

ECONOMICS U\$A LESSON #5

(MUSIC PLAYS)

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Stasio: Economics USA. One of a series of programs designed to explore Twentieth Century micro and macroeconomic principles. The subject of this edition is the Economics of John Maynard Keynes. Our guests are Robert Nathan, 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.

Stasio: The business of America is business. Calvin Coolidge made that proud claim while presiding over the biggest boom the country had ever known. Coolidge shared a view of a long line of economists and businessmen who believed that left to itself capitalism has built-in mechanisms to ensure full employment. Though there may be short business down turns from time to time, in the long run the system will always balance itself. The theories were wrong. Journalist Eric Sevareid remembers:

Sevareid: Something fundamentally broken down. We were plowing under food, killing little pigs, and people were going hungry. Millions of sick people and doctors going broke. Uh, it was just, well it was...what was going on? What was the sense in this in this rich country?

Stasio: When the Depression began in Nineteen Twenty-nine it looked like just another economic downturn – the inevitable result of the highflying economy of the previous decade. The experts weren't worried. After all, demand had dropped off so one should expect a decline in production. Pretty soon prices, interest rates would dip to levels that would encourage consumption and industry would be on its way again. That was the theory. But a few people began to believe that something else might be at work. Robert Nathan was a student during the early years of the Depression and conducted unemployment surveys for the Industrial Research Department of the Wharton School.

Nathan: The thing that was so distressing was here you had a plant like Philco with a capacity to produce radios. People wanted radios. They wanted to work to produce them so they could have an income and then people wanted the product. But it just, you couldn't do it. There was this...this, uh, kind of a disease of...of...of rigidity that had settled down where people didn't have money to buy, people couldn't get jobs so they could get the money, the factories wanted to produce and sell and they couldn't sell and they weren't making any profits and stuff just almost collapsed.

Stasio: The economic wisdom of the time held that money would either be spent on goods and services or saved in a bank. Banks in turn would have the money to provide loans for business investment. So one way or another, either through consumer spending or business investment, spending would stay up and the economy would keep moving. But by Nineteen Thirty-one investment fell off by almost ninety percent and consumer spending stayed very low. A British economist, John Maynard Keynes, recognized this and proposed a radical idea. Keynes said that during a recession it was possible for both consumption and investment to fall. Robert Nathan:

Nathan: Often the recession or depression phenomenon feeds on itself because the...the...the greater the unemployment, the less income, the less income, the less demand, the less demand, the greater the incidence about business to build up inventories or to build new plants and equipment to expand capacity. So that there tends to be feeding upon itself both on the downward side and on the...on the incline.

Stasio: Now money for consumption or investment can come from either private sources or the government. For Keynes the way out of the Depression seemed clear. If there was enough money in private hands to invigorate the sluggish economy, then the government would have to spend, even if it meant going into debt. But Keynes ideas did not square with a more widely held view about the nature of the Depression. Robert Heilbroner is a Professor of Economics at the New School for Social Research in New York:

Heilbroner: Keynes was indeed the first person to explain certain mechanisms by which we could more adequately talk about the...the stability preserving or the stability destroying properties of the system. The...these considerations led Keynes to the startling proposition that an economy out of balance, an economy out of equilibrium, would not naturally recover its equilibrium. Um, it isn't that Keynes believed that the boat would capsize. He believed rather that a boat might ship water and stay waterlogged. For a long effect there was nothing to...to slurp the water out. That...that a waterlogged boat would remain waterlogged and a high floating boat would remain high floating. His question was if you did have a waterlogged boat, for whatever reason the water got in there, how could you get the water out. Well one...one way would be the way that Keynes contemporaries talk about it. Was the believe that a waterlogged boat would in various ways so stimulate the entrepreneurs who were sitting in the boat that

they would start bailing like mad. They would invest like mad. And so the water will come out of the boat and the boat would rise in the water. Keynes believed that a waterlogged boat would discourage entrepreneurs rather than encourage entrepreneurs, um, and that the boat would simply remain waterlogged unless some other bailing mechanism was possible. And that bailing mechanism was the government.

Hoover: I find it difficult to express the very great appreciation that both Mrs. Hoover and I have for your coming in such enormous numbers to greet us here this morning. It is not only encouraging but it is a fine indication as to the support that you will give the Republican Party on the Eighth day of November. Thank you.

Stasio: For Herbert Hoover, federal deficits were dangerous, irresponsible government actions that could only make matters worse. Believing this in the early part of the Great Depression, he actually cut federal spending and persuaded Congress to impose a huge tax increase, actions which drove a staggering economy to its knees.

Male Voice: This coin here represents my share of the commonwealth of this hundred and sixty acres of ground. If I sell today at the present price of ten cents a bushel, it wouldn't bring enough to pay the cash rent on this place.

Male Voice: This hog used to be ten cents a hundred. Now they're two and a half. Four years ago you could get twenty dollars for an odd (inaudible) of today, two and a half a hundred.

Male Voice: My opinion is we should have equalization. If farmers are entitled to equalization, we should have same prices compared with those that receive in the city. We've gone as far as lowest we can yet the rut...we're at the low step of the ladder.

Female Voice: Those were serious times, uh, especially here in Washington; I suppose all over. Um, lots of people lost their homes. Um, their...many people lost their back accounts. I lost mine. Men were selling apples on the street. I don't know where they got the apples but they were very glad to get that small amount of money.

Stasio: The nation was looking for an answer. Keynes had one. It was that America spend its way out of the Depression. The federal government would have to go into debt to stimulate new demand. Robert Nathan explains how it works:

Nathan: Well it's...it's a lot of buying power that you're putting out into the community that starts a process of jobs, production, profits, uh, income, uh, sales, and then new jobs. So that it—one thing generates after another, creates more, and it is the investment that's terribly important because you're pouring out that buying power without the goods at the same time being produced. And the demand, then, I mean consumer goods, the demand then, uh, brings about more production of consumer goods.

Stasio: Nathan says that in a recession, government spending has a multiplier effect. So government deficits, by pumping money into the economy, increase sales which tend to encourage business to invest in new factories.

Nathan: When you build that plant, say, a new factory or a new office building for a hundred million dollars, you're putting out buying power and wages, interest, dividends

and so whether a hundred million. The people then spend that hundred million dollars for a car or shirts or shoes. And that creates jobs there so that has a...a secondary effect. And as these people then go back to work and produce these, that...then they...that further expenditure comes on so that what we have is a multiplier effect from investment and deficits that tends to bring about two dollars of production or two and a half dollars of production as a result of a one dollar investment.

Stasio: It's easy to see that as more people return to work, they will earn and spend more money. But how much more? That is what part of each additional dollar of income will actually be spent on consumer goods? Economists need to know the answer before they can determine the size of the multiplier. The proportion of extra income that consumers spend in the marketplace is called the marginal propensity to consume. The multiplier and the marginal propensity to consume are concepts that economists use to understand the effect of increased spending. Spending that John Maynard Keynes believed had to be initiated by the federal government if the battered economy of the Nineteen Thirties was to improve. Keynes' ideas were revolutionary. And like most new ideas with such sweeping implications, they were fiercely resisted at first. But Robert Heilbroner says it would be a mistake to view Keynes himself as a radical.

Heilbroner: He was, of course, a...a true blue conservative. I mean Keynes is, uh, Keynes' purpose was to reform in order to preserve capitalism. He had no interest in socialism. Um, he was prepared to accept a certain amount of what he called socialization of investment, government investment. But certainly not to over...overdo the system. He was...he was in deep sense of the word a cultivated bourgeois and liked that and his politics were liberal and he would certainly have described himself, uh,

in...in the sense that I'm talking about as a conservative. He was quickly became regarded in certain circles in this country as a worse than Marx and there was even a...a rather famous member of a distinguished family who...who started a society of the purpose of which was to expunge Keynes from the Harvard curriculum.

Roosevelt: ...Franklin Delano Roosevelt do solemnly swear that I will faithfully execute the office of President of the United States and will to the best of my ability preserve, protect, and defend the Constitution of the United States so help me God.

Stasio: Franklin Roosevelt did not enter the White House ready to put Keynesian principles to work fighting the Depression. In fact he lashed out at Herbert Hoover in the Nineteen Thirty-two Presidential campaign, accusing him of too much public spending. At the very worst of the Great Depression even Franklin Roosevelt wanted to balance the federal budget.

Roosevelt: New or increased taxes are not needed to enable us to balance the federal budget and to begin very soon a rapid reduction of the national debt. Why? Because recovery is with us. Federal revenues are increasing, emergency expenditures are decreasing, a balanced budget is on the way. Does it sound like bankruptcy to you?

Stasio: Roosevelt was slow to adopt Keynesian economic ideas partly because they were untested and partly because Roosevelt had little patience for the carefully drawn scholarly theories that explained Keynesian principles. Moreover, Keynesian economics flew in the face of conventional wisdom. Roosevelt, like Hoover before him, felt that deficits would be seen as fiscally irresponsible. Economists and policymakers believed that the effect of the deficit would be to discourage consumer spending and business investment

and actually worsen the depression. In fact, it was declining sales and rising unemployment that had shaken public confidence, not the deficit.

Nathan: If the economy tends to move, be moving into a recession and unemployment's increasing and people are uncertain about the future, they're going to save more than there's...than they would spend because they're afraid they might become unemployed. See on the other hand, it's just the opposite. When you're coming out of a recession and unemployment's going down and job opportunities increase, people tend to save relatively less.

Stasio: Now, of course, many other variables influence the amount of money consumers are likely to spend. People with a good deal of wealth in reserve investment savings and so forth can weather temporary declines in income without having to cut spending. People with good credit ratings can borrow to keep up their consumption. And then spending habits change at different points in people's lives. But it is changes in income and expected changes in future income that cause huge swings in consumption and influence booms and busts.

Nathan: It's like so many things in life it's perverse. You know in...in a decline it would be fine if people spent their money because there isn't a demand for the savings but they're worried about their future, they'll save more. And when you have a rise in activity when businesses investing in likes to get your money and sell bonds to you and sell stocks to you, that's when you tend not to save so much because you're optimistic about the future.

Stasio: Business people tend to react to the economy in much the same way as individual consumers. Although changes in investment spending tend to follow a more irregular pattern than changes in consumption. This is because investment tends to rely on technological changes which are introduced at unplanned intervals and also investment decisions can be put off from time to time because of the durability of capital goods. In hard times a firm may decide to put up with the inconvenience of an old piece of equipment rather than buy a new one. But in the end, the decision to build a new factory or buy new equipment is based on expectations that demand will increase. Before businesspeople invest, they first ask is it worth it? Can we expect a big enough jump in profits to justify the expense? One of the biggest costs of expansion is the cost of money or the interest rate. Robert Heilbroner explains how interest rates affect the decisions of both large and small companies to invest.

Heilbroner: When money costs less, uh, you're obviously more eager to go and borrow it and when money costs more, you're not. Uh, cost factors can be very important on the negative side. When money costs twenty percent, it's just too damned expensive. This is particularly true for small business. Big businesses, when they...when they invest, often invest for large scale, long-term return—returns. They have in mind, take—let's take GM with this projected Saturn car. Uh, GM isn't producing the Saturn car to make seven percent or eleven percent. They're producing the Saturn car because they hope to produce a car that's going to revolutionize the car market. It's going to be made differently. It's going to sell all over the world. It...it's not just even a question of whether it's going to make forty-two percent or twenty-sev—it's going to give GM a lease on life. GM wouldn't be changed in its...in its attitudes about producing the Saturn

car if the discount rate went from ten percent to thirteen percent and isn't going to be accelerated if the discount rate dropped to six percent. If indeed money jumped to forty percent, then it might actually be so expensive that GM would be deterred or delayed in its plans. But big business isn't all that influenced by...by the cost of...by cost considerations, cost to money considerations, maybe even labor cost considerations. Little business is very influenced. When you're an automobile dealer, when you're a contractor, when you're a small merchant, um, then the...the, your willingness to invest invested inventory, invest in a new storefront, invest in a...in a extra room in...in your office, invest in...in small scale investments; matters a lot to as to whether...whether or not you can borrow money at ten percent or...or fifteen percent.

Stasio: Using Heilbroner's example, if General Motors didn't think it would capture a substantial share of the market, it wouldn't invest in the Saturn even if the interest rate was very low. Now imagine what business people in the Nineteen Thirties thought about new investment when they saw the grim prospects for sales created by the Depression. Even with the interest rate below one percent, investment was stagnant. The reason demand remained flat may seem clear now but in the Early Thirties policymakers believed that low interest rates alone would be enough to spur business investment. This was part of a belief that if consumption fell, savings would increase. A greater supply of money in the bank would drive down interest rates which would encourage investment. In short, investment spending would increase whenever consumption fell. But the old theory didn't take into account the way expectations influence investment. Keynes pointed out that business is not likely to invest if the sales outlook is poor.

Heilbroner: In the old days, before Keynes came around and said...shed so much light and shed so much obscurity all at the same time, people used to define savings investment in the way that...that ordinary people as being different. I mean savings were what people saved and investing is what they invested and of course the sums are different, for god's sakes. And...and there was more saving investment or more investment than saving, whatever it is, and...and it worked out just like supply and demand in some sense. Keynes simply decided for convenience sake and for very good reasons in many ways that, uh, it's best to...to, just to define savings investment from an, uh, a balance sheet point of view. To stop the economy at one particular instant and then add up the items that are...are palpable in the economy at that instant. And the economy then divides into two big streams so it be—forget government, big consumption stream and the stream of something else. The stream of something else had two sides. From one point of view since it was not consumption it was saving. From the other point of view since it wasn't spent for consumption it was spent for what isn't consumption which by definition is investment. So from that point of view savings investment are defined as opposite sides of the same coin.

Stasio: By emphasizing the way expectations influence business investment, Keynes solved the great riddle that had perplexed most of his contemporaries. Once he understood the problem, Keynes was able to suggest a solution: deficit spending. As Robert Nathan points out, these ideas weren't actually new but John Maynard Keynes was the man who gave them credibility.

Nathan: There were economists before Nineteen, uh, Twenty-nine even that did write about the fiscal policy but not with a dramatic clarity that...that...that Keynes did, uh,

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and not with the...the timing. You see one of the things one has to recognize is that there was a degree of desperation in Twenty-nine, Thirty-two and...and almost a sense of hopelessness that had not prevailed before. Uh, Keynes came along at that time and just said that if the government would spend more than it took in clearly that was injecting more money into the private sector.

Stasio: Unfortunately, Keynes' ideas were not totally embraced in the Nineteen Thirties. The economy continued to limp along at low levels of government spending and low levels of consumption. As long as production and consumption were equal, there were no incentives for growth. The Great Depression was proof that the economy could be stuck in a prolonged state of sluggish economic activity.

Roosevelt: Yesterday, December Seventh, Nineteen Forty-one, a date which will live in infamy, United States of America was suddenly and deliberately attacked by naval and air forces of the Empire of Japan.

Stasio: Likewise, it took a dramatic event like World War Two to demonstrate that forces outside of the normal business cycle might be necessary to correct the problem.

Roosevelt: Our war program for the coming fiscal year will cost fifty-six billion dollars or, in other words, more than half of the estimated annual national income...

Stasio: The deficit spending that Keynes called for finally materialized in the Nineteen Forties. Government spending on the war effort quickly propelled the economy to a high level of employment. If the government had been willing to accept massive deficit spending before the war forced it to do so, the Depression would have ended much

earlier. Keynes' ideas were vindicated, and the role of the government in maintaining a high level of employment was redefined. Let's look back to Keynes' theories regarding the causes of depressions.

Stasio: Before Keynes, most economists thought that recessions would be short. Falling prices, wages, and interest rates would encourage the recovery of spending, particularly investment spending on plants and equipment. These economists argued that the government should try to balance its budget. Running deficits, they reasoned, would worsen the situation by eroding confidence in the financial stability of the economy. Keynes argued that the economy would not automatically return to full employment. He noted that business would not commit millions of dollars to expand their factories no matter how low the interest rate if they were pessimistic about their ability to increase their sales. The economy, Keynes said, could get stuck at a point at which total spending was in balance with total production but that balance point would be at a low level of employment. The best policy for depressions, therefore, is massive deficit spending. Every dollar's worth of deficit spending would encourage consumers to spend more and business to invest more so the spending would have a multiplied effect on the economy. The exact size of the multiplier depends in part on how much of an additional dollars' worth of income people are willing to spend on goods and services. This is called the marginal propensity to consume. Of course, many other factors affect peoples' spending; factors such as their savings and their age. But business cycles are mostly concerned with the way changes in income cause changes in consumption. Keynes stressed the role of business expectations in the investment decision. In calculating the expected rate of return on their investment, business planners have to estimate what their future sales will

be. And if those estimates are pessimistic, they will decide against new investment. Investment spending is one of the most erratic categories of spending in the economy, and changes in the level of investment are a major cause of business cycles. The theories of John Maynard Keynes are responsible for many fundamental changes that have taken place in our economy since the Depression. The way those changes come about is the subject of future programs on Economics USA.

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Stasio: You've been listening to Economics USA one of a series of programs on micro and macroeconomic principles. Our guests have been Robert Nathan, New Deal Economist and President of Robert Nathan and Associates in Washington, DC, and Robert Heilbroner, author and professor of economics at the New School for Social Research in New York. Economics USA has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

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