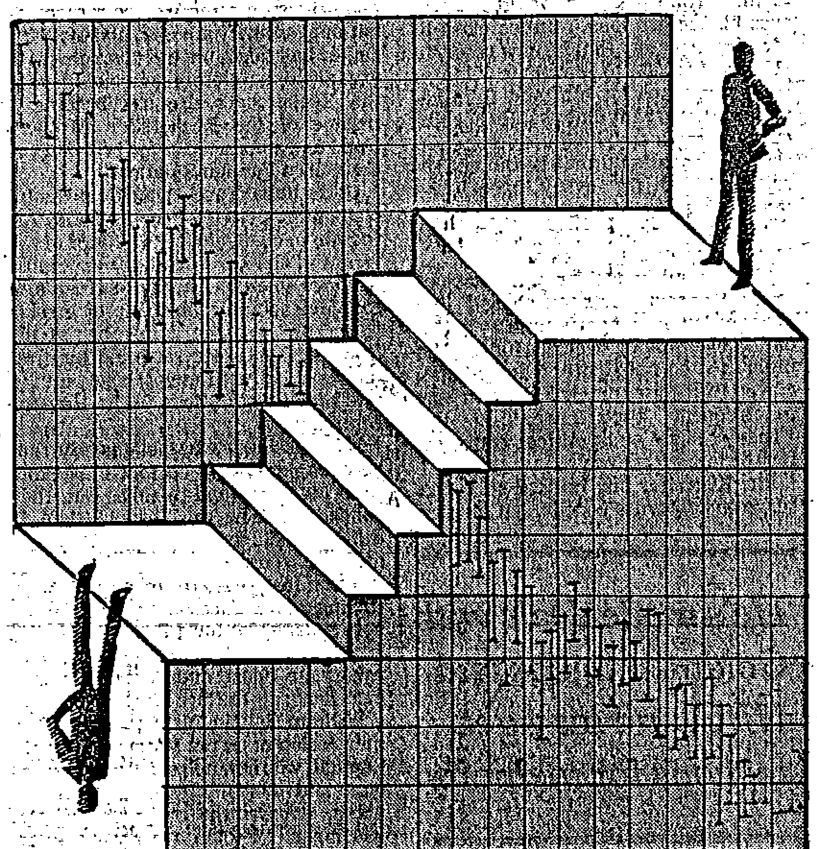
Stagflation: The Worst of Two Worlds

By ALFRED S. EICHNER

Most economists remain puzzled by the simultaneous occurrence of unemployment and inflation. But the phenomenon is readily explained by a body of economic theory that has only recently emerged to challenge the orthodox Keynesian and monetarists models. The new analytical framework has been termed "post-Keynesian," both to differentiate it from the "neoclassical synthesis," which dominates the teaching of economics in the United States, and to indicate that it represents a logical extension of Keynes' own break with orthodox thinking.

The new approach has its origins in works published two decades ago, but it is only now coming to the attention of American economists, as evidenced by the current series of articles in *Challenge* magazine and the appearance of a *Journal of Post Keynesian Economics*.



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The Earmarks

The key points of post-Keynesian theory:

- It is formulated with the most important economic fact of the past several centuries clearly in mind. This is the continuous, though uneven, expansion of the various national economies over time. In contrast, orthodox theory views the economy as coming to rest at a particular "equilibrium" point.
- It views investment as the key determinant of economic expansion, both secularly and cyclically, and it regards investment as being inextricably linked to pricing and income distribution. In contrast, orthodox theory emphasizes only the role of prices, and those only as a determinant of resource allocation.
- It is meant to describe an economic system with advanced credit and other monetary institutions — all of which play a key role in dynamic processes. In contrast, orthodox theory, including the monetarist variant, focuses largely on the stock of money, ignoring the effect which the broader range of credit arrangements has on real economic activity.
- It acknowledges the critical role played by large corporations and trade unions in the economy. In contrast, orthodox theory recognizes only the atomistic competitive firm, regarding all manifestations of monopoly power as exceptional cases.

The Premises

The basic propositions of post-Keynesian theory lead to a quite different understanding of stagflation and suggest a quite different policy response from those to which orthodox theory gives rise. Among them:

- That the growth of real wages over time depends on a series of economic and technological factors, including the rate of growth of output per worker, the rate of investment and the proportion of non-wage income devoted to purposes other than investment.
- That the growth of nominal wages over time depends on a series of socio-political factors, including the relative strength of the trade union movement, the size of the key bargain negotiated in a bellwether industry and the stance taken by the Government as to what increase in nominal wages is fair and reasonable.
- That a rise in the price level, i.e. inflation, occurs when the growth of nominal wages, as determined by socio-political factors, exceeds the growth of real wages, as dictated by economic and technological factors. This is because businesses will pass the higher costs on to purchasers in the form of higher prices, thereby producing a rise in the price level that brings the nominal and real wages into line with one another.
- That the set of factors determining the rise in prices is not entirely the same as those determi of real output so that have economic growtl tion and inflation wi growth. The corollary tion is that a policy whi inflation by curtail growth is likely to prove

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Alfred S. Eichner is economics at the State New York, Purchase, search associate on the Human Resources Proj University. This article from an article he pre Joint Economic Comm gress.

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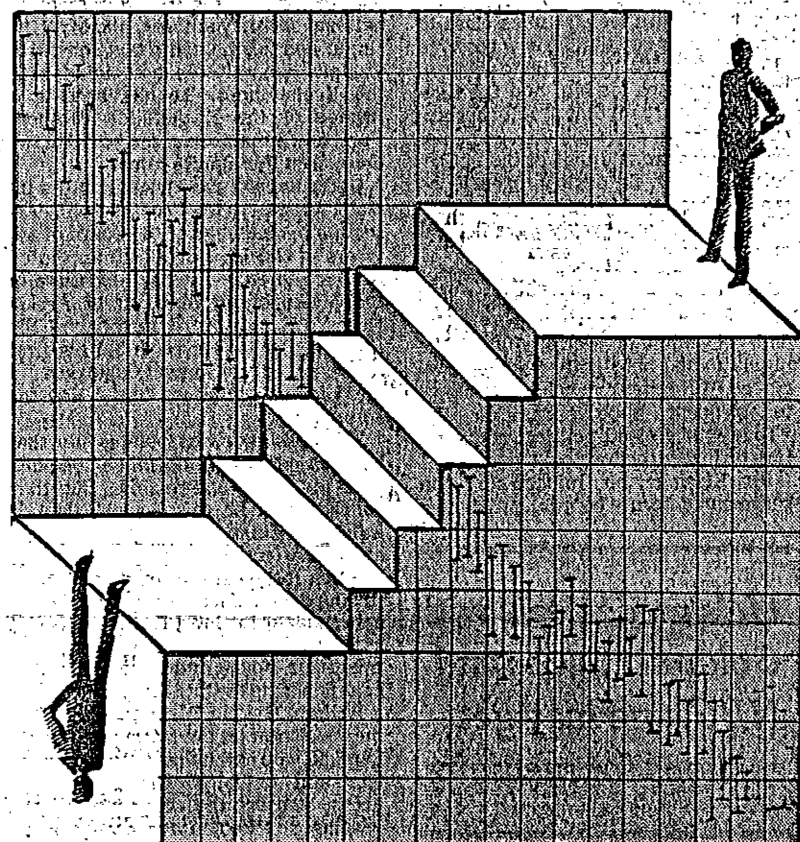

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- That the set of factors determining the rise in prices is not entirely the same as those determining the growth of real output so that it is possible to have economic growth without inflation and inflation without economic growth. The corollary to that proposition is that a policy which seeks to limit inflation by curtailing economic growth is likely to prove ineffective.

Indeed, to the extent that the policy leads to a lower rate of investment, and therefore to a slower growth in productive capacity, it is likely to prove self-defeating. Thus the so-called "Keynesian" policies in the past of short-term demand management to curtail inflation, since they have had an adverse effect on the long-term rise in supply potential, may actually have contributed significantly to the current stagflation problem.

Needed Changes

The principal policy implication of a post-Keynesian approach is that some form of incomes policy needs to be added to the existing fiscal and monetary instruments for regulating the pace of aggregate economic activity. Such a policy cannot be implemented in an institutional vacuum but must instead follow from other changes to be made in the way economic policy is determined. Among the changes:

- The better integration of the private interest groups that will be affected by any incomes policy into the process of economic decision-making.
- The better coordination of policy within government itself.
- The better linking of policy making bodies to technical secretariats with data collection and analytical capabilities.

The intellectual implication of the foregoing is that the post-Keynesian approach needs to be taken more seriously than it has to date by American economists, both within Government and without. In this way, perhaps the country can recover from the present intellectual bankruptcy of economic policy.

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