

ECONOMICS U\$A LESSON #4

(MUSIC PLAYS)

Announcer: Funding for this program was provided by the Annenberg CPB Project.

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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.

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 Eighteen Nineteen. But by the Eighteen Thirties, 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.

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 Nineteen Twenty-four and Nineteen Twenty-nine, stock prices had soared four hundred 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 Nineteen Twenty-nine.

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 left one end go and it collapsed and he said bust.

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

Stasio: October Twenty-ninth, Nineteen Twenty-nine, the Great Crash and the beginning of a depression that would force fourteen 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.

Heilbroner: 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 with impossible to do that. You couldn't really glut the system. And Ricardo believed you couldn't really glut the system which would be a sort of a self-induced reason for a...for a large scale self-administered shock.

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 Carl Marx.

Heilbroner: Mar...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 – 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, it, 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 on the other way.

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?

Heilbroner: 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.

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.

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 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 there're 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're 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.

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?

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.

Nathan: The demand curve looks at what the market demand is and at you know 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.

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 onto 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.

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 eighty percent of capacity, it's working sixty-five or seventy 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.

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.

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 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.

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 Nineteen Eighty-five unemployment figures to explain.

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 indicates that unemployment rose over six-tenths of one percent. As the automotive industry idled over fifteen thousand workers...

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 ninety-five percent of the workforce. While unemployment statistics can indicate trends in the rate of joblessness, there are important qualifications. Professor Robert Heilbroner:

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 PhD, 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 hour are actually employed.

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.

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 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 car fare 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.

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

Heilbroner: To be unemployed in Nineteen Thirty, to have well when one person said I'm unemployed, um, in Nineteen Thirty, had a diff—has a...had a very socio political meaning from one person saying I'm unemployed in Nineteen Eighty-five. 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 Thirties 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.

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.

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.

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 over production and high unemployment. Economists Robert Nathan.

Nathan: I just myself don't believe that this 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.

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.

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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, DC, 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.

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