Some Views on Market-Oriented Macroeconomic Policy

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I. Introduction

I am pleased to have this opportunity to participate in this Sixth Annual International State of the Economy Conference. These conferences help to enhance understanding among both the general public and policymakers about critical economic issues that often form the basis for public policies.

Public policies based on false principles or faulty economic reasoning have done great harm in this century. Since the mid-1980s, the world has witnessed substantial changes in the views of economists and policymakers about the role of public policies in influencing economic activity. Regrettably, however, general public understanding has not advanced along with the professional debates.

In my remarks today, I will comment briefly on changes in policy perceptions over the last decade or so, and will then discuss at some length areas of macroeconomic policy in which debate continues among professionals and where lack of public understanding continues to hamper progress toward greater prosperity.

II. Market Forces versus Government Control: A "Contest of Ideas"

During the past six or seven decades, we have witnessed a great "contest of ideas" regarding the efficacy of market-directed versus centrally-directed economies. The 1930s represented a watershed decade around the world. In the wake of a worldwide depression, the response in many countries was to adopt corporate statism as a way of organizing political and economic life. The scope for market forces to direct economic activity was diminished as governments became a partner or boss for many

economic enterprises. Governments throughout the world greatly increased their intrusion into such decisions as what could be produced and where, how much things would cost, how much could be paid for labor, what interest rates could be paid or received, and even how much profit could be earned.

These intrusions were most extreme in the communist nations. The great experiment with central ownership began following the Russian revolution, and after World War II, it expanded to eastern European nations, China, and elsewhere.

For a time, these command systems appeared capable of directing resources toward highly valued political objectives--especially in the military arena. Propaganda machines persuaded many of us that substantial gains in public health and living standards were also being achieved. But in the 1970s and 1980s, it became apparent that those systems were unable to deliver rising standards of living to their people. Most dramatic has been the recent exposure of the vast degradation of environment, infrastructure, and public health in eastern Europe and the former Soviet Union over the past several decades. We now see that the shortcomings of central planning were even greater than most of us had imagined.

While the centrally planned economies were moving toward their inevitable collapse, market economies were sprinting ahead. The mixed-market economies of North America and western Europe have long demonstrated the abilities of market systems and personal freedom to generate ever-greater gains in living standards. More recently, and much more dramatically, the economies of Japan, South Korea, Taiwan, Hong Kong, and Singapore--the so-called Asian tigers--have reinforced this

point.

Indeed, the 1980s seem to have been another watershed decade, a time when previous beliefs about the appropriate role of government in the economy were questioned. People around the world came to recognize that living standards improved most rapidly in countries where markets, not governments, directed resource allocation. This is evident in comparisons not only between the centrally planned countries and the western industrialized nations, but also among Third World countries with differing levels of freedom from government intrusion into everyday economic decisions.

Almost everywhere, government involvement in the economy is increasingly seen as a problem, not a solution. On every continent, we find examples of denationalization (privatization) and deregulation. It is hard to name a single country in which government is aggressively nationalizing private industry--instead, governments are either privatizing, deregulating, or maintaining the status quo. Controls on credit, interest rates, wages, prices, exchange rates, and capital flows are being removed.

As recently as five years ago, when eastern European refugees flooded into the West in the great flight that culminated in the fall of the Berlin Wall and the collapse of the Soviet Empire, no more than 20 percent of the world's 5 billion people lived in some form of market economy. Now, more than half of the world's population live in nations that either have, or are moving toward, market economies. Perhaps the world is entering a golden age of capitalism.

In more and more places and for more and more people, private property

rights are being established and price systems are being used to allocate resources to their most productive uses. Such trends can give a great boost to productive capacity. In the jargon of economists, the world's production possibility boundary is being shifted outward.

III. Continuing Debates about Economic Principles

Despite significant progress in the recognition that market economies are inherently superior to command economies, debate continues about the appropriate role of macroeconomic, or stabilization, policies. Disagreements on these issues are seriously hindering the progress that market economies could be making toward even greater prosperity. Let me now spend a few minutes setting out my views on the debate.

A. The Nature of Market Economies: Stagnation versus Inherent Resiliency

The beginning of the 1980s saw a crisis of macroeconomics in much of the western world. The twin evils of double-digit inflation and double-digit unemployment were frustrating economic policymakers and politicians in most major market economies. Some observers asserted that "the old laws of economics no longer work."

The conventional wisdom then held that there was a trade-off between inflation and employment growth, and that macroeconomic stabilization policies could be used to influence first one, then the other. With the presence of both high inflation and high unemployment, the choice of "tightening" policies to combat the former or "eas-

ing" policies to fight the latter was unpalatable. The frustration fostered the need for reassessing macroeconomic demand management policies.

The search for better policies produced a significant shift in thinking. Several firmly held ideas of the 1960s and 1970s about activist, discretionary macroeconomic policies seem now to have been discredited. Growing numbers of observers recognize the success of approaches that focus on strengthening the functioning of markets.

For several decades following the Great Depression, the predominant view was that a market system was subject to unacceptably large fluctuations in income, output, and employment growth. Often there were assertions about the "inadequacy of aggregate demand" in the absence of government actions to ensure a sufficient amount of total spending.

The underlying concept was that a market economy could stagnate at less than full utilization of its productive resources. The policy prescriptions that followed involved recommendations for various "pump-priming" actions to both stimulate and augment private demand. The menu included increased government spending, especially on various public works or "jobs" programs, reduced taxation, increased monetary growth, greater credit availability, lower nominal interest rates, reduced reserve requirements on bank deposits, and lower margin requirements on securities transactions. One or more of such discretionary policy actions were viewed as essential to jump-start a recovery. Also, forecasts of future economic activity often reflected assumptions about the effects of these stimuli starting to wear off, resulting in diminished growth or another downturn.

An alternative view that has gained adherents in the past decade is that a capitalist system naturally tends toward stability and growth. According to this view, government actions frequently have a destabilizing effect on the economy.

Friedrich von Hayek, among others, challenged the stagnation thesis of the 1930s by arguing that a private, market-oriented economy is inherently resilient and naturally gravitates toward full utilization of its productive resources following any temporary economic shock. These can include wars, droughts, energy or other key-commodity price changes, perverse government policies, and substantial exchange-rate changes. Exchange-rate shocks are especially important to small, open economies.

According to this view, government "pump-priming" not only is unnecessary, but can often be counterproductive. While the intention is to be countercyclical, the result of such actions has frequently been procyclical, because several lags are involved in pursuing discretionary, activist, "demand management" policies. The first lag is in recognizing that growth has slowed or that output and employment are declining. The second lag is in enacting and implementing changes. Tax and expenditure programs can be especially difficult to alter. The third lag is in the time before new policy initiatives start to have an effect. Taken together, these lags can cause lengthy delays in the adoption, implementation, and effect of discretionary policies, even if the theories were correct.

B. The Role of Monetary Policy

Current conventional wisdom in the United States includes some important misunderstanding about the role of monetary policy. For example, consider two

assertions found recently in major national publications:

> *The New York Times* stated that "...reports [of vigor in housing and employment have] fanned fears that overly rapid growth could revive inflation."[1]
>
> *The Wall Street Journal* reported that "the Fed's current goal is to slow the economy to an annual growth rate of about 2.5 percent to avoid a significant acceleration of inflation."[2]

These examples reflect a widely held view that because U.S. monetary policymakers are "anti-inflation," they must necessarily be "anti-growth" or "anti-employment."

My views about monetary policy reject the following three common assertions about monetary policy:

> (1) That interest rates paid by households and business would have remained low this year if monetary policy had remained "stimulative."
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> (2) That rising federal funds rates--or, more specifically, overnight interbank loan rates--will shorten or retard the current economic expansion.
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> (3) That the monetary authorities control inflation by controlling the

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[1] "New Signs of Growth Fan Inflation Fears," *The New York Times*, September 30, 1994, p. 1.

[2] David Wessel, "Fed Decides against a Rise in Rates Now," *The Wall Street Journal*, September 28, 1994, p. A2.

real growth of the economy. (In fact, just the opposite is true: Central banks want to eliminate inflation in order to foster the highest sustainable rate of real economic growth.)

A question that has often been asked in the United States this year is, Why are interest rates rising? By way of analogy, let me start with a different question: Why does the price of apples rise? The answer to this question is, of course, simple. The price of apples rises for either of two reasons. One is that the price of apples increases along with everything else when the purchasing power of money falls--the phenomenon we refer to as inflation. The other reason is that, even when there is no inflation, the price of apples will rise in response to an increase in demand for apples or a reduction in their supply.

This simple example is directly relevant because an interest rate, after all, is really just a price. In particular, it is the price paid to savers and by borrowers. Like apple prices, then, interest rates rise either because the rate of inflation increases--or, more precisely, because the expected rate of inflation increases--or because there is an excess demand for the funds that are provided by national saving.

A blight on orchards would raise apple prices and reduce the quantity of apples demanded at the new higher price. In this case, we would be inclined to believe that the price increase is unhappy news for apple lovers. However, suppose a credible scientific report indicated that apples prevent a variety of diseases. Then the price of apples would soar because of a boom in apple demand--and a corresponding decline in the demand for something else, such as oranges. In that case, one would be

perfectly willing to see the price hike for what it is: the natural consequence of market forces in response to buyers' increasing desire to consume apples.

The failure to think carefully about what is happening to the demand for credit leads some people to ignore the possibility that rising interest rates are merely a by-product of better times. In periods of expanding output, economic prospects brighten, and households and firms respond with a heightened desire to consume as well as invest. In financial markets, these desires translate into less saving and more borrowing. The result is higher interest rates.

Rising market interest rates are indeed important to understanding recent monetary policy actions, but not for the reasons that are generally believed. Central banks do not control interest rates such as mortgage rates, car loan rates, or corporate bond yields. They do control the supply of money. Unfortunately, though, monetary authorities have considerable difficulty in estimating the amount of monetary balances that people want to hold. This is critical because, in the words of Milton Friedman, inflation is everywhere and always a monetary phenomenon.

This crucial point is often misunderstood because central banks employ interbank lending rates to control the quantity of money. If done correctly, money growth will equal money demand, so the price level will be stable. But as general economic conditions change, the interbank interest rate consistent with this result will also change.

Sailing provides a good analogy. The helmsman of a boat leaving the English coast bound for the continent must set the tiller based on wind direction, tides, cur-

rents, and surface chop. Those of you familiar with weather patterns in the English Channel know that it won't be long before the sailor will confront different wind and water conditions than those that prevailed near the coast. Experience, of course, will lead the helmsman to adjust the tiller in response to evolving conditions. Such an adjustment certainly does not imply a change in destination. Quite the opposite: The adjustment is required if the boat is to have any hope of reaching the destination as planned.

This is how I would like the public to think about monetary policy actions. In response to changing economic weather, it has been imperative that central banks adjust the monetary tiller, lest they drift ever further from the unchanged goal of price stability. It is also important to understand that price stability is not the ultimate objective.

I would argue that monetary policy actions this year are part of a long-term pro-growth policy. The rationale for focusing on the purchasing power of money is rooted in the overriding goal of maximizing social welfare. This requires that policy be devoted to promoting the conditions that yield the highest rate of sustainable economic growth in the long run. Sound money is crucial to sustained prosperity.

When the price level is uncertain, market participants face the prospects of capricious and unanticipated redistributions of wealth. Because of this, uncertainty about the future purchasing power of money channels resources away from the direct production of consumption and investment goods and toward activities that serve only to protect decisionmakers from the reallocative consequences of inflation.

Achieving price stability would be akin to a technological advance. It would release resources from inflation hedging/risk avoidance activities and increase the amount of real goods and services that can be produced with the economy's existing resources. In this way, moving toward price stability is pro-growth. Thus, it is a false dichotomy to view monetary policy actions as either "pro-growth" or "anti-inflation."

In my view, it should be mandated that monetary authorities have no objectives regarding short-run growth of output, employment, or other real magnitudes, because maintenance of price stability is the only sustainable growth-oriented monetary policy.

C. Continuing Debates about Fiscal Policy

Improved understanding of the effects of the spending and taxing actions of government can also lead to better economic performance. A crucial ingredient in fiscal policy is the adoption of clear rules limiting the scope of discretion so that consistency over time is assured. Under consistent policy, households and businesses face less uncertainty and are thus able to make better decisions about consumption, saving, investment, and production.

Contrary to conventional wisdom, changes in the levels of government expenditures or tax revenues have little lasting effect on total spending in the economy. The notion of a balanced-budget multiplier or an even larger deficit-spending multiplier is no longer accepted by most economists. Any transitory effect on total spending in the economy as a result of a change in government expenditures or tax revenues will be approximately matched by an opposite effect in a relatively short period of

time.

However, government spending and taxing can influence the allocation of the economy's resources, which can change the long-run growth path of output. The extent to which resources are used to satisfy demand for current consumption rather than to enhance potential future output and consumption is the critical dimension. It is these allocative effects, rather than any presumed addition to total demand, that determine the merits of alternative fiscal programs.

The whole array of government expenditure programs, including credit subsidies or other transfers to producers or various consumer groups, government production of goods and services, and federal capital-expenditure programs, should be evaluated from the resource-allocation standpoint. Similarly, alternative methods of collecting tax revenue must be assessed with regard to their effects on resource allocation and incentives.

A common misperception is that the burden of taxation is determined by the current level of tax revenues. The true fiscal burden is actually determined by the amount of government spending. Ultimately, all government expenditures must be financed by present or future explicit taxation, by government money creation, or by unilateral transfers (gifts) from foreign sources. Actions that reduce current tax revenue without decreasing either present or future government expenditures do not constitute a reduction in actual tax burdens. Conversely, decisions that reduce either the current level or the growth of government expenditures from what they otherwise would have been are a genuine reduction in tax burdens, even if explicit tax revenue

is not altered.

Another common misperception is the belief that by levying taxes on businesses, a tax burden on individuals can be avoided. But in reality, only individuals ultimately pay taxes. Tax policies should be evaluated by considering whether individuals bear the tax in their roles as workers, consumers, or investors. To tax something is to discourage it, and the most important dimension of a tax regime is its effects on incentives. Nations should not use tax policies that discourage working, saving, investing, inventing, or innovating. The primary incidence of taxation should fall on consumed income, or some measure of household or individual expenditures; taxation should be minimized or avoided on capital assets. The ownership and use of productive resources should not be discouraged by taxation.

Despite much wishful thinking, deficit spending is not an alternative to explicit taxation. Rather, it is a method of deferring explicit taxation, or changing the method of taxation to the implicit tax associated with debasement of the nation's currency. Inflation is just a different way to tax. In this sense, monetary policy can be viewed as a fiscal instrument--an alternative method of financing government expenditures.

To the extent that government issuance of debt occurs, zero-coupon bonds or index-linked bonds, stated in real interest rates just as British gilts are, should be used. Such indexing removes the possibility that government will be tempted to finance its expenditures through inflation.

A general principle is that government should do only those few things that the market economy clearly cannot do well. Because such a standard can be difficult to

apply, an alternative approach is to set a specific limit on government spending that can be altered only by constitutional amendment or super-majority of the legislature. The limit could be expressed as a share of national income or as a rate of growth. Part of the objective is to create an effective budget constraint on the government wherein opportunity cost cannot be ignored.[3]

Let me say a bit about support programs, which have grown explosively in the last half of this century. Whether they provide for basic necessities such as food, clothing, shelter, medical care, or any other type of subsistence, support programs should be means-tested so that income transfers to middle- and upper-income members of society are avoided. Further, government may choose to mandate, but should not administer, retirement programs. Any such programs need to be fully funded to avoid the negative effects on saving of redistributive pay-as-you-go schemes. The latter redistribute resources toward individuals with higher consumption propensities (the retired) and away from those (active workers) with lower consumption propensities. Fully-funded systems, on the other hand, if credible, serve to redistribute consumption intertemporally (toward the future), and thereby promote current saving. The example of privately administered, competing pension programs, such as exist in Chile, would be a better model than the U.S. Social Security System.

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[3] James Buchanan argues that there should be a constitutional limitation on "the absolute level of fiscal exaction." See "Constitutional Imperatives for the 1990s" in *Thinking About America: The United States in the 1990s*, Annelise Anderson and Dennis L. Bark, eds., Hoover Institution Press, Stanford University, 1988, p. 256.

IV. Summary and Concluding Remarks

Despite substantial advances around the globe in professional understanding of the role of public policies in economic activity, the general public's understanding of these issues often is flawed.

The idea that command-directed economies can function well has been thoroughly discredited, and most nations are moving toward greater use of market forces to guide their economies. Nevertheless, there are still significant disagreements about the Phillips curve, the stagnation thesis, the efficacy of demand management policies, the goals of monetary policy, and basic principles of fiscal policy. To the extent that activist, discretionary macroeconomic policies are being pursued, the world is less prosperous than it could be.

I have a word of advice for government authorities in nations that are shifting from centrally-directed to market-oriented economies: Don't make the mistake of signaling a lack of confidence in the magic of the marketplace by trying to accelerate the adjustment process with artificial "pro-growth" policies to boost aggregate demand. Recessions are caused by excessive prior stimulus, not by a lack of current stimulus to aggregate demand. Proactive, discretionary "demand management" strategies should be resisted. Institutional arrangements such as enforceable property rights are much more essential to economic development than are discretionary economic policy actions, no matter how well-intentioned they may be.

In the case of both fiscal and monetary policies, establishing rules that will constrain the degree of discretion that policy authorities can exercise over time should

be a high priority. The objective is to minimize uncertainty on the part of private agents toward the economic environment they will face in the future.

In this final decade of the century, it seems that the clearest trend around the world is to reduce the role of the nation-state in economic affairs. Deregulation, denationalization/privatization, and tax reduction/tax reform are all part of a process that is restoring and enhancing the wealth-creating capability of markets. Resources, especially investment capital, move quickly to those regions that are making the most progress--such as today in Mexico, Argentina, or the Czech Republic--while resources move away from those regions making little or no progress. This trend is part of what I consider a healthy process of re-instituting nineteenth-century economic liberalization. The result will be a freer and more prosperous world, with ultimate autonomy not in the nation-state, but in individual choice.