

ECONOMICS U\$A
PROGRAM #14

STABILIZATION POLICY:
ARE WE STILL IN CONTROL?

BY FRANK M. NESBITT

AIRSCRIPT
JANUARY 7, 1986

14. THE ROLE OF THE GOVERNMENT: SHOULD THE GOVERNMENT TRY TO STABILIZE THE ECONOMY?

PURPOSE:

To discuss the arguments for and against active government counter-stabilization policy.

OBJECTIVES:

1. Classical economists believe that there is little that the government can do to reduce unemployment and increase GNP growth, especially in the long run. They maintain that in the long run fiscal stimulus raises interest rates and monetary stimulus raises prices without affecting real growth.
2. Expectations may reduce the effectiveness of government stabilization policies.
 - a) expectations that the government will reverse an anti-inflation policy will keep the policy from being effective
 - b) “rational expectations” may keep a stimulative policy from lowering unemployment because individuals and firms may simply demand higher wages and prices.
3. It is difficult to determine exactly what monetary policy to pursue because neither interest rates nor the money supply are perfect indicators of the restrictiveness of monetary policy.
4. Government fiscal policy has often been complicated by political problems, and large structural deficits make it even more difficult to use discretionary fiscal policies.

KEY ECONOMIC CONCEPTS:

Classical perspective
rational expectations, credibility of government policies
constant growth rate rule
interest rates vs. money supply
structural deficits
inside and outside policy lags

ILLUSTRATIVE EVENTS:

The 1982 recession is discussed from three different points of view:

1. why expectations made a deep and long recession necessary to slow inflation.
2. why monetary policy may have been tighter than Volcker really wanted it to be
3. the effect of the tax cut in bringing the economy out of the recession and the emergence of structural deficits.

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TEASER

DAVID SCHOUMACHER: In 1981, the Federal Reserve set out to quell inflation once and for all. A year later, 12 million workers were unemployed. Why was it so hard to break the back of inflation? In 1985, the leaders of the industrial world gathered in Bonn to wrestle with the question, “Why was a growing international trade making it harder to solve domestic economic problems?” By 1985, the economy appeared to be slowing down and economists were still asking, “What can we do about the next recession?” The activists’ theories of fiscal and monetary policy have dominated modern economics since the Great Depression. By the mid-1980s, we were having second thoughts about our ability to manage the economy. Stabilization Policy: Are We Still In Control? That’s the story we’ll investigate with the help of economic analyst Richard Gill on this edition of Economics U\$A. I’m David Schoumacher.

(MUSIC PLAYS - OPENING TITLES)

(STABILIZATION POLICY: ARE WE STILL IN CONTROL? appears on screen)

PART I

DAVID SCHOUMACHER: For many years after the Great Depression, the basic goal of national economic policy was to minimize unemployment. But the winter of

1982 saw 12 million men and women unemployed, and many complained bitterly that they were the victims of a needlessly cruel government policy. This time public enemy number one was inflation and the jobless workers were the casualties in the war. The severity of the battle cast new doubt on the ability of the government to effectively manage the economy...or the wisdom of even trying. Why was it so hard to break the back of inflation?

RICHARD M. NIXON: “The time has come for decisive action...action that will break the vicious circle of spiraling prices and costs.”

GERALD FORD: “Inflation is domestic enemy number one...”

JAMES E. CARTER: “Present high inflation threatens the economic security of our nation.”

DAVID SCHOUMACHER: From Richard Nixon through Jimmy Carter, president after president set out to fight inflation. But when that fight threatened to increase unemployment, president after president reversed course, opting for stimulative policies to keep the economy growing and unemployment low.

GERALD FORD: “We must shift our emphasis from inflation to recession..”

DAVID SCHOUMACHER: For more than a decade the economy grew a little and prices grew a lot. American ended 1979 with significantly higher inflation than we had in 1970. By the end of the decade most Americans expected inflation to be with them forever...And they conducted themselves accordingly. Fred Schultz was Vice Chairman of the Federal Reserve in 1979...

FREDERICK H. SCHULTZ: “When you have inflation, money becomes worth less and the financial assets of bonds and stocks don’t respond as well...and the thing you need to do is to go out and buy things. You need to buy art and stamps

and gold and land and houses. So people got in the habit of going out and borrowing all they could borrow and spending all they could spend. And it takes a long time to change the way people carry out their activities. In the 1970s, people were convinced we were going to get inflation under control, and only in the latter part of the 1970s...1978 and '79...did they become convinced that we weren't going to get it under control. And so, then, that's when inflation really began to heat up very rapidly."

DAVID SCHOUMACHER: In the closing months of 1979, Federal Reserve Chairman Paul Volcker, announced a new tight money policy to counter inflation. He was forced to abandon this policy in the recession of 1980...and 1981 brought a new President and a renewed determination to clamp down on inflation. But the Reagan administration wanted it all...both lower inflation and higher growth. The Fed sent out warning signals.

FREDERICK H. SCHULTZ: "We kept saying, all through the early part of 1981, that if there's too big a tax cut...or if it is not matched by expenditure cuts...that's going to make the monetary policy more difficult, because, if you're putting fiscal thrust into the economic system, and you are trying to restrain it with monetary policy, that means that interest rates are going to be higher than they otherwise would have been. And we made speech after speech...We had meeting after meeting in which we said, 'If this tax cut's too big or if their expenditure cuts are not big enough, interest rates are going to go very high'...and they did."

DAVID SCHOUMACHER: When the Federal Reserve began once again to tighten the money supply, workers and businessmen alike refused to believe that the government was serious about ending inflation. Wages and prices continued upwards, growing faster than the money supply. The economy was out of balance...It was bound to topple...And it did. Late in 1981, the economy headed into a recession and millions of Americans headed for the unemployment line. But even as the unemployment line grew, workers continued to ask for increases to pay

for the inflation that had become part of their lives. The Fed stuck to its guns...by the spring of 1982 things were bad throughout America...By the summer, they were worse. Fred Schultz was given the lonely job of explaining why the Fed was causing so much pain.

FREDERICK H. SCHULTZ: “But I’ll never forget...The worst thing that happened to me the whole time I was on the Fed Board was...I had made a speech and tried to explain...and this was to a group of automobile dealers...and one of them stood up and said, ‘I understand what you’re trying to do, Mr. Vice Chairman, but I want you to know I’ve tried for more than 30 years to build up a successful automobile dealership and next week I’m going to close my doors.’...And I’ll tell you, that kind of thing stays with you for a long time. It was very hard on us, you know, to be in that kind of a position where you know you’re causing individual pain...It’s not something that’s just theoretical...You know you’re hurting people out there...and to know it’s something you have to do is tough when you’re doing it, but I think the results have shown now that it was successful. The country is back on a much sounder path.”

DAVID SCHOUMACHER: As the summer wore on, and unemployment passed 10%, the inflation rate began to drop. In August, Volcker announced that the time had come to ease monetary policy. Wall Street was the first to respond. But the bitter memories of the recession lingered on...and faith in counter-cyclical policy was one of the casualties. Many people blamed the misery on the failures of stabilization policies in the 1970s. Others, like Congressman Henry Reuss, blamed the unnecessarily harsh policies of the 1980s.

CONGRESSMAN HENRY C. REUSS: “Now I’m all for curing inflation...but, in my view, it could have been done without stepping on the brake so hard that the economy was thrown through the windshield.”

DAVID SCHOUMACHER: By Christmas, the economy was growing again. Workers began returning to their jobs and inflation held at 4% throughout 1983. By 1985, after 2 years of recovery, inflation remained at 4%...but the economy still bore the scars of the recession. Millions of manufacturing jobs were gone for good...and unemployment remained stuck at 7%. Fifteen years of entrenched inflationary expectations had been sharply reduced, but only after the government had finally proven its willingness to pay the price necessary to wring inflation out of the economic system. We asked economic analyst Richard Gill why a tight monetary policy had caused such hardship?

(MUSIC PLAYS - COMMENT AND ANALYSIS I)

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RICHARD GILL: If one takes a benign view, one could argue that the difficult times of the early 1980s were really a reflection of the success of our past policies. Keynesian economics was directed mainly at stabilizing the growth of real national income and, if you compare recent decades with the decades before World War II, you find that the American economy did pretty well. Here is the way the growth of our real GNP fluctuated before World War II. And this is what happened from the 1950s to 1980. In real terms, the economy was much more stable in the recent period. The very success of these policies, however, undoubtedly contributed to the recent inflationary tendencies of the economy and, perhaps more significantly, to the expectation of future inflation. By 1980, they had created a general sense that the government would back down in the inflation fight as soon as it began to create serious costs in terms of recession and unemployment. People, in short, began betting on continued inflation. And this made the government's task infinitely more difficult. The government had to act strongly enough to break the back of these well entrenched inflationary expectations. It not only had to fight inflation, but to fight a general belief that it would not fight inflation that hard. Expectations are important in economics. They made the task of monetary policy much harder in

the early 1980s. Some economists, indeed, have come to the conclusion that they make stabilization policy virtually useless in general. According to this new school...the so-called “rational expectationists”...only unexpected government policies are likely to have any effect on the economy, and these unexpected policies will more than likely be harmful. So far have we come from the happy days of the Keynesian revolution!

PART II

DAVID SCHOUMACHER: In 1983 America came bouncing out of the recession with a boisterous recovery. But a funny thing happened on the way to prosperity. Out of all those billions of dollars of consumer spending, too much seemed to be pouring overseas. At the same time, foreigners had a high percentage of our national debt. By 1985, economists both here and abroad were asking, “Is our domestic economy the hostage of international forces?” Those international forces had been building throughout the 1970s. During that decade, the percentage of our economy devoted to foreign trade doubled, passing 10% by 1981. What problems would this create for the conduct of economic policy? We asked economist Robert Gordon...

ROBERT GORDON: “The problems that that creates would be no problem at all if it were not for the flexible variable exchange rate of the dollar...Which means that conducting policy in Washington now has side effects that didn’t used to exist...Namely, if we decide to fight inflation with tight money and loose or easy fiscal policy...the policies of the 1980s...then we’re going to find that part of our economy is harmed while another part benefits. And we are really taking from Peter to pay Paul.”

DAVID SCHOUMACHER: 1983 was a year of vigorous growth for America as the economic recovery surged ahead. It soon became obvious that many Americans were being left behind. While millions of jobs were being created in the service

industries, millions more in manufacturing appeared gone for good...lost to overseas competition.

RAY CALORE: “Well, there’s no question about it. We’re in deep trouble...and specifically...right here in Tarrytown where about 2,000 people will be laid off...they’re in deep trouble. I don’t know any place in the state of New York where there’s anybody gonna hire 2,000 people.”

DAVID SCHOUMACHER: In the 60s and 70s, expansive economic policies had created jobs for American workers. Now these same policies were creating jobs overseas while Americans remained unemployed. The situation was causing severe problems for American policymakers, as Federal Reserve Governor Henry Wallich explains...

GOVERNOR HENRY WALLICH: “You may want to expand the economy...let us say by budget deficit or easier money...but some of this demand goes abroad. People buy Japanese cars and so you get expansion in Japan but not in Detroit. For instance, we’ve got a 200-odd billion dollar budget deficit, but half of the money is going abroad and so we’re getting stimulation only from half. Fiscal policy is losing much of its power.”

DAVID SCHOUMACHER: No one in the Reagan administration had foreseen this effect in 1981 when the administration first embarked on its expansive course...But as our trade deficit shot past the 100 billion dollar mark, economists and politicians alike began to search for a solution. Most economists agreed that the trade deficit was caused by the overly strong American dollar, which was in turn caused by the runaway budget deficit. But many politicians began to argue for trade barriers to keep out the flood of imports. The Reagan administration resisted this approach.

BERYL SPRINKEL: “All economists...I’d say 99.9% of economists...believe that we will gain from free trade. This administration believes we gain from free

trade...And therefore, we are not going to lead the world down a protectionist road which will reduce our standard of living and reduce standards of living abroad.”

DAVID SCHOUMACHER: In May of 1985, the heads of state of the leading industrial nations of the free world met in an economic summit conference in Bonn, West Germany, to try to resolve differences in economic policy. The Europeans and the Japanese urged the U.S. to get its budget deficit under control. We urged them to expand their economies to create new markets for American goods. No firm decisions were made, but international cooperation remains a promising approach to economic problems. Beryl Sprinkel speaks for the Reagan administration...

BERYL SPRINKEL: “When governments recognize a particular set of policies are in their interest, they are very likely to move in that direction. The great difficulty is trying to get them to do something which they perceive is against their interest. They won’t do it. They shouldn’t do it. And we won’t do it either. But I think that working together you can make some progress on the economic front and, in fact, I think we have done so over the past give years.”

DAVID SCHOUMACHER: Five months after the Bonn summit, the U.S., Japan, France, Britain and Germany announced a coordinated effort to reduce the value of the U.S. dollar. The move was a promising effort to ease the U.S. international trade dilemma and possibly create more jobs for American workers. But major problems remained. By 1985, the United States was running 200 billion dollar budget deficits. But half the economic stimulus, the amount of the U.S. trade deficit, was going overseas and any effort to contain this deficit or to promote continued growth had a major impact around the world. We asked economist Richard Gill why the international aspect was much more important in U.S. policy.

(MUSIC PLAYS - COMMENT AND ANALYSIS II)

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RICHARD GILL: The main reason the international aspect is so important today is that the numbers have gotten so big. We had our first post-war merchandise deficit in 1971: A little over \$2 billion. By 1984, our merchandise deficit was over \$105 billion. And what these numbers mean is that we can't separate our domestic stabilization policies from our international trade policies. To take a simple example: It has been argued that our trade deficit in 1984 was mainly due to an overvalued dollar. This made our exports too expensive and foreign imports too cheap. Well, the value of the dollar is determined by supply and demand. Thus, the high value of the dollar must have been due to a great demand for dollars...largely for investment in the U.S....in relation to supply. Simple solution: Increase the supply of dollars. Have the Fed start printing money and buying back those billions of dollars of U.S. Treasury securities held by foreigners. But wait a second! Hadn't we just gone through a very painful period of monetary restraint to break the back of our inflation? If the Fed began printing up money like that, what would happen to those dread "inflationary expectations" we had been at such pains to destroy? The simple fact is that, in an interdependent world economy, we have many more variables to take into account. And this creates still another difficulty for our already rather shaky efforts at economic stabilization.

PART III

DAVID SCHOUMACHER: The Employment Act of 1946 created a Council of Economic Advisors to give the president the benefit of the best professional economic thinking. For almost 40 years the essence of this advice was to manipulate the economy to prevent inflation and to promote growth. It was called counter-cyclical policy. But, by 1985, the man who occupied this office was urging a receptive president to keep his hands off. Whatever became of our ability to fine-tune the economy? There was a time, back in the 1960s, when we were convinced that we had unlocked the mysteries of economics and learned to control the ravages of the business cycle. Walter Heller served two Presidents as Chairman of the Council of Economic Advisors. We asked him, "Was the 1964 tax cut a success?"

WALTER W. HELLER: “It came out of the textbooks and it went back into the textbooks as the greatest single success in fiscal policy in modern times. That is to say, it was a tax cut that came into an economy without inflation...in which the Federal Reserve was able to cooperate and accommodate this stimulus to purchasing power...and it worked like a charm.”

DAVID SCHOUMACHER: Walter Heller left the Council in 1964. By 1985, the man who held this office sharply rejected the idea that the government could fine-tune the economy.

BERYL SPRINKEL: “We cannot do it now, and we couldn’t do it then. Some of my predecessors in this office believed they could, and it’s very clear that so far as the Reagan administration is concerned, we recognize that. We try not to fine-tune because we know it would be a road toward disaster.”

DAVID SCHOUMACHER: What happened between the 60s and the 80s? The 70s happened. And the 70s were bad years for the theory and practice of macro-economics. Monthly fine-tuning of monetary policy created havoc in the economy, as Martin Feldstein explains.

MARTIN FELDSTEIN: “I think the 1970s, in particular, was a decade in which monetary policy pursued the wrong goals and was based on the wrong premises and got us into terrible trouble. It was the excessive growth of money, more than anything else, that brought us to the double-digit inflation rates at the end of the decade.”

DAVID SCHOUMACHER: If monetary policy was a disaster in the 70s, fiscal policy was not much better.

MARTIN FELDSTEIN: “By the time Congress got around to some change in fiscal policy... a tax cut or an increase in government spending... it was already too late, and instead of dampening the business cycle, they were actually increasing the fluctuation of unemployment and inflation.”

DAVID SCHOUMACHER: By the end of the decade, the idea of fine-tuning the economy was thoroughly discredited. When Paul Volcker initiated a new monetary policy designed to quell inflation once and for all, he made much of the fact that the new policy was on for the duration. No more starts and stops. When Ronald Reagan embarked on the most expansive fiscal policy in history, he locked his policy in place three years in advance. No turning back. 1983 and 1984 were years of growth in the American economy, but, as the economy grew, the budget deficit grew even faster. By 1985, many economists felt that fiscal policy was dead... a casualty of the towering deficit.

WALTER W. HELLER: “We’re almost forestalled from using positive fiscal policy when we’re running deficits of 200 billion dollars. Can you imagine the President and the Congress going to the people and saying, ‘Well, we’re running 200 billion dollar deficits, but they really ought to be 300 billion dollars because we need to rev up the economy... And we may be denying ourselves the use of an extremely important anti-recession tool because of these gargantuan deficits.’”

MILTON FRIEDMAN: “I believe that the only effective option is a monetary. That doesn’t mean it’s a desirable option...”

DAVID SCHOUMACHER: Conservative economist, Milton Friedman...

MILTON FRIEDMAN: “Because the tendency is... has always been... to respond too late and too much, and to create a subsequent period of bumps. In my opinion, the right way to respond... I don’t mean the right way, but the most desirable way to respond to a recession... is to have a monetary policy... a steady monetary

growth...as a result of which the recessions will be mild when they occur...and will correct themselves...as the effects of the various forces unleashed by the recession work out. And you will have not a perfectly steady economy, but a much stabler economy than you now have.”

WALTER W. HELLER: “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.”

MARTIN FELDSTEIN: “I would say that you can’t iron out the little wiggles in the business cycle, that counter-cyclical policy may be useful if the economy gets very much off track. And I think we have the tools, monetary and fiscal tools, for dealing with that kind of situation. So we’re not going to see a return to the kind of experience we had in the 1930s. But the kinds of policies that were pursued in the 60s and 70s...trying to prevent one or two percent increases in unemployment that come about because of changes in consumer preferences or changes in foreign demand or changes in investment behavior...that’s a futile activity, and it almost inevitably leads to worse problems that the problems it’s trying to cure.”

DAVID SCHOUMACHER: In 1985, the sour notes in our economic performance warned that problems of inflation and unemployment were still with us. But the consensus of the economic community was that the most effective response was a policy of coarse-tuning rather than the more active management of an earlier generation. But, as Paul Volcker continued to point out, hard choices remained...choices that could not be put off forever. We asked economic analyst Richard Gill to comment on future trends of counter-cyclical policy.

(MUSIC PLAYS - COMMENT AND ANALYSIS III)

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RICHARD GILL: Back in the 1950s and 1960s, the Keynesian view was dominant. With slight turns of the rudder of monetary and especially fiscal policy, one could, most economists felt, steer the economic ship past the Scylla of inflation and the Charybdis of unemployment. But today even Neo-Keynesians concede that economic navigation may be less of an exact science than was once imagined. In general, the shift of emphasis from fine-tuning to coarse-tuning has been a shift in time perspective from the short to the longer run. Active intervention in the short-run, many economists now feel, may only intensify our longer-run problems. Unfortunately, there is no real agreement as to what the truly important long-run factors are. The Monetarists, under Professor Friedman, still stress the steady long-run growth of the money supply. On the other hand, the supply siders who came to prominence after the oil and other supply-shocks of the 1970s, emphasize cutting taxes and stimulating the long-run growth of investment, technology and labor supply. And finally, there are the rational expectationists. These economists argue that, in the long run, business, labor and consumers will always figure out what the government is up to and will respond in ways that defeat the government's intentions. The future of counter cyclical policy? It is likely to be less interventionist, more long-run in its orientation and more careful about international consequences than in the heyday of the early post-war period. We shouldn't overlook our achievements in that earlier period. Equally, we cannot overlook the very different shape of the problems that lie ahead.

DAVID SCHOUMACHER: Can we control the economy? Well, for many years we were convinced that we could. However, economists are no longer so hopeful. The problems of entrenched inflation, the effective expectations on people's behavior and the increasing interdependence of the world's economies have forced economists and policymakers to face increasingly difficult and complex decisions. But the huge engine of the American economy continues to be a powerful force throughout the world...and prudence demands that this engine be kept under some

form of control by the government. But how...and how much control...continues to be the topic of lively debate. For Economics U\$A, this is David Schoumacher.

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