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THE ECONOMICS OF THE 1980'S

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the 1977 Annual Meetings of the

Allied Social Science Associations

New York City

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The topic of this meeting -- "The Economics of the 1980's -- Post Keynesian Theory" -- comprises one major assumption and several options. The major assumption is that we make it from here to there. Assumptions being the stock in trade of economists, I shall assume that we have assumed this and turn to the options. Under the general heading "Economics of the 1980's" one could talk, with equal justification, about (1) the directions that economics as a discipline might take, (2) about the economic problems that may have to be faced, and (3) about policies designed to deal with these problems. I shall touch lightly on all three areas.

I am indebted to Dan Laufenberg for research assistance and helpful comments.

The directions that economics as a discipline are likely to take are being guessed at today, and in no small measure actually determined, by young researchers choosing their dissertation topics. It is of some interest, therefore, to see how the latest choices that can be observed, indicated by the topics of recently completed dissertations, have been evolving. It is unfortunate that we no longer have a listing of dissertations that are underway.

A review of the doctoral dissertations in political economy in American universities and colleges as reported in the American Economic Review from 1969 to 1976, yields a few notable, if not unexpected, observations. Interest seems to have grown considerably over this period in two general categories of dissertation topics: In "Monetary and Fiscal Theory, Policy and Institutions" the share of dissertations increased from 9.1 per cent in 1969 to 12.9 per cent in 1976. In "Welfare Economics; Consumer Economics; Urban and Regional Economics" it increased from 6.8 per cent in 1969 to 12.0 per cent in 1976. Moreover, interest has apparently faded substantially in one category: the share of dissertations in "Business Administration; including Business Finance and Investment, Insurance, Marketing and Accounting" declined from 19.2 per cent in 1969 to 6.4 in 1976.[1/]

1/ The results reported here were obtained by applying a degree of casual empiricism to the AER dissertation listings. Similar but more detailed directional shifts of interest in economic literature were found in a careful survey undertaken by Naomi and Mark Perlman of the subject matter of the economic publications listed in the Journal of Economic Literature for the period 1970-74. The results of that survey are reported in "The Changing Modes of Data in Recent Research," The Organization and Retrieval of Economic Knowledge, proceedings of a conference held by the International Economic Association at Kiel, Germany.

I find encouraging the apparent ability of economics, indicated in these shifts of interest, to spread itself over new ground. It reflects the concern of economists with "relevance," a much depreciated concept that is nevertheless still "relevant."

It also seems to reflect the fact that economics represents, not just a body of thought about economic phenomena, but a method of analysis that is an ingredient of any theory of choice. Individuals and groups have to make choices in many areas outside the economic one. The analytical techniques developed in economics can make contributions in all of them where quantification is possible, and often also where it is not. From this point of view, the progress of economics will consist in important degree in permeating other disciplines. This process, of course, is already well under way in political science, law, and other fields.

As theory advances, I hope it is not too much to ask that it should also become more responsible. The propensity of theorists to move in one quick step from abstraction to policy recommendation, as it were from the drawing board to the production line, is less than responsible. If there were something in economics like the Food and Drug Administration, presumably that agency would require a careful process of testing before human beings, institutions, and societies could be exposed to new economic wonder drugs. Failure of the public to impose such precautions on economists' prescriptions seems to reflect the widespread view that economic advice is one of the few remaining areas in which amateurs can compete effectively with professionals.

Economic Conditions and Problems

I next turn to my second option -- what are the 1980's going to be like? One of the plausible propositions about the future has always seemed to me that it will be much more like than unlike the past. No doubt, as any other generalization, this is a half-truth, so formulated as to irritate the man who believes the other half. But even though I see much more inertia than change ahead, I feel less confident about this than I would have felt saying the same thing during the 1950's or 1960's.

The recession of 1974-75 and its sequel do seem to mark more of a break than analogous events in the past. Perhaps what is needed is a prolonged period of convalescence, at the end of which the presumptive future may look much more like the past than it does now.

Let me list some specifics. We now have both inflation and high unemployment, and we are less sure than we used to be that we know what to do about either. The rate of growth is likely to be lower. Resource problems, albeit in good part of our own making, are appearing. There seems to be a growing unwillingness to accept the adjustments that need to be made in order to deal with the problems of energy, of job creation, of foreign trade, of regulation. Unless these adjustments are made, the performance of the private sector will become increasingly unsatisfactory. The response then may well be to reach for remedies via the public sector that would further deteriorate the performance of the private, and so on in a vicious circle that may take away from us what we have without giving us what we want.

One thing seems clear. We are further away today from an economy of abundance, from a diminishing concern with material wants, than we believed ourselves to be twenty years ago when we first read "The Affluent Society." For thirty years, economics has focused on the management of demand, in the happy belief that the problems of supply had been solved. Today we are back to the problems of supply. During the 1980's, I believe, the supply side of economics -- labor force, capital stock, energy, food, and materials -- will absorb a greater proportion of economists' attention than they have of late. Accordingly, microeconomics is likely to play a greater role relative to macroeconomics than before.

Policy Issues

Policy issues are my third option for the economics of the 1980's. Since I find myself in a job in which I may have to make some sort of contribution, however modest, to the policy making of that period, this is a matter of practical concern for me. This circumstance, I hope, will be accepted as an excuse for a parochial approach concentrating mainly on monetary policy.

Monetary policy during the 1970's has focused far more heavily on control of the money supply than in the 1950's and 1960's when interest rates constituted the main fulcrum of monetary policy. Monetarism, in other words, has largely displaced Keynesianism. There is more to this than the amiable self-deception of looking at what one has been doing and calling it "policy." There have been reasons for this change of approach. But there is less to these reasons, I believe, than the victory of truth over error, or the advance from a lower to a higher stage of policy making.

Keynesianism was the child of depression, a response to the failure of monetary policy to perform in dealing with the problems of the 1930's. Monetarism, or at any rate its present vogue, is the child of inflation, the response to the defects of Keynesianism and the conditions created by it. The truths of both are relative. If we succeed in overcoming inflation, I expect that the present emphasis on the money supply will diminish and more attention will again be focused on interest rates.

I believe that we can and indeed must overcome inflation. The belief that the system can adjust to inflation, and the attempt to act on this belief, is simply an invitation for inflation to accelerate. An effective way of coping with inflation, in my view, is one in the development of which Sidney Weintraub and I have collaborated, and which has been elaborated, hopefully improved, and fortunately supported by others. About this approach, which uses the tax system as an incentive or penalty for the purpose of winding down inflation, I have talked elsewhere and shall not repeat myself here. Monetary policy, I believe, can also do the job, although it may take longer and cost more. In any event, the job cannot be done altogether without monetary policy.

In order to wind down inflation, it is obvious that the rate of growth of the money supply -- M_1, M_2, or whatever -- must be slowed. The Federal Reserve, in setting its one-year target ranges for the aggregates, has been trying to do that. At the present rate of reduction in those target ranges, the job will take a number of years even if reductions are continuous, as they have been so far. I hope very much that this policy of gradually pulling down the aggregates can be continued. Nevertheless, the Federal Reserve has made clear that the target ranges are subject to change in the light of circumstances. Circumstances could arise that would make an interruption in the downward progression of the target ranges necessary.

One such circumstance could be a slowing in the income velocity of money, especially of M_1. For over two years a relatively moderate growth of M_1 has been made consistent with expected growth of nominal GNP by a downward shift in the demand curve for money, which has meant above normal gains in velocity. Some of these gains have been the result of changes in payments techniques that were instigated by regulatory actions of the banking authorities. Other factors that have contributed to unusual gains in velocity can be interpreted in different ways and are less readily understandable. I have been concerned of late that these special gains might be diminishing, but the evidence is by no means conclusive. The Federal Open Market Committee has been proceeding with great caution, as evidenced by the fact that the Committee, in its monthly directives published since June 1977, has narrowed the range within which the Federal funds rate can move without further action by the Committee, from a usual spread of one per cent to one of one-half per cent.

Returning from these immediate policy concerns to those of the 1980's, it seems clear to me that success in dealing with inflation as well as with other problems will depend on the adoption of more long-run oriented policies than have been our habit in recent years. We have learned that fine-tuning is very difficult. We have learned also, I hope, that if we change our goals frequently, the economy cannot follow these twists and turns. By this I do not mean to say that we should engage in long-run planning. Our political process has given every evidence, I believe, that as a nation we lack the talent for planning. The tendency is to try to do too much too soon, with consequences that tend to accelerate inflation and damage the economy. Instead, we need to put in place policies that will improve the performance of the market system, and then let it work. This means policies that put the long run ahead of the short. If we succeed in doing that, the outlook for the 1980's should be good.