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The Three Faces of Economic Policy

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I was once persuaded to attend a lecture by a surrealist painter because of the particularly provocative title he had selected for his remarks. My anticipations were abruptly chilled when at the very outset of his speech he opined that he had found, in this case, it was much easier to think of an intriguing title than of a speech that would match it.

I have had somewhat the same feeling toward this speech tonight. I am obviously under more compulsion to sensibly connect the title and the speech than a surrealist painter, who might be expected to be influenced by the esoteric and obscure titles often used for surrealist paintings. But while the title gave me trouble in constructing my remarks so they might be responsive to your advance impressions, it was not intended to be facetious or obscure. Thus in referring to economic policy as having three faces I did not intend to use the phrase as a graduated form of the epithet "two-faced." Nor did I intend to introduce you to anything more abstruse than a classification of economic policies which I hope might be helpful in thinking about our economic problems and the programs advocated to deal with them. The three-way classification which I propose to use groups policies under these headings: monetary, fiscal, and structural. In order to avoid the impersonality of classifying ideas I will often personalize these categories and refer to them by the names of their protagonists -- the monetarist, the fiscalist, and the structuralist. I think you will recognize the advantages of this form of identification.

The first problem to be cleared away is why, in an economy based on private enterprise, I should be directing your attention to economic policy alternatives for government. With what we call economic freedom goes the prerogative to pursue individually selected economic actions and policies. Individuals make their own decisions regarding an occupation; businessmen make their own decisions regarding what and how they will produce and what prices they will charge; consumers exercise free choice regarding the use of their incomes. Generally speaking, it is the free play of the competitive price system which directs resources to uses that will be most productive for the economy as a whole.

Despite all of this, government has positive economic functions and a pervasive influence on the environment in which the private economy operates. The most obvious evidence of this fact is that government spends, and therefore taxes, and the private enterprise system can hardly escape the effects of both operations. It is mainly the size of government spending that gives rise to economic policy issues and this is a characteristic of modern government likely to be with us indefinitely. Even if government did nothing more than operate the defense establishment, the public schools, the public highways, and police and fire departments it would be very, very big. And this bigness, combined with the possible differences in the timing of government capital outlays and the practicable alternatives among deficit financing, pay as you go, or pay before you go, makes for a considerable effect on the private economy. An aggregative effect, moreover, which can be subjected to economic policy objectives.

I might add that the continuing American preference for the private enterprise system has meant that even in those areas where we have chosen to have government (Federal or State or local) supply services, we are not in any significant sense a socialist economy. Socialism as usually defined involves government ownership of the means of production. Yet our government, in supplying services, purchases and utilizes materials and equipment produced by privately-owned firms.

A second activity of government that involves economic policies is its role as a regulator, reflecting the social conscience. This function stems from a recognition that the private market system does not always operate in the public interest but may, if unregulated, involve abusive exercise of economic power. Thus government regulates the prices and services of natural monopolies such as public utilities; it pursues antitrust activities; regulates entry and merger of financial institutions, establishes minimum wages, subsidizes industries before their prime and after their prime, and so on. In these activities, government affects the working of the free market system.

The third economic function of government is its responsibility to provide a sound, adequate money system. Before this audience, there is no need for a detailed exposition of how this is done today. You are all familiar with the process by which the Federal Reserve, in adding to, or absorbing, bank reserves, has an influence on the credit-granting and deposit-creating activities of commercial banks. You know how, when it wants to encourage economic expansion, the Federal Reserve relies on your profit-seeking propensities for a leading edge as it manufactures money out of I.O.U's or securities, and how it depends on your judgment of individual creditworthiness to ration credit when it wants to restrain the growth in economy. And, you are even more aware of how this chain of action and reaction, in turn, affects interest rates, credit conditions, and the money supply and, ultimately, aggregate spending in the economy. The need for monetary policy is vividly expressed in the statement that "money does not manage itself." Our history of financial panics and price instability in the century and a half before the establishment of the Federal Reserve System provides ample support for such a statement.

So much, very briefly, for reasons why we are, even in a free enterprise system, inevitably, continuingly, and deeply concerned with the formulation of national economic policies.

The major issues of economic policy are semi-permanent or at least recurring. In recent years we have been most anxious to find a method of reducing unemployment, of achieving a higher rate of economic growth, of reaching a balance in our international payments. Not so many years ago we were trying to curb inflation while rebuilding and upgrading our stock of factories, homes, consumer hard goods, and community facilities. In the Thirties the problem was deep depression. In the Twenties it was maintaining prosperity, concern for European economic restoration, and what to do about a wild credit-financed boom in the stock market. For all of these problems the monetarist, the fiscalist, and the structuralist have answers or comments -- some positive, some negative. But running through the prescriptions advanced in particular cases there is a line of cleavage between the structuralist and the other two which is noteworthy.

Management of money--and its balance sheet counterpart, bank credit--is concerned with the total supply of money and credit. By its nature, monetary policy does not aim at influencing one sector of the economy more than another. Everyone uses money and most of us use credit.

It is true that some types of expenditures--those that are heavily financed by long-term borrowing--are especially sensitive to changes in credit conditions. But as monetary measures affect these types of activity, the secondary effects spread throughout the economy. In any case, the greater impact of monetary policy on some types of activities results from the characteristics of those activities rather than from the nature of monetary policy. General monetary policy cannot be aimed at a single target while other targets are exempted from its impact. When we have had reason to direct monetary or credit measures exclusively at individual areas, we have had to develop special-purpose instruments, such as regulation of margin requirements in the case of stock market credit, and this type of approach, as I note later, comes under the heading of structural policies.

Just as money cannot manage itself, a budget will not manage itself, especially when it has become large in relation to the size of the economy. The actions of a dominant firm in a small town have an enormous impact on the economic well-being of that community; similarly management of its outlays and tax revenues by the Federal Government--the largest single unit in our economy--affects the welfare of the entire population. Changes in government expenditures, taxes, and the relation between them inevitably affects total economic activity, for good or ill. When it was recognized that this impact exists, it became desirable to adapt budgetary decisions to the goal of steady growth and stability of the economy. To this effort, we give the name fiscal policy.

Fiscal, like monetary, policy has generalized effects throughout the economy. Though Federal expenditures are concentrated on certain industries, their effects on incomes and output spread everywhere. Similarly, we all feel the impact of taxation. Yet fiscal policy is also adaptable to the solution of specific problems, regional or otherwise. For example, some expenditures can be deliberately directed to depressed areas; some types of activity can be given special tax treatment as an inducement or deterrent. These selective uses of fiscal policy, and of monetary policy, are illustrations of the third type of policy approach -- the structural.

As I have stressed, monetary and fiscal policies are aimed primarily at influencing the level of aggregate demand and, therefore, of total economic activity, with a view to preventing both inflation and deflation and encouraging steady economic growth at stable prices.

Yet not all economic problems within the Government's sphere of responsibility are amenable to a generalized approach such as that of monetary and fiscal policies. In the case of some problems, we utilize specific remedies which can be focused on specific problems. These specific diagnoses and remedies are what I call the structural approach to economic problems. The vital difference between the structuralist approach and the monetary-fiscal tools lies in this very specification. The structuralist diagnoses the cause and prescribes a remedy--in the political-economic world he sticks his neck out--and the more specific his diagnosis and remedy the farther out his neck. It is not surprising that even in a world of short memories structuralists with positive proposals are relatively rare.

The monetarists and fiscalists have no such handicap.

The reactions that monetary and fiscal actions induce are obscure to most people--not because these moves are some sort of financial shell game--but because there are, for the public at least, no equivalents of isotope tracers which can be used as connective evidence of effects on the economic community. This lack of a generally accepted demonstration causes some to say that monetary policy, for example, did not, or could not have had any effect, while at the same time others say it did or could have had the desired effect. There are no controlled laboratories for testing the effectiveness of general monetary or fiscal policy. In the real world, the environment, the cyclical condition, and the dosage vary so much as to require involved analytical techniques to demonstrate results. This leaves the many who subscribe to the efficacy of monetary policy on faith prepared to believe and contend that monetary policy supplied a necessary ingredient if not the one which actually precipitated the desired economic effect. The scoffers, and some of the believers, when it suits their purpose, can say in any given situation, that monetary action played a passive role, implying that within practical limits it could not have done otherwise. Of course, using this latter argument, it is possible for the money managers to have the better of a bad situation and the best of a good one. They live as blameless neuters when things go wrong and as perceptive regulators when all is well.

Turning now to some comments on the relative merits of these alternative types of policies, one example of considerable topical interest can be found in the measures that are being adopted to deal with the unemployment problem. Both fiscal and monetary policies have been aimed at stimulating total economic activity, which in turn is expected to increase employment and reduce unemployment. At the same time, however, it is recognized that some of the unemployment will not yield merely to increased demands for labor. In some cases, technology has changed so that demands for the products of certain industries are unlikely to increase enough to absorb the labor force attached to those industries; coal mining, for instance. In other cases, rapid technological advance has rendered certain skills obsolete, or has permanently reduced the demand for unskilled labor.

To deal with these structural aspects of unemployment, structural measures have been adopted. These include an area redevelopment program and a retraining program for workers who are technologically unemployed. The existence of these programs reflects an awareness that merely increasing aggregate demand in the economy at large will not solve the entire unemployment problem. In fact, an effort by government to expand total demand for goods and services until all the unemployed were absorbed, aside from a normal margin of frictional unemployment, would probably send the economy off into a severe inflation. A fiscal-monetary solution is not appropriate for the structural portion of the unemployment problem.

Another area in which a structuralist approach has come to be regarded as more appropriate than the monetarist approach, and one that goes back 30 years, is the regulation of stock market credit. As you know, the Federal Reserve is directed by Congress to utilize a special-purpose instrument in regulating credit used to purchase and carry stock. In contrast to general monetary policy, which operates by influencing the supply of bank credit available, but leaves the determination of interest rates and other credit terms to market determination, this special instrument specifies a maximum amount of credit that can be extended to finance individual stock purchases. It is possible, therefore, for the Federal Reserve to affect the amount of credit used to purchase stock without invoking a change in general monetary policy, which would affect credit availability for all purposes.

What was the rationale for adoption of this special-purpose structural approach? As some of you may recall from memory and others from a study of history, stock market speculation involving heavy use of credit was rampant in the late 1920's. The great crash of 1929 imposed severe hardship on many people throughout the country and also did much to accentuate the depression. It became evident that the purchase of securities with small cash payments and large amounts of credit had contributed to the excessive rise in stock prices and, when prices turned around, attempts to liquidate this credit aggravated the drop in stock prices.

In the face of this developing situation in the late 1920's, the Federal Reserve confronted conflicting policy objectives. The only way it could attempt to lessen the flow of credit into the stock market was by restricting credit availability to the entire economy. Yet, though this was a period of general prosperity, commodity prices were stable, and some sectors of the economy (notably agriculture and construction) were ailing. Aside from the stock market situation, there was no need for a severely restrictive monetary and credit policy. On the other hand, there was no way to shut off the flow of loans for stock speculation. The only means available consisted of general monetary policy instruments. It is no wonder that the Federal Reserve authorities were puzzled and internally divided in their policy recommendations.

I have failed to do justice to this colorful, if unfortunate, episode in our financial history. I believe I have said enough to make it clear that here was a problem calling for the tools of the structuralist, not the monetarist. And, as a result of that experience, we have selectively tied treatment to a specific diagnosis.

I am naturally led by these observations to wonder whether the policy problems raised by our present balance of payments difficulties are not somewhat comparable to those of the late 1920's. Not, let me hasten to say, because of a prospective crisis in the balance of payments comparable to that in the stock market of 1929 but because this may also be a case more for the structuralist than for the monetarist.

As you know, our domestic economy is exhibiting an inadequate rate of expansion. After rapid recovery from the 1960 recession, total output in the past year has increased too slowly and has not made any further inroads on the margin of unemployed manpower and unutilized productive capacity. At the same time prices have been generally stable. In these circumstances both fiscal and monetary policy have been directed to stimulating economic activity. For monetary policy, such a posture means encouraging bank credit and monetary expansion and, as a consequence, downward pressure on interest rates.

Meanwhile, our international accounts are in deficit with the result that our gold stock has declined substantially and foreign central banks have accumulated large amounts of dollar claims on us. Our balance-of-payments problem, however, is not of the traditional type. Our trading position is strong and we have a substantial excess of exports over imports. But we are asking this trading balance to carry a part of the foreign aid and military spending programs whose size and characteristics are dictated by the world-wide struggle between communism and our kind of freedom and in that context balance-of-payments difficulties have a lesser priority. This doesn't mean that the balance-of-payments problem can be swept under the rug but only that additional methods of paring down the deficit will have to be found.

The other element in our excess of payments abroad is an outflow of private capital, both short and long term. This capital flow takes many forms and ordinarily would be entirely appropriate for the richest country in the world. When I say this, I mean there is a very fundamental difference between a balance-of-payments deficit based on spending beyond one's income for current consumption and investing one's savings in the expectation of earning a return and getting back the principal. The latter is what we are doing and it is no more profligate than any saving-investing act. Actually, as a result of these investments, we have added about 23 billion dollars to our private holdings of foreign assets in the past 5 years, bringing the total to about 60 billion dollars. Moreover, U. S. Government claims on foreigners rose about 5 billion dollars in these years to a total of roughly 22.5 billion dollars. As these asset categories have been rising we have lost nearly 7 billion dollars of a non-earning asset -- gold, and added about 12 billion dollars to our liquid liabilities. Over-all this is clearly a significant strengthening in our balance sheet position.

But there is a problem here, partly psychological, partly technical, and wholly one of timing. At the moment, our capital outflows, though they add to our future inflows of dividends, interest, and the return of capital, press on our current liquidity position.

One way to curtail the net outflow of capital is to reduce the interest rate incentive for Americans to lend abroad and for foreigners to borrow here. As you know, this consideration has been an important influence on Federal Reserve monetary policy (and Treasury debt management policy). In the period of relative ease in monetary policy since 1960, the Treasury bill yield has not been permitted to fall much below 2-1/2 per cent and recently has been closer to 3 per cent, whereas in earlier periods of monetary ease, bill rates fell as low as 1 per cent.

The effort to prevent short-term interest rates from falling has operated as a constraint on the actions of the Federal Reserve to stimulate the economy. If monetary policy had been more vigorous, commercial banks would have been in a position to purchase more earning assets and interest rates would have been under greater downward pressure. On the other hand, if Federal Reserve adopts a more restrictive policy in order to discourage capital outflows, credit availability and interest rates for domestic borrowers will be affected and, consequently, domestic credit-financed expenditures will be deterred.

If our balance-of-payments deficit were of the traditional type, such a monetary policy would be appropriate. Traditionally, balance-of-payments deficits have accompanied domestic inflation. Thus a monetary policy designed to arrest excess demand at home also operated to improve the balance of payments. In our present situation, however, domestic considerations call for a monetary policy just the opposite of that dictated by the balance of payments.

It is for this reason that I call your attention to the analogy with the late 1920's. And, by the same token, we need to give more emphasis to structural approaches to the balance-of-payments problem.

Many of the actions taken by the Government to deal with the dollar problem have, in fact, been of a structural and selective nature rather than aggregative. Foreign aid has been tied to U. S. exports. Export promotion and export credit schemes have been adopted. Duty-free import allowances for tourists have been lowered. Measures of this type are designed to deal with the specific balance-of-payments problem without hampering domestic economic expansion.

The problem before us is whether we can, consistent with our responsibilities as a good citizen of the international community, find and implement enough structural approaches so that we can correct the balance-of-payments disequilibrium without having to undertake monetary actions that are inimical to the domestic economy.

I have not come here with a specific package of proposals that would lead us out of the present dilemma. If these were readily available, and were consistent with all our obligations, they would presumably have been adopted already. What I am suggesting is that we turn our minds and energies more strenuously to finding additional structural approaches to the balance-of-payments problem. The need for solution to the balance-of-payments problem is pressing. But the need to restore vigorous expansion in the domestic economy is also pressing.

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