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Tilting at Windmills: The Economics and Politics of Inflation-Fighting

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ABSTRACT

The Central Bank of the United States, the Federal Reserve, has a dual mandate to maintain both full employment and price stability. However, inflation-fighting had always eclipsed the full employment objective without much accountability. Today, the Federal Reserve provides regular testimony before Congress on how well it is achieving its dual mandate. Professor Galbraith wrote that section into law (among others), which requires the Federal Reserve to report to Congress on its work.

According to Professor Galbraith, the law intentionally kept the scope of Federal Reserve policy wide. The purpose was not to impose some economic theory on the policymaker, but to promote an open dialogue between the Federal Reserve and Congress over what monetary policy is and does. And yet, the legacy of monetarism continues to influence monetary policy today: the belief that there is a trade-off between inflation and unemployment firmly guides contemporary Federal Reserve policy. Even as the Federal Reserve's own research finds that labor markets are not the driver of inflation, economists, including at the Fed, continue to insist that unemployment and labor market slack are the way to fight price increases. In this keynote, Professor Galbraith highlights other, more effective and enlightened ways of dealing with inflation.

KEYWORDS: Economic Insecurity, Money and Finance

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I am pleased to introduce this special Keynote Address of the Economic Democracy Initiative, hosted by the Franklin Delano Roosevelt Presidential Library in Hyde Park, NY on June 15, 2023.

Dr. James K. Galbraith is the Lloyd M. Bentsen Jr. Chair in Government and Business Relations at the Lyndon B. Johnson School of Public Affairs and a professor of Government at The University of Texas at Austin. Professor Galbraith is a world-renowned expert and sought-after policy advisor, whose list of pioneering research, seminal books and papers, and consequential policy work is long.

It is worth recalling one key episode in his illustrious career. In the late 1970s, Professor Galbraith was an economist for the House Banking Committee of the U.S. Congress and later became the executive director of the Joint Economic Committee. As part of that work, he drafted the monetary sections of one of the most important laws in U.S. history: the Humphrey-Hawkins Act of 1978, formally known as the Full Employment and Balanced Growth Act.

The Central Bank of the United States, the Federal Reserve, has a dual mandate to maintain both full employment and price stability. However, inflation-fighting had always eclipsed the full employment objective without much accountability. Today, the Federal Reserve provides regular testimony before Congress on how well it is achieving its dual mandate. Professor Galbraith wrote that section into law (among others), which requires the Federal Reserve to report to Congress on its work.

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Professor Galbraith is also the son of another towering figure in American intellectual life, the late Institutionalist economist John Kenneth Galbraith. Galbraith, the father, worked for the Franklin Delano Roosevelt administration as the head of the Price Section of the U.S. government's Office of Price Administration during WWII. It was the agency that prevented runaway inflation during WWII and price gouging by wartime contractors.

Today, price controls are once again being hotly debated. How shall the Federal Reserve move forward? That is the subject of this special Economic Democracy Keynote address.

I welcome your feedback and comments.

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Introduction

I am reminded now of some events that happened quite a long time ago, and it might have occurred to you that, since I was actually capable of making the transition from my chair to this podium, that in the late 1970s I could not have been very old. And the truth was that when I was first assigned to work on monetary policy and the problem of Federal Reserve accountability to the Congress, I had just arrived after one year in graduate school, and I was at the ripe age of 23. This is how governments actually function under some conditions. Question is: why did I get this responsibility? And the answer is, obviously, the only possible answer is that nobody else thought the issue was worth taking an interest in. And so it was left to the most junior person on the staff. To look out on this audience, this may well happen to some of you at some point. Just keep your eyes open. Don't let the opportunity pass you by because 50 years later, somebody won't come along and remember what happened.

In any event, we're here at the FDR Library, in what is essentially a shrine to the theme of the symposium—economic democracy. Pavlina encouraged me to talk a little bit about a problem which most people do not associate with the Roosevelt administration. Most people, when they think about the Roosevelt administration, remember, first of all, the Great Depression and the New Deal. Then, they think about the mobilization when we went to war—most people do not think about inflation. And they don't think about inflation because inflation was a problem that was handled. And it also was a problem within which the way it was handled is something which our profession, the economics profession, has put an enormous effort over the subsequent seventy years into forgetting.

Inflation: History and Theory

Today, I want to walk you through a little bit of that experience, and then talk about its application to our present. But before we do that, we first need to take a moment and ask ourselves: what actually is inflation? We need to ask the question because I imagine that most of you who have encountered it, at least in the classroom, in a textbook, have a particular theoretical notion of what inflation is. I want to suggest that first of all, it is something more than the very prosaic idea of a change of the rate of change of prices over time, which is the definition given to it very recently by a couple of the senior advisors in the Biden White House (Jared Bernstein, for one). Instead, we need to have a definition that gives us a greater understanding of the concept we're dealing with.

Also, although it is often paired with unemployment as a concept, inflation is not like unemployment. It's something very different. Unemployment is something you experience as a person, something you can count. It is a concept that was invented for statistical and administrative purposes, actually, in the Commonwealth of Massachusetts in the 1860s-1870s, to deal with an emergent phenomenon of the industrial age.

Inflation is an event that happens to the society as a whole. It can happen presumably from anywhere, and it is measured in a particular way, technical way, by constructing a price index and looking at the change of that index over time. So it's not an accounting phenomenon in the same sense as unemployment.

We have a tendency, then, to abstract our notion of inflation, to conceptualize it in terms that I would call *pure inflation*, a textbook concept in which we think about the devaluation of the monetary unit with respect to newly produced goods and services, or, in other words, a general increase in the price of everything that has been indexed. This is a very convenient definition from the standpoint of economic ideology. Milton Friedman was adverting to it when he said that inflation was always and everywhere a monetary phenomenon. And I want to suggest that in the real world, this is something which is rarely or perhaps never experienced.

In 16th century Europe—okay, that's sufficiently remote, I wasn't around—the influx of American silver, mainly, and also gold from the Spanish conquest, was associated with a general decline in the monetary unit. But in the modern world, I think, we do not see significant examples of this phenomenon, certainly not in countries which have relatively stable monetary systems. So, I want to focus our attention on the kind of inflation that is called everyday inflation, which we have experienced in our lifetimes, that we've experienced in the last few years.

The Roosevelt administration confronted it at the outset of the Second World War—typically, the propagation of some event, a shock to price (often but not always energy prices) that then moves through the structure of prices and wages. Typically, war is a major source of this kind of disruption because it up-ends the normal course of civilian economic life. Left unchecked or undealt with, everyday inflation of this kind, unlike the pure inflation of the textbook, always has an effect on distribution. There are always winners, and always losers. And this is what makes it particularly important as a political topic.

Everyday inflation may be something that goes away after a period of time, but it can also be sustained by mechanisms inside the structure of the economy. In the 1970s, when I was first working on this, balance structures were embedded in a sequence of major trade union contracts—automobile, steel, rubber, the so called Treaty of Detroit—because they were staggered. If one union got a good settlement, then the next one insisted on the same settlement, and the process repeated over time. That's not the system that we see now. But we can see a certain persistence, and that persistence of that period has stuck in the minds of the economists of my generation (we will revisit this point).

Does this matter? Whether we take one view or another of the inflation process? Well, I think it obviously matters a great deal. And I think it matters an enormous amount that we, you and I and everybody else, have been guided toward a theoretical vision of pure inflation as a monetary phenomenon over time. What are the consequences of that? The consequences are that we accept the handing over of responsibility for inflation to a monetary authority (specifically to the central bank).

On the other hand, if you take the alternative view, that the problem that we are encountering—and nobody has said that it's not a problem—the problem we are encountering is one which is associated with practical questions of resource availability or supply chains, which we've experienced recently, then you may be led to ask: How can we deal with those problems? What's the nature of those problems and what should we do to handle them?

Well, then you have to ask: how would we judge whether such a policy had been successful? And the answer surely cannot be simply that after a certain period of time, the rate of change in the price index slows down and stops. You have to ask, at what cost? With what consequences? With what effect on the coherence, viability, even the survival of the society? And specifically this is the question which we were focused on in the late 1970s, trying to draft essentially an amendment to the Employment act of 1945, a new version that brought full employment into this framework explicitly.

The answer has to be: How can you do this without inflicting undue hardship on the most vulnerable people, without impoverishing people, without mass unemployment? In Wartime, of course, it's even the problem that becomes escalated. It's even a question of national survival—of life and death. And to do this effectively, a country which breaks down in wartime situations under hyperinflation is unlikely to be able to sustain the military effort that's required of the conflict.

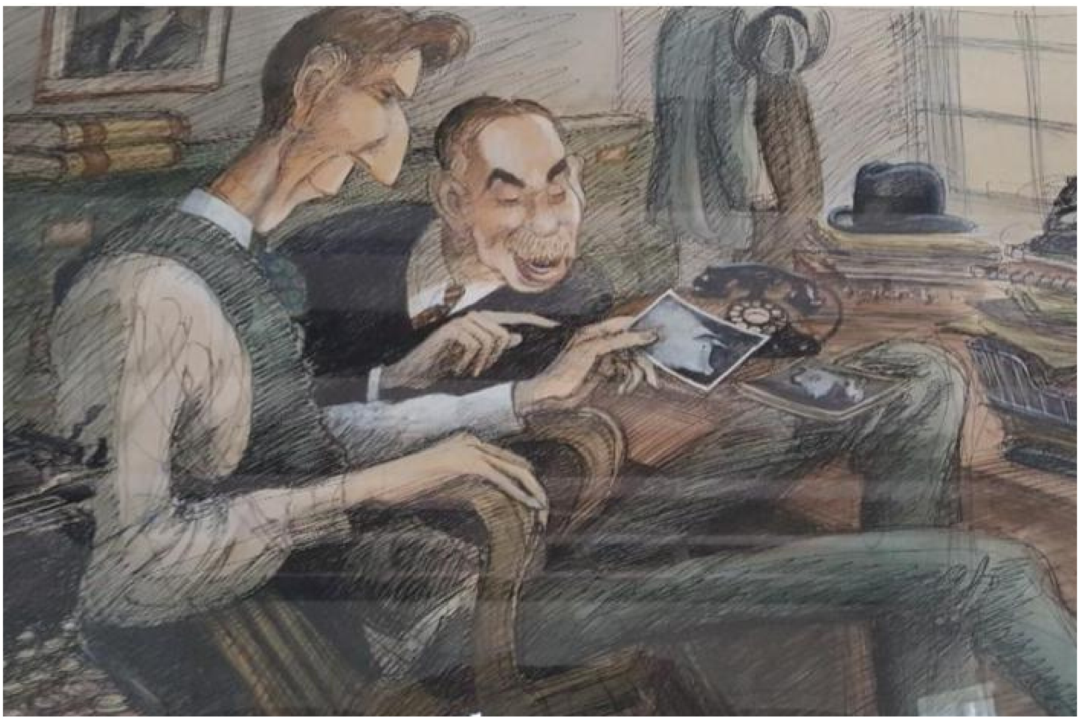
WWII and Price Controls

Has such a success ever been achieved? The answer to that, and this is the great forgotten point, is yes: it was achieved between 1941 and 1946 under the administration of Franklin Roosevelt, during which unemployment was held at zero, a war was fought that required that the total economic output of the country be doubled, be doubled over four years, and yet inflation remained under very strict control. That policy was implemented by an agency, the Office of Price Administration, of which a 33 year old man by the name of John Kenneth

Galbraith, my father, was placed in charge of prices in 1940. The key implementation of the program was in two phases. One began in May of 1942, the General Maximum Price Regulation, which requires essentially that if you wish to raise any price, anywhere in the country, you had to get the permission of my father, or one of the 17,000 people who worked for him. I asked him how he managed to find 17,000 people in a few months to staff the Office of Price Administration. And he said, land grant colleges—I hired all of the economics professors. He also hired all kinds of interesting people who went on to... I could go on about that history at length, on the history of the government... but I won't.

In May of 1943, due to a conflict over particular implementation of policy, my father was dismissed because they thought they needed a businessman to deal with these issues. They brought in an advertising executive named Chester Bowles, who proved to be even harder line than my father was. It was basically a hold-the-line order, which froze all prices for the duration of the war. And this is important for this seminar. Because this was in fact the greatest exercise in economic democracy in the history of the United States. How was that enforced? It was enforced by setting up civilian boards in every community in the country like the draft board. And you had to go through your local press board if you wanted to raise any prices; they were always going to say no. So this was enforced by bringing the entire consumer population of the country into the economic governance and democratizing what had been preserved for private business.

You know, we often think, and I'm sure many of you have experienced at least a little bit of contact with the work of John Maynard Keynes, of him shortly in terms of government deficits and fiscal and monetary policy, but the work of the Office of Price Administration was very micro-oriented. And one day, Keynes came to the OPA with a paper that he wanted



to share with my father. It was about the problem of the price control of what he called maize and pigs—corn and hogs. Keynes was raising pigs on his farm in England, so he was interested in this area.

And you see, here he is, John Maynard Keynes, there's my father, John Kenneth Galbraith, there, according to The New Yorker cartoonist Edward Sorel. They are examining the photograph of a pig. Well, that is a bit of a stretch of the imagination, but everything else —the typewriter—is from 1940 to 1942, and this meeting did happen. My father said it was like St. Peter dropping in on the parish priest…

So, how did price controls work? I think we can answer that at the micro level and at the macro level. At the micro level, they worked very simply by preventing the abuse of monopoly market power, by preventing price gouging. And when you did not have the option of raising your price, what could you do if you wanted to make money? You had to improve your productivity or increase your volume. Those are the options. And that was why the United States was able to double its total output—to hold its civilian output constant and increase its non-civilian output to 100% of civilian output: tanks, planes, the atomic bomb, aircraft carriers, everything. So that's number one: it created an environment for economic expansion and full employment.

And number two, at a more macro level, the fact that there was no inflation meant that if you were holding a financial asset, the United States government bonds, series-E bonds, you were happy to hold them at 2% and hold them into the 50s and the 1960s, because you thought they were going to maintain the purchasing power. And that was what price controls achieved. And that meant that the excess savings, which was again 100% of the civilian purchasing power, did not come back and was not used to, did not come back to drive up the price of commodities and cause hoarding and other other disruptions.

Well, this was not popular with everybody, but it was in fact broadly popular with the population. There were riots in 1946 when price controls were released. But fair to say, a fair fraction of the business community did not like being under price controls. I'm not saying everybody. But they do infringe on the natural right of a business person to charge whatever the market will bear. They also empower both government officials and ordinary civilians to take a role in decisions that businesses characteristically believed to be their own, and the professional economists, who are always in a majority of their number in line with the ideology of the business community, hate price controls because they run counter to the standard theory of the economics profession, which is that price adjustment is how markets work to achieve efficient resource allocation. It's not how markets work to achieve... that's just textbooks telling you that they work. But in fact, markets don't work that way at all.

The Contemporary Understanding of Inflation

But in any event, over the course of the subsequent decades, the idea that price adjustment in markets was the key to allocation of efficiency became the core. My bet for those of you and I'm sure everyone here has taken a basic economics course is probably the first idea that comes in that textbook. And that that's simply not the way the world has worked. What works now is to set up an ideal world in which there is no market power, in which there is no stability of cost in relation to cost of prices. A world which does not exist, and I think it's fair to say has actually never existed. But there is also a body of macro thinking (if you like) that’s associated with it. This emerged in the 50s and 60s of the last century in a way that reinforced tendencies of microeconomics: the conjecture of a Phillips Curve with a stable trade off between inflation and unemployment, advanced by Solow in 1960. It lasted for about a decade before it began to fall apart. Once it did, it gave people the idea that perhaps it was not a universal truth.

It was suggested that Phelps and Friedman—Edmund Phelps and Milton Friedman—in 1967 and 1968 basically shoved the old Phillips Curve aside and replaced it with the notion of a very steep or essentially vertical relationship. The so-called long run Phillips Curve is associated with a so-called natural rate of unemployment or non-accelerating inflation rate of unemployment (the NAIRU) that has been a plague on thinking of the macro section of textbooks for the last 50 years. These ideas have not been always unchallenged. I give you a couple articles that appeared exactly the same journal (Journal of Economic Perspectives). One of them is by a notoriously bad tempered dissident who published in 1997 under the title “Time to Ditch the NAIRU.” And the other one is by [Olivier Blanchard], a much nicer person, a leading mainstream economist, former chief economist of the IMF and chairman of the department at MIT, who came along in—that was in 2018—with an article in the same journal with a question: Should We Reject the Natural Rate Hypothesis? Well, you can say it took me 21 years to raise two daughters to voting age and I was not able to persuade the mainstream of the economics profession to move, except a tiny little bit, off of a settled position.

But this reasoning here, underlying this hypothesis, continues to be a part of our dialogue. Here's Jason Furman, Harvard University, arguing in 2022: labor markets remain extremely tight, therefore, essentially, inflation is high and possibly rising, and therefore we must tolerate several years of very high unemployment in order to get down to that target of 2%—an average unemployment rate of 6.5% percent in 2023 and 2024. And I make a note that Professor Furman did not himself volunteer to join the unemployed in this scenario in his public, spirited crusade.

A second kind of argument, which I don't want to spend too much time on, is the idea that the economy naturally fluctuates around a total output: people were able to surmise a trend.

And we can see that reasoning underpinning, for example, a work by Larry Summers from May of 2021, talking about how inflationary pressures are mounting from boosts in demand given by the pandemic, given by the Federal Reserve's policy, given by forecasts—I don't know how forecasts affect inflation—that doesn't... never mind. The syntax here is perhaps a little overheated. But you will notice that these are all macro factors. There's no mention here of oil, no mention of semiconductors, no mention of anything else that's specifically driving up prices…

Inflation Since 2020

Now let's move on to the question of where this leaves us in terms of a policy focus. The mainstream has settled on the notion that the central bank has responsibility. That is supported by administrations, including the Biden administration, which are happy to have another agency, preferably one insulated from the electorate, take responsibility for inflicting pain. So politically, it's very convenient. There's a target that's set at 2%. Sometime 20 or 30 years ago, some economists said that's what we want. There's no basis in law, it's not in the Humphrey-Hawkins Act for 2%, it has never been codified by Congress. And there's no specific way this is supposed to be achieved. Milton Friedman had the idea that it should be done by controlling the money supply. They allegedly attempted that for a few years in the late 1970s, early 1980s and abandoned it. And since then, we have had some kind of mystical relationship, control of interest rates subject to the Federal Reserve basically declaring what its inflation target is.

I have to take personal responsibility because all of this emerges from precisely the congressional hearings for which I was responsible for almost a decade in the 1970s. This was Chairman Paul Volcker appearing before the House Banking Committee, with the ghost of Wright Patman, staring over his shoulder in vast disapproval. I am undoubtedly sitting on the other side of that camera in the back with the members of Congress. And this is the process which has become extremely familiar, embedded institutionally to the point where it has become almost a cult in the economics profession, to believe that the Fed can tell the world what it's going to do and the world will cooperate with it.

Again, Ken Rogoff of Harvard talking about the relationship between inflation and Federal Reserve policy, Jason Furman—they are all Harvard people, who knows why that's the case—talking about the need for the Federal Reserve to ratchet up its policies. Those of you who are Roosevelt fans may have encountered his great Madison Square Garden speech in the campaign of 1940, when he named the three "forces of darkness" in American politics, members of Congress. He said, "that's Martin, Barton, and Fish." Well, now, in my view, it's Jason, Larry, and Ken. In any case, Jason's timing was exquisite since almost as soon as he had published the need for the Federal Reserve to continue raising rates for inflation to fall, inflation started falling. In fact, it had already peaked in June of 2022—which tells you just how good the guidance that mainstream economics, mainstream macroeconomics, gives to the practitioners of this group is—and has, of course, been falling ever since. There are reasons why we are led to believe that inflation is more persistent than it is. One of them is how the numbers are published. The headline always refers to a 12-month phenomenon—the last 12 months— which means that the monthly numbers are volatile, and a 12-month number is much more stable. But it also means that if there's a single shock, it continues in the numbers for 11 more months, even though there's nothing new. And this has a terrible consequence, which gives Jason, Larry, and Ken each 11 additional opportunities to write op-ed pieces on why the Federal Reserve should continue to raise interest rates. You have to recognize the interplay between media practice and economic policy.

Now, coming back to the real world: what were the actual sources of the increase in prices that we experienced in 2021 and 2022 (and that have since tapered off, although I will be the first to say that we may not be at the end of experience of seeing this kind of problem)? The first one clearly was oil. Oil prices collapsed at the start of the pandemic, to the point that the Ford price of a barrel fell below zero briefly. And that creates a steep gradient, even when oil prices simply recovered to the levels that it had held a year or two previously. But there was an additional factor, which is that when the price collapsed, the properties became cheap, and speculative interests moved into the oil patch. And when the demand recovered, they didn't raise supply to meet the demand, they raised it at a slower rate and enjoyed the vast windfall on all barrels that they did produce—good profit maximizing behavior if you happen to be a private equity investor in this particular asset. So that's one problem that was dealt with actually by the administration through the sale of oil.

A second phenomenon was in the automobile sector. There was a shortage of new cars because there was a shortage of semiconductors. New car prices didn't rise much, but used car prices went up by 50%. Because that's a market, an asset market, in which the dealer will sell it to you for whatever they can get. That's much more volatile. It's also not a newly produced good, and it shouldn't be in a measure of pure inflation, but it is in the statistic component of the consumer price index.

And then there's a third issue, which has to do with the way rents are translated into the housing component, which is 40% of the index. We do not have time to go into the details of this specifically, but that is a very major distortion in the way in which we measure this. Are there issues that need to be dealt with? Yes, just as there were in the 1940s, just as there were in the 1970s, just as there were in 2021, 2022. But these are issues that arise, if you like, on the —I don't like the “supply and demand”—but they arise within the structure of the economy and its provision of particular goods and services. One of them is the tendency of businesses to leapfrog each other, raising margins, in order to hedge against the risk that their costs may go up in the period, and so you'll get what is in fact a kind of profit-profit spiral.

A major component of increasing prices both here and in Europe, by the way, has been an increase in business margins. The appropriate policy response to that, as it was under the Office of Price Administration, is selective and strategic controls, or maybe comprehensive controls with selective exceptions (like we had in 1942). And yet that idea remains strongly off the mainstream agenda.

The second possibility here, second risk, is that the energy sector is not stable. Yes, there are uncertainties of geology and uncertainties of geopolitics, and we need a policy that is focused on that sector in a coherent way, taking account, of course, of the environmental challenge we face.

A third is what is called an iatrogenic disease—ailments caused by the doctor—that is the application of the high interest rate policy to the cost structure of businesses. Interest is a cost. If a business is affected by a higher interest rate, it will try to pass that on to its customers. In that respect, until the interest rate policies actually crack the economy and produce mass unemployment, they are not, generally speaking, anti-inflation measures, they're adding fuel to the fire.

And finally, the fourth thing is, I think we're all basically familiar with the fact that we are moving, slowly, perhaps, but inexorably, towards what can be described as a multipolar world, in which the Dollar’s purchasing power over the world's supply of Commodities is going to erode over time. I'm not sure that there is any sensible or effective solution to that problem. It may be something which we will, as Americans, have to live. We could perhaps have avoided it had we conducted a more coherent, and let's say worldly, global policy over the last 25 years, but we didn’t, and we will pay the price for that.

Conclusion

Alright, our last point, and that is if you are inclined to take the words I'm offering you seriously, you need to be aware that you will be running a very significant professional risk... There is an example of a young scholar whose work I can think is among the among the best in the next generation—Isabella Weber, the University of Massachusetts, who had the temerity in December of 2022 to suggest that perhaps the history of price control in the United States in the 1940s and the Roosevelt administration still has relevance for current policymaking. The reaction was beyond interest. I mentioned Paul Krugman, who holds down the position of the avatar of the modern left in the New York Times—he made a comment that Isabella was “extremely stupid” on social media. The remark has since been retracted, but, nevertheless, he had made it to his vast audience. And in the current issue of The New Yorker, Zackery Carter tells about the wave of hostile reaction in the social media space, in the professional economic space, that Isabella Weber, who was 33, had to endure.

I'm happy to say that Isabella Weber has been vindicated in the New Yorker article, titled "What if We're Thinking About Inflation All Wrong", and as of two days ago, was granted tenure. So, it is possible to triumph over this kind of adversity, but it takes a certain amount of determination and moral courage. So with that I will say thank you and good luck.