PERSONALLY SPEAKING

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UNEMPLOYMENT + INFLATION = STAGFLATION

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Recent increases in food and energy prices coupled with reductions in payroll employment call to mind the 1970s when the United States was beset by a puzzling combination of economic conditions – higher unemployment and rising prices -- which economists could not reconcile with contemporary macroeconomic theory which asserted that unemployment occurs during a business cycle slump and inflation during a business cycle boom. Based on fiscal policy that targeted the demand side of the macroeconomy, higher unemployment called for stimulating demand, rising prices called for dampening demand. At that time, no one was able to provide a satisfactory explanation for those unheard-of conditions and so in their bewilderment they labeled them "stagflation" by combining parts of *stagnation* and *inflation*. By the end of the 1970s economists were forced to abandon their failed ideas about demand and fiscal policy for the new ideas of managing macroeconomic affairs through the money supply and monetary policy.

Mayo Research Institute is convinced that the key to explaining the stagflation of the 1970s, including what may be re-emerging today, lies outside the economy in the seismic changes occurring in human affairs that greatly unsettle economic affairs. In the 1960s and 1970s, the United States was shaken severely by five major tremors -- a disastrous war in Vietnam, a constitutional crisis during Richard Nixon's presidency, the civil rights movement, the sexual revolution, and the Supreme Court's decision on the abortion issue -- that destabilized the economy just as a major earthquake brings down structures that were built to withstand minor to moderate tremors but not the kinds of shocks associated with a major seismic event. An economics based squarely on the demand side of the macroeconomy could no more withstand the tremors of the 1960s and 1970s than the economics of the 1920s could survive the devastating economic earthquake of the Great Depression.

Fast forward to the present. On the monetary policy side, the Federal Reserve has reduced interest rates to stimulate the economy. On the fiscal policy side, the federal government has approved a tax rebate for the same purpose.

Still we are left with this nagging question: what to do about rising prices? Monetary policy calls for higher interest rates to combat inflation but for months the Federal Reserve has been cutting interest rates to stimulate the economy and to provide liquidity to crisis-ridden financial institutions. Fiscal policy calls for higher taxes and reduced spending in order to dampen demand and to moderate price increases but the federal government has

just passed a tax rebate that will put $150 billion additional dollars in the hands of taxpayers to boost consumer spending.

We are caught in a dilemma in which we cannot stabilize prices and at the same time check the slowdown in the economy because we are beset by conditions either entirely new in economic affairs or by events taking place outside the economy with profoundly important effects on economic affairs. These seismic shocks include the terrorist attacks on 9/11, unprecedented labor migration from the southern hemisphere to the northern hemisphere, capital flight associated with economic globalization that has been gutting U.S. manufacturing, an increasingly unpopular war in Iraq, and a casino mentality that has spawned hedge funds and an array of risky financial instruments.

Mix in the partisan bickering in Washington that puts personal and party advantage ahead of the needs of the American people and the result is that economic policy makers simply do not know how best to address the ailing economy. Little wonder that so many Americans feel angry about today's higher energy and food prices, are anxious about the next round of job cuts, and bitter about the loss of equity in their single most important asset -- their homes.

We live in times where human events beyond our understanding and control are impacting our lives and economic affairs and for which we have no remedies that work effectively on the most serious symptoms of an ailing economy – higher unemployment and rising prices. In its March press release the Federal Reserve confirmed that "growth in consumer spending has slowed and labor markets have softened … and uncertainty about the inflation outlook has increased."

The decline in housing values can be reversed but more than 50 years of experience demonstrates that housing cannot be made affordable by market forces alone unless unrestrained gain-seeking is removed from the institutions that originate and trade mortgages. Neither monetary nor fiscal policy is effective in this regard.

Nor are they effective in directly addressing higher energy prices because the demand for energy is driven by worldwide economic growth and development, notably in China, and the supply of oil is under the thumb of OPEC.

There is, however, one policy option available that may help reverse rising food prices that originate from food shortages: end the huge subsidies for converting corn into ethanol. The GAO in March stated that corn-based ethanol has increased food prices and due to its corrosive properties creates challenges in developing an infrastructure to distribute it. Some studies indicate that it returns more energy than it uses, others say that it has a negative return.

Brazil produces fuel from sugar cane. The Italian car manufacturer Fiat now offers a vehicle that runs on either gasoline or methane, a combustible gas. Volvo in Europe sells a car that burns five kinds of fuel including methane. A car fueled by methane reduces greenhouse gas emissions by roughly 25 percent. Operating costs compared to gasoline are 20-60 percent lower with methane. Compared to diesel those costs are 20-40 percent lower. USEPA reports that methane comes from human-related and natural sources and that the

main human-related sources are landfills, natural gas systems, and farm animals. Methane already works in Europe. In Italy alone at least 400,000 cars operate on methane. What are we waiting for in the United States?

Edward J. O'Boyle is Senior Research Associate with Mayo Research Institute. Since completing his doctorate in economics from Saint Louis University more than 35 years ago, Dr. O'Boyle has specialized in economic research and analysis increasingly from the perspective of the human person engaged in everyday activities both as a unique individual and as a community member. In January 2004 the Association for Social Economics conferred on Dr. O'Boyle its prestigious Thomas Divine Award for lifetime contributions to social economics and the social economy. He taught economics at a state university in Louisiana for 30 years prior to his retirement in 2007.

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