

The Fearsome Dilemma: Simultaneous Inflation and Unemployment

1. Introduction

There is a story of a cleric who was fond of using Latin phrases even though many of his parishioners were ignorant of that tongue. He once proposed a congregational meeting "to discuss the *status quo*", and was immediately asked what that term meant. "*Status quo*", he replied, "is Latin for 'the mess we're in'".

Robert Triffin's article in the March 1978 issue of this Review¹ offers a refreshingly forthright analysis of the international *status quo* in this sense, and of how we got into it. His comments on the basic intolerability of high inflation, high unemployment, and humanly-repugnant income inequalities, on the failure of inconvertibility and fluctuating exchange-rates to improve the world economy, on the inappropriateness of the "locomotive" prescription that three of the world's richest countries should reduce their capital transfers to the rest of the world or should continue to absorb capital instead of to supply it, on the effects of the U.S. balance-of-payments deficits in spreading inflation, and on the abortion of international monetary reform are badly-needed contributions to common sense. I wish to support him by looking at some of the non-monetary (or not specifically monetary) aspects of the problem, which he explicitly excluded from his analysis.

I will emphasize the domestic considerations and the links between domestic economics and international economics in a general-equilibrium context. Much of the analysis will inevitably be couched in terms of money values, but the focus will actually be on real output, real income, employment, resource allocation, and other non-monetary objectives.

¹ "'Europe and the Money Muddle' Revisited", pp. 49-65.

2. The Fearsome Dilemma

In a 1975 contribution to the Review² I spoke of the widespread dilemma of an unacceptable rate of price increases and an uncomfortable level of unemployment — which we may justifiably designate as the Fearsome Dilemma, because of its virtually-world-wide incidence and its apparent intractability. I was there concerned with its international implications, particularly with the conclusion that any international equilibrium attainable under current conditions must be unstable. Another important implication, however, was that the achievement of international economic stability will require the solution of the Fearsome Dilemma in all (or at least in the major) countries either jointly or severally. It is undeniable that the ability of any one country to deal with the problem will be positively or negatively affected by the success or failure of others to do the same, because of competitive pressures as well as normal trade repercussions. Nevertheless the dilemma is in essence a purely domestic problem, as witness the fact that even those countries that are willing and able to ignore their balance-of-payments problems (or to push them off onto their trading partners) have not been fully successful in either eliminating inflation or reducing unemployment to truly tolerable levels. Too vigorous support for employment worsens the already-excessive rate of inflation, and *vice versa*, so neither objective can be fully attained.

The problem is not as new as it may seem, though it has become much more acute in recent years. In the early applications of demand-management after World War II it was generally accepted as a reasonable first approximation that inflationary pressures would not become serious unless expansionary measures were pressed beyond the full-employment level. In retrospect this seems an unduly optimistic hypothesis, but for some years experience seemed to support it; exceptions could be rationalized in terms of the structural adjustments necessary in many countries after war-time distortions, or in terms of special factors like the Korean War. Nevertheless there was persistent creeping inflation in even the most stable countries, which was actually welcomed by some economists, and by the late 1950's substantially higher unemployment rates were again being

² "The Essential Conditions for International Economic Stability", June 1975, pp. 3-15; hereafter "Essential Conditions".

experienced in a number of countries. This prompted one Canadian economist to observe that simultaneous inflation and unemployment was the economist's hell on earth. Well, he should see us now! Instead of price increases of one or two percent per annum and unemployment that had breached the three-percent level then commonly identified with the boundary of full employment, the last few years have seen typical inflation rates that were often in the double-digit range and unemployment rates that in many cases have approached that range.

The reasons for the deterioration in the effectiveness of demand-management after its initial successes are clear enough in broad outline, though some of the major details are obscure and economists are by no means unanimous on matters of emphasis. It is now pretty widely agreed that the simultaneous achievement of multiple policy goals requires at least as many effective and non-redundant policy instruments as policy objectives, and that the attainment of each objective must be influenced by at least one instrument, though it has been perhaps less explicitly recognized that the instruments must also be capable of differentially affecting progress towards each separate objective — i.e. capable of positively or negatively influencing it independently of all other objectives. Unfortunately our present arsenal of instruments does not entirely meet these three requirements. We do not have enough instruments of sufficient power and sufficiently differential incidence.

For our present purposes we may confine ourselves to the three major goals of full employment (which may be taken to include optimum real output), stable prices, and a viable balance of payments, partly for the sake of brevity but mainly because other objectives do not press as heavily on day-to-day decisionmaking even though some of them (like individual freedom) are of major importance in their own right. On an unweighted basis we can certainly oppose our three major objectives with an almost-unlimited array of policy instruments, including a great variety of taxes, subsidies, and other incentives, but two are incomparably more powerful than the others: monetary policy and fiscal policy.³ No other instrument or

³ The term "fiscal policy" is sometimes used in a broad sense, to include all aspects of government taxing and spending (and perhaps other) policies. For our purposes, however, it seems preferable to use it in the narrow sense of deficit-spending or surplus-taxing, and to treat specific spending and taxing decisions as separate policy instruments.

group of instruments can match the effect of these two on the spending stream, either positively or negatively. Furthermore both monetary policy and fiscal policy are very general in their impact on the spending stream — that indeed is why they are so highly compatible with the market system — and both affect it in much the same way, though neither is redundant because each can do things the other can not. Neither of them can differentiate effectively between the price and the quantity (output) components of the spending stream, nor can any other instrument or group of instruments. Consequently the authorities must either validate whatever rate of price increase is being currently generated in the economy or allow an oppressive unemployment rate to get even worse.

Price controls are not a satisfactory third major instrument for permanent use, though they may well be less distorting to the market mechanism in the long run than uncontrolled inflation. It would be inequitable to control some input prices, such as wages or rents or interest rates, without attempting to control profits as well. But pure profit may be viewed as a differential return to cost-cutting innovations, as Schumpeter has taught us; without the hope of this reward there would be no reason for business management to offer serious resistance to upward pressures on input prices. Indeed, management's resistance to cost increases is likely to be weak enough at best in an inflationary environment, as the public becomes psychologically conditioned to accept continuing increases in the prices of final products. In sum, if price controls do not include profit controls they are not likely to prove acceptable except as a temporary measure, and if they do include profit controls they are virtually certain to degenerate into a systematic cost-plus inflation:⁴ each producer will be entitled to add an arbitrarily-determined markup to whatever costs he has incurred.

Many economists may fault me for ignoring exchange-rate policy as a third major policy instrument, but I feel it does not qualify because it is not truly controllable by the domestic authorities and because its effects are too uncertain. On the first point, it has long

⁴ In the early days of World War II three Canadians are said to have met for a business luncheon. One offered to pay for all three, saying he could charge it to his corporate expense account and get 50% of it back as a tax deduction. The second said, "No, let me have it! I am in the excess-profit-tax bracket, I will get 85% back!" "Oh, no!" said the third, "I'll take it — I am on a cost-plus contract and will make money on it!"

been recognized that under a fixed-rate system a nation's exchange-rate can not be unilaterally determined but must be acceptable to the international community as a whole. Under fluctuating-rate systems the situation is not materially different; even if all countries scrupulously adhere to "clean float" policies, their exchange-rates will be affected promptly by every significant domestic policy action, by the external repercussions of those actions, and by similar initiatives abroad. On the second point, any persistent and material change in the exchange-rate will have prompt feedback effects on domestic prices. An appropriate exchange-rate pattern is indeed an important aspect of international economic equilibrium, but the exchange value of the local currency is not a reliable instrument of domestic policy.

3. International Considerations

3.1. *A Theory of External Reserves*

Even though the Fearsome Dilemma is primarily a domestic problem for each nation individually, its full implications in an economically-interdependent world can only be realized in the context of the international monetary arrangements that have become institutionalized through a combination of market practices and international agreements. Central to these arrangements is the continued reliance on national currencies as external reserves when in the hands of other countries, against which Triffin has continually inveighed in his writings over the last twenty-some years. The essential features may be summarized in the following series of points, with a brevity that doubtless makes them sound more dogmatic than is justified. Some striking parallels with the characteristics of domestic money are duly noted:

1. External reserves consist of whatever media are conventionally accepted for that purpose by the international community, just as domestic money consists of whatever means of payment are conventionally accepted by the domestic community. At present this means gold, certain national currencies (mainly the dollar and the pound),

I.M.F. reserve positions, and SDR's. Some economists may now wish to delete gold, however, on the grounds that its reserve use is effectively inhibited by the high prices ruling in free bullion markets at present, and that it is presumably in the process of demonetization.

2. Within external reserves so defined we may distinguish between (a) reserves-to-hold, or digested reserves, and (b) reserves-to-spend, or undigested reserves, just as we may distinguish between money-to-hold and money-to-spend in the domestic sphere — potent sources of misunderstanding in each case. Reserves-to-hold may be further subdivided into (i) true reserves, i.e. reserves held to meet the perceived needs of the holder, and (ii) accommodation balances, i.e. national currencies held as a means of stabilizing international exchange markets or for similar reasons, which are essentially loans to the issuer rather than reserves for the holder; this distinction is not widely recognized, however, and all holdings of conventionally-accepted reserve currencies are usually treated as external reserves.
3. The role of external reserves today is *not* primarily to maintain established exchange-rates even under fixed-parity systems, but to assure emergency command over essential imports in case of need. Their use does tend to stabilize exchange rates, even in a fluctuating-rate system, but they are essentially contingency funds; they may properly be run down to zero for good cause, or made negative on a net basis (by borrowing).
4. Various reserve media are more-or-less-acceptable substitutes for one another, rather like domestic monies and near-monies.
5. The demand for external reserves, like the demand for domestic money, is a function of the income and the wealth of the holders, of the interest rates and other asset returns available to them, and presumably of other factors as well. The demand for a particular reserve medium is also a function of the net earnings from or net costs of holding it, the rate of change of its purchasing power, and any other specific risks or advantages of holding it.

6. The supply of gold is inelastic in the short run; that of national currencies is very elastic to creditworthy nations through national money and capital markets, at the (normally relatively low) cost of the difference between the interest rate payable on a marginal increment of long-term external borrowing and that receivable from reserves invested in short-term issues; whereas the availability of I.M.F. reserve drawings and SDR's is regulated in essentially the same way as the domestic obligations of a central bank. Further elasticity in the supply of reserve currencies is provided by inter-central-bank borrowings; the lender will normally consider his claim on the borrower as a part of his own external availabilities, while the borrower or his transferee will similarly count the loan proceeds. However, the main growth of the world's external reserves for many years has been from the deficits of key-currency countries.
7. Like the "money illusion" in the domestic economy, there is a "key-currency illusion" in the international system: natural and juridical persons (including central banks and governments) continue to accept conventionally-recognized national currencies as international monies even though their purchasing powers are seen to be declining, for a complex variety of reasons. (Let us hope we will be spared the international equivalent of a true domestic hyperinflation, i.e. an attempt at the complete abandonment of national currencies as international monies.)
8. The given world supply of external reserves is virtually indestructible, except by either (a) the repayment of I.M.F. credits or other borrowed reserves or (b) the net tendering of key-currency balances for the purchase of goods and services in the issuing country (which came to be known as "unrequited exports" after World War II, when sterling balances accumulated during the war were being run down).⁵

⁵ There is another close parallel with domestic money here, strikingly encapsulated in Say's observation that «...the only way of getting rid of money is in the purchase of some product or other» (*A Treatise on Political Economy*, trans. from the 4th ed. of the French by C.R. Prinsep, New American Ed., Philadelphia,

3.2. *A Rationally-Operating World Economy*

In a rationally-operating world economy — by which I mean one in which the major domestic goals of full employment and stable prices are being satisfactorily achieved — the international mechanism of adjustment ought to be able to operate quite effectively. I do not wish to get involved here in the controversy over fixed vs. fluctuating exchange-rates, which is largely irrelevant for the matters I wish to discuss because it relates primarily to the channels through which the international mechanism of adjustment operates and not to the nature of the equilibrium to which the system tends; however, stable domestic prices in the various national economies do imply *stable* exchange-rates even in the absence of any commitment to *fixed* exchange-rates. In such a world temporary balance-of-payments deficits may indeed occur, but should be resolvable without too much difficulty in ways adumbrated on page 8 of "Essential Conditions". This will normally involve some shift of resources in one or more countries, which in turn implies some inconvenience and even pain for some of the individuals most immediately affected, but with the help of income-maintaining measures and other cushioning devices the adjustments should not be traumatic. A temporary excess of any currency (whether it is a key currency or not) on world markets will be fairly promptly converted into goods and services, i.e. into unrequited exports of the issuer. If deficits here and surpluses there do tend to become persistent, they should be comparatively easy to remedy by mutually agreeable measures — probably but not necessarily a simple realignment of exchange-rates — reached through a civilized process of negotiation.

We may note in passing that this model of a rationally-operating world seems to be a reasonable interpretation of the international community the original Articles of Agreement of the International Monetary Fund envisaged, and as already observed it seemed for many years to be attainable through known demand-management techniques. What has come unstuck is not the Articles of Agreement as such, but the ability of member countries to attain their major domestic economic goals simultaneously.

Claxton Remsen and Haffelfinger, 1880, pp. 134f). The expansionary power of domestic monetary policy lies in the dynamic effects of the public's efforts to get rid of surplus (newly created or otherwise undigested) monetary balances in the purchase of some product or service or asset.

3.3. *Le Monde Comme Il Va* (with apologies to Voltaire)

In the world we live in these conditions are not met. Inflation is evident in most if not all countries, and at markedly different rates from one country to another. Uncomfortably-high unemployment is equally widespread. As was argued in "Essential Conditions" (pp. 9f), no mutually satisfactory solution is possible. Or, if you like, the only way to an accommodation is through *uncivilized* negotiations, i.e. by international pushing and shoving, or the exercise of naked economic power.

What we are interested in here, however, is the feedback effects on the Fearsome Dilemma in individual countries. Let us again summarize the situation in a few brief and perhaps overly-dogmatic points:

1. The world demand for *true* external reserves (measured in current money-values) is the sum of the demands of individual countries. With relatively little error we may say it is a function of current money-income: $D_r = f(Y_{mo}) + E$.
2. Under inflationary conditions real interest-rates tend to be low or even negative, and by hypothesis the purchasing powers of those reserve media that are in elastic supply (mainly national currencies) are persistently declining; also, the current level of international cooperation ensures that substantial external credits will be available to reasonably responsible countries in case of need. We may therefore suppose that the demand for external reserves at any given income-level is now relatively low, and probably declining as nations increasingly recognize the implications of the situation.
3. The supply of reserves as conventionally computed is being continually augmented by key-currency deficits, I.M.F. drawings, the activation of SDR's, and inter-central-bank lending.
4. There is no longer any firm link between a country's actual holdings of external reserves and its domestic money supply (or its domestic financial assets), so a loss of external reserves need not impose any domestic financial restraint. (This is simply the obverse of the willingness to let external reserves decline to or below zero for reasons considered adequate.)

5. Nothing in either the first or the second amendment to the Articles of Agreement of the International Monetary Fund has effected the slightest improvement in any of the foregoing points.
6. Whatever a fluctuating-exchange-rate system *can* do, it clearly *can not* solve the balance-of-payments deficits of key-currency countries. As long as additional balances of any national currency continue to be counted as increments to the external reserves of the recipient countries, however reluctantly, nationals of the issuing country can continue to pay for imports by the simple act of tendering their local currency. Rising prices of foreign currencies will indeed tend to deter these external purchases, but the feedback effects on domestic prices will tend to maintain the competitiveness of imports.
7. Hence rising money-income in the world as a whole is the only significant factor working towards the equation of the demand for reserves with the supply of reserves. However, it takes considerable time for world money-income to rise to a level appropriate to a newly-increased supply of conventionally-counted reserves, by which time the supply of reserves has further increased.
8. Under such conditions the hope of ending or even materially slowing the process of inflation in the world is virtually non-existent. In fact, barring self-imposed measures by the key-currency countries to end their deficits, it will be extremely difficult for any other country to control its domestic inflation unless it can independently find a solution to the Fearsome Dilemma that has so far evaded all seekers after it.

4. In Search of a Solution

What is the solution to this complex set of problems?

I hasten to admit that I do not know — and to assert that I believe this makes me a member of a very numerous company of fellow economists. But I venture to predict that the search for a solution of the Fearsome Dilemma of simultaneous unemployment and inflation will long be the focus of attention for economists of the

present generation, just as unemployment and *deflation* was the main focus of attention for economists of the generation that spanned World War II. I believe the solution will be neither easy to find nor easy to apply. The magnitude of the problem has only gradually become apparent, but its structure has been evolving over the last 25 years or more, and its resolution will probably require major changes in the public's attitudes and economic criteria.

Where should we look for a solution? Certainly not in further tinkering with the international payments mechanism. Successive international committees have tried since 1963 to remedy the malaise in that mechanism, with minimal success, for it is but a symptom of the general malaise in the world economy, which they were not empowered to investigate. Their principal success has been the creation of SDR's as a candidate to replace gold as the world's major reserve medium, but unfortunately it is a cumbersome and awkward instrument because of the need to compromise widely divergent views about it, and its regulatory potential has been negated by the continuing acceptance of key currencies as external reserves. Even if the SDR was already enshrined as the only acceptable international reserve medium, however, and even if "international reserve policy" was now managed as skilfully as domestic monetary policy has been under the most efficient central banks ever known, the major benefit would be that balance-of-payments discipline would apply more evenhandedly among members of the international community; this would enforce greater uniformity in national rates of inflation, but would not eliminate it.

I believe that by far the most promising place to start the search for a solution to the Fearsome Dilemma, and consequently a solution of the present malaise in the international payments mechanism, is in the microeconomics of how the pricing process actually works in the real world. The theory of imperfect or monopolistic competition offers material improvements over the purely competitive model in our understanding of the pricing process, but in its present state it still does not give a satisfactory explanation of how prices are actually set in practice. The approach continues to be largely hypothetical, with inadequate empirical support. Only as a broad generality do we recognize that profit maximization does not play as dominant a role in the real world as it does in our simpler models, and that typical business game-plans may give greater weight to growth rates, market shares, interregional or international expansion, and other objectives.

Except for some rather general observations about joint costs and overhead costs, we can say little about the basis on which a firm chooses the range of products or services it will offer.

In the purely competitive model competition is the ultimate arbiter and ensures that the entrepreneur's search for private gain redounds to the public's benefit through the pricing mechanism. In the imperfectly or monopolistically competitive model this force is blunted and distorted, and its ability to influence the pricing process in the public's interests becomes very questionable. In the real world, however, we know very little about how the pricing process actually works, though its importance for the public good remains unquestioned.

Suppose you work for a particular department in some line of economic activity or other — a business firm, a government service, an educational institution, or whatever — and your department's budget is up for review before a corporate committee. Wouldn't you and your department feel very unhappy if you did not have a strong representative on that committee? Well, that is the position the general public finds itself in with respect to the pricing process: it is without representation on the various corporate and other committees that decide the pricing of the myriad of goods and services that affect its welfare, including the prices of final products, intermediate goods, and factors of production.

To put it more eruditely, we are faced with a generalized application of Pigou's distinctions between private and social net product and net cost. Unfortunately, neither Pigou nor anyone else has yet told us how to ensure that social net products and net costs are adequately considered in the forums in which pricing decisions are taken. Apparently the public's representatives must be party to the details of each pricing decision, taking account of all the various costs, competitive prices, and other factors involved. How the public's participation can be made meaningful without introducing intolerable delays in the decisionmaking process, however, is obviously a major obstacle.

Nor can we simply say, "Let the Government do it!". Governments themselves, even the most democratic, must be considered in a monopolistically or imperfectly competitive context, not a perfectly competitive context. They do not listen passively to what the public says it wants and how much it is willing to pay, and then dutifully find the point of indifference at the margin between these

demands and the corresponding costs. Rather, just like any business firm with its products and prices, they put together a package of spending and taxing measures they think will appeal to the public, typically amounting to a substantial portion of total GNP, and enlist all the wiles of the public-relations fraternity to sell it to the electorate. The pricing decisions of governments as well as those of business enterprises need monitoring in the public interest.

In closing, I revert to the proposition that, whatever may ultimately turn out to be the answer to the Fearsome Dilemma, more complete knowledge of how pricing decisions are actually made in the real world is the most promising place to start our search. If so, it will mean that microeconomics will become the focus of practical policymaking, and may attract the ablest of the rising generation of economists. Since the middle of the 1930's macroeconomics has largely shouldered microeconomics aside, because it has been the area in which the glamorous advances in economic theory and practical policy-making have occurred; perhaps a reversal of roles will benefit both the science of economics and the welfare of the world.

Toronto

ALEX N. MCLEOD