

ECONOMICS USA  
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PROGRAM #16

BOOM AND BUST:  
WHAT CAUSES THE BUSINESS CYCLE?

AIRSCRIPT

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Final Transcript

Annenberg Learner (Logo and Music)

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DAVID SCHOUMACHER: The business cycle is proof that Capitalism has failed according to Karl Marx...but in the 1920s Joseph Schumpeter sees these cycles as proof of the glorious success of Capitalism. Is either man right? 1929 is the year of collision between 19<sup>th</sup>-century economic theory and 20<sup>th</sup>-century economic reality. Out of the ruins of the great crash John Maynard Keynes provides the basis for a new theory of the business cycle. What was his revolutionary idea? 2008. A Great Recession. Could a little known economist, Hyman Minsky, foretell this major fluctuation in the business cycle? Booms and Busts – Who can explain the business cycle? With the help of economic analysts Richard Gill and Nariman Behravesh we'll explore that question on this 21st Century Edition of ECONOMICS USA. I'm David Schoumacher.

(MUSIC PLAYS – OPENING TITLES)

PART I

DAVID SCHOUMACHER: Boom or Bust: Why is the economy so unstable? Well it's a story as old as capitalism itself. Factories sit idle or stagger along at half pace because no one has any money to spend. Meanwhile, workers sit home without any money to

spend and hope the economy gets better so they can get their jobs back. It's a vicious cycle. No one wins but it's a pattern that repeats itself over and over again.

DAVID SCHOUMACHER: World War I. President Wilson promised to keep America neutral but he couldn't keep his promise. The country went to war in 1917 singing "The Yanks Are Coming." A year and a half later the doughboys came home, bloody, weary, glad it was finally over over there. Returning soldiers found neither peace nor prosperity here at home. The war had been good for the American labor movement. Employment high, wages good, the government sympathetic to unions. But with the armistice, the economy slowed down, the demand for manpower shrank, support for unions virtually disappeared. American workers were angry. Labor strikes turned violent. Critics of the Capitalist system were roused from their homes, jailed, even deported. One man had predicted all this turmoil, the economic instability, the growing militancy of labor, and the eventual destruction of the Capitalist system, and where earlier economic theorists had worried over the plight of the businessman. Karl Marx seemed to be speaking directly to the worker. Irving Kaplan remembers the intoxication of the Marxian theory.

IRVING KAPLAN: "The idea that the worker, the value of the product is the work put into it...I had the feeling that ever since that time is the key to the popularity of Marxism in the working class. Namely, 'I'm the big shot. I'm the one who produces all these things.' Labor is raised thereby, to a level of great, the greatest dignity. The preachers talked about the dignity of work, but this was now an explanation of why I'm the source of all the value and the son-of-a-bitch who lives so well is living at my expense 'cause he's appropriated part of this value."

DAVID SCHOUMACHER: As workers and businessmen continued to struggle in the postwar years, prices continued to rise. The bubble burst in June of 1920. Within a year prices had dropped by 50 percent while unemployment, virtually nonexistent during the war, jumped to 14 percent in 1921. Among the economic theorists of the 19<sup>th</sup> century, only Marx had an explanation for what was happening. Robert Heilbroner explains...

ROBERT L. HEILBRONER: “Marx was the first economist really to conceive of a self-generated cycle in which good times produced eventual bad times and the bad times produced good times. He really had a theory of the business cycle, a very complicated, long theory, in which good times produced their own, in Marx’s terms... contradictions... tension is a good word... which eventually brought the thing to a climax. And then the bad times in turn produced healing properties. Businesses would go under, wages would go down, business would be for sale very cheap, or capital goods for sale very cheap. So the stage was set say for a turnaround in the other way.”

DAVID SCHOUMACHER: Marx had predicted these recurring cycles of “Boom” and “Bust,” and as the economy of 1921 sputtered and gasped, Marx’s followers were quick to point out the failure of Capitalism. Were they right? Not according to a young economist who was busy forming his own theory of the business cycle. His name was Joseph Schumpeter. Where Marx had looked at the “bust” side of the cycle and forecast destruction... Schumpeter looked at the “boom” side and called it... “regeneration.”

ROBERT L. HEILBRONER: “When Schumpeter came in and preached the belief that Capitalism was by its nature intrinsically dynamic... I mean that was the essence of Capitalism... to invent, to innovate, to risk was the Capitalist, he thought, just like in feudal days, to get on a horse, to ride, to joust, and to fight was the very essence of what it was to be a knight. So he deeply believed that the real propulsion of the thing was provided by its faculty for continuously generating technological change, of a both constructive and destructive kind. In would come a new invention and down would go three old businesses... you know... he called it the ‘gale of creative destruction.’ ”

DAVID SCHOUMACHER: In January 1922, without the benefit of any government intervention, the economy came surging out of its doldrums and into the roaring 20s... “The Big Boom.” The evidence of growth seemed to support Schumpeter. Industry prospered, helped along by such innovations as the assembly line. And if workers were not always happy or prosperous, Schumpeter would argue that it was the Capitalist that gave life and energy to the system and the workers who would benefit in the long run.

Marx and Schumpeter, two economists looking at the system and seeing it differently. Karl Marx saw economic fluctuations as increasing evidence of the failure of the system. Joseph Schumpeter saw these same business cycles as evidence of economic growth and the success of the system. Richard Gill, how could these two come to such radically different views?

(MUSIC PLAYS - COMMENT AND ANALYSIS I)

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RICHARD GILL: They did have very different views, but on one point they were agreed. Both Marx and Schumpeter held that crises were a built-in, not an accidental feature of the Capitalistic system. In this they both differed from the classical economists who held that depressions were temporary and uncharacteristic. But they did differ from each other. Writing in the mid-19<sup>th</sup> century, Marx had been deeply impressed by the horror stories of the English Industrial Revolution: Child labor, workers replaced by machines, peasants dispossessed of their land. He saw business crises as increasing in intensity over time: workers emiserized, labor thrown out of work by Capitalists to keep wages down, Capitalists themselves unable to find markets for their goods. Schumpeter, by contrast, wrote three-quarters of a century later and was deeply impressed by the phenomenal economic growth realized under Capitalism. For him, business cycles represented no more than the digestive process of Capitalism, absorbing the great new flood of goods, then bouncing back to produce still more goods. The laboring classes were actually the greatest beneficiaries of this engine of Capitalist mass production. I myself took an undergraduate course from Schumpeter on Marxian economics. While he admired the scope of Marx's analysis, he could never accept Marx's theory of the exploitation of labor. It must be said, however, that Schumpeter's own theory of the business cycle was very loose and not fully convincing. Thus it was, on the eve of the Great Depression, most economists were still locked into the classical world of Say's Law.

## PART II

DAVID SCHOUMACHER: This is the Herbert Hoover building in Washington, D.C., headquarters for the Commerce Department and monument to a man who was considered at least until 1929, to be the world's greatest humanitarian. Just a few years after that the name Hoover was virtually a curse word, used bitterly to signify a cold, uncaring government. Hoover had the misfortune of presiding over the beginning of the world's worst depression... a time of national torment that lasted for thirteen years. How did it happen? And why were we so unprepared?

DAVID SCHOUMACHER: Looking back on the 1920s, our memories go first to the fads, the heroes, the loose morals of what seemed to be known as the Lost Generation. But there was a more serious side to life. That was the full and glorious flowering of the Industrial Revolution and it was presided over by a man who positively despised governing. The business of America is business declared Calvin Coolidge and the financial community couldn't have agreed more. With the clarity of hindsight we can see today that the economy of the 1920s was fundamentally unsound. There was a huge gap between the richest and poorest Americans. For six years before the crash, banks were failing at the rate of two a day. Two million workers were unemployed and the agricultural economy was in a state of depression throughout the 1920s. But those weaknesses weren't obvious at the time except to the victims. From a business perspective the economy was booming. Throughout the decade, production, productivity and profits kept climbing as prices and wages remained relatively stationary. Huge profits were re-invested, the stock market soared, fortunes were made overnight and rags to riches stories filled the daily papers. Even high school students could play the game, as noted economist Paul Samuelson recalls:

PAUL SAMUELSON: "My high school teacher and I, my mathematics high school teacher, Algebra, used to pour over the financial page. She was in favor of Hupp Motors. I thought Auburn Motors was better. Both of them went off the board completely in the end. The, literally the case, the Pullman porter, the elevator boys, we called... would ask

you, ‘What do you think’s good, is Barney Baruch buying? What about the big boys at National City Bank...are they running things up or down?’ ”

DAVID SCHOUMACHER: The dominant economic voice of the time belonged to Andrew Mellon, the Secretary of the Treasury from 1921 to 1931, and everyone was convinced that the smartest man in America was the Secretary of Commerce, Herbert Hoover. Even the hardened cynics of the Washington Press Corp were impressed by Hoover, as Richard Strout remembers:

RICHARD L. STROUT: “I had unstinted admiration for him. He would sit at the end of a long oval table and the reporters would sit on either side of it. This was when he was Secretary, and we’d each ask him a question and he’d look fixedly down...he was a shy man...fixedly down at the table, and then, at the end, the last man had asked his question, he’d put his head up and he’d remember each question and answer it. He knew more about what was going on in America than any other American. And as he went out, the reporters who were a hard-boiled bunch, we’d just say to each other, this is an incredible man.”

DAVID SCHOUMACHER: Then one day the magic stopped working. At first the business community tried to weather the storm. President Hoover told the nation that the slump was temporary...that prosperity was just around the corner...but calming words could not reverse the decline. Professor Willard Thorp was an early analyst of the business cycle. He recalls the mood of the time:

WILLARD L. THORP: “Chaos was just around the corner in the minds of people like myself. Even though I’d studied plenty of cycles in the past, and they’d always turned around, this one had gotten to a stage where it was...it either had to turn around awfully fast or else too many people would be just completely hopeless.”

DAVID SCHOUMACHER: In 1928, Herbert Hoover told the nation we were on the threshold of abolishing poverty. Four years later he complained bitterly that his

opponents were playing politics with human misery. Was President Hoover the villain of the crash of 1929?

WILLARD L. THORP: “Well I don’t know that Hoover was a villain. Hoover was carrying on the existing point of view that had dominated the behavior of the government up until that time, namely that by and large it wasn’t the government’s business. Laissez faire was the way in which the economy should operate. The price system would make the necessary adjustments, and if things were going well people would make profits, and if they weren’t they wouldn’t make profits, and that would help in the adjusting process. This was the state-of-mind. This was what economists were saying and the government had behaved that way for a long, long, long time.”

DAVID SCHOUMACHER: As the 1920s faded and with them the memories of prosperity, the 1930s brought a growing awareness that there was a serious split between traditional economic theories and present economic realities. At the same time, in England, John Maynard Keynes was building a theory that dealt with the total purchasing power of the economy...aggregate demand...and asking whether this was in proper balance with aggregate supply. His answers transformed modern economics and pointed to a path out of the Depression.

WILLARD L. THORP: “Essentially, what Keynes is saying is that the way to get rid of the Depression is to create a demand. And that’s the heart of his theory, and that the difficulty is that the demand for some reason has shrunk more than the supply of goods.”

DAVID SCHOUMACHER: While Keynes was groping for an explanation that fit the facts of the Depression, Treasury Secretary, Andrew Mellon, clung to the classical view that things would soon get better. He viewed the Crash as a form of Darwinian selection designed to nourish the strong and sweep away the unfit. But in the streets, people were less confident of the social benefits of the disaster. In the playgrounds of America the children chanted: “Mellon pulled the whistle, Hoover rang the bell, Wall Street gave the signal and the country went to hell.”



In 1922, the country had enjoyed a miraculous, almost overnight recovery from the recession, but there were to be no miracles this time. In 1930, President Hoover declared “the corner has been turned.” In 1931 he said it again and still the economy plunged downward. In England someone asked John Maynard Keynes if he could think of anything similar to this Depression...”Yes,” he said. “It was called the Dark Ages and it lasted for four hundred years.” Richard Gill, what was so different about the way Keynes viewed the economy?

(MUSIC PLAYS - COMMENT AND ANALYSIS II)

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RICHARD GILL: To realize what a revolutionary idea Keynes had, we have to recall again the classical view, which said that, in total, supply creates its own demand. One way to phrase this is to say that if consumers don’t want to consume all their incomes, they can lend their savings to businesses who will invest it in machines, factories, and the like. The idea is that, if consumption demand goes down, investment demand will go up, or if investment goes down, consumption demand will go up. In either case, total demand remains high. Now what Keynes said was that, if you had a fall in investment spending, say, this might lead not to a rise but to a fall in consumption spending. Total demand – consumption demand plus investment demand – might fall. Indeed, it even might be a multiplied fall once the process got started. Let me stress what a shocking idea this was. When demand falls, it may not repair itself, ala Say’s Law. It may fall further! A lot further! And then, indeed, there may not be enough total demand to provide markets for all the goods society can produce, or the labor that produces them. For the first time, the economics profession as a whole was coming to grips with the possibility of a serious depression. It was, in fact, on the verge of a revolution, not of Marx’s proletariat – but of ideas!

### PART III

DAVIDSCHOUMACHER: George Santayana once wrote: “Those who cannot remember the past are condemned to repeat it.” In the early part of the 21<sup>st</sup> century the American economy nearly collapsed. Why did previous economic theories fail to explain the crisis of 2008? And who had developed an alternative theory to explain it?

DAVID SCHOUMACHER: The Roaring ‘20s....In 1919, at the birth of a turbulent era, an economist was born who would provide a plausible theory. His name was Hyman Minsky.

DAVID SCHOUMACHER: Minsky’s parents were Russian immigrants. They moved to Chicago where Dora, his mother, became active in the Trade Union movement, Sam, his father, joined the Socialist Party, and young Hyman became a scholar.

The sting of the Depression must have weighed heavily on the young Minsky as he studied the economic theories of Karl Marx and John Maynard Keynes, which had gained the interest of many young economists. Minsky, like many other academics, went on to teach and publish...shaping his own theory about the causes of booms and busts in the economy.

Minsky tested his theory against events of the 1970s, ‘80s, and ‘90s, as the de-regulation of the business community and financial Industry got underway during the presidencies of Jimmy Carter, Ronald Reagan, George Bush, and Bill Clinton.

In 2005, the American economy was booming and nowhere was it more apparent that these were the salad days for the American Dream than in the housing market. And it was the eventual collapse of that market that fueled the financial crisis of 2008.

Who could explain what happened? There was one economist, credited by many with anticipating the financial crisis of 2008. Hyman Minsky. In fact, the economic press

dubbed the crisis a “Minsky Moment.” An outspoken critic of the Reagan revolution, Minsky had offered his "financial instability hypothesis," which described how bubbles form in a capitalist economy, and how they can bring about potentially disastrous consequences.

DOUG ELLIOT: “Hyman Minsky was a great thinker, whose thoughts are particularly relevant to financial crises like we’ve been through. In particular, what he observed, and many academics hadn’t realized, is that many of the problems that financial systems develop that create the crises are internal.”

DIMITRI PAPADIMITRIOU: “Minsky thought that this was not actually... that we had crises not only because of shocks...but because of the inherent inherency that exists in our system.”

DAVID SCHOUMACHER: Unlike most economists who attributed recessions to external shocks, Minsky theorized that busts were an inevitable consequence in a capitalist system unless government steps in to control them.

DOUG ELLIOT: “Individuals over invested in homes and in the stock market. People got into the habit of taking more and more chances. Regulators relaxed...Wall Street relaxed. The rating agencies relaxed. Individuals relaxed.”

DAVID SCHOUMACHER: Home Equity Loans became all the rage. Homeowners began to re-finance their homes, paying high transaction fees to banks in the process. Profits for these banks were soaring. Larger international financial institutions found this burgeoning industry too attractive to pass up.

DOUG ELLIOT: “Banks were investing a lot in housing, in various ways. They were making a lot of loans. But what they would do is, they would take those housing loans and package them together and sell them off as securities... So that people who didn’t happen to own a bank, say a mutual fund, could still participate.”

DAVID SCHOUMACHER: By 2006 the American economy was in full “boom.” But in the world of Hyman Minsky, any economy living on borrowed capital was an economy “booming” on borrowed time.

DIMITRI PAPADIMITRIOU: “People tend, out of emotion or out of greed, if you like, to extend further investment and then...reaching a Ponzy finance, which means it’s like a house of cards.”

DAVID SCHOUMACHER: As the bubble grew, more and more consumers were stretching the limits of their debt burden. Financial institutions, eager to squeeze the goose that laid the golden egg, began to create highly complicated and risky financial instruments.

DOUG ELLIOT: “These instruments initially were very simple...but they started to make them more and more complex. At a certain point people didn’t understand what they were buying anymore. But in a world in which you could buy anything and make money, you didn’t ask enough questions. Once people started asking questions...they got very scared.”

DIMITRI PAPADIMITRIOU: “So that recreates the point at which then you reach the unraveling of the financial structure, which is really the ‘Minsky Moment’ as we now know it.”

DAVID SCHOUMACHER: That so-called Minsky moment came into sharp focus as foreclosure signs began popping up across the American landscape and a major financial institution filed for bankruptcy. One by one, major financial institutions began to fall. The U.S. government was forced to take action to prevent a total collapse and, by 2008, the worst financial crisis since the Great Depression had begun.

BARACK OBAMA: “If we act boldly and swiftly to arrest this downward spiral then every American will benefit.”

DAVID SCHOUMACHER: Hyman Minsky died in 1996. But it was years before he was finally recognized for his explanation of the Great Recession of 2008. We asked Economic Analyst Nariman Behravesch to comment.

(MUSIC PLAYS - COMMENT AND ANALYSIS III)

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NARIMAN BEHRAVESH: In the words of economic historian Charles Kindleberger, financial crises are a “hardy perennial.” In other words they keep happening with rather distressing frequency. Recently, the International Monetary Fund catalogued 42 crises in 37 countries...since 1970 alone.

In fact, booms and busts of this kind have been regular events in the global economy for centuries. Early examples include Tulip Mania in the 1630s, the South Sea Bubble in the 1720s, and the U.S. railroad bubble in the 1860s and 1870s, which was followed by the longest U.S. recession ever—one that lasted five and a half years.

While it may be tempting to place all the blame for the sub-prime crisis and other financial convulsions of the last couple of centuries on free-market capitalism and financial de-regulation, we should resist that temptation. Two of the worst financial crises of the last three decades occurred in Japan and South Korea. These were heavily regulated economies—which, nevertheless, still ran into serious trouble. The “animal spirits” that drive booms and busts may be very hard to control. The best we may be able to do is limit the economic damage.

DAVID SCHOUMACHER: Periodic economic instability seems to be the curse of our free market system. Whether the downturn comes as a small dip as in 1914, a major crash as in 1929, or a deep recession as in the early 21<sup>st</sup> Century, every fluctuation takes

its toll in lost opportunity and personal hardship. We know now that these cycles are not really the death- throes of Capitalism but we also know the system may not automatically correct itself. We have learned that business cycles are the result generally of shifts in aggregate demand or total spending. How we learned this lesson and how we should apply it are future subjects on this 21<sup>st</sup>-Century Edition of Economics U\$A. I'm David Schoumacher.

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