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Studies in Economic Policy

Notes on Stagflation

Howard S. Ellis

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INTRODUCTION

The argument of this paper rests on the following propositions: (1) Keynesian orthodoxy informs the policies of modern governments in most of the industrial West; (2) this orthodoxy, resting on Keynes's *General Theory*, is based on several erroneous components, including the principle that underconsumption is linked with hoarding, the concept of money illusion on the part of workers with respect to inflation and real wages, and a peculiar monetary theory of interest; (3) policies based on these erroneous notions have conduced to inflation and stagflation; and (4) the forces that foster and reinforce stagflation are extraordinarily hard to deal with in today's institutional and political environment. Fiscal and monetary measures run into the dilemma that curbing inflation threatens to worsen unemployment; it is necessary to invoke other measures, some of them very pervasive.

While this argument lays a heavy responsibility for our present economic impasse upon Keynesian doctrine, it does not pretend that this is the only cause. Nor does the argument overlook the fact that Keynes supplied a heartening activism at a time when many economists had sunk into helpless resignation as they confronted the greatest depression in history. Also not to be forgotten is Keynes's emphasis on the behavior of certain large aggregates at a time when the prevailing microeconomics did not afford an illuminating perspective on the economy.

Since the day of Keynes, mathematical economics and econometrics have evolved into major literatures and have produced illuminating models of the American and other economies. Although they

This paper has benefited greatly from the criticisms and encouragement of David Alhadeff, William Fellner, Gottfried Haberler, Walter E. Hoadley, Frank Kidner, J. M. Letiche, and Barry Siegel.

are sometimes referred to as Keynesian, only part of the *General Theory* has carried over into these fields.

But it was the *General Theory* that produced the revolution, infused fervor into its participants, supplied a program of action, and, most important, presented a kind of ideology. And it was that ideology which, in Keynes's prophetic words, carried over from the cloistered theorists to parliaments and ministries. When one speaks of the economic consequences of Lord Keynes, these are the things that count. A critical retrospect of the *General Theory* has become necessary because many economists have forgotten its tenets and think only of its emphasis on macroeconomics.¹ Despite the modifications of the doctrines of the *General Theory* in subsequent years, its general posture as to *policy*, however poorly founded, has carried on with scarcely reduced momentum until very recently.

¹ This seems to be the case with the otherwise outstanding presidential address of Lawrence R. Klein, "The Supply Side," *American Economic Review*, vol. 68, no. 2 (March 1978), pp. 1-7.

1

Keynes's Revolution: Theory

Underconsumption

Keynes held that individual acts of saving destroy themselves because in the aggregate they contract effective demand, employment, investment, and income.¹ It is underconsumption that ushers in depression and—on a longer view—explains “equilibrium with less than full employment.”

Can a whole society *underconsume*? A communist government can deprive its population by forced underconsumption, as the U.S.S.R. certainly did for many years; depression and unemployment did not follow because the state itself did the investing, and the government did not hoard (governments seldom do!). How about a private enterprise economy? The answer is, of course, yes, if the saving eventuates merely in unspent accumulation, that is, in hoarding,² by the general public or by business or financial institutions to which the public

¹ J. M. Keynes, *The General Theory of Employment, Interest and Money* (New York: Harcourt Brace, 1935), pp. 84, 324, 359.

² The activity of increasing one's holdings of money in real terms can of course be expressed in several words or phrases, such as a shift of the demand for money or liquidity preference function to the right, transferring money from M_1 (active money) to M_2 (contingency reserves), increasing one's cash balance, or hoarding. Appropriate definition of these terms can easily make them more or less synonymous. I prefer the term “hoarding” chiefly because of its brevity and because it carries approximately the right connotation to the lay reader. It does not bespeak a commitment on my part to simplistic quantity theory or monetarist convictions. Indeed, the exposition in these pages will reveal agreement with one proposition (but not all) of the Latin American “structuralist” position, namely that the impact of monetary change on prices depends on many institutional factors, and with Keynes's emphasis upon psychological elements in the demand for money.

entrusts its savings, a familiar and universally recognized attribute of depressions. Then why is not an underconsumption theory a first-class "general theory" of less than full employment?

The answer, quite simply, is, first, that saving and hoarding are distinct phenomena: saving without hoarding does not and cannot diminish the flow of expenditure, employment, national income, and so forth. And second, as incomes rise in the recovery and boom phases of a cycle, savings increase—of course—but not consumer hoarding. I emphatically do not believe that economic downturns have characteristically been marked by either a gradually developing or a sudden consumer strike; and even if they were, it would be not the reduced consumption per se, but the hoarding per se, that would be responsible. Once a depression is under way, both consumers and producers hoard, though probably not in any important degree the consumers who still have jobs. In a depression it is wise for the government to offset hoarding by new money.

In confusing private saving with hoarding, Keynes was overlooking a vast and important literature concerning the causes of depressions that existed in his own day and generation. Much thought was devoted to the obstacles that could—and sometimes do—retard the flow of savings into active investment. One thinks of such economists as Fisher, Mitchell, and Marget in the United States, Lavington, Hawtrey, Robertson, and the Keynes of the *Treatise of Money* in England, and Wicksell, Cassel, Lindahl, and others on the Continent, all of whom confronted the problem of depression and assigned to underinvestment an important role.

Followers of the *General Theory* have, in general, abandoned it as a general theory of economic activity and have fallen back on its usefulness as depression economics. Even in this role, however, its relevance seems limited if the downturn into depression has to rest on underconsumption. Keynes argues that private savings are abortive, but he neglects the sustaining power of private saving and investment in the maintenance of plant when the economy "bumps along the bottom," as well as—more important—the generally accorded contribution of private investment during the recovery process.

When we look aside from more or less typical depressions to the present scene of inflation with less than full employment, is anyone prepared to assign a basic role to underconsumption or oversaving?

The Keynesian Multiplier

The Keynesian multiplier is the ratio of total income accretions, ensuing from a series of expenditures of money against goods, to the

original investment that sets it afoot. As Keynes explains, its magnitude varies directly with the proportion of the increment of *consumption* expenditures to the increment of the income of the community.³ Two characteristics of this multiplier could be noted. First, the magnitude of the multiplicand (amount being multiplied) is an increment of investment. As national income rises in recovery or in the process of growth, the proportion of income that the public spends on consumption declines, and saving increases. Compatible with the oversaving thesis, in which most or all private saving is hoarded, the increment of investment comes through public spending; Keynes is explicit about this. But no matter how questionable the government spending may be, it always “creates” employment. Second, also consistently with the oversaving thesis, the share of expenditure that does not go into consumption drops from view in the multiplicative income generation ensuing from a unit of investment. Thrift cannot be allowed a role in expanding income or employment. Only consumption outlays make positive contributions to expanding income in the multiplier, and most or all investment is made by government and appears in the *multiplicand*.

Later Keynesians sought to compensate for the one-sided bias of the multiplier by adding the acceleration principle to allow for the contribution of spontaneous private investment. Although this supplement to the *General Theory* filled in one lacuna, it produced no impression on the Keynesian denigration of thrift, on the complete indifference of the *General Theory* to the weal or woe of private investment, or on the standard prescription for underemployment of cheap money, government spending, and inflation.⁴ Savers remain the bêtes noires of the private enterprise community, never its unsung heroes.

Involuntary Unemployment

Keynes defines involuntary unemployment as existing if a rise in the cost of living relative to money wages increases both the supply of and the demand for labor.⁵ This definition is noteworthy in two respects: first, because it defines involuntary unemployment in terms of the cure that Keynes believed would work, something of an acro-

³ Keynes, *General Theory*, pp. 115–116.

⁴ A further refinement would be to note that, even if saving exceeds investment in the domestic economy, no contraction of incomes would follow if exports exceed imports in like degree.

⁵ Keynes, *General Theory*, p. 15.

batic feat of circular reasoning; secondly, because it is a candid declaration that, if laborers can be cheated out of a part of their real wages, more people can be employed. One can readily understand why government expenditures financed by budget deficits and cheap money secured through central bank and commercial bank credit expansion constitute the approved therapy.

One cannot readily understand, however, why Keynes, who accorded to anticipations an excessive role in the theory of interest,⁶ should have ignored them in the case of wages. This implicit reliance upon money illusion on the part of laborers to produce a fall of real wages and an increase of employment carried the Phillips curve through a decade or more of acceptance but eventually proved its undoing. Thus, in the end, involuntary unemployment could no longer be explained as the result of insufficient inflation.

The Theory of Interest

If a theory is to be revolutionary, it cannot, of course, countenance the generally accepted convictions. The diametrical opposites must be proclaimed: the rate of interest is a monetary phenomenon; short-term interest rates determine the long-term rates; and general equilibrium is worked out not over a broad range of markets but specifically through the rate of interest.

Each of these three attributes follows from the oversaving, underconsumption general theory. First, the term "marginal productivity," with its quite obvious reference to real capital goods, is out of place in a monetary theory, and such real determinants on the supply side as a time preference must yield to the supply of money and the demand for speculative uses of funding. If underconsumption is to be cured by inflationary levies on wage earners' incomes, the rate of interest must depend not on technological and deep-seated psychological factors but on something easily manipulated, and the supply of money fills the bill exactly. Thus also the second and third characteristics of Keynesian interest theory follow: short-term monetary rates govern the long-run real factors of "marginal efficiency" and the propensities to consume and save; and the interest rate is what brings these general equilibrium factors into equality.

In this matter the evidence of history is unequivocal. Efforts to

⁶ Keynes's remarks that the rate of interest "is largely governed by what its value is expected to be" (*General Theory*, p. 203), led D. H. Robertson to comment that the Keynesian interest rate resembled the smile of the Cheshire cat, which persisted after the cat had vanished.

lower money interest rates by dosages of money and inflation may succeed in the short run but not in the long run. This therapy generally tends to *raise* money interest rates, but not always enough to prevent the real rate from falling. Inflation also tends to sidetrack investment into such escape channels as real estate and already produced items, such as gold coins, jewelry, and oriental rugs; and even production can be directed into similar nonproductive forms. If usury laws exist and are at least partly enforced, interest rates may be prevented from rising enough to offset the inflation, and both saving and productive investment are penalized.

The supposed dominance of the rate of interest over the realization of equilibrium follows from the supposed dominance of money over the rate of interest. But the uniqueness of the interest rate as the indicator of the opportunity cost of borrowing cannot be maintained even for short-term rates, and for long-term rates it becomes completely implausible. Practical money and banking experts have repeatedly stressed that, in addition to the rationing function exercised by rates of interest, bankers lay down conditions for making loans, such as the borrowers' maintaining minimum amounts in checking accounts, pledging securities of prescribed quality, and meeting other criteria pertaining to business risks, character, quality, and so on. On the side of general *real* equilibrium, it seems a gratuitous formality to conduct *all* the important forces involved, even wage rates, through the needle's eye of the interest rate; by implication also, this downgrades all other factors into subordinate significance.

The Phillips Curve

Though not a part of Keynes's own theoretical structure, the Phillips curve, expressing the terms upon which an inflationary rise of prices can be traded off for an increase in employment, came to be a working tool of the post-Keynesian orthodoxy. For a considerable period—some say for the years between 1954 and 1968—the Phillips curve fitted the inflation-employment data in the United States "like a glove."⁷ Of course a perfect fit is not tantamount to a vindication of a policy of purchasing additions to employment by inflation. First, the policy can be and should be challenged from the standpoint of ethics. Second, the American public was being given a clear and prolonged schooling in the workings of inflation: expectations were coming to be framed in terms of this year's price increases as merely

⁷ Arthur M. Okun, "Inflation, Its Mechanism and Welfare Costs," *Brookings Papers on Economic Activity*, no. 2 (1975), p. 354.

the point of departure for all subsequent years' rates, discounted back into the present.

The data on inflation and employment began in the 1950s and 1960s to fit the Phillips curve less and less "like a glove," as explained by Milton Friedman. In his Nobel lecture in 1976, he stated that in the seven leading industrial nations for at least the decade after 1965 "it became increasingly difficult to accept the [Phillips] hypothesis in its simple form. Many attempts were made to patch up the hypothesis by allowing for special factors." In the end, however, the rate of unemployment was discovered to be "largely *independent* of the average rate of inflation." By the autumn of 1976, James Callaghan, prime minister of the United Kingdom, and a Canadian White Paper were ready to declare that the *positive* correlation of inflation and unemployment runs "directly counter to the policies adopted by almost every Western government throughout the postwar period."⁸ Thus the Phillips curve became the chief casualty of Keynesian orthodoxy, and inflation was revealed as a chief cause of the unemployment component of stagflation.

Say's Law of Markets

The law popularized by J. B. Say was also clearly stated by James Mill, John Stuart Mill, and David Ricardo, and it continued to be regarded as an important truth until the time of Keynes. The law set out the equality of the aggregate of goods offered on the market and the demand on the market. Like the Keynesian equality of savings and investment, it can be interpreted in two ways: an equality reached by an adjustment process during which inequality may persist, or, abstracting from frictions and time-consuming processes, an identity that is instantaneous and continuous.

Say's law aroused Keynes's ire probably because he thought it implied that crises and depressions cure themselves through the automatic workings of markets. Possibly some economists have thought so, but not the serious business-cycle and general economists who have been pointed to as leaders in the profession in Europe and America and cited earlier in these pages. Had they believed in any such automaticity, they could not have written with evident concern about the problem or taken pains to elaborate fiscal, monetary, and other remedies. But nothing in Say's law, taken either as an identity

⁸ Milton Friedman, "Nobel Lecture: Inflation and Unemployment," *Journal of Political Economy*, vol. 85, no. 3 (June 1977), pp. 451-472, especially pp. 459, 460, 464, 469.

(which cannot imply anything as to policy) or as the result of an equilibrating process (which does not necessarily include a reference to the social costs of the process), denies that institutional, psychological, or other factors can impede the flow of savings into investment.⁹ Nor does the law deny that the intervention of the state may be required to facilitate that flow.

Keynes's strictures on Say's law have caused more than a generation of younger economists to excoriate it as a monstrous piece of deception or to laugh at it as an absurdity. In certain contexts, however, the proposition carries important truths. It should be realized that (to retain figures now outdated) 135 million people in the United States consume more than do 400 million Chinese because the United States produces more.¹⁰ The Third World should recognize the truth of this assertion when it regards, with great moral indignation, the large proportion of certain raw materials consumed by the United States—though in some cases, of course, American wastefulness, such as our automobile consumption of gasoline, may be just cause for rebuke.

On the other hand, for affluent countries and their citizens, accustomed to government largesse and to the idea that incomes are largely fortuitous, there may be some therapeutic value in the truth that if one citizen consumes more than he contributes to the aggregate social income, someone else must consume less. There is, forsooth, no such thing as a free lunch.

Virtually all the important constituent parts of Keynes's theory have proved to be fallacies: the underconsumption basis, the definition of involuntary unemployment, the multiplier, the theory of interest, and the attack on Say's law. From the standpoint of practical policy, the ultimate debacle comes in the failure of inflation to yield positive increments to employment—no matter if it renders the situation worse, as now seems to be probable. The Keynesian revolution has made an important contribution to stagflation.

⁹ See Robert Clower and Axel Leijonhufvud, "Say's Principle: What It Means and Doesn't Mean," *Intermountain Economic Review* (Fall 1973), pp. 1–16, especially p. 3.

¹⁰ B. M. Anderson, "The Road Back to Full Employment," in *Financing American Prosperity*, Paul T. Homan and Fritz Machlup, eds. (New York: Twentieth Century Fund, 1945), pp. 9–70.

2

Keynes's Revolution: Derivative Policies

Budget Deficits, Cheap Money, Public Debt

In the pre-Keynesian orthodoxy, the goal of a balanced federal budget hovered in an uncertain zone between a means toward securing economic stability and an end in itself, somewhat like attitudes concerning the international gold standard. Enlightened opinion favored balancing the budget over the cycle. As for increases in the public debt, economists patiently explained that it differed from private debt in that public debt held internally means only that "we owe it to ourselves." But John Maurice Clark at an early juncture warned that the higher taxes to support the service of the debt "when taxes are already very heavy, may become a factor limiting investment and production."¹

During the Keynesian epoch, the creation of new money by deficit financing, cheap money, and increasing public debt were viewed variously with approval, equanimity, or misgiving, but the center of gravity for loyal followers of Keynes was an easy optimism. One well-known economist explained that there was no reason a country should not borrow to pay interest on its debt. And James Tobin, president of the American Economic Association in 1971, justified the Phillips curve association of more employment with more inflation. However, his justification has been shown by William Fellner

¹ J. M. Clark, "Financing High Level Employment," in *Financing American Prosperity*, p. 91.

to depend on *actual* inflation's outrunning the *expectation* of inflation by wage earners.²

Most of these liberal ideas have dropped away under the strong light of stagflation, which permits no illusions about the beneficial results of budget deficits and cheap money in the present scene. Stagflation would certainly seem to necessitate a year-by-year reduction of deficits and a movement toward a balanced budget.

Fiscal versus Monetary Policy

Followers of Keynes have generally believed that fiscal measures to combat less than full employment are superior to monetary devices. Erroneously believing that monetary measures act only through lowering the rate of interest, they regarded them as "pushing on a string," in the popular phrase of the 1930s and 1940s. By contrast, budget deficits could put money directly into circulation through a variety of easily accessible channels, such as unemployment benefits, public works, and subsidies to local government units.

Without denying some merit to this argument, D. H. Robertson summarized the case for monetary policy. Fiscal policy is particularly intractable to being put into reverse by parliamentary debates. Even after a particular course is resolved upon, substantial lags in execution must be expected. And one must not forget that, in Anglo-Saxon countries at least, the habit of paying taxes is a valuable asset for the control authorities. How would this habit stand up under the frequent, swift, and apparently capricious changes that might be required if taxation devices were to be made "the sole regulator of economic activity"?³

In fact, fiscal policies including the specific structure of taxes do not have the categorical superiority attributed to them by Keynesians, nor is there any categorical superiority of monetary measures. Future programs to control stagflation will have need of both.

It would be erroneous, however, to limit the attack to purely aggregative magnitudes involved in stagflation, particularly since the aggregative approaches have generally taken their orientation from the demand side of the market. In his presidential address to the

² James Tobin, "Inflation and Unemployment," *American Economic Review*, vol. 62, no. 2 (March 1972), pp. 1-18; and William Fellner, *Toward a Reconstruction of Macroeconomics* (Washington, D.C.: American Enterprise Institute for Public Policy Research, 1976), pp. 26-28, 44-47.

³ D. H. Robertson, *Utility and All That* [reprint of "What Has Happened to the Rate of Interest?" 1948] (London: George Allen and Unwin, 1952), pp. 83-96, especially p. 93.

American Economic Association, Lawrence R. Klein presents a refreshingly new and salutary emphasis on the supply side. This will lead not only to a further departure from Keynesian theory and Keynesian remedies but also to a recognition of important micro-economic contributions to the solving of macroeconomic problems. "One way, but not the only way, of getting to full employment without generating fresh inflationary pressures," he writes, "is to design a jobs program for about 1.0 million long-term, hard-core unemployed."⁴ One could envisage numerous other projects for the improved operation of the economic system, and hence for the mitigation of employment and inflationary pressures, that could arise from detailed studies of the supply side.

Full Employment as the Overriding Aim of Public Policy

Misgivings about the long-run consequences of a commitment to full employment were expressed early in the period of propagation of Keynesian ideas. In 1945 I ventured the opinion that "without a thoroughgoing program of institutional reform to favor competitive enterprise and venture capital, I would expect continued resort to deficit financing to carry us along to a fascist or socialist state."⁵ Authority was lent to this view by J. M. Clark, who believed that "if the country sets for itself a rigorous standard of completely full employment—the only system which can meet this test will be an outright collectivist economy."⁶ Rather surprisingly, these thoughts were shared even by Keynes, who wrote, "a somewhat comprehensive socialization of investment will prove the only means of securing full employment."⁷ Forces making for inflation, in the analysis of Robertson, are that (1) a policy of full employment "encourages the maintenance of a swollen stream of monetary demand," (2) this in turn diminishes resistance to wage demands, and (3) "the fear of creating pockets of unemployment tends to cut across and stultify other government policies directed toward breaking down monopolistic practices and barriers to international trade."⁸

Extending this line of comment to the contemporary scene, two

⁴ Klein, "The Supply Side," p. 5.

⁵ Howard S. Ellis, "Economic Expansion through Competitive Markets," in *Financing American Prosperity*, p. 138.

⁶ Clark, "Financing High Level Employment," p. 72.

⁷ Keynes, *General Theory*, p. 378.

⁸ Dennis H. Robertson, "Creeping Inflation," in *Economic Commentaries* (London: Staples Press, 1956), pp. 118–120.

American economists attempted to explain why Britain pursued policies that led to its suffering the worst inflation in the Western world. They ascribe this result to the fact that "price stability has simply not been regarded as an objective of paramount importance, in the way that full employment has been."⁹

Quite aside from the *fullness* of employment, it is questionable whether employment itself is an overriding goal of economic activity, since this runs the risk of justifying any sort of make-work regardless of economic productivity. Production and consumption are the basic goals, and economists themselves may well bear this in mind, even if they freely concede employment goals to politicians and governments as secondary objectives.

⁹ John Williamson and Geoffrey E. Wood, "The British Inflation: Indigenous or Imported?" *American Economic Review*, vol. 66, no. 4 (September 1976), pp. 530-531.

3

The Role of Inflation in Stagflation

Chapters 1 and 2 have played a predominantly, but not exclusively, negative role in clearing away the debris of the Keynesian under-consumption theory, a necessary preliminary operation before the central theme, which is positive, can be tackled. Stagflation is a relatively new phenomenon, and theorizing is correspondingly recent. A very considerable effort will be essential to reorient economic discussion to this kind of economy and to evolve a satisfactory and internally consistent set of policies.

In this panoramic view, some peculiarities or earmarks of the present approach may be mentioned. One is that stagflation has many facets and will require multiple remedies.¹ Second, the mutually intensifying nature of several causal factors must be emphasized. Third, the role of public anticipations needs to be strongly highlighted.

Monetary Factors

The role of money in economic fluctuations, as both a cause and an instrument of control, has been well covered in the economic literature of the twentieth century by such writers as Cassel, Wicksell, Mises, and Schumpeter in continental Europe; Marshall, Pigou, Hawtrey, Lavington, and Robertson in England; and Fisher, Marget,

¹ While the following pages set forth several potential policies specifically oriented toward stagflation in the current situation of the United States, many other policies amply warrant the attention of academic and nonacademic economists. See, for example, "Ten Ways to Cut Inflation," *Time* (April 10, 1978), p. 87. Research on such issues might well supplant some of the niceties of theoretical speculation that occupy so much space in the current economic journals.

Mitchell, Haberler, Friedman, Fellner, and others in the United States. All of these writers have ascribed to money a significant role, as both cause and cure. During the next decade I would expect a revival of interest in the older of these writers and a salvaging of useful analysis undertaken during the Keynesian era.

As a consequence of Professor Shaw's demonstration of the growth of money substitutes in the United States, it was fashionable for a time to believe, though not because of any contention by Shaw to this effect, that a policy of monetary restraint could always be offset by greater resort to—or invention of new—money substitutes. More recently, however, money defined as the total of currency and checking and time deposits in commercial banks (as in one old-fashioned description) has evinced a substantially stable ratio to GNP over periods of nearly a decade, stable enough at any rate to belie any supposed futility of monetary policy.

Countercyclical monetary policy could of course be emasculated through wrong ideas about what it should try to do. For one thing it is clear that there is no merit, indeed great error, in omitting *any* price from the index to be stabilized unless the item is of trivial quantitative importance. Thus the high price of oil cannot be omitted on the ground that it is imported, not indigenous, inflation. By such casuistry, wages could also be excluded from inflationary costs on the excuse that they *result* from inflation instead of contributing to it. Such concessions would undermine monetary controls completely.

Fiscal Elements in Inflation

In the United States the federal government, unlike some cities and even some states in recent years, has never faced bankruptcy. This immunity rests in part on the federal government's having exploited income taxation more heavily and earlier than most states and—more crucially on its exclusive prerogative of creating money. Not unnaturally this difference has led to the belief that federal grants-in-aid to states and cities are fair, humane, equalitarian, and also economically beyond reproach.

This transfer system probably has substantial inflationary effects, however, involving as it does an absolute divorce of the source of the funds, which is federal, from their expenditure, which is by states and municipalities. The combination encourages irresponsibility, first as to the amount of the outlays and second as to their questionable economic productivity, both inflationary factors. President Carter's proposal to continue the 16 percent average annual increase

of this item in recent years by allocating to it 17 percent of the total federal outlays in the budget for fiscal 1979 would seem to be a step in the wrong direction. Reducing federal taxation by a part or all of the amount of these transfers would have a counterinflationary effect, unless of course offset by increased deficit spending.

Another and perhaps more important inflationary force is the automatic advancement of federal income tax payers to higher tax brackets, even if the rise of their money incomes does no more than keep their real incomes from falling. A recent study by Professor Fellner and his associates shows that in 1975, with a 10 percent annual inflation, federal revenues increased 17 percent, leaving a net 7 percent transfer of real income to the government. Such a windfall accretion of revenue undcutbtedly boosts government spending and demand-induced inflation. To prevent this enormous concealed source of federal revenues, these economists propose a compensatory automatic increase in the income tax exemption limits, tax credits, standard deductions, and the lower and upper limits defining each bracket.²

On balance this proposal appears to be sound despite a possible objection that it prevents an increase in taxes in an inflation setting in which conventional logic would approve it. But it does seem plausible that a typical congressman, in deciding how to vote on a proposed new expenditure or even on a grant-in-aid appropriation, would feel greater restraint if he believed that he would also have to vote for an increase in the income tax or for raising the national debt limit than if additional revenue would be forthcoming through the automatic workings of inflation on the tax yield.

Aside from such ad hoc measures, however, fiscal policy should be endowed with certain far-reaching programs and objectives aimed specifically at stagflation. A general but gradual shift of the burden of taxation from business to the personal income tax would supply a much needed correction. Economists have long maintained that effective progressivity can be achieved only by personal income taxation; furthermore, the levies on business involve double taxation. In the midst of numerous impairments of business motivation in the United States, such a reform has much to recommend it, not only for its equity but also for its timeliness.

At a juncture when budget deficits and inflation are being

² William Fellner, Kenneth Clarkson, and John Moore, *Correcting Taxes for Inflation* (Washington, D.C.: American Enterprise Institute, 1975); and Fellner "Money Supply and the Budget: Current and Future Problems of Demand Management," in *Contemporary Economic Problems, 1977* (Washington, D.C.: American Enterprise Institute, 1977), pp. 108-112.

revealed as enemies of society, fiscal policy should take as its basic objective the reduction of deficits year by year. This implies, as Professor Fellner maintains, that fiscal and monetary policy accept responsibility for progress toward a balanced budget and "a gradual return to an approximately horizontal price trend as the only safe target."³

Wage-Induced Inflation

Practical unanimity exists today among economists that wage increases in the current scene contribute positively to inflation. The monopoly power of labor unions, however, antedates the present stagflation, and monopoly prices can limit employment and constitute an inflationary force from a standing start, that is, operate independently of wage increases. First, any income in excess of marginal product under competitive conditions signifies a money payment exceeding the flow of produced goods and services, as Friedrich Lutz correctly maintained.⁴ To be specific, the absolute height of wages in the organized building trades can be a cause of unemployment or inflation or both, independently of increased wages in recent times. Second, the mere downward inflexibility of the wages of unionized labor can engender inflation. Similarly a monopoly-controlled price rise, as in the price of imported oil, would require a fall of other prices if overall price stability were to be maintained. Otherwise the average level of prices must rise, and inflation is under way, as a number of earlier writers, and more recently Charles L. Schultze, have explained.⁵

In the present stagflation dilemma not much help can come from the far-reaching but slow-moving basic reforms that could alleviate the microeconomic excesses of monopoly wages over productivity and the downward inflexibility of wages. Consequently, the discussion of the wage element in inflation has centered on increases in wages. Furthermore, because the correlation between prices and

³ William Fellner, "Criteria for Demand Management Policy in View of Past Failures," in *Contemporary Economic Problems, 1976* (Washington, D.C.: American Enterprise Institute, 1976), pp. 85–88. Furthermore, as Herbert Stein argues (p. 83 in the same volume), if the fiscal and monetary authorities act convincingly toward these objectives, it should be easier to persuade businesses and workers to "act in a way consistent with that outcome."

⁴ Friedrich A. Lutz, "Cost- and Demand-Induced Inflation," *Banca Nazionale Del Lavoro*, no. 44 (March 1, 1958), pp. 3–18.

⁵ Charles L. Schultze, *Recent Inflation in the United States*, Study Paper no. 1, Joint Economic Committee, 86th Congress, 1st session, September 1959.

wages is so close as to preclude in practice the separation of demand-pull from cost-push,⁶ possible remedies have largely dealt with *excessive* wage increases, such as A. M. Okun's proposal for taxing firms that grant greater than average raises and rebating business taxes for those acceding to less than average increases.⁷ Although such measures would offer a welcome decelerating influence, they accept the average of wage inflation as their point of departure.

Product Prices under Monopolistic Control

Conceivably, even if commodity prices were completely competitively determined, sufficiently powerful union domination of the labor market could result in a vicious and continuing inflation of both wages and prices. There can be very little doubt, however, that product monopoly and monopolistic competition of finished goods could be as inflationary a force as wage demands. In contrast with temporary price increases as a result of natural shortages on the supply side, wage and product monopolies engender more or less continuous inflation by their potent influences on the supply of money through political pressures in and on the Congress. Furthermore, the more widespread these monopolistic elements are, the more the consequences of inflation are visited upon a smaller and smaller portion of the market, and the more inflation becomes a competitive game, a veritable *bellum omnium contra omnes*.

Industrial, commercial, and financial monopolies are so formidable and so ancient a problem that few bright ideas are forthcoming specifically concerned with their behavior in inflation and the current stagflation.⁸ Basically there seems to be a resurgence of conviction that fundamental structural reforms are prerequisites of inflation (and stagflation) control. For a long time I have maintained that successful control of inflation depends finally on reducing union

⁶ Geoffrey H. Moore, "Lessons of the 1973-1976 Recession and Recovery," in *Contemporary Economic Problems*, 1977, p. 154.

⁷ But Gardner Ackley, former chairman of the President's Council of Economic Advisers, believes that Okun's proposal would encounter insurmountable practical obstacles. See "Okun's New Tax-Based Incomes Policy Proposal," *Economic Outlook*, U.S.A., Winter 1978, pp. 8-9.

⁸ Howard M. Wachtel and Peter D. Adelsheim demonstrate that industries with a high concentration of control tend to counter a shrinkage of their sales by increasing the markup on their products. Thus stagflation increases inflation in a vicious circle. The authors, however, do not suggest countervailing public policies. See "How Recession Feeds Inflation: Price Mark-ups in a Concentrated Economy," *Challenge*, vol. 20, no. 4 (September-October 1977), pp. 6-13.

power, securing freer international trade, improving productivity, reducing rigidities, and, in general, increasing competition.⁹

The Role of Expectations in Inflation

Knut Wicksell, that great genius of Swedish monetary theory in the early twentieth century, believed that brief or unexpected inflation can usually be mastered but that if inflation comes to be embodied in expectations, it is a raging avalanche.¹⁰ This profound observation is borne out in the histories of serious inflations wherever and whenever they have occurred. In the German postwar inflation of 1918–1923, which I witnessed as a student at the University of Heidelberg, anticipations came finally to play so strong a role that prices outstripped the rate of issue of fiat money. The peculiar phenomenon developed of an actual shortage of money to carry through transactions at posted retail commodity prices.¹¹

While public anticipations are a powerful force and inflation does indeed feed upon itself, it would be a mistake to represent these factors as always capable of overriding monetary policy. Unless expectations are validated by monetary policy, they cannot prevail.¹² In another setting of runaway inflation, to which I was a witness in Brazil, a determined policy of curbing the rate won out, even though the population had for fourteen years (1952–1966) experienced an annual increase in the cost of living that was never less than 14 percent and rose to 92 percent by 1964. Certainly adverse expectations could scarcely have had a more solid background. Nevertheless, within four or five years the policy called “corrective inflation”

⁹ See Howard S. Ellis, “Economic Expansion through Competitive Markets,” in *Financing American Prosperity*, pp. 126–196; “Monopoly and Unemployment,” in *Postwar Economic Studies*, no. 4 (Washington, D.C.: Board of Governors of the Federal Reserve System, May 1946), pp. 67–94; and “The Conflict between Growth and Control of Inflation,” in *Economic Development with Special Reference to East Asia*, Kenneth Berrill, ed. (London: Macmillan, 1964), pp. 255–269.

¹⁰ Knut Wicksell, *Geldzins und Güterpreise* (Jena: G. Fischer, 1898), pp. 85 ff.; and Wicksell, *Vorlesungen über Nationalökonomie auf Grundlage des Marginalprinzips* (Jena: G. Fischer, 1922), preface, p. xi, and pp. 222–224.

¹¹ Howard S. Ellis, *German Monetary Theory, 1905–1933* (Cambridge, Mass.: Harvard University Press, 1934), p. 279.

¹² A group of contemporary economists, who have come to be known for their work under the caption of “rational expectations,” hold that public anticipations of government measures and their consequences negate the effectiveness of such action. While this is in some degree true, anticipations are seldom immediate and total. The lag and the incomplete participation of the public in the anticipations always leave room for wise measures to have good results and unwise measures to wreak havoc (see *Business Week* [November 8, 1976], pp. 74, 76).

brought the annual rate down to about 20 percent.¹³ Undoubtedly public confidence in the Costello Branco government, including its prestigious economic members, contributed greatly to this success, underscoring the importance in economic policy of the factor of credibility, which William Fellner has emphasized in his recent publications.

In a context of unemployment conjoined with inflation there are, of course, certain forces that operate in the opposite direction, but the general ambience practically ensures their being submerged. Thus the unemployed may liquidate real assets, and this has a deflationary effect. But since money is depreciating and real wealth is appreciating, the rational choice dictates drawing down on money holdings; hence an inflationary force prevails. Similarly unemployment prompts a belt-tightening by the victims and their families. But again, deflationary reaction by the unemployed minority (generally a small minority) is lost in the spending spree of the majority, which responds to the illusory gains in wealth and income.

Unemployment compensation and various types of welfare, including social security, involve deflation so far as they are paid for by worker and employer contributions. But in times of abnormally high unemployment, disbursements are bound to exceed inpayments, and inflation results. Indeed, when the federal government bridges part of the gap by budget deficits, "high-powered" money going into commercial bank reserves creates a multiple effect on inflation; and the same result follows when federal subvention relieves the pressure on local government units.

Account must be taken of the disruption of relative prices that inevitably attends inflation. As Schumpeter eloquently argued in tracing the forces that convert booms into depressions, the rational weighing of price-cost relations becomes difficult, entrepreneurial choices often err, and business motivation suffers. Economic growth falters and threatens to turn into recession. Thus an ideal setting is created for the continuance of stagflation.

Indexing has been advocated as a way of rendering inflation innocuous. But as far back as 1955 Dennis Robertson pointed to the fatal shortcomings of this approach, which he characterized as an attempt to "contract out." He quoted Professor Lundberg to the effect that in Sweden even then, thirty or more years ago, "the trade union movement attempts to forecast *the effect of [its own] wage claims*

¹³ Howard S. Ellis, ed., *The Economy of Brazil* (Berkeley and Los Angeles: University of California Press, 1969), chapters 5 and 7.

on prices and to write up the claim in accordance with a multiplier formula which takes account also of *the marginal rate of taxation being higher than the average.*" What we now call indexing would probably omit some categories of income receivers, with corresponding social injustice. But the more nearly universal indexing is made, the more it would "destroy the gradualness of the inflation."¹⁴ It should be clear why most of the outstanding contemporary specialists in macroeconomics now reject indexing "as anything more than an incomplete mitigation of inflation."¹⁵

Playing the Game of Inflation

Once inflation really begins to roll, the public seems to be seized by a kind of vertigo in which real values, good judgment, and even honesty are swept away. People who would not knowingly cheat their neighbors directly do so indirectly without a qualm by cheating the government, which comes to appear a veritable El Dorado, through grants, aids to local governments, subventions, tax exemptions, loopholes, refuges, projects, job proliferations, junkets, fringe benefits to legislators, and virtually any outlay undertaken in the name of conservation, education, and public health. Let me illustrate by reference to the last of these worthy causes. In the annual national public health bill of \$150 billion, inflation fortified by malpractice suits and excessive jury awards can be held accountable for the skyrocketing of hospital costs. In combination, these factors undoubtedly explain the annual rise of these costs by 9 percent for fifteen years before the institution of Medicare in 1966.

But in the five years following 1966, these costs rose by an annual average of 15 percent.¹⁶ The Social Security Act provided that payments should be made to hospitals and doctors through fiscal agents selected by the doctors and hospitals themselves. The choice has been overwhelmingly Blue Cross and Blue Shield, the boards of which are preponderantly composed of representatives of doctors and hospitals. Small wonder then that these fiscal agents have largely determined the payment policies and scales of the Medicare program.

¹⁴ Robertson, "Creeping Inflation," pp. 116-128. (Emphasis added.)

¹⁵ A carefully weighed, adverse judgment of indexing with special reference to Brazil has been presented by Alan Abouchar in the *Canadian Forum*, vol. 54 (August 1975), pp. 12-14.

¹⁶ Robert Claiborne, "The Great Health Care Rip-off," *Saturday Review*, vol. 5, no. 7 (January 7, 1978), pp. 10-16, 50. Figures and statements come from this source.

Medicare maximums for specific medical and surgical services rapidly become the minimums actually charged, prompting a rise to new maximums, and so on indefinitely. In addition, the accounting rules of the Social Security Act have proved to be a gravy train for hospitals, it is said, actually permitting depreciation charges, for example, to be applied to new and additional equipment.

Government Contributions to Inflation and Unemployment

Pride of place at the end of a list of factors making for and perpetuating stagflation belongs to policies of the federal government.¹⁷ Foremost among these are policies related to agriculture, followed closely by policies related to labor unions and wages and to industry. In the current scene, fairly characteristic of recent years but especially lamentable in a setting of two-digit inflation, come the measures designed to raise farm income by boosting inflation—not by decreasing it. Feed grain and cotton farmers would be paid \$600–\$700 million for keeping 5 million acres out of production. The administration proposes to raise the support price of wheat from \$3.50 to \$4.50 a bushel and of soybeans from \$3.50 to \$4.00. In addition, there are the usual import restrictions for agricultural products and the “voluntary” limits expected of foreign suppliers.

Unemployment is being countered, not by programs to train large numbers of youths in the mechanical arts, but by unemployment benefits (including strike compensation) that sometimes compete successfully with earnings from actual employment. As an exception to the minimum wage law, Arthur Burns has advocated that the government offer jobs on public works at a wage slightly below the federal minimum wage level. As a further inducement to work, it has been proposed to extend the income tax to unemployment benefits.

As for wage rates themselves, the absurdity of the conventional improvement factor of 2.5 percent, ostensibly warranted by increases in productivity, has been pointed out, in view of the actually recorded

¹⁷ Gottfried Haberler has strongly emphasized the inflationary impact of government measures in several publications, including the outstanding general analysis of “The Problem of Stagflation,” in *Contemporary Economic Problems*, 1976, William Fellner, ed. (Washington, D.C.: American Enterprise Institute, 1976), pp. 255–272. See also the longer exposition in Haberler’s “Stagflation: An Analysis of Causes and Cures,” in the Festschrift for William J. Fellner, *Economic Progress: Private Values and Public Policy*, Bela Balassa and Richard Nelson, eds. (Amsterdam: North-Holland Publishing Company, 1977), pp. 311–329.

gain in productivity in the United States of only 1.5 percent annually over the past decade. The difference of 1 percent over the vast field of labor contracts is a purely gratuitous contribution to inflation. Furthermore, by the terms of the Davis-Bacon Act, the secretary of labor is instructed to reimburse labor on federally sponsored projects at the prevailing wage rates, but it is reported that rates substantially higher than the market are actually mandated. Of course, matters of this sort are minor compared with union wage scales supported by apprenticeship systems that create monopolistic scarcities. Union dominance is complemented by the tendency of nonunion wages to follow the example of union contracts. Further leverage is, of course, being fortified by the proliferation of unions into service occupations, including some in government employment.

While government intervention in industry creates windfalls in some cases and losses in others, the outcome in either event usually proves adverse to expanding output and employment and to curbing inflation. Thus the Bureau of Internal Revenue practice of basing depreciation allowances on historic costs rather than on current values puts pressure on profit margins in double-digit inflation periods. When this is added to the penalty imposed upon private enterprises that have to pay wage advances in excess of productivity gains, business incentive declines. Reflecting this adverse climate, research and development expenditures currently are reported as 13 percent below their level in 1968. Capital formation, and hence output and employment, suffer from the growing proportion of investment required by environment and safety regulations and the high costs of reporting to regulatory authorities at various levels of government.

Unfortunately where American industries have actually gained by federal intervention, as for example from protective tariffs or "voluntary" restrictions on imports imposed by foreign governments at American insistence, the economic outcome is to limit the productivity of the economy and exacerbate inflation. In the field of finance, the government has "favored" the building and loan associations by maximum interest rates, ostensibly to protect their profits from corrosive intra-industry competition. But their business has thus been artificially limited, and the supply of capital has been impaired.

This rapid review of the role of government does not pretend to be systematic or exhaustive, but to present examples of ways in which governments contribute to stagflation. In a country where private enterprise accounts for the bulk of production and employment, concentration on this subject would promise a social dividend and enhanced esteem for economics.

Concluding Word

In conclusion, it cannot be repeated too often that the Keynesian belief that increased employment can be purchased by inflation is a colossal error that has cost England and the United States dearly. It is a particularly dangerous doctrine for two reasons. First, until the public realizes that it is being duped and while it has not contrived to escape the trap, inflation can for a time actually expand effective demand; when inflation comes to be built into expectations, the fun is largely over. Second, inflation is extraordinarily dangerous because it is a beguilingly easy way to finance the federal government. Indeed, in democracies it may be politically nearly impossible to avoid it. Having been nurtured on the Keynesian fallacy for more than a generation, we may require an equal interval for the disillusionment to take practical effect.

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Notes on Stagflation, by Howard S. Ellis, traces the demise of the Keynesian revolution from the early—but unheeded—doubts of Keynes’s contemporaries to its final debacle in the collapse of the so-called Phillips curve. Keynesianism prevailed until the discovery that inflation can add to employment only transitorily and that it finally impedes output. In the present setting of stagflation, the important tasks of economics are no longer the elaboration of abstract models but the discovery and refinement of practicable measures for increasing output without engendering inflation. Most of these remedies must be found in the microeconomic sphere since stagflation itself attests to the inadequacy of merely aggregative monetary and fiscal policies in our present society.

Howard S. Ellis, Flood professor of economics, emeritus, University of California, Berkeley, has been president of both the American Economic Association and the International Economic Association.

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