

ECONOMICS U\$A
PROGRAM #26

STABILIZATION POLICY: ARE WE STILL IN CONTROL?

AUDIO PROGRAM TRANSCRIPT

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(MUSIC PLAYS)

ANNOUNCER: Funding for this program was provided by Annenberg Learner.

FRANK STASIO: This program was originally recorded in 1985. Though times have changed, the basic economic principles presented here remain as relevant today as they were when the series was produced. Also, please note that individuals interviewed on this program may no longer hold the same titles they held when this program was recorded.

(MUSIC PLAYS)

FRANK STASIO: Economics U\$A. One of a series of programs designed to explore twentieth-century micro and macroeconomic principles. The subject of this edition is Stabilization Policy. Our guest is Phillip Cagan, Professor of Economics at Columbia University, and a visiting scholar at the American Enterprise Institute. I'm Frank Stasio.

FRANKLIN D. ROOSEVELT: "We know increased taxes are not needed to enable us to balance the federal budget and to begin very soon a rapid reduction in the national debt. Why? Because, recovery is with us. Federal revenues are increasing."

JOHN F. KENNEDY: "Every dollar saved from taxation that is spent or invested will help create a new job and a new salary. And these new jobs and new salaries can create other jobs and other salaries. And more customers available."

GERALD FORD: "There are serious setbacks in sales and unemployment. Therefore, we must shift our emphasis, from inflation, to recession."

MALE VOICE: “Restraint on the money supply. Reducing its growth over time toward levels consistent with price stability.”

FRANK STASIO: Since the Great Depression, economists and policymakers have sought ways to predict and avoid sharp swings in economic activity. During the ‘40s, deficit spending was crucial to America’s recovery from the Depression. Though the deficits of that time were due to the war and not a conscious policy, the effect of the deficits in pulling the country out of stagnation converted many skeptical economists to the doctrine of economic activism. But there is still much debate over when and how the government should intervene. Economists disagree over what forces are most important in driving economic activity. The Monetarist view stresses the importance of the money supply in influencing the business cycle. If the economy is in balance and the growth of the money supply starts to slow, the country heads toward a recession. If the money supply grows rapidly, from the point of equilibrium, there tends to be inflation. So, for example, the severity of the Depression in the 1930s, for a Monetarist’s point of view, was caused by a sudden sharp contraction in the money supply. Phillip Cagan is a professor of economics at Columbia University, and visiting scholar at the American Enterprise Institute.

PHILIP CAGAN: “In the famous study by Milton Friedman and Anna Schwartz, *A Monetary History of the United States*, that is their prime example, you might say, of... of their empirical support, from a Monetarist point of view, that the Depression of the 1930s was primarily a monetary phenomenon. From 1929 to ‘33, the money supply was allowed to contract by 25 percent. So, in their view, it made what was...would have been...an ordinary recession into a major disaster. Following 1933, the money supply started expanding very rapidly, and, for the next four years, the rate of growth of nominal income in the economy was the fastest for any four-year period in our history. The trouble is, is that we started from such a low level that, even after four years, we still had a considerable amount of unemployment. Then, in 1937, the money supply again was allowed to contract very sharply, so that the recovery that was going on from the 1929, ‘33 contraction was, then, interrupted in 1937, ‘38 for a second severe contraction in economic activity in a row, so that, with that, in 1938, ‘39 and ‘40, we were still at a very

low level. So, that even though the 1930s is a period of considerable change, up and down, we tend to look upon it as just one vast wasteland because unemployment was large, and never...never really got down low enough. But it was a period of change, and was, in their view, one that is almost completely explained in terms of these— terms of its economic disaster— almost completely explained by what was an inadequate monetary policy and...and disastrous contractions in the money supply.”

FRANK STASIO: Keynesian economists feel that the severity of the Depression was not due to monetary forces, but, rather, a breakdown in the market mechanism. The automatic adjustments, which earlier economists believed would offset a decline in spending, failed to materialize. Now, Keynesian economists don't deny that the money supply fell during the Depression. The question that divides economists is, which came first. Which is the cause, and which is the effect? Trying to solve this riddle is no idle exercise. Whether you believe the money supply drives demand or demand drives the money supply will have a noticeable effect on the remedies you prescribe.

PHILIP CAGAN: ‘Well, an early Keynesian view didn't put much emphasis on money at all, but a much more recent Keynesian view would be consistent with the idea that monetary policy should have... take discretionary steps to offset what is happening in the economy because it's subject to a lot of ups and downs that are generally unpredictable. Whereas a Monetarist view has been that, if you had a fairly stable rate of growth in the money supply, this would take away most of the sources of changes in the economy, in aggregate demand. And that the remaining ones would not be too serious, but, in addition, that there wouldn't be much that you could do about these anyway through monetary policy. So, that the best...best thing that the monetary authorities could do would be to follow a stable monetary growth policy.’

FRANK STASIO: One of the major disagreements between Keynesians and Monetarists is the question of whether a free market economy, left to itself can automatically correct swings in the business cycle. Phillip Cagan points out that the Keynesians have less faith than Monetarists in the market's ability to automatically stabilize the economy when it has reached high levels of unemployment.

PHILIP CAGAN: ‘The Monetarist view would be that there can be shocks that will occur... that, to aggregate demand, and that these shocks will tend to cause changes in aggregate spending, but that the economy can quickly adjust to these by changes in the price level or wage level, so that we remain more or less at a full-employment level. Whereas the Keynesian system has certainly pointed out that, in many cases, prices and wages are sticky, so that the shocks tend to show up in changes in...in output, instead.’

FRANK STASIO: When Cagan talks about stickiness in wages and prices, he means the tendency of wages and prices not to fall in spite of declining demand. Keynesians argue that the failure of prices to quickly adjust to changes and demand creates a role for countercyclical policy. To simply set the money-supply growth rate at a constant level would be poor policy because the relationship between the money supply and economic activity called, “velocity,” changes from year to year. To counter these changes, Keynesians argue that the government must lean against the wind, that is, use countercyclical fiscal and monetary measures. On the other hand, Monetarists hold that velocity is quite stable, and, as such, monetary growth should be fixed and stable as well. Professor Cagan says that, at different points in history, both changes in velocity and the money supply have played the leading part in changes in the business cycle.

PHILIP CAGAN: “Over some periods, the changes in velocity have been rather minor, and, in other periods, they’ve been rather important. Certainly, in all the major, large changes in the price level, during major inflationary periods, and those changes in...in the price level and output that occur over long-run periods, changes in the money supply have clearly been the most important factor. While velocity does change and has changed, both in the short run and the long run, its changes have been limited, and the really large changes have come from the quantity of money. When you look at very short-run periods where the changes in the quantity of money are not very large, then, relatively speaking, the velocity changes become important.”

FRANK STASIO: But Monetarists argue that changes in the money supply always come first. According to Nobel Prize winning economist Milton Friedman, large changes in velocity are only likely to occur when the government creates uncertainty with erratic

monetary policies. Friedman says that the severe economic slump of nineteen seventy-nine was an example of the damage that can be caused by discretionary adjustments to the growth of the money supply. In order to bring down inflation, which had risen to eleven percent and was still climbing, the Fed, through its open-market operations, reduced the supply of money to the economy. By 1982, the Fed succeeded in pushing back inflation to four percent, but the cost was enormous. Unemployment shot up to more than 11.5 percent, higher than any time since the Depression. Also, at a post-Depression high was the number of bankruptcies, particularly among small businesses. Nearly a trillion dollars of potential GNP was lost. Friedman notes that the Fed failed to follow its own policy, announced in 1979, of adhering to a fixed growth rate in the money supply to fight inflation.

MILTON FRIEDMAN: “Let me point out, as a matter of, just, fact, that volatility in the rate of money growth, the fluctuations, the extents of fluctuations, from 1979 to 1982—three years—is greater than in any other three-year period in the history of the Federal Reserve. The volatility of interest rates is greater, was greater than any other three-year period. The volatility of the economy was greater than any other three-year period since at least the end of World War II. So, these three things, inevitably, in my opinion, go together. They’re not; it’s not an accident that those three went together. If money supply is volatile, interest rates are going to be volatile, and the economy is going to be volatile. That’s why I am in favor of steady monetary growth. That’s why that’s been a major component of the Monetarist position about monetary policy. The fluctuations in the money supply are a source of uncertainty in the economy. They affect the economy, not instantaneously, but with a considerable lag. The Federal Reserve, in trying to offset changes in the economy, is always, in a sense, fighting the last war. What it does now has an effect six or nine months from now, with respect to the economy, a year or two years from now, with respect to inflation. It’s impossible for them to foresee what action now is appropriate in light of the future. As a result, in my opinion, the actions of the Federal Reserve have added to the uncertainty, have added to the instability of the economy, rather than reduced it. And let me emphasize, stable monetary growth is not a guarantee of stable economy. It’s a guarantee that you will not have disturbing elements

introduced by the operation of monetary policy. It's a way, I said, for... to keep the Federal Reserve from doing mischief and not a way to produce nirvana.'

FRANK STASIO: Keynesians claim, the extreme fall in velocity in 1982 shows a flaw in Friedman's constant-growth rule. But Friedman argues that the erratic shifts in Fed policy caused the changes in velocity.

MILTON FRIEDMAN: "The Federal Reserve's policy from 1979 on, and insofar as it influenced the course of events, did bring inflation down. But it brought inflation down at an excessively high cost. And what brought inflation down was not the announced policy. What brought inflation down as rapidly as it did, was that they introduced so much uncertainty into the economy by the rapid ups and downs of the money supply, by the rapid ups and downs in the interest rates, that the business community, as a whole, was put in a position where it felt it needed much more liquidity to be able to cope with uncertainty. We have a lot of experience over history, over centuries, that, the more uncertain the world, the larger the fraction of their resources that people want to keep in a highly liquid form. And if you put this in technical economic terms you say, velocity of money declined. And the reason it declined, a major reason it declined, not the only one, a major reason it declined during that period was because of the increased volatility of the economy, and the increased uncertainty. And in that sense, you can say the policy worked. But had they followed their announced policy, had they actually targeted the money supply, and stuck to their targets, and been consistently steady, you would have brought inflation down less, in my opinion, than they actually occurred— but at a much lower cost to the economy without going through these violent gyrations, and with a greater potential, of keeping your achievement intact in the long run, of continuing along that road and getting to a stable long-run position."

FRANK STASIO: Friedman says the government would be better off without a Federal Reserve System. He and other Monetarists argue that, in the long run, economic stability is achieved through a steady, predictable growth rate in the money supply.

MILTON FRIEDMAN: "Given that there is a Federal Reserve, the best way for it to operate would be to set targets for a single monetary aggregate, and stick to those targets,

and keep to them as closely as possible. Those targets should be set so as to go from wherever you start to a rate of growth in the money supply which is consistent with zero inflation. If they target them M-1, what's called, "M-1," the narrow money supply, including transferable deposits, if they target them M-1, that means the rate of growth to about three to five percent a year for M-1, maybe one to three percent a year, somewhere in that neighborhood. I'm not going to argue about the exact number. They should not try to achieve that overnight, but they should go from wherever they start, to that number gradually, over a period of four or five years, and then stay there, and never depart from it, and keep the money supply as close to that growth as possible."

FRANK STASIO: The Keynesian-Monetarist debate is not just about the conduct of monetary policy. Generally speaking, the Monetarist view favors less government intervention, and the Keynesian approach looks for active involvement. These general prescriptions hold for both monetary and fiscal policy. The Keynesian theory that government should run a deficit during a recession to stimulate demand was viewed with skepticism at first. Philip Cagan.

PHILIP CAGAN: "If you borrow money, in some initial sense you might not create any additional demand at all. This was one of the points that Keynes was concerned with, that, when he argued that a deficit would expand aggregate demand, he was arguing against a view of, prevailing in the British Treasury at that time, that if you tried to, if the government tried to spend more by simply borrowing money from the public, the government would spend more, and the public would spend exactly that much less, and there would be no net change in aggregate demand. And Keynes developed his system in order to argue that, under those circumstances, there would, in fact, be a change in aggregate demand. Well, the change as it turns out in his theory comes about because the government's borrowing raises the interest rate, and the higher interest rate induces people to hold less money, so, in that way, you get extra spending from this process, even though there's been no increase in the money supply."

FRANK STASIO: Monetarists argue that the stimulative effect of deficit spending is offset by a crowding-out of private investment.

PHILIP CAGAN: “Crowding-out is the effect on private investment when the Treasury runs a deficit and borrows because, as I just mentioned, this process can raise aggregate spending through a rise in interest rates. But the rise in interest rates can also discourage private spending in the economy that’s influenced by the interest rates. So, the rise in the interest rate will not produce as much increase in aggregate spending as would happen if you would increase the money supply and hadn’t had any increase in the interest rate. So, there is a crowding-out here of private spending, not as much as the government, presumably, is spending. But there would be some offset to the...to the government spending through the deficit, through a process of crowding out private spending, and this, presumably, would fall mainly on private kinds of investment spending that would be influenced by this rise in the interest rate.”

FRANK STASIO: Does crowding-out have different effects at different levels of output?

PHILIP CAGAN: “It could, although this has never been clearly demonstrated. If you were at low levels of output, there might be a couple of things that would happen. First of all, there would no tendency for prices to increase, which would be an additional crowding-out effect, so that the effect of the spending showed up in a price increase rather than an output increase. Low levels of output, there’s very little pressure on prices, so any increase in spending shows up in output, rather than prices. It might also be thought that, at very low levels of output, you have a rather flat demand for money functions, so that any tendency for interest rates to rise produces a considerable reduction in the amount of money that people want to hold. And, in this way, you don’t get much of an interest rate increase. You get a lot of extra spending through the rise in velocity, and, therefore, a little crowding out in this particular case. This has never actually been demonstrated, but it seems to me there might be some truth in this. So that, at low levels of output, there is likely to be less crowding out. When you get to very high levels of output, or, actually, to a full-employment level, then, presumably, the crowding out gets to be fairly complete in terms of real output because the economy, first of all, is not capable of producing much more in terms of real output. And, in addition, if you get very, if you have a fairly steep demand for money function here, then you’re going to get

more of a rise in the interest rate, and most of the Treasury's extra borrowing is going to show up in a reduction of private investment.”

FRANK STASIO: Milton Friedman and other Monetarists say that Keynesian economists try to fine-tune the economy; a task they argue is beyond the reach of even the best of economists. But those who argue for more active remedies say they can adjust the economy without the minute changes suggested by the phrase “fine-tuning.”

MILTON FRIEDMAN: “That, you know, conjures up a picture of people twiddling the dials and...and running policy in a way that is, you know, beyond anyone's imagination, certainly beyond mine.”

FRANK STASIO: Walter Heller was the chairman of the Council of Economic Advisors under Presidents Kennedy and Johnson.

WALTER HELLER: “And it involves a certain amount of chutzpah, that you could move this economy by small degrees, hither and thither. I don't think that the concept, change it to ‘gross-tuning,’ not fine tuning. I don't think that concept is at all out of date in the sense that, if the economy is sliding or is failing to achieve its objectives, full employment, and so forth, that you do have to adjust monetary policy and, if possible, fiscal policy, taxes and spending, to achieve either an offset to recession, or to achieve the full-employment potential of the economy. I don't think that concept is gone at all. And in particular, I think what's worth saying in light of the Monetarist, the Friedman point of view, that you should just set the dials at one level and let the economy, then, adjust, so to speak, to a steady growth of the money supply. I just don't believe in that. It seems to me that, with all the information we have about the economy, there should be feedback. You should constantly feedback, into the policy process, what you can learn from the economy, and then adjust policy, not every day, not every week, not every month, but over a cycle, or, in light of various crises that hit the economy, you ought to adjust it in the light of the information. I don't think you should deny yourself that information.”

FRANK STASIO: The debate over stabilization policy is not restricted to the Monetarists and Keynesian views. A theory of rational expectations has received some attention as well.

PHILIP CAGAN: “It’s a view that’s grown up in recent years in response to the importance of...of expectations in econometric model building and a criticism of the typical way in which expectations were handled in econometric models previously. Previously, a typical way was adaptive expectations in which an expected values of variables--which were, of course, important in explaining how the public responded to changes in variables-- the expectation under the adaptive method would usually assume that the public would adapt their expectations to what was actually happening. A result of this was that expectations were always slowly adjusting to what was going on in the economy, and this often seemed rather irrational on the part of the public, because they might be making the same mistake in their expectations, for months and years in a row if...if the changes going on were always operating in the same direction, and they were always slowly adjusting to what was going on. And so it grew up that an idea in economic modeling might be better, to assume that the public’s expectations were always going to be unbiased, which is to say that they might make mistakes, but they would not be systematic mistakes. People would not make the mistake over and over again.”

FRANK STASIO: Cagan explains how rational expectation theorists might come to different conclusions about business activity.

PHILIP CAGAN: “First of all, if you take the adaptive expectations approach, if inflation begins to develop, you, in the adaptive expectations, the public does not immediately respond to this developing inflation. So, the rise in prices is a surprise to the public-- their money holdings don’t fall as much as they otherwise would if the public had been more alert as to the rise in the inflation rate-- and the other adjustments that they might make are much slower, so that prices and wages in general would be more sluggish in their response to this increasing inflationary pressure. Under rational expectations, it’s imagined that the public will see that inflation is developing as soon as it occurs, both, because it will understand what the monetary authorities are doing in terms of the money

supply, and what effect this is having on aggregate demand in the price level. Consequently, the effects of inflation on the demand for money will occur immediately or, perhaps, even ahead of time as the public seeks to adjust its money balances to the coming inflation. Prices and wages in the economy will adjust ahead of time, or, certainly, would not without any lag to the coming inflationary pressures. And consequently, if inflationary pressures are coming along, under rational expectations, the effect on prices in the economy will be much stronger because of the anticipation by the public over this inflationary pressure.”

FRANK STASIO: Economists who support the rational expectations theory, argue that government activism can be self-defeating because firms and individuals will neutralize government policy by anticipating its effects. Another approach that has influenced government policymaking in recent years is supply-side economics. It, too, argues that government activism does more harm than good. Supply-side economists focus on the elimination of federal policies that discourage long-term growth.

PHILIP CAGAN: “These would be governmental policies that would influence the way in which goods are supplied in the economy. This would pertain, most particularly, to taxation policies. If you tax something that discourages its production, if you have marginal taxes on people’s earnings, it discourages their efforts. You have high taxation on the returns from investment; it discourages investment, and investment in capital goods that can produce future growth. So, these kinds of government policies definitely influence the supply of goods in the economy. But there might be other government policies, controls over pollution, which would influence the chemical industry, other kinds of regulations in different industries that may inhibit either the incentive to produce certain goods or influence the kinds of goods that are produced. So, there’s a whole array of government influences on the economy, particularly since the 1930s when the government has intervened to a much greater extent in the economy.”

FRANK STASIO: How does it differ from the demand management policies that we’ve had since the thirties?

PHILIP CAGAN: “Well, I would say the main difference is that the demand management policies tend to look at the economy in the macro-sense from an overall point of view. Is that total amount of spending in the economy appropriate? Is the movement of the price level going too rapid, or should we try to reduce inflation? So, we don’t focus on a particular area of the economy, but look at the economy as a whole. Supply-side factors always focus on a particular sector. What is the price doing to this particular industry? What are taxes doing to a particular industry? What are taxes doing to investment? What are regulations, environmental, and other kinds, doing to particular industries? It’s very hard to think of supply-side policies as influencing the whole economy in the same way that our aggregate demand policies do.”

FRANK STASIO: Let’s review some of the important ideas in our discussion of Stabilization Policy. Monetarism stresses the relationship between the money supply and sharp swings in the business cycle. This differs with the early Keynesian view that changes in the money supply are the result and not the cause of shifts in the business cycle. Today, Keynesians hold that change in the rate of growth of the money supply is only one of many factors that affect the business cycle. Keynesians and Monetarists have also differed over the volatility of spending and the desire to hold liquid assets. Monetarists believe that spending and velocity are inherently stable. Partly because of this view, Monetarists advocate a fixed growth rate for the money supply. They also maintain that the lags between the creation of monetary policy and its effect often result in the policy being pro-cyclical. That is, it feeds economic trends, rather than work against those trends, to keep them under control. For these reasons, they argue that discretionary adjustments to the money supply create uncertainty and ultimately do more harm than good. Keynesian economists see spending and the economy as much more volatile. They advocate discretionary changes in the money supply and fiscal policy that work against the business cycle. The proper countercyclical fiscal and monetary policies will, in the Keynesian view, take out the booms and busts in the business cycle. Another theoretical argument that concerns stabilization policy is the rational expectations theory. This theory holds that government efforts to stabilize the economy are offset by the actions of firms and individuals who will anticipate changes in economic activity and take steps to protect themselves against the adverse trends. These preemptive moves

would tend to neutralize federal policy prescriptions. Still another point of view, but one that is not, strictly speaking, directed toward stabilization policy, is that held by supply-side theorists. Supply-side theories seek to stimulate aggregate supply in the long run through tax reductions, and through changes in burdensome standards and regulations. It is important to understand that there is a wide disagreement over stabilization policies, even within the various schools mentioned here. But economists argue that stabilization policies, if they're to work at all, must evolve with changes in economic behavior. Theories on stabilization of the economy, which may have applied to one set of circumstances, are not always helpful in other situations.

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FRANK STASIO: You've been listening to Economics U\$A, one of a series of programs on micro and macroeconomic principle. Our guest has been Phillip Cagan, a Professor of Economics at Columbia University, and a visiting scholar at the American Enterprise Institute. Economics U\$A has been produced by the Educational Film Center. I'm Frank Stasio.

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Announcer: Funding for this program was provided by Annenberg Learner.