

The Baffling New Inflation: How Cost-push Inflation Theories Influenced Policy Debate in the Late-1950s United States

Norikazu Takami¹

After the large price increases in the period between World War II and the Korean War, the United States successfully avoided inflation in the mid-1950s. However, prices started noticeably rising in 1956 and this upward trend continued through to 1960 with a short interruption in 1958. This persistent inflation attracted widespread attention for it was occurring in peacetime and did not seem to fit the traditional explanations of general price movements. The government and Congress actively engaged in the resultant debate, and many economists offered divergent interpretations of what was widely seen as an unprecedented phenomenon. This presentation will provide a historical narrative of this controversy that highlights and analyzes the role of cost-push inflation theories in attempts to understand the peacetime inflation of the late 1950s.

Inflation theories focusing on increased production costs over excess aggregate demand were nothing new in the late 1950s. In the Bullionist controversy in England at the turn of the nineteenth century, opponents of David Ricardo and Henry Thornton ascribed the inflation of the Napoleonic Wars to bad harvests. The same arguments were subsequently repeated over the course of the debate surrounding the Bank Act of 1844; and in the United States the Greenback and Bimetallist controversies in the late nineteenth century saw the “quality” theories of money, which essentially explained the contemporaneous deflation by declines of production cost. But the revival of interest in cost-push theories in the late 1950s was unusually intense. A major factor behind the revival was the massive increase in labor union membership that occurred after World War II: from a pre-war level of

¹takami.jp@gmail.com. Institute of Economic Research, Hitotsubashi University, Japan.

The older version of the full paper is available at: <http://www.ier.hit-u.ac.jp/Common/publication/DP/DP604.pdf>. The paper will appear in a forthcoming issue of the *History of Political Economy*.

25 percent, union membership in 1950 comprised 40 percent of non-agricultural labor, with more than half of the workers in heavy industries organized in labor unions.

This presentation, however, focuses on another reason for the rise of cost-push inflation theories: namely, the apparent lack of excess aggregate demand. For sure, the recent rapid increase in union membership was readily touted as an alternative explanation for the ongoing inflation; but it is also important to see why traditional, demand-pull inflation theories were so promptly abandoned. There is evidence for a fairly rapid abandonment of aggregate demand as the working factor in explanations of the late-1950s inflation. Contemporary commentators often highlighted the budget surplus of 1956 and the apparent failure of the tight money policy to stop the inflation. Then, after 1958, general prices increased alongside a sharp rise of unemployment (see the graph below). All these peculiarities suggesting a lack of excess aggregate demand despite the concurrent inflation came to be seen as signs of deviation from the orthodox world depicted by demand-pull theories, or as signs of the emergence of the “new inflation.”

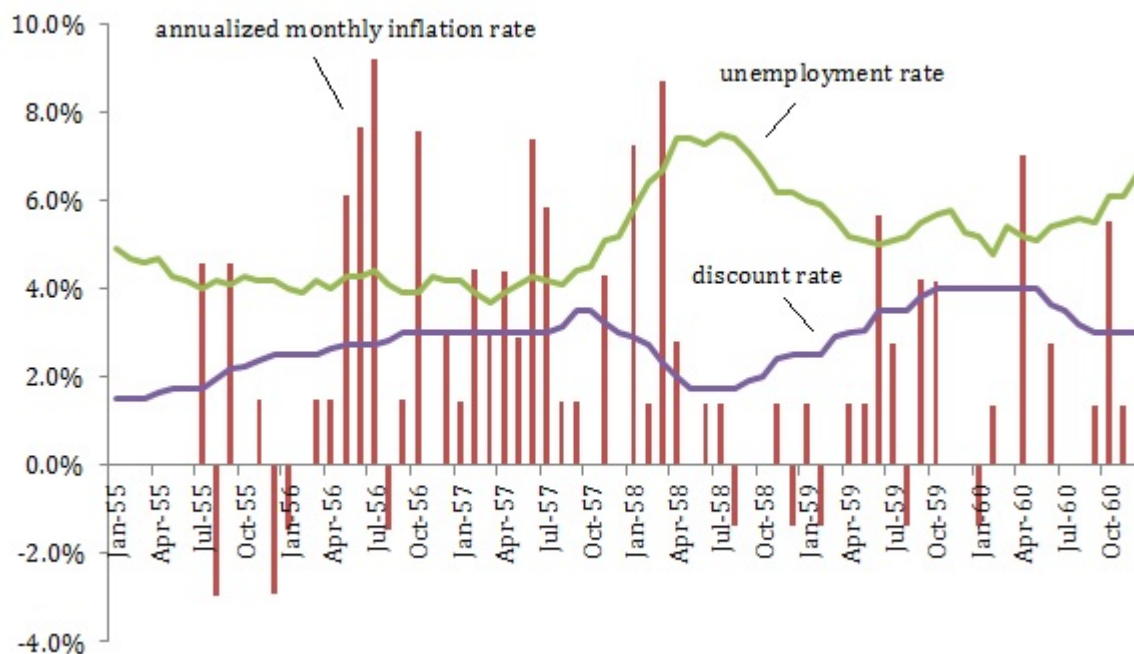


Figure 1: Changes in unemployment and inflation, 1955-60. Inflation and unemployment rates are based on the figures of the US Bureau of Labor Statistics; the discount rate on those of the Federal Reserve Bank of St. Louis.

The administration first publicly recognized this creeping inflation in November 1956, and here cost-push inflation was emphasized. Faced with a clear sign of steady inflation, President Eisenhower used a press conference to express his determination to fight inflation. Answering a question about the trend of general prices, Eisenhower told reporters that there were two types of inflation: the one monetary, caused by the cheapening of money via deficit spending and printing money; the other arising from cost increases, or in his terms, “brought about by the efforts of all people to gain a bigger portion.” Following up this presidential remark, Edwin Dale, an economic reporter for the *New York Times*, wrote an article analyzing the state of the U.S. economy. Dale noted the government budget surpluses and low growth rate of the money supply, and suggested that the current inflation could not be attributed solely to the first type of inflation distinguished by the President.

John Kenneth Galbraith (1908-2006) published an essay in the *Atlantic Monthly* in next February, in which he ascribed the ongoing inflation to an increase in production costs, generated by the activities of large corporations and organized labor. Galbraith had become a hugely popular economic commentator in the wake of the great success of *American Capitalism* (1952) and *The Great Crash, 1929* (1954; Parker 2005). In his essay in the *Atlantic Monthly*, he observed that prices had increased more distinctly in those industries in which unions were strong and linked this diagnosis with his discussion of remedies. The policy of tight money, now in place for over a year, appeared to him ineffective: such a policy “has been applied with increasing severity for many months. . . Prices are still rising” (Galbraith 1957, 40). But this seemed to him perfectly reasonable since the profits of large corporations were higher than they had been and even a substantial increase in interest rates would be unlikely to prevent large corporations and unions from raising their prices and wages. In the end, his several suggested minor remedies are cautiously guarded by his remark on the political influences of special interests, an undertone that would be further emphasized in what would become his signature work published a year later, *The Affluent Society*.

A recession set in at the end of 1957. In November the unemployment rate suddenly increased by half a percentage point, from 4.5 percent in October. The increase of unemployment continued until the unemployment rate reached 7.4

percent in April 1958, the highest level since 1940. In February 1958, President Eisenhower took the unusual step of making a televised speech to assuage people's concerns over the recently published unemployment figures. Eisenhower long resisted the term 'recession,' but later in the same month he finally adopted the term as he expressed his determination to end it as quickly as possible.

Even with recession enveloping the whole country, the problem of inflation did not completely disappear. Indeed, during this recession, general prices were rising rather than declining, and this peculiar phenomenon was recognized by various actors. The *Washington Post* financial columnist Harold Dorsey (1900-1970) ran an article in May criticizing cost-push inflation theories. Dorsey complained of how: "The recent announcement of another increase in the Consumer Price Index for the month of March . . . brought forth a chorus of 'I told you so's' from those who have been believers in the inevitability of persistent creeping inflation." Dorsey's complaint supports our claim that cost push inflation had a large following, and it further suggests that they felt it to be verified by the fact that recession accompanied general price increases. In the same month, an economist of Duquesne University sent a letter to the editor of the *New York Times* observing the peculiarity of the ongoing recession: "One characteristic of the current recession is a persistently high level of prices. . . . how can a recession, obviously a result of deficient total demand, coexist with inflation?" The author of the letter went on to express support for cost-push inflation theories.

Although many economists expressed their views on inflation and recession on the occasions mentioned above, they were also provided with a more serious outlet by one particular congressional committee. The Joint Economic Committee of the U.S. Congress (JEC), which had been known as the Joint Committee on the Economic Report before 1955, is one of the twin organizations instituted by the Employment Act of 1946 (the other being the Council of Economic Advisors, or CEA, which serves the President). The Committee's regular task is to review the CEA's annual economic report at the Congress, but on occasion it also undertakes independent studies of various pressing economic issues. The peculiar inflation that began in 1955 was inevitably picked up by the radar screens of the committee. Two studies of the inflation were initiated, entitled respectively *The Relationship of*

Prices to Economic Stability and Growth (1958) and *Employment, Growth, and Price Level* (1959), which latter we have already encountered above.

The above second study started to publish its outcome in September 1959. This first volume was solely devoted to the paper by Charles Schultze (b. 1924). Schultze had served on the Council of Economic Advisers as a staff economist and had then worked as an instructor at Indiana University. His paper, “Recent Inflation in the United States”, put forward a theory of ‘demand shift inflation.’ Schultze began by admitting that it was difficult to statistically differentiate between the effects of demand-pull factors and cost-push causes, but then argued that the issue could be reduced to the “sensitivity of prices and wages to changes in the demand for goods and services” (Schultze 1959, 1). He assumed upward flexibility and downward rigidity of money wages and described how this assumption leads to general inflation under specific circumstances. When demand shifts from one sector to another, he suggested, money wages in the second sector increase while those in the first sector do not decline because of downward rigidity. Furthermore, in the case where the sector in which demand declined is supplied by the other sector, prices of products in the former must increase to absorb the increase of costs. Thus, when demand shifts between different sectors in the economy, inflation must result even though aggregate demand remains unchanged.

At the annual meeting of the American Economic Association, held in December 1959, a session was organized to discuss the “Problem of Achieving and Maintaining a Stable Price Level.” One of the papers presented was the now famous Samuelson and Solow’s essay, often credited with introducing the Phillips curve into modern macroeconomics. This paper referred to the study papers by Eckstein and Fromm as well as by Schultze. However, Samuelson and Solow were not the only ones concerned with the ongoing JEC inquiry, and the other participants of the session also extensively discussed Schultze’s demand shift theory. In fact, the sense of urgency is more clearly seen in the discussions of these other participants, who prepared long lists of concrete policy proposals designed to address Schultze-type creeping inflation, such as holding national labor-management conferences and lowering tariffs and regulations in order to promote competition. Two discussants, Lester Chandler (1906-1988) of Princeton and Joseph Pechman (1918-1989) of the Committee for Economic Development, so wholeheartedly accepted Schultze’s

inflation theory as an explanation of the inflation of the second half of the 1950s that they questioned Samuelson and Solow's failure to distinguish between price movements before and after 1955 in their derivation of a quantitative estimate of the relationship between inflation and unemployment.

Inflation was no doubt one of the most widely discussed political issues in the United States in the late 1950s. In fact, concern over inflation could influence the outcome of national elections. In such a situation, no doubt even ad-hoc policy guidance was highly appreciated. Indeed, concerning such urgent questions as how much unemployment was necessary to keep inflation under control and how much inflation should be considered 'stable,' the JEC in one of the official inquiries mentioned above sought the intuitive guesses of professional economists. Confusion concerning the cause of inflation—cost push or demand pull—was certainly one motivation behind Samuelson and Solow's 1959 paper, as is evident simply from the content of the paper; but the political urgency of the issue would have played a decisive role at a different level – that which orients research interests and determines those types of final products regarded as important. The Phillips curve did answer the urgent need of economic experts felt during the puzzling inflation.

Edwin Dale's articles reveal to us that this inflation brought to economic experts forced realization of the complexity surrounding general price movements. The theories that gained the attention in the resultant public debate tended to separate aggregate demand and general prices and emphasize the autonomous rise of production cost as a cause of persistent inflation. Charles Schultze's demand shift theory was ostensibly a version of demand-pull theory, but it must be noted that this theory leads to similar policy recommendations as cost-push theories. It contended that prices could increase even in industries from which demand shifted when these industries are supplied by industries where demand shifted to. Therefore, even in this theory, cost increases are independent of aggregate demand. We thus conclude that the general perception that emerged from this experience was that inflation, or at least a part of it, should be controlled by measures that directly addresses cost increases in the private sector. Our account helps explain why this perception was so convincing to the economists who offered advice to the Democratic administrations in the 1960s.