ECONOMICS U$A

PROGRAM #16

BOOM AND BUST: WHAT CAUSES THE BUSINESS CYCLE?

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 examine twentieth-century micro and macroeconomic principles. The subject of this edition is The Business Cycle. Our guests are Robert Nathan, New Deal economist and President of Robert Nathan and Associates, and Robert Heilbroner, Professor of Economics at the New School of Social Research in New York. I'm Frank Stasio.

MALE RADIO VOICE: "The economy showed a decided downturn in this third quarter as the nation's leading economic indicators fell almost two points…."

FEMALE RADIO VOICE: " At the White House yesterday, the President indicated that the current economic growth rate was well above predictions made last year by his economic advisors…."

MALE RADIO VOICE: "Members of the House Budget and Finance Committee urged the President to act now, as GNP continues to fall and unemployment rose to an unprecedented eight point seven percent."

FRANK STASIO: The United States has had its share of good times and bad times. By the turn of the century, this country had been through a number of economic cycles. There had been a Depression in 1819. But by the 1830s, westward expansion had driven the economy to new heights. Then, a bank panic and a depression. And on it went, boom and bust, all the way through to the greatest economic surge the modern world had ever seen.

FRANK STASIO: The Roaring Twenties. America was entering a new era of economic prosperity. Output rose as Americans rushed to buy the latest technological miracles. Americans showed their unquestioning confidence in the growing economy by leaping into the stock market. In the five years between 1924 and 1929, stock prices had soared 400 percent, and most Americans were convinced the good times would never end. There was nothing in the conventional economic thought of that time to predict the disaster that lay just ahead. Robert Nathan was a student of economics at the Wharton School in 1929.

ROBERT NATHAN: "My professor, uh, I often said, this is, it's not a joke, that he was quite serious. He took a rubber band out of his pocket and pulled it way apart, and said, 'boom,' and then he let one end go, and it collapsed, and he said, 'bust.' "

FRANK STASIO: This simple lesson in the dynamics of business fluctuations came at the very start of the worst economic catastrophe of modern times.

FRANK STASIO: October 29th, 1929, the Great Crash and the beginning of a Depression that would force 14 million people to lose their jobs. One quarter of the work force was idle, and, still, economists and public officials held to their belief that good times would follow bad times, as surely and as naturally as day followed night. It was all part of a pattern which economists had only recently discovered. The business cycle, as such, wasn't really talked about until the last part of the nineteenth century. Before then, classical economists like David Ricardo and Adam Smith saw severe economic downturns as flukes, temporary aberrations in an otherwise well-balanced system. Robert Heilbroner is an economics professor at the New School of Social Research in New York.

ROBERT HEILBRONNER: "The classical economists didn't really think about business cycles. That's partly because David Ricardo wrote in the first two decades of the nineteenth century and…and Smith wrote his great book in the seventh decade of the eighteenth century, before there were cycles. I'm sure there was some boat-rocking. I mean, all systems that are so…that are so unplanned as capitalism is develop their internal tremors, so to speak. Um, there…there were shocks, certainly, in Smith's time. Good harvest, bad harvest, Napoleonic Wars in Ricardo's time. And those shocks gave rise to tremors. And already by Ricardo's time, not in Smith's time, they were talking about the possibility of saturating a market, overrunning the market. And a French economist, uh, Jean-Baptiste Say, developed a theory that said that, quote, 'proved it was impossible to do that. You couldn't really bluff the system.' And Ricardo believed you couldn't really bluff the system, which would be a sort of a self-induced reason for a…for a large scale self-administered shock."

FRANK STASIO: But while the ideas of Ricardo, Smith, and Say dominated economic thought in the nineteenth century, there were some dissenting voices. The best known is Karl Marx.

ROBERT HEILBRONNER: "Marx was the first economist really to conceive of a self-generated cycle, in which good times produced, eventually, bad times… and the bad times produced good times. He really had a theory of the business cycle – a very complicated and long theory – in which good times produced their own in…in Marx's terms, contradictions, tensions is a good word, which eventually brought the thing to a…to a climax. And, then, the bad times, in turn, produced their own healing properties. Businesses would go under, if, uh, wages would go…go down, uh, businesses would be for sale very cheap, or capital goods for sale very cheap, so the stage was set, see, for a turnaround the other way."

FRANK STASIO: Now there is no debate about whether economic activity is cyclical. Business moves along like a roller coaster, edging production upward, then sliding down, and back up again. Economists have divided the business cycle into phases. The upswing, when productivity is increasing, is called expansion. During an expansion, we can expect unemployment to fall. But, as we'll see, expansions may also lead to higher prices. When the economy comes to the end of an expansion, we have reached a peak. As business activity slows down, the economy moves into a recession. Production is lower, and unemployment is likely to rise. Finally, the cycle bottoms out, and the economy is said to be in a trough. Here, unemployment is at its worst point in the cycle. But why? Why can't business gauge demand, control production, and put an end to the booms and busts? Why can't it, in effect, straighten out the roller coaster and send the economy on a smooth ride?

ROBERT HEILBRONNER: "There seem to be two large-scale answers. One is external shocks. Something comes and hits the system from the outside, like oil shock, which is very dramatic. Um, or, like some particularly powerful kind of invention, the railroad, which suddenly got invented and began to spread, or the automobile, or a war. You can devise a whole lot of sort of exogenous external shocks, and trace them through, and they clearly give rise to deviations from the trend. The…the other explanation about why you have cycles in the first place is that there are internal mechanisms working within the system that, in a fairly regular way, um, tend to involve it in contradictions, self-contradictory, um, failures, self-imposed failures. It uses up its…it undercuts its own labor market by throwing people out of work through technological unemployment. Um, it exhausts its bank credit because it…it systematically over invests. So, that the…the essential, uh, cyclical phenomenon does not come from outside shocks, which also aggravate the thing, but from internal processes."

FRANK STASIO: There is another reason. According to Robert Nathan, it is unrealistic to expect business and industry to predict with perfect accuracy what the demand will be by the time they develop the means to meet it.

ROBERT NATHAN: "And I give you the best examples right here in Washington. Washington, now, is in a period when there is excess office space available. And uh, take, uh, our office happens to be at Thirteenth and Pennsylvania Avenue, a couple of blocks from the White House. And on Thirteenth Street, within the next six or eight blocks, ther are about six or seven big new office buildings, and they were almost all built at the same time. And you think how silly people they…they had ideas; others were coming in. Why all build at the same time? Well the…the situation was different then. There was a shortage of buildings. Rent was going up like mad. Uh, space per foot practically doubled the cost for us. So, everybody jumped in to build new buildings. Well, these buildings, some of these buildings have been finished now for twelve months, and there are no tenants or…or just a half dozen in it. So, what you'll find is, suddenly, people will tend to stop building and three, four, five years from now when things get settled out, suddenly, there'll be a shortage of space, and rates will go up and…and then you'll have another boom in building. So that, that time element, the lag in leads make it almost impossible to smooth it out entirely."

FRANK STASIO: Robert Nathan has given one example, using a single commodity. Total output is determined by the relationship between aggregate supply and aggregate demand. Aggregate supply is the amount of real national output that will be produced at each price level. Aggregate demand is the amount of real national output that will be bought at each price level. Changes in the level of demand, in particular, are among the major causes of the business cycle.

AUCTIONEER: "Who has got ten dollars? Who's got twenty dollars? Twenty, will you give? Twenty, will you give? Twenty, will you get? Twenty, at twenty-five? Will you give twenty-five, and thirty? Thirty, will you give? Thirty, will you give? Thirty, at thirty-five?"

FRANK STASIO: The effects of changes in demand can be seen most clearly at an auction. The more people want something, the more they'll pay for it. When the auctioneer puts, say, a piece of furniture on the block, bidders bid on that one piece. As the price goes up, fewer people bid. There is a similar relationship between price and total output in the economy as a whole.

ROBERT NATHAN: "The demand curve looks at what the market demand is, and at what are you, as a consumer, uh, going to buy, or what are you interested in. And demand is, also in very considerable sense, responsive to prices, but are also an influence of prices. Because, if suddenly there's a change in…in, uh, style, and some of these big designers come out and say, ‘here, today you’re going to wear shirts with long collars and…and short sleeves,’ or whatever changes they are going to have, and, suddenly, people all follow this and discard the old ones, you may have a rather significant response in demand, and prices tend to go up. Now, as prices go up, that sort of softens the demand in itself because there’s a point at which you…you won’t or can’t buy as much as you otherwise would if prices had been stable.”

FRANK STASIO: An increase in aggregate demand will result in higher prices, most often when manufacturers have to expand or modernize to meet rising demand. This is because producers tend to pass their new costs on to the consumer. There are times when greater demand will not result in higher prices, particularly if output begins to expand at a time when unemployment is high.

ROBERT NATHAN: “At the lower levels of economic activity, for instance, when you’re coming out of a recession, you can increase your supply – namely, increase production of cars, or clothing, or shoes, or whatever it is – without any problem because you have the plant and the equipment readily available. And often, in a recession, instead of an industry working at 80 percent of capacity, it’s working 65, or 70, so that you have the physical capacity to expand production. Also, you have the unemployed labor that has occurred during a recession as jobs are lost, so, that, as you increase your…your…the demand increases, uh, you can increase your production, and the costs stay about the same.”

FRANK STASIO: So, while higher prices tend to make people less willing or able to buy, at the same time they serve as a signal for producers to turn out more goods and services. Remember Robert Nathan’s story about office space in Washington: when it was at a premium, builders rushed to fill the need.

ROBERT NATHAN: “When you can sell goods for a higher price than previously, you will tend to expand your capacity to produce it, and you’ll tend to increase production. And, uh, it’s the other way around that, when prices drop, supplies tend to follow. People produce less when prices are down, because, you know, businessmen aren’t in business for fun, or love, or deficits, and, uh, they don’t like losses. And, so, when they see that prices are down and they can't sell their goods at a profit, they tend to reduce production."

FRANK STASIO: Learning about supply and demand helps us to understand the pattern of business cycles. But, to fully grasp the hardship of those cycles, we need to look at measures of unemployment. High unemployment has both direct and hidden social and economic costs. Robert Nathan uses 1985 unemployment figures to explain.

ROBERT NATHAN: "There's seven percent of our labor force–over seven percent, today–who are able to work or willing to work, and who are actively seeking work. And when I think of what those people could do, and I think of the tax revenues that would come from their being productive, and the goods and services that we could enjoy in public as well as private services, there's no question, if we were down to six percent unemployment or five and half instead of seven point three, we'd have more money, and more goods and services for defense, for police, for schools, for education, for health, for housing, and all the things that our society wants. So, that, whether we're in a recession or a boom has tremendously important implications for our policy and what our…what our national policies are going to be."

MALE RADIO VOICE: "Latest figures from the Bureau of Labor Statistics indicate that unemployment rose over six-tenths of one percent. As the automotive industry idled, over fifteen thousand workers…"

FRANK STASIO: Unemployment statistics provide a good way to follow the movement of the business cycle. But it's important to understand that not all unemployment is alike. Economists have identified three different kinds: frictional unemployment, which includes seasonal workers, people just entering the workforce, and those who have quit their jobs. Then there is structural unemployment, which includes people who are out of work because of new technologies which have made their skills obsolete. And, finally, cyclical unemployment, which goes up and down with the business cycle. Economists try to measure the difference between what the economy could have turned out at full employment, and actual output. The amount of goods and services that might have been produced with full employment is called the potential GNP. There is, of course, a certain amount of unemployment that is inevitable. Frictional and some structural unemployment fall into this category. Now, let's suppose that economists have decided that five percent is the acceptable level of unemployment. Potential GNP would be the amount of output that could be produced with 95 percent of the workforce. While unemployment statistics can indicate trends in the rate of joblessness, there are important qualifications. Professor Robert Heilbroner:

ROBERT HEILBRONER: "Employment now includes the women in the labor force, as well as the men in the labor force. People enter the labor force later, you don't start working at fourteen, you start working at twenty-four, something like that, uh, after you're done…after you get your Ph.D, then, you begin as a…as a delivery boy. And you…you…you don't retire when you drop dead. Uh, you retire when you get to social security age, so the…the duration of the size of the labor force changes as composition changes. So it's…it's a very complicated business about counting up what percent of the total available, possible, imaginable labor hours are actually employed."

FRANK STASIO: And there are other considerations. For instance, some people are vastly overqualified for the jobs they hold but can't find more suitable work. Still, they are considered fully employed, as are people with only part-time jobs. And then, there are those who are unemployed but don't get counted, because they've stopped looking for work.

ROBERT HEILBRONER: "When jobs are scarce or lousy, uh, so, the people don't volunteer so quickly for work, either the pay is very poor, uh, or they've given up even hoping to find jobs, so they…they're not unemployed, and they're not, technically, unemployed. To be technically unemployed means you've got to be looking for work. And if you're just lounging around the house, you're not looking for work. Now, this applies with particular importance to the female labor force. Um, the female labor force is still a supplemental labor force. It's not the main labor force. The man is still primary breadwinner in most American families. The wife's contribution is very important. Not aside, a…a…aside from what it means to her, herself, to have that independence, it means a lot to the family. Just the same, it is supplementary, and not primary. And the wife is usually more—the female part of the labor force, the wife is more quickly fired than the man. The man has, quote, a permanent job, pumping gas, uh, and the woman has a temporary job. She does part time…working and part time, uh, oh, she clerks at the supermarket on…on Monday, Wednesday, and Friday, or she…or she fills in some. So when…so when times got bad, the manager says, 'I'm awful sorry, Millie, but I mean, are things, I got to let you go.' Um, so, she was employed for a while; now she's unemployed. For the first month after she's unemployed, she looks around, and she asks her friends, she reads the paper. Um, she'd like to get back doing some part-time work or maybe even some full-time work. Well, there's nothing, nothing around. So, after a certain amount of…and during that period, when, if and when, the census taker comes around, she reports the fact she's looking for work– she's a…she's a member of the unemployed. A month passes, she quits. I mean it's too, it's ridiculous. She's wasting more money in a carfare than it is…so, it doesn't pay. So, she, quote, without making a conscious decision, she just stops looking. She withdraws from the labor force. When the census taker says, have you been looking for work in the last, whatever, she says, quite truthfully, no. So, she doesn't count as a member of the unemployed. Unemployment has gone down. But it's gone down for the…for the reason of what's called 'discouraged worker syndrome.'

FRANK STASIO: But, even after allowing for all of the distortions, there is another variable. The effect of unemployment changes over time.

ROBERT HEILBRONER: "To be unemployed in 1930, to have, well, when one person said, 'I'm unemployed,' um, in 1930, had a diff—has a…had a very sociopolitical meaning from one person saying, ' I'm unemployed,' in 1985. The…in those days, by and large, to generalize, um, each employed person supported one household. Most households had one employed person. When one person said, 'I'm unemployed,' it meant that a whole household was cut loose from a support system. Nowadays, most households have at least two earners. So, when one person says, 'I'm unemployed,' it means that that household is probably cut from half, or a quarter, or a third, some fraction, but not the whole limited income stream. In addition to which, in the '30s, you know, when somebody was unemployed, there really was no recourse other than community soup kitchens. And today, that's not true. The safety net may have big holes in it, but there is still some kind of safety net. So the…the…aside from the difficulty of…of the statistics, and they are difficult, um, there's the fact they have different social…social meanings."

FRANK STASIO: We've said that raising output is one way to lower unemployment. This is generally true over the long run, but it's possible for improvements in production to contribute to unemployment.

ROBERT HEILBRONER: "One thing booms do is, they destroy older industries. And we don't think about the automobile as destroying an older industry, but the automobile really dealt a considerable blow to the train. Um, the…the…the jet plane, uh, dealt a terrible blow to…to…to the railroad. So, people gained employment as stewardesses and pilots and…and what have you, radar operators, and lost employment in terms of locomotive engineers, and tenders, and so on. So booms have side effects, undertow effects like that. Booms also, well particularly when they…when they're based on very sophisticated technology like the computer, booms can give rise to sort of widespread changes in the amount of labor you need to produce output, as a whole."

FRANK STASIO: Let's look back, now, at some of the ways economists measure and interpret the business cycle. The business cycle has four phases: the expansion, when production is rising; the peak, when output reaches its highest level; a recession, when production slows down, and the trough, when real output is at its lowest point. Total output is determined by the relationship between aggregate supply and aggregate demand. Aggregate demand shows how much real national output will be bought at each price level. Aggregate supply is the level of real national output that will be produced at each price level. Rising demand will trigger higher levels of output, and may also push up prices. Price hikes may not occur if production begins to expand during a period of high unemployment. Higher prices tend to dampen demand but serve as signals to producers to turn out more goods and services. The greatest hardships in the business cycle are felt when falling production leads to higher unemployment. There are three types of unemployment: frictional, which includes seasonal workers and those just entering the job market; structural, which includes people thrown out of work when their skills become obsolete; and cyclical, which rises and falls with the business cycle. The social costs of high unemployment include goods and services that could have been produced if the economy were operating at full employment. The amount of output that might be expected at full employment is called potential GNP. Finally, recognition of business cycles and their potential for damaging the economy is fairly recent. Before the Great Depression, the so-called classical economists believed that the economy had built-in mechanisms to control overproduction and high unemployment. Economist Robert Nathan.

ROBERT NATHAN: "I just, myself, don't believe that, as one of my professors, when I was studying business cycles way back, fifty years ago, said, 'whatever goes up must come down; whatever goes down must come up,' and, therefore, business cycles were unavoidable, and you just had to wait it out. And, sooner or later, things would turn up, again, and then they'd get out of whack, and then they'd turn down again. Well, we don't believe in that anymore. We, I think, really believe that we can help, if not avoid the cycle, but certainly, moderate it, and I think we've done a great deal in that direction, and, uh, mark up what I would regard as considerable progress and good performance overall."

FRANK STASIO: The man most personally responsible for changing attitudes about the inevitability of booms and busts was the British economist John Maynard Keynes. Keynesian economics is the subject of future editions of Economics U$A.

(MUSIC PLAYS)

FRANK STASIO: You've been listening to Economics U$A, one of a series of programs on micro and macroeconomic principles. Our guests have been Robert Nathan, noted economist and President of Robert Nathan and Associates in Washington, D.C., and Robert Heilbroner, Professor of Economics at the New School of Social Research in New York. Economics U$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

(MUSIC ENDS)

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