

ECONOMICS USA
PROGRAM #4

BOOM AND BUST:
WHAT CAUSES THE BUSINESS CYCLE?

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AIRSCRIPT
APRIL 11, 1985

4. BOOMS AND BUSTS: THE MYSTERY OF THE BUSINESS CYCLE

PURPOSE:

To show how successive schools of economic thought struggled unsuccessfully to give a satisfactory explanation of business cycles until John Maynard Keynes showed that shifts in aggregate demand were the primary cause of these fluctuations.

LEARNINGS:

1. Classical economists did not have a satisfactory explanation for business cycles. Instead, they viewed them as temporary phenomena brought on by financial panics. They believed that the natural forces in the economy would always bring about an equilibrium between total supply and demand for goods in the economy.
2. There were two other more satisfactory explanations of business cycles which provided partial explanations of why the economy could find itself with high levels of unemployment and large inventories of unsold goods.
 - a) Karl Marx provided a theory of mass unemployment in the context of his view of the capitalist system as the exploiter of the working classes.
 - b) Joseph Schumpeter explained business cycles as a natural by-product of growth and innovation. Economic growth, he maintained, resulted in periodic overproduction and subsequent retrenchments.
3. It was not until the mid-1930s that John Maynard Keynes developed the concepts necessary to understand how the economy could move toward and remain at a less-than-full-employment equilibrium. One of the key concepts developed by Keynes was aggregate or total demand.
4. In very simple terms, aggregate demand is the sum of all the goods and services that buyers are willing to purchase at a given price level.
 - a) Shifts in aggregate demand are affected by the circular flow. The circular flow of income has leakages (savings, taxes, and imports) and injections (investment, government spending and exports).
 - b) If the amount of leakages equals the amount of injections, then the circular flow (i.e., aggregate demand for GNP) will remain constant—it will be in equilibrium.
 - c) If the injections are larger than the leakages, aggregate demand for GNP will grow, and vice versa.

KEY ECONOMIC CONCEPTS:

circular flow	investment	imports
leakages	taxes	aggregate supply
injections	government spending	aggregate demand
savings	exports	classical economics
		Keynesian economics

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TEASER

DAVID SCHOUMACHER: (MUSIC IN) August 1914. As Europe goes to war America slides deeper into still another recession. People despair and ask why is the economy so unstable? 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 19th century economic theory and 20th 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? “Booms and Busts” – who can explain the business cycle? With the help of economic analyst Richard Gill we will explore that question on this edition of ECONOMICS U\$A.

(MUSIC PLAYS – OPENING TITLES)

(BOOM AND BUST: WHAT CAUSES THE BUSINESS CYCLE? Appears on screen)

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 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. Few people worried about trying to explain economic fluctuations during the nineteenth century. Americans were too busy building railroads across the country, expanding commerce overseas, or creating new industry. The years after the Civil War saw a continuing expansion of the American economy and, although this prosperity was interrupted by periodic slumps, few people seemed to worry. After all, didn’t the economy always bounce back? On the eve of WWI economists still had no theory to explain these recurring downturns. Why not? We asked some economic historians...

ROBERT L. HEILBRONER: “The bubbles and the panics and the convulsions, revulsions all these funny words, crisis, gluts, they were actually noticed back in 1810s and 20s, but the idea of the cycle, of the recurrence of these things, good times and bad times took a long time until it really reached the level of let’s call it the professionals. They were just beginning to be professional economists. Then it took an even longer time until people began to think that there was really a mechanism that turned one into the other.”

LEE J. ALSTON: “I think it was that the economy was just more resilient in the 19th century. I’m sure that a lot of thought and energy didn’t go to explaining a problem when they didn’t see a problem, that wages would adjust and they adjusted much more quickly in the 19th century than in the 20th century. Interest rates would adjust, so no sense creating a too old problem that to them wasn’t there.”

ROBERT L. HEILBRONER: “And I think economists believe that in bad times when investments stopped, when people, businessmen, simply stopped putting up real plants, savings would keep on going and pile up in the banks. Banks make their money by making loan, after all. The competition among banks to get rid of their savings have pushed down the rate of interest. I think that was another reason why people thought it would be a self-maintaining, self-correcting – not only the on-going dynamism of the system but the fact that this continuous flow of savings would sooner or later push the

rate of interest down and that would serve as a stimulus, or as an investment, or an inducement to businessmen to go back to their business of investing.”

DAVID SCHOUMACHER: In the early 20th century businessmen still clung to a theory called Say’s Law which said that when they produced a commodity they automatically created a demand for that product. But early in 1914, it was obvious that something was wrong. Unemployment was climbing, prices were falling, factories were closing – it was an old story repeating itself again. The slump had no apparent cause, at least none that was evident to the Wilson administration. Treasury Secretary William McAdoo shrugged off the recession as in his words, “a propaganda of pessimism.” But the Republicans had no doubt why the economy faltered. It was that dangerous Democrat in the White House – Woodrow Wilson. But while many were quick to blame the Wilson administration few thought the government should intervene to correct the situation.

LEE J. ALSTON: “The prevailing point of view seemed to be that the business cycle was correcting an imbalance and that by intervening you might only make things worse. By the government coming in and trying to purchase more goods and services to take up for the lack of business investment, they might adversely affect the little business investment that there was.”

DAVID SCHOUMACHER: It’s doubtful that this attitude provided much comfort to the unemployed workers who lined the streets of NY demanding assistance – workers who had barely recovered from the panic of 1907. But when relief came it arrived with the fury that changed the world. (Guns, cannons firing – MUSIC IN) When the nations of Europe hurled themselves into battle in August 1914, the neutral Americans began to supply food and weapons for the belligerents on both sides. The recession soon vanished as American farms and factories cranked up to meet the new demand. Looking back it seems obvious that uncertainty over the course of events in Europe caused the American economy to turn sour. When that uncertainty evaporated in the face of full scale war the economy boomed once again. There were some radicals who complained bitterly that war was the health of the state but on the whole the Americans welcomed the return to

prosperity. Richard Gill, what did economists of that time think of all these fluctuations in the economy?

(MUSIC PLAYS - COMMENT AND ANALYSIS I)

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RICHARD GILL: They saw these fluctuations as basically temporary. There was a long tradition in “classical” western economics, that there could be no such thing as general overproduction. Depressions would always cure themselves. When labor was unemployed, as in the recession of 1913-1914 all labor had to do was to accept lower wages and then, of course, businesses would be happy to rehire them and prosperity would soon return. Underlying this view was a doctrine we refer to as Say’s Law, after the 19th century French economist, J.B. Say. What did Say say? Well, what he said was that in total, supply always creates its own demand. There can never be any long-lasting overproduction of economic goods, since each good we produce is either demanded by ourselves or, more commonly is used to demand some other good. In the early part of this century, for example, a businessman might go into production of ladies’ bonnets. He produces 2000 of them. But what does he do with these bonnets? Well, one or two he may give to his wife, but the rest he takes to the store and exchanges them for other goods. He buys a stove, a car, a box of candy. This is the big point: these added bonnets represent added demand for other goods: stoves, cars, candy. When you get down to it, demand is really nothing more than one set of goods being offered in exchange for another. Of course Say admitted there could be temporary problems with all this. There might easily be overproduction of a particular good, like bonnets. Also, money could be a problem. A collapse of confidence in the banking system such as occurred in the panic of 1907 could throw a monkey-wrench into the works. But only temporarily. Ultimately there would always be a market for goods and the labor that goes into producing them. Wages might have to come down a bit. Producers might have to shift from bonnet production to making more stoves. But, finally, everything works out for the best and the economy bounces right back again. So said J.B. Say, and, for over a century, most economists agreed with him. Most, but not all.

PART II

DAVID SCHOUMACHER: (MUSIC IN) WWI. 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 the 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 taught 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% while unemployment, virtually nonexistent during the war, jumped to 14% in 1921. Among the economic theorists of the 19th 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...tensions...is a good word...which eventually brought the thing to a climax. And then the bad times in turn produced their own healing properties. Businesses would go under, wages would go down, business would be 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, 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.” 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.

DAVID SCHOUMACHER: (SFX Whistle) 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 II)

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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-19th 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 im-miserized, 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. On the eve of the Great Depression, most economists were still locked into the classical world of Say's Law.

PART III

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? 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. (MUSIC IN) 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 Hup 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 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 – 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 “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:

PROFESSOR 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?

PROFESSOR 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.

PROFESSOR 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 St. gave the signal and the country went to hell.” In 1922 the country had enjoyed a miraculous,

almost overnight economic 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 when 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 ANALAYSIS III)

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RICHARD GILL: (MUSIC IN) 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!

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 or a major crash as in 1929, every fluctuation takes its toll in lost opportunity and personal hardship. We know now that these cycles are not really the death-throws of Capitalism but we also

know the system does not automatically correct itself. We now understand that business cycles are the result generally of shifts in aggregate demand or total spending. How we learn this lesson and how we apply it are the subjects of future editions of ECONOMICS U\$A. I'm David Schoumacher.

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