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What Is the Proper Balance?

A STABLE ECONOMY:
THE PRODUCT OF SHIFTING POLICIES

Remarks of

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A STABLE ECONOMY:
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The relationships between business and government, or for that matter among business, labor, and government are far beyond the compass of any single paper. The relationships encompass virtually every aspect of our economic life and, to a growing extent, of our underlying social structures. Witness, for example, growing industry efforts to undertake constructive efforts--though yet on a limited scale--to cope with the mounting problems of our big cities or those of the untrained, the unprivileged, and the negroes.

Today, I am going to concentrate on a much narrower, but nonetheless broad and central aspect of the relationship. Specifically, I shall consider some of the problems of over-all economic stabilization and the resulting interdependence of the roles of the government and business. Economic stabilization policies aim at promoting steady growth and employment with high-level use of manpower and industrial capacity, with rising standards of living, and with reasonably stable prices. Balance of payments equilibrium is also a goal of policy primarily for fear that disequilibrium will, sooner or later, interfere with the attainment of the ultimate goals of internal stabilization, as witnessed, for example, by the recent experience of the United Kingdom.

I don't have to belabor the obvious that everybody has a stake in stabilization and benefits from it. The questions relate rather to means and, at times, to the apparent incompatibility of goals. What is the role of business in a free enterprise economy in fostering and attaining these goals? From one point of view the role is enormous. The dynamism of the American economy is largely attributable to business. Our amazing long-term growth rests heavily on capital accumulation and on invention and innovation embodied in capital. Growth in productivity is the resultant of many influences, including education, but much of it has been based, and continues to be based, on the dynamism of management--on the unending quest for doing new things and on doing old things in a better way. I do not mean to imply that all of these things are done perfectly or that stodginess is absent from American corporate management, but by and large the generalization seems true. Much of the responsibility for adequate long-term growth rests, and must continue to rest, with business.

When we come to shorter term stability, or cyclical instability, the role and responsibilities are not so clear. In fact, we are now in the midst of a debate over the necessary relationship between business and governmental policies in the attempt to diminish short-run fluctuations in the economy. Recently there seem to have been more frequent arguments raised in many areas to the effect that the number of requested changes in taxes and the major shift in monetary policy experienced last year have led to instability rather than stability.

Part of the debate may be over the question of whether the shifts have been capricious or necessary. No one can attempt to defend a rapid change in policy in and of itself. Clearly each policy change has a definite cost. Their number ought to be kept as few as possible.

However, in the extreme, the debate seems to have gone beyond this. Questions seem to be raised as to the degree to which the government should abdicate its responsibilities assumed under the Employment Act of 1946 and return to business the responsibility for avoiding depression and inflation. Were the lessons of the 1930's improperly learned? Would we be better off without the New Economics and the attempts by the government to maintain a steady non-inflationary growth? If the government does have a responsibility for stability, might it be better if policies changed only at rare intervals? What are the prospects that the uncertainties introduced by policy changes will be greater than those which would exist without them?

The Economy by Its Nature Is Unstable

Both experience and analysis tell us that the economy without conscious policy shifts is likely to be unstable and either sluggish or inflationary. In the past, we have experienced both large and small depressions. Even in the postwar era, there was a long period of far from optimum growth.

We know that the records of financial markets and of business and consumer spending show large fluctuations. The past two years give no indication that their magnitude has diminished. There is no real reason to expect that they should or will. The reasons for wide swings in private spending on plant, equipment, houses, autos, etc., are inherent in our basic economic structure. The forces which lend major dynamic strength to our economy lead at the same time to instability.

Hopes have been raised that at least in the financial sphere fluctuations would be narrower. Such a diminution in movements has been accomplished with respect to major contractions. These arose in the past from widespread failures of financial institutions primarily as a result of too severe contractions of credit and liquidity. While some observers feared such a financial collapse might have occurred last year, I believe their fears were highly exaggerated. Financial institutions will continue to fail as a result of poor management and individual speculation. If, however, many sound institutions fail as a result of a liquidity squeeze, this will be an indication that the Federal Reserve System has failed to perform a basic function. In such a case, the country should demand and I hope would get a new financial management.

On the other hand, there is little in the record of the past two years to indicate that typical excessive short-run swings in financial expectations have ended. Au contraire. This period has experienced major swings in the capital markets with definite indications that to a large extent they were based on changing expectations and speculative views of the future. The history of financial markets shows many periods when there existed only a slight correlation between borrowings and the basic underlying requirements for funds. Rushes into and out of the market on both the demand and supply side have been frequent.

Finally, the Federal government, too, through its expenditure programs is a natural source of instability. The demand on resources of wars and major shifts of defense spending have historically been large. War and defense related run-ups in expenditures with their associated expectational and spending impacts on the private economy have been the most destabilizing of all spending streams. Vietnam is clearly not an exception to the general rule.

Uncertainty Is Reduced by Shifting Governmental Policies

From the business point of view, the uncertainties affecting the entire economy with respect to future demand, to availability of goods, and cost and availability of credit, are added to the specific uncertainties surrounding the demand for individual products and industries. Have the uncertainties been increased or reduced by the fact that the government periodically shifts its tax or credit policy in an attempt to increase stability by offsetting some of the other fluctuations in the economy?

I must say that until recently most opinions seemed clear. We have in recent years had more stability in the economy. Business has been able to take a longer run view of investment and spending. The number of financially induced failures has been low. This last period of sustained growth has been the longest in peacetime history. Unemployment rates have been reduced. The average degree of price stability in the past seven years has been as great as in all but one or two similar periods in our history.

It would be wonderful if this record could have been achieved without major changes in government policy. But it was not and almost certainly could not have been. Most would agree that much of the stability has been the result of policy changes offsetting movements which otherwise would have caused severe fluctuations in prices, output, and employment. The Council of Economic Advisers has pointed out that there have been six major tax actions in the past five years designed to influence the over-all level of economic activity. Monetary policy has had similar major changes and because of its nature, many more of a minor sort.

For the intermediate future, I see no alterations in the structure of the economy which are likely to lead to a requirement for fewer changes in policy. In fact as long as we face the problems of war spending and a postwar contraction, pressures would seem to be going in the opposite direction. Clearly, policy changes should cause as little upset as possible. This goal, however, may require more frequent and a greater variety of changes rather than less.

What Else Have We Learned?

The recent past also seems to offer other lessons for the future with respect to the type and manner of use of these policies.

1. Monetary and fiscal policy can and do have significant impacts on spending, resource use, and prices. Few would disagree that at least some of the changes in the economy in the past five years can be traced directly to alterations in the availability of credit, tax rates, and government expenditures.

2. It also appears true that monetary policy is more flexible, in some sense, than fiscal policy. In part, this greater flexibility arises out of the nature of the two decision-making processes. Changes in monetary policy can be made by the Federal Reserve Board and the Open Market Committee, meeting every three or four weeks, infinitely more easily and swiftly than can changes in fiscal policy be made through the combined action of the Administration and Congress. The greater flexibility of the monetary policy-making group, meeting frequently and with access to expert staff work, allows policies to be modified and adapted relatively quickly to emerging needs. The most striking recent example of this is the easing that got under way last fall.

3. Sharply restrictive monetary policy can have severe differential consequences. Last year, housing purchases and construction were cut sharply. Holders of most types of securities saw their values fall. Some firms got little or no credit while others had access to more than they could use. These credit changes influence not only the industries directly affected but their impact spreads throughout the economy in a gradually widening circle.

4. The mix between monetary and fiscal policy is important apart from their total influence. This follows directly from the fact that they cause large differential impacts in the short run on the separate parts of the economy. It also holds true, however, over a longer period. Even though many different mixes may give adequate stability, each will have a separate impact on the amount and rate of growth as well as on the allocation

of resources and the distribution of income. Almost certainly the future long-run development of our economy would be along better paths if there had been an earlier increase in taxes last year.

5. Changes in policy must be based on projections and forecasts. These are necessary and useful even though they may be subject to errors. The current state of the economy is different from what it would have been if the Federal Reserve System and the Administration had not been willing to change policy based on forecasts. There is a lag both in adopting policies and in their effects. If we wait for certainty, we will always be battling last year's war. Forecasts contain many errors, but the results of their use are likely to be better than if policy is based only on what we know about the recent past.

Current Experience

Our experience thus far this year is a clear indication of some lessons learned and of the stabilizing impact of shifting government policies. There seems but little doubt that if the economy depended entirely on business decisions to spend or not to spend we would now be in the midst of a typical recession, perhaps a severe one.

The economy last quarter experienced a very sharp cutback in inventory investment. This is typical of the events in many previous periods. Such changes occur, as is well documented in existing studies, because of the technical lags and accelerations which relate investment in inventories to changing levels of output and sales. While errors in judgment may accentuate these movements, they are not the basic cause. Both up and down inventory fluctuations are a logical reaction to shifting demand.

This same period experienced a slowdown in the rate of growth of investment in plant and equipment and consumer durables. Again the causes for this slowdown are well known. The acceleration principle and similar movements have been observed and documented for over 50 years. Furthermore, there has been no obvious basic institutional change that would cause these oscillations in the demand for investment to disappear.

Because the typical consequences of the actual and prospective falls in demand were recognized, the beginning of this year witnessed many very pessimistic statements as to the likely trend of the economy. To a somewhat biased observer it seemed clear that many of these were based on a somewhat myopic view in which too much weight was given to the indicators of private demand and too little to offsetting governmental policies. In actuality the slowdown has been less serious than many had predicted and others feared.

There are fairly obvious reasons for this relative stability both in comparison to the past and to the magnitude of the depressing forces weighing on the economy.

Demand from the government sector has continued to expand. There is both a war in Vietnam and a rising trend of state and local demand and revenues.

Monetary policy shifted from restraint. There has been a return flow of funds to financial institutions. General financial liquidity is being reconstituted throughout the economy.

An activist fiscal policy requested the reversal of the suspension of the investment tax credit, and added to the flow of income and future income through the release of holds on commitments and spending.

Corporations recognized the implications of these policy changes and maintained their confidence and expectations. As we know from the past, recessions have traditionally been deepened by rapid shifts in business expectations which have caused the level of investment to fall sharply. This has not occurred this year. Furthermore, corporations appear to have made a major effort to maintain their labor force. After the battle to obtain and train workers, it apparently seemed cheaper and more profitable to hold employees under the slightly slackened demand conditions brought about by the requirements of an inventory adjustment rather than to have to start all over again to hunt for or train skilled employees. This policy has helped to maintain income and consumer demand.

The favorable results thus far this year do not, however, mean that we can relax and rest on our laurels. There are too many alterations which can occur. The need for flexible fiscal policy is still great.

What About the Future?

I think it is clear where monetary policy has moved in the past six months. Where it will be in another year is far less certain. The coming year has far too many imponderables to permit me to guess--let alone put subjective probabilities on what direction monetary policy may move in this period.

I feel certain about only one thing and that is the extreme unlikeliness of the future being a simple replay of the past. Our banking and financial institutions like most others experience a learning process. The events of the past year are bound to influence the reactions of future years.

Monetary policy could carry the major burden of stabilization policy last year because of particular circumstances. We started the year with a surplus of housing. Thrift institutions had a record low liquidity. Banks were entranced with a relatively new major source of funds--negotiable CD's. Government cash receipts were increased by a more rapid collection of taxes and sales of participation certificates.

As a result of these circumstances, the impact of monetary changes on output and spending was probably greater than might normally be expected. Monetary policy could bear more than its normal share in the fight to lower the level of excess demand. A duplicate situation will not occur again, or at least not soon. Businesses may be tempted to make future plans based upon their experience with the policy mix of the past year. But they should recognize that if another period arises when demand must be restored, the policies to achieve this goal are likely to be different. The means and the methods will be dependent on the specific economic environment. The specific policy mix is unpredictable.

In the same way, it probably is wrong to assume that monetary policy will face the same problems next year as it did last. If we can forget our recent traumatic experiences, we will recall that too little demand for goods and services, not too much, was the greatest problem over most of the past ten years. Until recently the debate was over the need for tax cuts, not a tax increase. Clearly, in our economic sphere as in many others, Vietnam has caused an involuntary shift in our policy needs.

It is also apparent, looking back over this recent period, how much of what we experienced was the result of shifting expectations. This was particularly true in our financial markets. The transition from over to under demand and back again was fast but not simple. The impacts were widespread. They made it particularly hard to judge the true underlying situation.

Conclusion

The facts of uncertainty and rapidly shifting expectations make the tasks of the analyst difficult. They do appear to complicate matters and to give more latitude for variances. Do they also argue in favor of a more constant and less flexible role for policy? It may well be that our aspirations are set higher than our statistical or political ability can achieve. However, what is not certain is whether we would be better off falling short of achieving very difficult goals or whether we would gain more by aiming somewhat less high.

The question of whether our goals are set so high as to require too fine tuning cannot yet be answered, but the recent experience does seem to reinforce the need for flexible rather than relatively inflexible public policies. It would obviously ease the tasks of policy makers and be a welcome relief if we could simply set the rudder of policies straight ahead and not worry about what was occurring around us. However, I doubt that ease for policy makers is a very logical goal for our country. It seems to me that it would be a major step backward to set as a basic goal a minimization of government policy changes. We should strive for more not less ability to adjust.

The cost of not achieving a more flexible tax policy is likely to be wider fluctuations in the level of income and demand. The economy will experience longer periods of more severe unemployment and more severe price rises. This probably means that more thought must be given to methods of making tax changes more flexible. The idea of the tax surcharge has obvious advantages. It means that the impact on firms and individuals is simplified. They need only to consider their changes in income, not all of the other adjustments which accompany a structural change in taxes. There also seems to be great value to some of the thoughts of the Joint Economic Committee and various students of taxes with respect to how tax action can be taken more rapidly. The future costs of failing to adjust taxes can be very high. Any structural alterations in the procedures whereby taxes are considered and put into effect can reduce these costs.

It would be fine if we could have all our "'druthers"--a stable, rapidly growing economy with monetary and fiscal policies that changed rarely if at all. Unfortunately, past history doesn't give much promise of such an easy solution. The past two years showed how fast total demand could shift, particularly as a result of greatly increased war expenditures. The ability to change policies allowed us to absorb much of both the inflationary and subsequent deflationary impacts of this demand, plus that of the related investment movements.

No one can say how much of past results were due to chance, to unknown forces, to luck, or to good analysis. Obviously, this will be true of the future also. Future results, too, may frequently depart farther than past ones from our goals. With the tremendous variability in our economy we should hardly be surprised if the results of policies also move more widely around their goals. Some fluctuations and some misses cannot be avoided.

These facts do not, however, remove the basic underlying question which still remains--that of whether as a result of shifting policies we are able to avoid very severe contractions and inflations which otherwise would occur and whether on the average we come closer to achieving desirable results than would otherwise be the case. I think both a comparison of the last seven years to similar periods of the past and a comparison of the last two years to similar periods beset by war demands and major inventory and investment cycles argue for greater rather than less flexibility in policy.