

## ECONOMICS U\$A LESSON #14

(MUSIC PLAYS)

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Stasio: Economics U\$A. One of a series of programs designed to explore Twentieth Century micro and macro economic principle. The subject of this edition is Stabilization Policy. Our guest is Philip Kagen, Professor of Economics at Columbia University and a visiting scholar at the American Enterprise Institute. I'm Frank Stasio.

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

President Ford: Every dollar saved from taxation, that we spend or invest, will help create a new job and a new salary. And these new jobs and new salaries can create other jobs and other stuff. And more customers available....

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

Male Voice: Restraint on the money supply. Reducing its growth over time toward levels consistent with price stability.

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

Kagen: In the famous study by Milton Friedman and Anna Schwartz a monetary history of the United States, that is their prime example you might say of... of their empirical support from a Monitarist's point of view, that the Depression of the nineteen thirties was primarily a monetary phenomenon. From nineteen twenty-nine to thirty-three the money supply was allowed to contract by twenty-five percent. So in their view it made what was, would have been an ordinary recession into a major disaster. Following nineteen thirty-three the money supply started expanding very rapidly and for the next four years, the rate of growth of nominal income in the economy was the fastest for any four-year

period in our history. The trouble is, is that we started from such a low level that even after four years we still had a considerable amount of unemployment. Then in nineteen thirty-seven the money supply again was allowed to contract very sharply so that the recovery that was going on from the nineteen twenty-nine, thirty-three contraction was then interrupted in nineteen thirty-seven, thirty-eight for a second severe contraction in economic activity in a row so that with that in nineteen thirty-eight, thirty-nine and forty, we were still at a very low level. So that even though the nineteen thirties as a period of considerable change up and down, we tend to look upon at it as just one vast wasteland because unemployment was large and never...never really got down low enough. But it was a period of change and was in their view one that is almost completely explained in terms of these, terms of its economic disaster, almost completely explained by what was an inadequate monetary policy and...and disastrous contractions in the money supply.

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

Kagen: Well, an early Keynesian view didn't put much emphasis on money at all, but a much more recent Keynesian view would be consistent with the idea that monetary policy should have, take discretionary steps to offset what is happening in the economy because

it's subject to a lot of ups and downs that are generally unpredictable. Whereas a Monitarist view has been that if you had a fairly stable rate of growth in the money supply, this would take away most of the sources of changes in the economy, in aggregate demand. And that the remaining ones would not be too serious, but in addition that there wouldn't be much that you could do about these anyway through monetary policy. So that the best...best thing that the monetary authorities could do would be to follow a stable monetary growth policy.

Stasio: One of the major disagreements between Keynesians and Monitarists, is the question of whether a free market economy left to its self can automatically correct swings in the business cycle. Philip Kagen points out that the Keynesians have less faith than Monitarists in the market's ability to automatically stabilize the economy when it has reached high levels of unemployment.

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

Stasio: When Kagen talks about stickiness and wages and prices, he means the tendency of wages and prices not to fall in spite of declining demand. Keynesians argue that the failure of prices to quickly adjust to changes and demand, creates a role for countercyclical policy. To simply set the money supply growth rate at a constant level

would be poor policy because the relationship between the money supply and economic activity called, “velocity,” changes from year to year. To counter these changes Keynesians argue that the government must lean against the wind. That is use countercyclical fiscal and monetary measures. On the other hand, Monetarists hold that velocity is quite stable and as such monetary growth should be fixed and stable as well. Professor Kagen says that at different points in history, both changes in velocity and the money supply have played the leading part in changes in the business cycle.

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

Stasio: But Monetarists argue that changes in the money supply always come first. According to Nobel Prize winning economist Milton Friedman, large changes in velocity are only likely to occur when the government creates uncertainty with erratic monetary policies. Friedman says that the severe economic slump of nineteen seventy-nine was an example of the damage that can be caused by discretionary adjustments to the growth of the money supply. In order to bring down inflation, which had risen to eleven percent and was still climbing, the Feds through its open-market operations reduced the supply of

money to the economy. By nineteen eighty-two the Feds succeeded in pushing back inflation to four percent, but the cost was enormous. Unemployment shot up to more than eleven and a half percent, higher than any time since the Depression. Also at opposed Depression high was the number of bankruptcies, particularly among small businesses. Nearly a trillion dollars of potential GNP was lost. Friedman notes that the Fed failed to follow its own policy announced in nineteen seventy-nine of adhering to a fixed growth rate in the money supply to fight inflation.

Friedman: Let me point out as a matter of just fact that volatility in the rate of money growth, the fluctuations, the extents of fluctuations, from nineteen seventy-nine to nineteen eighty-two, three years, is greater than in any other three-year period in the history of the Federal Reserve. The volatility of interest rates is greater, was greater than any other three-year period. The volatility of the economy was greater than any other three-year period since at least the end of World War Two. So these three things inevitably in my opinion go together. They're not, it's not an accident that those three went together. If money supply is volatile, interest rates are going to be volatile and the economy is going to be volatile. That's why I am in favor of steady monetary growth. That's why that's been a major component of the Monitarists position about monetary policy. The fluctuations and the money supply are a source of uncertainty in the economy. They effect the economy, not instantaneously, but with a considerable lag. The Federal Reserve in trying to offset changes in the economy is always in a sense fighting the last war. What it does now has an effect six or nine months from now with respect to the economy, a year or two years from now with respect to inflation. It's impossible for them to foresee what action now is appropriate in light of the future. As a

result, in my opinion the actions of the Federal Reserve have added to the uncertainty, have added to the instability of the economy rather than reduced it. And let me emphasize, stable monetary growth is not a guarantee of stable economy. It's a guarantee that you will not have disturbing elements introduced by the operation of monetary policy. It's a way, I said, for, to keep the Federal Reserve from doing mischief and not a way to produce nirvana.

Stasio: Keynesians claim the extreme fall in velocity in nineteen eighty-two shows a flaw in Friedman's constant growth rule. But Friedman argues that the erratic shifts in Fed policy caused the changes in velocity.

Friedman: The Federal Reserve's policy from nineteen seventy-nine on, and insofar as it influenced the course of events did bring inflation down, but it brought inflation down at an excessively high cost. And what brought inflation down was not the announced policy. What brought inflation down as rapidly as it did, was that they introduced so much uncertainty into the economy by the rapid ups and downs of the money supply, by the rapid ups and downs in the interest rates. That the business community as a whole was put in a position where it felt it needed much more liquidity to be able to cope with uncertainty. We have a lot of experience over history over centuries that the more uncertain the world, the larger the fraction of their resources that people want to keep in a highly liquid form. And if you put this in technical economic terms you say, "velocity of money declined." And the reason it declined, a major reason it declined, not the only one, a major reason it declined during that period was because of the increased volatility of the economy and the increased uncertainty. And in that sense you can say the policy worked. But had they followed their announced policy, had they actually targeted the

money supply and stuck to their targets and been consistently steady, you would have brought inflation down less in my opinion than they actually occurred. But at a much lower cost to the economy without going through these violent gyrations and with a greater potential of keeping your achievement in tact in the long run, of continuing along that road and getting to a stable long-run position.

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

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

Stasio: The Keynesian-Monetarist debate is not just about the conduct of monetary policy. Generally speaking the Monetarist view favors less government intervention and the Keynesian approach looks for active involvement. These general prescriptions hold for

both monetary and fiscal policy. The Keynesian theory that government should run a deficit during a recession to stimulate demand was viewed with skepticism at first. Philip Kagen.

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

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

Kagen: Crowding out is the effect on private investment when the Treasury runs a deficit and borrows because as I just mentioned, this process can raise aggregate spending through a rise in interest rates. But the rise in interest rates can also discourage private spending in the economy that's influenced by the interest rates. So the rise in the interest rate will not produce as much increase in aggregate spending as would happen if you

would increase the money supply and hadn't had any increase in the interest rate. So there is a crowding out here of private spending, not as much as the government presumably is spending. But there would be some offset to the...to the government's spending through the deficit, through a process of crowding out private spending and this presumably would fall mainly on private kinds of investment spending that would be influenced by this rise in the interest rate.

Stasio: Does crowding out have different effects at different levels of output?

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

demand for money function here, then you're going to get more of a rise in the interest rate and most of the Treasury's extra borrowing is going to show up in a reduction of private investment.

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

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

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

Heller: And it involves a certain amount of chutzpah that you could move this economy by small degrees hither and thither. I don't think that the concept, change it to gross-tuning, not fine-tuning. I don't think that concept is at all out of date in the sense that if the economy is sliding or is failing to achieve its objectives, full employment and so forth that you do have to adjust monetary policy and if possible fiscal policy, taxes and spending, to achieve either an offset to recession or to achieve the full-employment potential of the economy. I don't think that concept is gone at all. And in particular, I think what's worth saying in light of the Monitarists, the Friedman point of view, that you should just set the dials at one level and let the economy then adjust so to speak to a steady growth of the money supply. I just don't believe in that. It seems to me that with

all the information we have about the economy, there should be feedback. You should constantly feed back into the policy process what you can learn from the economy and then adjust policy, not everyday, not every week, not every month, but over a cycle or in light of various crises that hit the economy, you ought to adjust it in the light of the information. I don't think you should deny yourself that information.

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

Kagen: It's a view that's grown up in recent years in response to the importance of...of expectations in econometric-model building and a criticism of the typical way in which expectations were handled in econometric models previously. Previously, a typical way was to, was adaptive expectations in which an expected values of variables which were of course important in explaining how the public responded to changes in variables.

The...the expectation under...under the adaptive method would usually assume that the public would adapt their expectations to what was actually happening. A result of this was that expectations were always slowly adjusting to what was going on in the economy. And this often seemed rather irrational on the part of the public, because they might be making the same mistake in their expectations for months and years in a row if...if the changes going on were always operating in the same direction and they were always slowly adjusting to what was going on. And so it grew up that an idea in economic modeling might be better to assume that the public's expectations were always going to be unbiased, which is to say that they might make mistakes, but they would not be systematic mistakes. People would not make the mistake over and over again.

Stasio: Kagen explains how rational expectation theorists might come to different conclusions about business activity.

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

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

Stasio: Economists who support the rational expectations' theory, argue that government activism can be self-defeating because firms and individuals will neutralize government policy by anticipating its effects. Another approach that has influenced government policymaking in recent years is supply side economics. It, too, argues that government

activism does more harm than good. Supply side economists focus on the elimination of federal policies that discourage long-term growth.

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

Stasio: How does it differ from the demand management policies that we've had since the thirties?

Kagen: Well, I would say the main difference is, is that the demand management policies tend to look at the economy in the macro sense from an overall point of view is that total amount of spending in the economy appropriate is the movement of the price level going too rapid or should we try to reduce inflation? So we don't focus on a particular area of the economy, but look at the economy as a whole. Supply side factors always focus on a particular sector. What is the price doing to this particular industry? What is tax, I'm

sorry, what are taxes doing to a particular industry? What are taxes doing to investment? What are regulations, environmental and other kinds doing to particular industries? It's very hard to think of supply side policies as influencing the whole economy in the same way that our aggregate demand policies do.

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

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

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Stasio: You've been listening to Economics U\$A, one of a series of programs on micro and macro economic principle. Our guest has been Philip Kagen, a Professor of Economics at Columbia University and a visiting scholar at the American Enterprise Institute. Economics U\$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

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