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## UNSOLICITED PROPOSAL TO FIGHT STAGFLATION IN THE UNITED STATES AND EUROPE

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May 7, 2022

Stagflation is a phenomenon caused by a reduction in labor productivity. Until today we do not have a satisfactory explanation about the causes of stagflation, that is, about the causes of a reduction in labor productivity. As a consequence, there is no formula that indicates how to combat the problem of stagflation when it occurs.

In this writing we are going to present an explanation of what causes the present stagflation in the United States and Europe. For this we will have to use classical economic theory. Specifically, we will use Adam Smith's theory of absolute advantage and David Ricardo's theory of comparative advantage. In addition, we will present three measures or economic policies that can be applied to combat the current problem of stagflation. Finally, we will have to use Milton Friedman's ideas to explain how the socialist measures implemented by the government in populist democracies reduce labor productivity and generate stagflation.

What produces stagflation is a reduction in labor productivity. This implies a reduction in aggregate supply and, consequently, a reduction in per capita production (recession) and a corresponding increase in the general level of prices (inflation). In Graph I it can be seen that a reduction in labor productivity generates a contraction in aggregate supply from  $AS_1$  to  $AS_2$ , which causes an increase in the general level or index of prices from  $IP_1$  to  $IP_2$  (inflation) and a reduction in the real output level from  $Y_{1Real}$  to  $Y_{2Real}$  (recession).

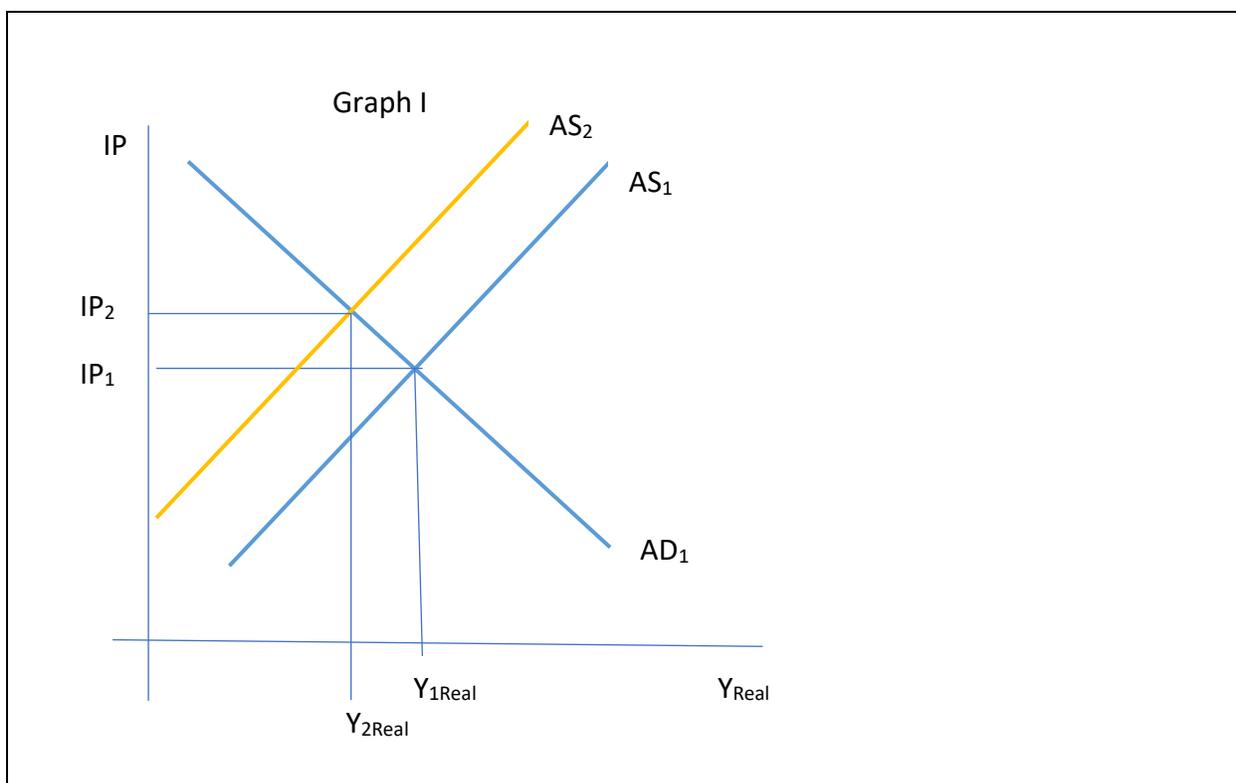
The workers do not realize that the productivity of labor has decreased and, therefore, the level of real output has decreased from  $Y_{1Real}$  to  $Y_{2Real}$  in Graphic I. Therefore, the workers do not realize that the reason why they can't consume the same as before is because  $Y_{2Real}$  production has been reduced and there are fewer goods to consume. The workers' perception is that they cannot consume the goods they are used to  $Y_{1Real}$ , not because there are fewer goods to consume  $Y_{2Real}$ , but because price inflation  $IP_2$  prevents them from doing so. Consequently, they claim through the strike and ask for salary increases from  $W_1$  to  $W_2$ . But since inflation is not due to excess liquidity but to a decrease in labor productivity, wage increases further contract aggregate supply from  $AS_{2w1}$  to  $AS_{3w2}$ . See Graph II. Consequently, there is a further increase in prices (inflation) from  $IP_2$  to  $IP_3$  and a decrease in the level of employment and real production (recession) from  $Y_{2Real}$  to  $Y_{3Real}$ .

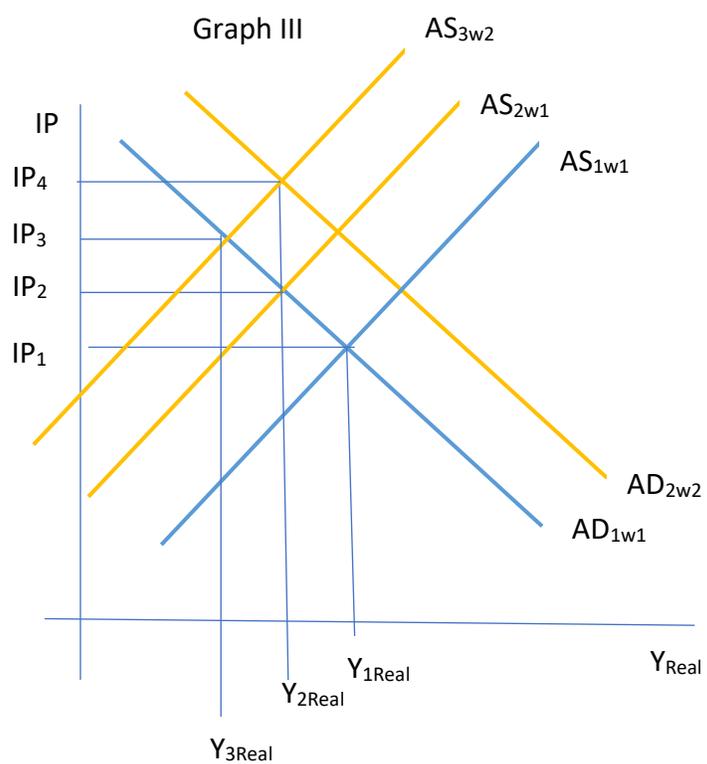
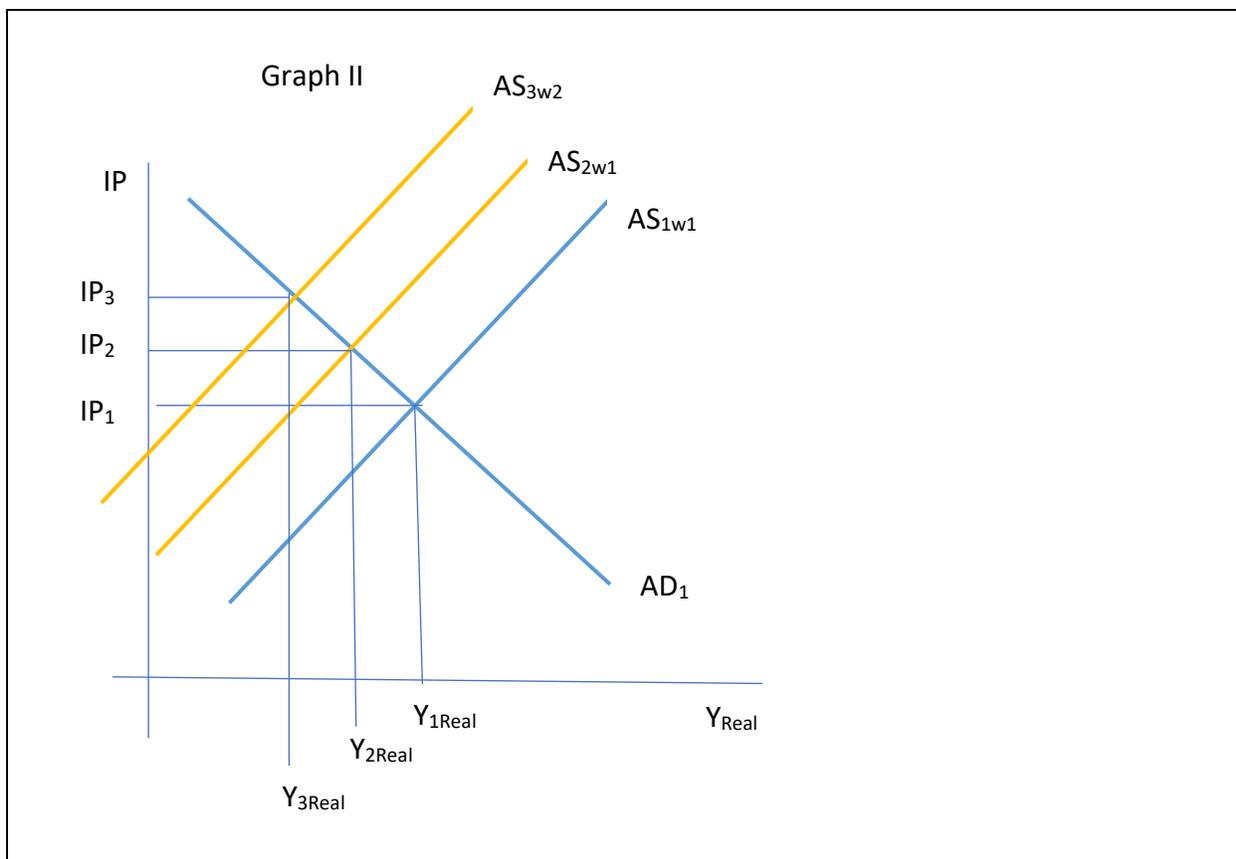
As a consequence of wage increases from  $W_1$  to  $W_2$ , an increase in aggregate demand is generated from  $AD_{1w1}$  to  $AD_{2w2}$ . See Graph III. Which is why the level of real production and

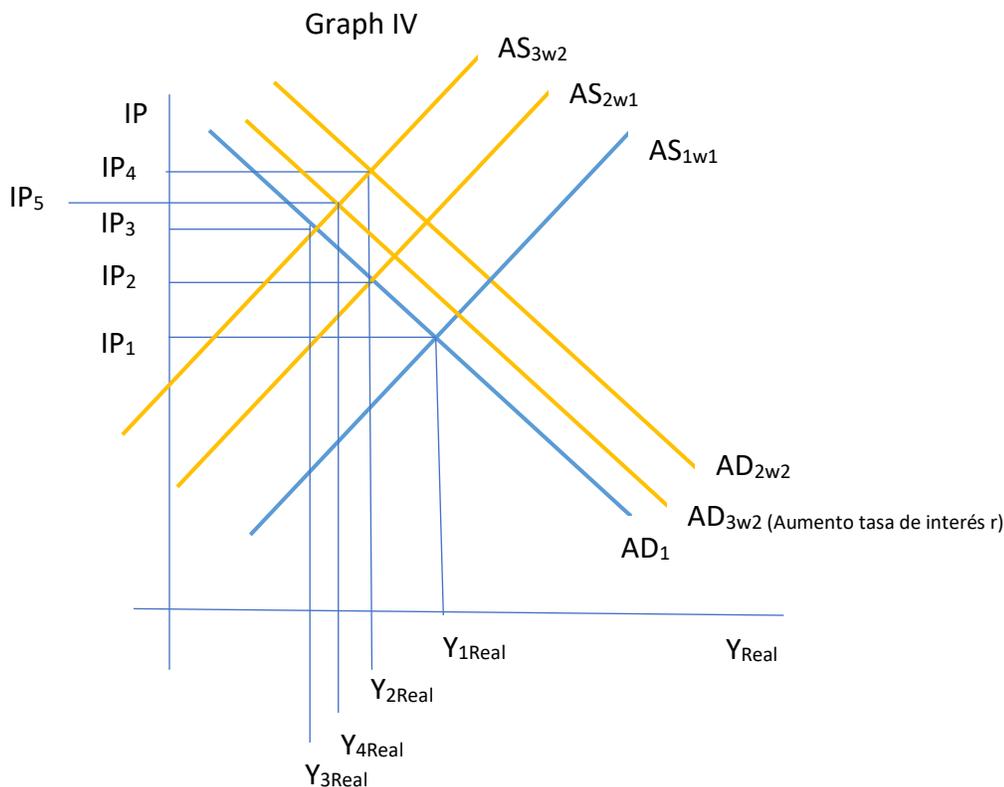
employment recovers to the previous level  $Y_{2Real}$ , but not to the original level  $Y_{1Real}$  to which workers had become accustomed. In other words, the recovery is generated at the production level  $Y_{2Real}$ , but with more  $IP_4$  inflation and at a consumption level below what the workers had become accustomed to  $Y_{1Real}$ .

To avoid inflation, the government intervenes by increasing the interest rate  $r$  and aggregate demand is reduced from  $AD_{2w2}$  to  $AD_{3w2}$  (Increase  $r$ ). See Graph IV. Reason for which the level of production and employment is again reduced to the  $Y_{4Real}$  level as well as inflation to the  $IP_5$  level. But inflation does not go away, and the recession continues. Therefore, stagflation continues. If the interest rate  $r$  were increased even more until aggregate demand contracted enough, inflation could be controlled, but at the cost of aggravating the recession.

The workers ask for wage increases again and the same cycle repeats itself.







### What Causes the Reduced Labor Productivity in the United States and Europe?

Apart from technological advances and increases in the capital stock per capita of the countries, the other variable that affects the productivity of labor in the countries is the degree to which the country specializes in the production of those goods where it has absolute or comparative advantages. So powerful is this variable as a determinant of labor productivity in a country, that throughout history it is evident. Ancient Greece, Phoenicia and Carthage are examples of past economic powers based on international trade. More recently England and the countries of Europe are also examples.

Where does the increase in labor productivity come from? The Greeks, Phoenicians and Carthaginians did not know this. It was the English economists Adams Smith (absolute advantage) and David Ricardo (comparative advantage) who discovered it. When countries trade with each other, they manage to increase their productivity when each country specializes in the production of those goods where they have absolute advantages or where they have comparative advantages.

The increase in productivity that is generated from international trade is a joint productivity. This increase in joint productivity means that, if each country were to produce all the goods without trading with each other, the sum of the production of all the countries would be less than the sum of the production of all the countries when they trade with each other, and each country specializes in the production of those goods where it has absolute and/or comparative

advantages. That increase in joint production that arises from the specialization of each country in the production of those goods where it has absolute or comparative advantages and from trade, is what will have to be distributed among all the countries that trade with each other. What each country will get from this increase in joint production will depend on multiple factors, for example, the size of each economy in each country, the size of the absolute or comparative advantage that each country has, the demand for each good in each country, etc. All these multiple factors will be reflected in the determination of the exchange rate of the currencies of the countries that trade with each other and, through the determination of the exchange rate of each country, it is determined in turn what will be having that country of the increase in the joint production of all the countries that trade with each other.

### Stagflation Caused by International Trade Sanctions

When sanctions are applied to a country, trade in those goods in which the countries have specialized and have generated increases in joint production as a result of increases in labor productivity in each country is abruptly impeded. Consequently, the labor productivity of each country involved in the sanctions decreases in proportion to the decrease in the labor productivity of the country that has been sanctioned. There is no way for one country to impose economic sanctions on another country and reducing its foreign trade, without at the same time that country that sanctions has a reduction in the level of labor productivity proportional to that caused in the sanctioned country. This means that the reduction in labor productivity in Russia, as a consequence of the sanctions imposed by the United States and the European Union, will generate a proportional reduction in labor productivity in the United States and the European Union. Therefore, there is no way to produce stagflation in Russia or China without in turn generating stagflation in the other countries that establish economic sanctions.

In addition to the United States and Europe, the reduction in labor productivity will occur in all other third countries that reduce or eliminate their trade with China and Russia for fear of being sanctioned as well. Consequently, all these third countries will suffer from stagflation as a consequence of the decrease in labor productivity and the corresponding reduction in their aggregate supply AS. Consequently, what these third countries must assess is which of the two losses will be more onerous, the loss of the market in the United States and the countries of Europe or the loss of the market in China and Russia.

### How to Reduce the Effect of Stagflation When Sanctions are Applied to a Country?

We can think of three economic policies to employ to counteract the problem of stagflation caused by economic sanctions.

1st Economic Policy Measure to Counteract or Combat Stagflation Caused by the Loss of Absolute and Comparative Advantages in International Trade

A first measure of economic policy should be to decree a temporary suspension of strikes and demands for salary increases at the same time that an awareness campaign is established among workers to make them aware of the cause of inflation and explain to them that salary increases will not allow them to go back to consuming at the same level as before but will only generate more inflation and recession with its corresponding increase in unemployment. If the suspension of salary increases were successful, inflation and recession would reach a first level  $IP_2$  and  $Y_{2Real}$  Graphic I but would stop.

However, we know that in a populist democracy these measures would be impossible to apply, since they would cause the loss of the elections for the party that proposes them. The only way these measures could be applied would be by changing the political system of the United States and Europe from populist democracies to non-populist democracies. A model on how to build a non-populist democracy can be seen in the article entitled:

PROPOSAL TO CHANGE THE POLITICAL SYSTEM FROM A POPULIST DEMOCRACY TO A NON-POPULIST DEMOCRACY 51

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In contrast, the countries on which the United States and the countries of Europe have imposed economic sanctions (Russia and China) would have no problem applying the above measures to stop stagflation because those countries have non-populist democracies. From that perspective Russia and China will have an advantage over us. That handicap will remain, until the day we change our political system from a populist democracy to a non-populist democracy.

2nd Measure of Economic Policy to Counteract or Combat Stagflation Caused by the Loss of Absolute and Comparative Advantages in International Trade

A second economic policy measure to combat stagflation would be the following:

Remove all sanctions imposed on Russia and China. This would end stagflation immediately. Accompanying these measures, we would have to force Russia and Ukraine to sit down to negotiate the end of the war.

### 3rd Measure of Economic Policy to Counteract or Combat Stagflation Caused by the Loss of Absolute and Comparative Advantages in International Trade

A third measure of economic policy to combat stagflation would be the following:

To reduce the effect of the decrease in labor productivity that countries that want to sanction others will have to suffer, a common market must be established between all the countries that trade with each other, including the country or countries that are going to be sanctioned. Then the former would gradually impose tariffs on the latter for 10 or 20 years. For example, a 2% annual tariff after 10 years would become a 20% tariff that would prevent sanctioned countries from competing and trading with the countries that sanction. In this way, enough time is generated for the non-sanctioned countries to readjust their economies and gradually specialize in the production of those goods where they have comparative advantages and that will have to replace the production of the sanctioned country or countries.

However, although the above measure would serve to generate a smooth transition in the long term of breaking off international trade with the sanctioned country or countries, it would not prevent, but rather reduce, the reduction in productivity and the joint production of all the countries involved. This reduction in the joint production of all the countries involved will be minimized in proportion to the magnitude of the comparative advantages of the sanctioned countries and their size of economies, as well as the speed with which the other non-sanctioned countries readjust their economies (make new investments) to specialize in the production of such goods where the sanctioned countries have comparative advantages.

A model on how to build a common market can be seen in the article entitled:

#### FORMULA TO DETERMINE THE COUNTRIES EQUILIBRIUM EXCHANGE RATE WITH THE DOLAR AND PROPOSAL FOR A SECOND BRETTON WOODS CONFERENCE 307

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### Stagflation Caused by the Establishment of Socialist Measures By Governments With Populist Democracies

Apart from the absolute and comparative advantages of Adams Smith and David Ricardo, a second cause of declining labor productivity that causes stagflation is the socialist measures taken by governments with populist democracies to get more votes. We owe this contribution to Milton Friedman. Socialist measures are those laws that discourage workers from seeking employment, such as unemployment wages, food stamps, housing payments. In addition, the

laws that make it difficult for employers to fire inefficient employees, having to pay them compensation and making dismissal very expensive, etc. There is a famous phrase from Friedman that sums it all up "There is no such thing as a free lunch."

The current coronavirus pandemic has generated a new currency issuance to pay workers who stay at home and do not go to work. More than 7 trillion new money has been printed. Undoubtedly, these socialist measures have also generated a reduction in labor productivity, which in turn causes stagflation.

### Inflation Caused By Other Factors

In addition to inflation that causes a reduction in labor productivity, another factor that generates inflation in the United States is the reduction in the hoarding of dollars in the central banks of foreign countries (bank reserves in dollars) as a consequence of not being able to buy to Russia in dollars and having to increase the hoarding of rubles (bank reserves in rubles).

To the extent that the United States applies economic sanctions to countries that trade with Russia, to that extent the hoarding of dollars in the central banks of foreign countries will be reduced to the extent that the sanctioned countries claim their payments in their national currency, and having to increase the hoard of other currencies to be able to trade, such as the Russian ruble or the Chinese yuan. Finally, if China is sanctioned for trading with Russia and, as a consequence, China will demand its payments in rubles or yuan, this could lead to a reduction in foreign countries' hoarding of dollars as a consequence of not being able to buy from China in dollars and having to increase their bank reserves in yuan or rubles.

The reduction of dollars in the bank reserves of foreign countries, as a result of China demanding its payments in yuan or rubles, would generate hyperinflation in the United States of very large proportions. The savings of people in the United States would disappear and the debts of bank loans too. Many individuals and banks would go bankrupt.