first and "hoard" their management employees during slack times. Yet, this leads to a further decline in productivity. Currently, the middle management personnel are discovering the unemployment line, and many for the first time. Two recent business journal articles report top management's willingness to trim their often hefty supervisorial ranks in the face of lower effective demand for their products. Even though minorities and women are the first to be laid off in any slump (usually on the basis of reverse seniority) the white male unemployment rate has gone up faster than the rate for other groups during this recession. This is a result in part of the managerial layoffs, and also of special problems in America's key manufacturing industries.

Alternative Strategies for Economic Recovery. There are many ways to control inflation without inducing a severe recession. Fighting inflation with higher unemployment is unnecessarily costly from a social viewpoint and imposes severe hardship on individual workers and their families. A prolonged recession results in an immediate loss of output and investment--which are lost forever. We can't make up the loss in production from idle workers and machines at a future date.

Price, wage, profit, and credit controls democratically administered, along with rational planning and well-directed job-training and public employment, and often-used solutions to economic problems in many Western industrial nations.

Economic controls have also been used to various degrees in the U.S. in the face of economic disruption, for example, during World War II and in the depression of the 1930s, Franklin Roosevelt summed up the need of such controls in his second fireside chat in May 1933. He explained the National Industrial Recovery Act as a "partnership in planning" with the government having the right to prevent unfair practices of industry with respect to labor, prices and planning. When warned that he was taking a big step away from the philosophy of laissez-faire, Roosevelt replied, "If that philosophy hadn't proved to be bankrupt, Herbert Hoover would be sitting here now."

Price, profit, wage, and credit controls, along with an explicit commitment to full employment, may be more effective now than at any other time in our highly concentrated economy with serious resource constraints. The traditional use of deflation through unemployment imposes a cost that is too high for the national economy and the workforce.

- Teresa Ghilarducci