

# FEDERAL RESERVE BANK OF ST. LOUIS

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# REVIEW



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# Public Policy for a Free Economy

Remarks by DARRYL R. FRANCIS, President, Federal Reserve Bank of St. Louis,  
Before the Students and Faculty of Washington University, for the  
Dedication of the Center for the Study of American Business  
Washington University, April 3, 1975

**I**T IS A distinct privilege to be the first speaker to address the Center for the Study of American Business. I view the inauguration of this center as a timely event, and one that marks the beginning of a program that could have a profound impact on the future of economic freedom in America. While my discussion will be limited to economic freedom, the ideas that I will express have a bearing on all freedoms — economic, social, and political. In my view the three are interdependent, and no one of them can exist without the others.

Let me begin by stating the basic premises upon which the discussion will rest. I view economic freedom as the freedom to determine and to seek to satisfy one's own wants as he sees them. Aside from its desirability as an end in itself, I subscribe to the widely held doctrine that the promotion of economic freedom is consistent with the attainment of the maximum possible standard of living for society. According to this view, state regulation should be viewed with suspicion as a potential enemy of society's material well-being. On the other hand, maximum freedom for individuals to act in their own self interest should be viewed as a source of the variety and diversification of ideas, experiments, and innovations which lead to the discovery of new products and more efficient means of production. If one accepts these premises, then a free economy should be viewed not only as precious in itself, but also as the most promising means by which the standards of living of all members of society can be raised.

## *The Role of Government — In Theory*

If we accept the foregoing proposition, as I am sure most of us do, what then is the role of public policy in assuring a free economy? I see the role as follows. The maintenance of maximum economic freedom demands the organization of our economic life largely through individual participation in a game with definite rules. The necessity of rules arises because absolute economic freedom is impossible. One man's

freedom can conflict with another's security and property rights. Hence, each person must give up some freedom in order to resolve individual conflicts. The major problem is determining those freedoms which the individual should give up in order to resolve conflict with others.

Just as a good game requires player acceptance of both the rules and an umpire to interpret and enforce such rules, so a free society requires that its members agree on the general rules that will govern relations among themselves, and on some device for enforcing compliance with them. Unfortunately, we cannot rely on custom or consensus alone to interpret and to enforce the rules; we need an umpire. These then are the basic roles of government in a free economy — to provide a means whereby we can establish some set of general rules, and to enforce compliance with the rules on the part of those few who would otherwise not play the game.

The advocate of a laissez-faire policy today realizes that there is a constructive role for government in the economy; he is not an anarchist. He recognizes that a system which promotes maximum economic freedom may not be a god-send and that its existence depends, in part, upon affirmative government action. However, he also recognizes that each new governmentally enacted rule of the game involves a loss of some freedom. Herein lies the problem; where do we draw the line? At what point does affirmative government action begin to have a net negative impact on economic freedom?

I can offer you no hard and fast principles on how far it is appropriate to use government to maximize economic freedom. However, I would suggest to you that in any particular case of proposed intervention, we should make up a balance sheet, listing separately the advantages and disadvantages of the proposed policy. Most importantly, we must always enter on the liability side of any proposed government intervention its effect in threatening freedom, and give this effect considerable weight. For it is an indisputable, yet



frequently overlooked, reality that every new rule has its costs in terms of a loss of some freedom.

### *The Role of Government — In Practice*

We have witnessed abroad the culmination of movements from constitutional government to dictatorships, from freedom back to authority. This spectacle, for most of us, is revolting, and something to be avoided at all costs. Yet, faced with the same problems as these other nations, we too have often adopted measures which call for more government authority and less individual freedom. We have often been too eager to justify and rationalize policies which propel us in a direction in which we overwhelmingly disapprove. As an indicator of how far and how fast we have moved in this direction, consider for a moment just a few facts and figures which are indicative of the tremendous growth of the government's influence on our economy.

1) It took 186 years for the Federal budget to reach the \$100 billion mark, a line we crossed in 1962, but in only nine more years we reached the \$200 billion mark, and in only *four* more years we broke the \$300 billion barrier.

2) In 1930, prior to the New Deal, government spending at all levels accounted for just 12 percent of our gross national product. Today, government spending accounts for over 32 percent of our gross national product, and if present trends continue, government could account for as much as 60 percent of GNP by the year 2000.

3) As the role of government has increased, the bureaucracy has also grown so that today one out of every six working men and women in this country works directly for either Federal, state, or local government.

Why is it, in light of the record, that the burden of proof still seems to rest on those of us who oppose new government programs which curtail our freedoms? Why is it that society seems so bent on curtailing the very freedoms that have netted us the highest standards of living and economic freedom in the entire world?

I submit to you that the reason for this drift is that there are natural biases in its favor. One of these biases has to do with what I will call the regulatory reflex that seems to have grown to almost epidemic proportions in our country. The other has to do with the same political realities which led Joseph Schumpeter to argue thirty years ago that there was an

irreconcilable conflict between democracy and free enterprise.

### *Regulatory Reflex*

The regulatory reflex operates in the following manner. Upon observation of what some individuals deem an undesirable result produced by the free enterprise system, government officials or the press suggest that this is an area in which the government should "do something." This usually has meant the creation of a powerful new government agency, or an increase in the powers of an existing one. Such an agency is empowered to make decisions regarding the allocation of resources according to its own interpretations of what is best, rather than leaving the outcome to determination by the market process.

Implicit in this reflex is the assumption that the free market system produces undesirable results and that government planning is the means of achieving a more desirable end. Unfortunately, the desired end sought by a group of regulators is frequently not the same as that which the members of society would choose for themselves. The process often results in some group of zealots determining that others should not have what they want, but rather should accept that which the regulators consider "best" for them. This type of thinking, combined with the power to implement it, poses a tremendous threat to freedom, and yet it is becoming increasingly common. For example, witness the proposed compulsory health insurance, social security, seat belt interlock mechanisms, and the issuance of food stamps instead of money to the poor, and the not so poor, to name just a few.

Another aspect of this regulatory reflex is that there are many people who still subscribe to the medieval notion that all business is a zero-sum game. That is, many people believe that one person's profit is another person's loss. Such notions are behind the frequently heard demands that the government should intervene in the market to limit what some consider to be the "obscene" profits of entrepreneurs and "protect" the powerless consumer. This kind of thinking is based on a notion that is absolutely false. Its acceptance requires that we also accept the proposition that some parties to all transactions are either irrational or victims of a fraud.

Free individuals will enter a transaction only if they can benefit their own interests as a result. Business transactions are never a zero-sum game as long as the participants are free to choose for themselves and as long as they have alternative choices. There is



no question that there are shoddy practices in every profession and that market economies produce goods that are often undesirable to some individuals or poorly made. However, the beauty of the free market system is that if the consumer does not want to purchase such products, he has alternatives, and the businesses that produce them will either shift to accommodate consumer desires or they will fail. The fact is that the alternative to free markets, planning by government bureaucracies, also results in the production of shoddy and expensive products (the postal service and automobile modifications, for example). The crucial difference, however, is that the plans pursued by bureaucracies are not subject to the forces of market competition, and therefore there is no way to test their relative efficiency or acceptability.

I believe that much of the blind faith in the efficacy of government intervention stems from impatience and shortsightedness on the part of many individuals, aided, of course, by the lobbying of those who stand to gain directly from a particular regulatory proposal. Most policies are formulated with an eye to the short run. In a familiar pattern we see a situation arise in which the short-run outcome of the interaction of free market forces is considered by many to be less than socially optimal. The key question is what is the alternative? For example, we have experienced several years of inflation. Impatience leads many to clamor for the quickest solution to the problem. Certainly, in this case, many people believe that wage and price controls fit the bill. A rigid system of wage and price controls will in fact keep reported prices from rising in the short run. Unfortunately, such controls will also create shortages and distortions in the economy that result in severe bottlenecks in the production process. *Reported* prices are temporarily fixed, but the consumer is robbed of the right to purchase those items which are in short supply. However, everyone concentrates on the immediate impact of the controls on the movement of reported price indices and says, "You see how simple that was?"

So it is with most cases of state intervention. The seemingly beneficial effects are direct, immediate, and visible. On the other hand, the undesirable effects are often gradual and indirect, and are frequently considered only when they actually occur, if even then. However, the ignored long-run costs of such intervention eventually show up. And, when they do, there is a call for more short-run intervention to correct the problems which arose as a result of the earlier policies. Over a long period of time there is a cumulative

and disastrous effect which erodes freedom and detracts from the efficiency of the economy.

Unfortunately, it is a truism that regulation begets further regulation and that regulations outlive their rationale. Though most government regulation was enacted under the guise of protecting people from abuse, much of today's regulatory machinery only provides jobs for the regulators, increases the cost of doing business, and shelters those who are being regulated from the normal consequences of free enterprise competition. In some cases, the Interstate Commerce Commission for example, the original threat of abuse no longer exists. In other cases, the regulatory machinery has simply become perverted. In still other cases, the machinery was a mistake from the start. In any case, the individual, from whatever presumed abuse he is being spared, is paying for the regulation through both a loss of freedom and a loss of material well-being.

While many regulatory programs seem to accomplish their goal (desirable or not) in the short run, they are seldom successful in the long run. The central problem with all of these measures is that they all involve an abridgement of some freedoms. They seek through government to force some individuals to act against their own immediate interests in order to promote a supposedly general interest. They substitute the values of outsiders for the values of participants. Some people are telling others what is "good" for them, or else the government is taking from some to benefit others. These measures are therefore counter to the attempt by millions of individuals to promote their own interests and to live their lives by their own values. This is the major reason why the measures have so often had the opposite of the intended effects.

### *Possible Conflict Between Democracy and Free Enterprise*

Despite the fact that the regulatory reflex contaminates so much of our society, I do not believe that it could be as pervasive as it has been were it not provided with a political framework conducive to its proliferation. Consider the situation in a community in which the mass of the people are in favor of economic freedom of choice in their daily lives and are against government direction. As will normally happen, however, many groups are formed which perceive an opportunity for material gain through a particular form of government intervention. Under the guise of such slogans as "fair prices," "equitable wages," or "fair trade" laws, they perceive an opportunity to be pro-



tected from the sources of competition. In such situations a political party hoping to achieve and maintain power will have little choice but to use its power to buy the support of these special interest groups by catering to their legislative demands. The reason they will do so is not necessarily because they think that the majority of society is interventionist, but rather because they cannot achieve and retain a majority if they do not solicit support through the promise of special advantages. This means, in practice, that even a statesman wholly devoted to the maintenance of freedom, and who realizes that every new regulation is an abridgement of those freedoms, will be under constant pressure to satisfy the interventionist demands of organized groups.

Some special interest groups undoubtedly favor intervention not for personal gain as much as for what they determine to be for the "good of society." These groups labor under the illusion that they can draft a law to prevent every outcome which they, and frequently only they, deem undesirable. In this case, the operation of the regulatory reflex merely feeds an insatiable appetite for power on the part of those who wish to impose their values on the rest of society. When regulation fails to accomplish its goals, as it almost inevitably does, these people do not call for the repeal of the laws. Instead, they push to amend them into infinite complexity until the purpose of the original law is lost. As a result, the hand of regulation ends up touching every aspect of human action. It is not only wasteful, but serves to destroy incentive and to discourage ingenuity.

### Conclusion

It is ironic that groups which constantly look for problems in our country insist on inhibiting the ability of the economy to respond to these problems. For

example, present technology does not permit us to have surgically clean air and plentiful electricity at less cost at the same time. However, there is no reason to believe that future technology could not provide those benefits. The essential ingredient is freedom to react to incentives and an understanding that individual liberty is not only precious, but efficient. Just as thought control is the great enemy of the freedom of inquiry in academia, economic controls are the great enemy of economic freedom and the entrepreneurial spirit which is needed to solve our problems.

Rediscovering the indivisibility and efficiency of political and economic freedom will take time in a society which has become so accustomed to over-reliance on government intervention. The political and intellectual bias against the free market is strongly entrenched, and there are some who will always find a platform to continue to feed this bias out of a complete misunderstanding of both the political and the market functions.

Those of us who firmly believe in the preciousness and efficiency of a system which maximizes economic freedom more often than not find ourselves on the defensive. Given the biases that seem to continuously propel our society away from such a system, being merely defensive is not nearly enough. We must take the offensive and encourage others to restudy the philosophy of free enterprise. It is in this regard that I applaud the inauguration of the Institute for the Study of American Business. We need to drive home the point that every new rule of the game involves the loss of some freedom and that one cannot erode freedom in one sector of society without adversely affecting all others. In other words, we must insist that public policy be based on a recognition of the desirability, efficiency, and interdependence of political, social, and economic freedom.





# Inflation, Unemployment, and Hayek

ROGER W. SPENCER

**I**N THESE times of high unemployment and rising price levels, one looks to the leaders of the economics profession for analysis and solutions. One possible candidate, who has investigated these problems in detail, is Friedrich August von Hayek. Hayek was awarded a share of the Nobel Prize for Economics last autumn. Born in 1899 in Austria, Hayek is probably better known in Europe than in the United States. After spending his formative years studying economics and law in Austria, he moved to England in 1931 and then on to the University of Chicago in 1950. Hayek accepted a chair at the University of Freiburg in Germany in 1962. Several years later he returned to Austria, where he now lives.

After teaching and publishing extensively in the economics field during much of the first forty years of his life, Hayek became more interested in political and social developments. In fact, he is best known for his *The Road To Serfdom*<sup>1</sup> which projected a dim future for capitalistic societies, given the steady encroachment of government into all phases of private life. That book, plus his participation in the founding of the Mont Pélèrin Society in 1946, placed Hayek in the front ranks of laissez-faire advocates throughout the world.

There was a time, specifically during the 1930s, when Hayek and John Maynard Keynes were intense rivals for the attention and leadership of the economics profession.<sup>2</sup> The obvious problem in those (perhaps simpler) days was unemployment alone, and any analysis, such as Hayek's, which also included the likelihood of a rising price level, was doomed to rejection. Keynes emerged the clear winner; his analysis of "inadequate" aggregate demand and prescription of stepped-up government spending were adopted by all capitalistic nations by the 1940s. From that time on, active governmental intervention to secure full

employment became the chief economic obligation of the leaders of the western world.

Today, Keynesian economic principles are being questioned more than at any time in the past thirty years. Economists are seeking new explanations and some have begun to look in the direction of Professor Hayek. This article is devoted to presenting and interpreting Hayek's analysis of inflation and unemployment.

## INFLATION

We discuss the inflation issue first because Hayek took the view that an extended period of rising prices would likely lead to a serious recession or depression. A concise explanation of this hypothesis was advanced in Chapter 21 of Hayek's book *The Constitution of Liberty*.<sup>3</sup> This chapter, entitled "The Monetary Framework", summarized a good deal of Hayek's economic analysis developed during the preceding forty-year period.

### Causes

The chief cause of inflation, Hayek wrote, is governmental control of the money supply.<sup>4</sup> As the government endeavors to provide more services, it tends to run up more debt. The increase in its own debt prompts government to take a more active interest in national financial matters — the creation of money, in particular. Hayek reasoned that as long as the government can avoid extensive debt financing, it is possible to maintain a completely free and independent monetary system. Increases in the money supply, which stimulate aggregate demand, constitute the underlying source of inflationary pressures. It is not a

<sup>3</sup>F. A. Hayek, *The Constitution of Liberty* (Chicago: The University of Chicago Press, 1960).

<sup>4</sup>In Hayek's words, "with government in control of monetary policy, the chief threat in this field has become inflation. Governments everywhere and at all times have been the chief cause of the depreciation of the currency. Though there have been occasional prolonged falls in the value of a metallic money, the major inflations of the past have been the result of governments' either diminishing the coin or issuing excessive quantities of paper money." *Ibid.*, pp. 327-328.

<sup>1</sup>Friedrich A. Hayek, *The Road to Serfdom* (Chicago: University of Chicago Press, 1944).

<sup>2</sup>"... it is hardly remembered that there was a time when the new theories of Hayek were the principal rival of the new theories of Keynes." John Hicks, *Critical Essays In Monetary Theory* (London: Oxford University Press, 1967), p. 203.



conscious desire of the government to foster inflation. However, short-run political expediency and guarantees of full employment and assorted other amenities of life for all citizens make a growing government, expanding money supply, and inflationary pressures virtually inevitable. The assorted amenities include social security programs, rent and food subsidies, and legislation designed to put floors under wages and ceilings on consumer prices.

Elsewhere in *The Constitution of Liberty*, Hayek specifically singled out labor unions for their part in fostering inflation and unemployment. It is his contention that by permitting unions to force up wages, the government is put into the position of validating the wage-price pressure through money supply increases, or facing general unemployment by failing to validate the union action.

Besides curbing government and union power, Hayek's solution to rising price levels involves stabilizing the rate of growth of the money supply. A rule of some sort, which recognizes the inexact relation between monetary policy actions and changes in the price level, is considered desirable because it lessens inflationary pressures and removes monetary policy actions as a source of uncertainty to private decision makers. The lessening of uncertainty has long been of interest to Hayek, especially with regard to the free market economy.<sup>5</sup>

### Consequences

What could we expect from growing inflationary pressures? Writing during the period of relative price stability in the late 1950s, Hayek described a number of events (although he did not list them) which accompany the onset of inflation. The following is an interpretation (and *only* an interpretation) of his view of these events, many of which were later realized:

(1) *At first, virtually all firms enjoy increased profits* because the jump in prices is not anticipated. Since most of their liabilities are contractually fixed in price (for a time) and their assets are not, the rise in asset prices enhances firms' net worth. Thus, in a rising market, as evidenced during the long expansion of the 1960s, profits expand and relatively few firms fail.

<sup>5</sup>F. A. Hayek, "The Use of Knowledge in Society," *The American Economic Review* (September 1945). In this article, Hayek wrote about the capacity of a free market economy to lessen uncertainty via the transmission of information which occurs as individual transactors make demand and supply decisions. Hayek is credited with being one of the early contributors to the current cost-of-information approach to micro and macroeconomic analysis.

(2) *Inflation encourages debt — private as well as public.* With growing incomes, people seem to be less reluctant to take on debt than at other times. Whatever one's view of the desirability of private debt, there can be little doubt that it has escalated rapidly in recent times. Private debt increased 300 percent over the past fifteen years. Public debt about doubled over this period, while that part of the public debt held by the Federal Reserve — which directly inflates commercial bank reserves and the money supply — approximately tripled.

(3) *Real costs, profits, and income become difficult to ascertain.* Price movements act as a veil concealing the true course of important economic variables. Recent efforts to uncover the values of "real" interest rates, "real" money supply, "real" profits and the "real" inventory situation suggest the accuracy of this observation.

(4) *Progressive taxation, coupled with rising prices, affects investment adversely.* It is difficult to show that investment growth has slowed over the past fifteen years, or that progressive taxation might have contributed to any such slowing. There is evidence, however, that profits have slipped in recent years and it is possible that taxes were partially responsible. Quite likely, the stimulative effects of unanticipated inflation on profits in the early 1960s were later reversed as price anticipations began to catch up with reality.

(5) *Sliding scale contracts emerge.* These are both a cause and a consequence of continuing inflation. Besides the growth in the number of union workers whose wages are altered monthly by changes in the consumer price index, social security payments have added over 30 million people to the list of individuals whose income is directly adjusted to changing price levels.

(6) Over an extended period, *the unemployment rate accompanying sustained inflation is no lower than in the absence of sustained inflation.* In Hayek's words, "The reasonable goal of a high and stable level of employment can probably be secured as well as we know how while aiming at the stability of some comprehensive price level."<sup>6</sup> Inflation may initially contribute to a lowering of the unemployment rate below what it would otherwise be, but after inflationary expectations catch up with reality, this is no longer the case. In other words, this means that the Phillips curve does not exist in the usually hypothesized "rounded - L"

<sup>6</sup>Hayek, *The Constitution of Liberty*, p. 337.



shape. Events of the past few years give credence to this hypothesis.<sup>7</sup>

(7) *Inflation leads to more governmental control.* Control is difficult to quantify, but the steady rise in all government employment relative to total employment, in government spending relative to total spending, and the recent price-wage control experience are all suggestive of increased control.

(8) *If prices do not continue to rise at an accelerating rate, a serious recession or depression is inevitable.* "Once it [inflation] has continued for some time, even the prevention of further acceleration will create a situation in which it will be very difficult to avoid a spontaneous deflation."<sup>8</sup> In 1973-74, a serious recession occurred despite continued *acceleration* of price increases. Just what is the relation of the recent increase in unemployment to Hayek's conjectures is not clear. For one thing, Hayek was vague in his later writings concerning the specific mechanism which would produce unemployment. For that reason, it may be profitable to turn to earlier analysis in which he spelled out in more detail his beliefs regarding the emergence of unemployment.

## UNEMPLOYMENT

Hayek advanced a prices-unemployment argument in the 1930s which was derived largely from his version of the concept of "forced savings."<sup>9</sup> A brief summary of the argument follows.

Starting from full employment, let us suppose there occurs a rise in bank credit to firms. The rise in such credit is accompanied by a fall in the market rate of interest below the "natural" rate.<sup>10</sup> The additional

credit permits firms to pay higher prices for factors of production, and they are able to bid resources away from consumers. The assumed shift in resources toward the production of more producer goods and fewer consumer goods leads to higher prices and a reduced supply of consumer goods. Many consumers, rather than pay the higher prices, choose to add to their savings — thus the term "forced" savings.

Sooner or later the banking system, taking note of inflationary pressures, cuts back its credit advances. Unless "new" saving is forthcoming, the market rate rises to the natural rate of interest, making investment projects, which appeared lucrative at the old, lower rate of interest, no longer profitable. The prices of consumer products continue to advance due to the earlier supply reduction as well as to the fact that the uncompleted investment projects add nothing to the existing stock of consumer goods. Workers in the declining investment goods industries cannot be easily shifted to consumer goods industries; thus unemployment emerges in the face of rising price levels.

If one gets the impression that this argument is something other than iron-clad, then one is probably on the right track. Economists were intrigued and baffled by Hayek's logic throughout the decade of the 1930s. But since Hayek's price effect went the wrong way (up), contrary to the experience of the 1930s, the Hayekian view was set aside.

Sir John Hicks, also a Nobel Prize winner in Economics, recently made another attempt at interpreting Hayek's theory. Recognizing the irrelevance of Hayek's diagnosis to the conditions of the 1930s, Hicks stated that, "because it was wrong then, it does not follow that it must always be wrong. It is possible that there may be conditions to which it is appropriate; and in these days (in 1967) one may not have to look very far before one finds them.

"It *can happen* that there is unemployment even while there is inflation."<sup>11</sup> Hicks envisioned conditions in which unemployment would occur due to a decline in the marginal productivity of labor. If labor fails to accept a decline in *real* wages, which could occur for any number of reasons, unemployment could arise in conjunction with rising price levels. The reason for the decline in real wages accompanying a fall in labor's marginal productivity might be disadvantageous shifts in foreign trade, the destruction of capital through war or political upheaval, or more rapid population growth.

<sup>7</sup>See the Prices and Unemployment chart of Darryl R. Francis, "Inflation, Recession — What's a Policymaker To Do?" this *Review* (November 1974), p. 6 for an indication of the failure of this relation to assume the rounded-L shape.

<sup>8</sup>Hayek, *The Constitution of Liberty*, p. 332.

<sup>9</sup>Hayek's most specific "forced saving" ideas can be found in *Prices and Production* (London: George Routledge & Sons, Ltd., 1946). See also F. A. Hayek, *Monetary Theory and The Trade Cycle*, trans. N. Kaldor and H. M. Croome (London: Jonathan Cape, 1933), and *Profits, Interest and Investment and Other Essays on the Theory of Industrial Fluctuations* (London: George Routledge & Sons, Ltd., 1939) for elaboration. The concept of forced saving, popular with numerous classical and neoclassical economists, can be traced at least as far back as Richard Cantillon, a Physiocrat, writing between 1730 and 1734. See Roger W. Spencer and William P. Yohe, "A Historical Analysis of the 'Crowding Out' of Private Expenditures by Fiscal Policy Actions," Federal Reserve Bank of St. Louis Working Paper No. 13 (January 31, 1971).

<sup>10</sup>Wicksell explained the natural interest rate as the rate "at which the demand for loan capital and the supply of savings exactly agree." Knut Wicksell, *Lectures on Political Economy*, Vol. II, *Money*, ed. Lionel Robbins (London: Routledge & Kegan Paul Ltd., 1935), p. 193.

<sup>11</sup>Hicks, *Critical Essays*, p. 214. Italics supplied.



But it is by no means excluded that it should happen for Hayek's reason: in the aftermath of an attempted expansion, greater than the economy was able, or willing, to afford — so that it has been abortive. If shortages develop from such a cause, prices will rise; . . . there may be no rate of price-rise which will not be altogether explosive, unless so severe a hand is kept upon the monetary circulation that unemployment results. There may be rapid inflation; but if it is to be kept down to a finite rate of inflation, there must be unemployment. This is the Hayek 'slump'. To such conditions the Keynesian prescription is irrelevant, as irrelevant as Hayek's was in 1931.<sup>12</sup>

How might we interpret the Hicksian view of Hayek, with an eye toward explaining price-unemployment developments in the 1970s? First, it is clear that the economy was overstimulated for a number of years, beginning in the 1960s. Second, "shortages" of all sorts emerged in the 1970s. Third, there has been a sharp decline in real wages. Fourth, although monetary expansion and inflation continued through much of the 1970s, a firm enough hand was kept on the monetary controls that money supply growth dropped sharply in 1974. Fifth, unemployment has risen substantially.

## IMPLICATIONS

Obvious modifications must be made in Hayek's basic theory to explain current economic developments. Hayek's increases in bank credit, or money supply as some might say today, have not benefited private investment, but rather government, at the expense of consumers. If one takes the long view, it is striking that consumer spending as a percentage of GNP declined from 75 percent in 1929 to 63 percent in 1974 while government spending increased over that period from 8 percent to 22 percent. Investment, which was at 16 percent of GNP in 1929, stood about unchanged at 15 percent in 1974. If Hayek had foreseen in the 1930s this rapid growth of the government sector, he would undoubtedly not have waited so long to shift the emphasis of his theory of "slumps" from one which accentuated excessive business expansion to one which highlighted excessive government growth.

Another obvious change in Hayek's theory required to accommodate actual events is the necessity of introducing exogenous supply shifts. The "shortages" envisioned by Hayek occur entirely because of prior excessive demand. There is no doubt that rapid increases in demand on a worldwide scale the past

decade contributed strongly to the recent shortages of such items as food, oil, paper, and chemicals. However, it is necessary to note, especially in the case of fuels, that an important decrease in supply also occurred. One might attribute this to government wage and price controls, effective oligopolies, or to a disadvantageous shift in the terms of trade, as suggested by Hicks.

The above are probably the two most important changes required to update Hayek's views on unemployment and inflation. Given that we are still experiencing economic discomfort in both these areas, what policies would Hayek prescribe to alleviate the situation? First, he would probably remind us that we would never have gotten into our current difficulties if we had maintained a fairly steady, moderate growth rate of the money supply. In particular, we would have been better off not allocating increased credit to expand governmental operations.

Second, now that we have both considerable inflation and unemployment, we should not rely on driving the money supply in one direction or another in order to get out of this predicament; steady money growth to stabilize prices should be initiated. In addition, Hayek would undoubtedly advocate a *reversal* of the progressive growth of the government sector as a significant step toward the achievement of monetary stability.

Third, one might conjecture the remedies Hayek would endorse to include: 1) getting labor to accept a smaller real wage temporarily; and 2) increasing (over the longer run) the marginal productivity of labor. With regard to the former remedy, Hayek would likely suggest action to curb possible monopolistic practices of labor (he was also concerned about monopolistic business practices). In addition, we should cut job information costs and reduce uncertainty by way of relying more strongly on the price signals emitted by a free market economy. With regard to the second remedy, Hayek would probably endorse policies directed toward maximizing labor efficiency through quantitative and qualitative improvements in the private capital stock.

What would Hayek's old rival Keynes suggest to alleviate our current economic discomfort? One might think that Keynes would turn toward vigorous government intervention in order to control unemployment and prices more closely. Keynes, however, was quite pragmatic in his approach to economic policymaking, as suggested by his change from a fairly or-

<sup>12</sup>Ibid., p. 215.



thodox, neoclassical economist in the years preceding the 1930s to an advocate of government action in the Great Depression. In his last conversation with Hayek, Keynes indicated that he adapted his economic ideas to fit the times. Hayek related the incident in the following passage:

Later a turn in the conversation made me [Hayek] ask him [Keynes] whether he was not concerned about what some of his disciples were making of his theories. After a not very complimentary remark about the persons concerned he proceeded to reassure me: those ideas had been badly needed at the time he had launched them. But I need not be alarmed: if they should ever become dangerous I could rely upon him that he would again quickly swing round public opinion — indicating by a quick movement of his hand how rapidly that would be done. But three months later he was dead.<sup>13</sup>

### SUMMARY

F. A. von Hayek was a man ahead of his time. Now living in Austria, he wrote extensively of price and unemployment problems before switching later in life to political and social concerns. His earlier writings competed for attention with those of John Maynard Keynes. Keynes, whose analysis focused on unemploy-

ment issues, showed impeccable timing in his endorsement of the desirability of government intervention to escape from the throes of the Great Depression. Hayek, whose analysis incorporated both inflation and unemployment issues, was pushed into relative obscurity by the developments of the 1930s.

It is not yet clear exactly who has the best explanation for the economic events observed in the first half of the 1970s. There has been inflation at times, unemployment at times, and there have been times at which the two have occurred simultaneously. The Keynesian analytical framework, erected to explain unemployment deficiencies alone, would appear lacking. However, it is not obvious that the “forced saving” argument advanced by Hayek would be necessary or sufficient to explain our current problems. Possibly, Hayek’s later theories, which interwove a concern for growing governmental control of resources and the money supply with a guarantee of full employment, are closer to the mark. His concern was that the inflationary tendencies inherent in these developments would eventually result in a pronounced change in the structure of capitalistic societies. In any event, the fact that Hayek foresaw many of the actual economic developments of the 1960s and early 1970s provides strong incentive for further study of his voluminous works.

<sup>13</sup>F. A. Hayek, *Studies in Philosophy, Politics and Economics*, (Chicago: The University of Chicago Press, 1967), p. 348.





# International Trade and Finance

## Under the Influence of Oil—1974 and Early 1975

HANS H. HELBLING

**I**N ANY given period, a country's economic performance in the international arena is determined by both domestic and foreign forces. In 1974, however, external forces (the operation of a foreign oil cartel) exerted an overwhelming influence on virtually all U.S. international transactions—both imports and exports.

In addition to the impact of higher oil prices, U.S. international transactions were affected by the depreciation of the U.S. dollar against most major currencies, high, though differing, rates of inflation here and abroad, cyclical downturns in many countries, and the removal of capital controls. Some of these factors are likely to continue to influence our international economic performance in 1975.

At the beginning of 1974, rates of economic growth in most of the world were declining in response to both supply constraints and earlier measures which had been designed to slow the unsustainable economic expansion which prevailed in 1972 and early 1973. Not the least of these supply constraints was the October 1973 - March 1974 oil embargo and the quadrupling in oil prices. This latter development also caused significant changes in relative prices within oil importing countries and thus influenced their reported rates of inflation.

### *Petroleum-Related Problems . . .*

With the announcement of higher oil prices, oil importing countries became concerned about ensuing oil payments and how to finance them. The fear was that oil exporting countries would accumulate claims on the output of all oil importers but would invest their oil revenues in only a few industrial countries. Furthermore, there was concern that the financing burden of some countries would be so large as to severely retard their future economic growth. Coinciding with the development of these fears was the implementation of an earlier U.S. decision to eliminate existing controls on capital exports. Thus, if U.S. financial markets would experience the anticipated surplus inflow of funds from OPEC (Organization of

Petroleum Exporting Countries), U.S. banks would not be restricted in the intermediation of such funds to other oil importers.

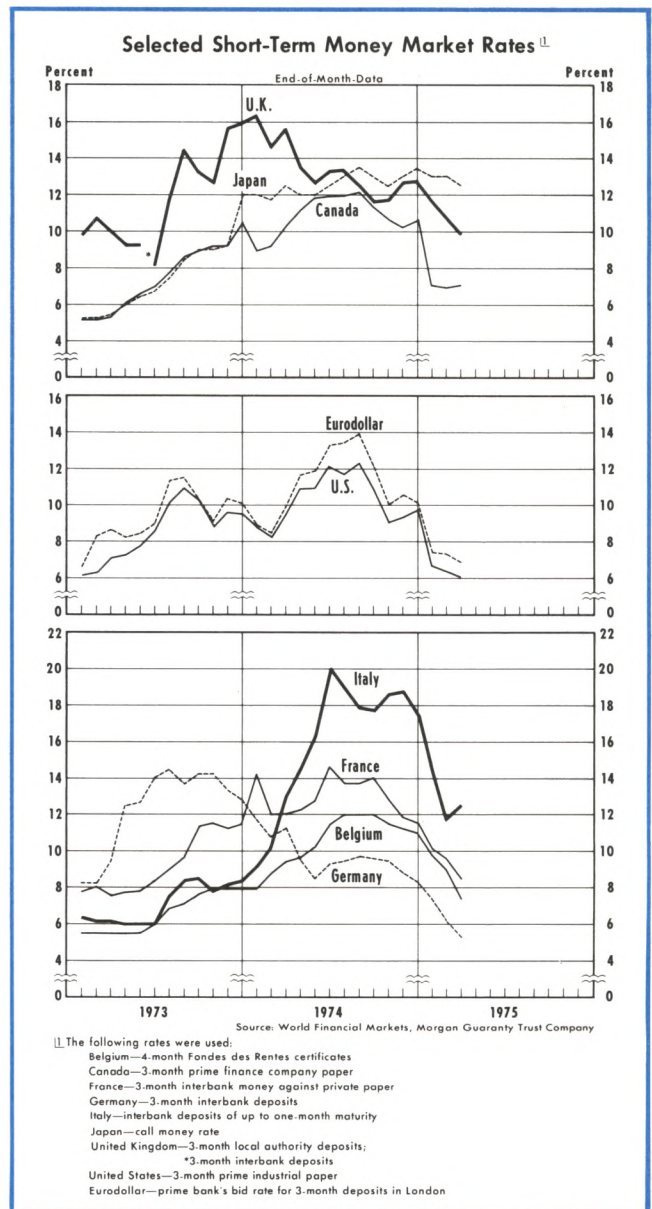
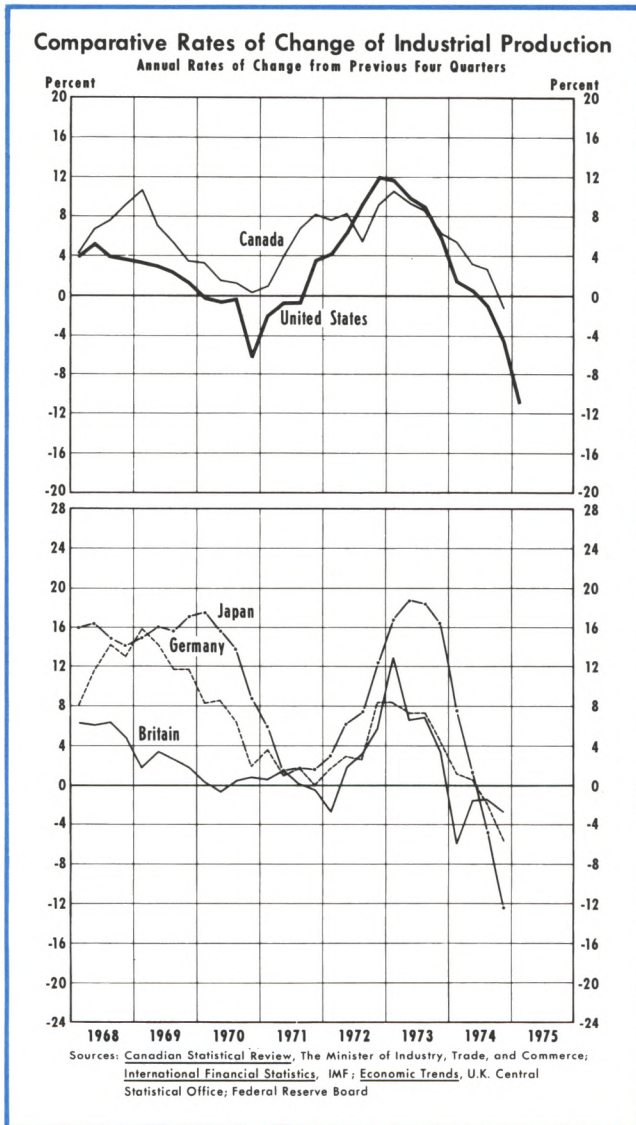
A further oil-related fear was that as a result of projected trade deficits, countries might pursue policies aimed at coping with their own problems while disregarding the possibly adverse effects on other countries—generally referred to as beggar-thy-neighbor policies. Thus, while one country might benefit in the short run, in the long run all countries would eventually lose if every country pursued such policies. In response to such fears, the countries belonging to the Organization for Economic Cooperation and Development (OECD) reached an agreement in May 1974 to refrain from implementing beggar-thy-neighbor policies.

### *. . . Proved Somewhat Less Burdensome*

The impact of the oil embargo, however, was not as severe as initially anticipated and there was a change in the pattern of demand for the world's currencies. Some commercial banks, which had incorrectly anticipated exchange rate developments and based their trading of individual currencies on earlier projections, incurred unusually large financial losses once their anticipations were not realized. This led to the insolvency of some banks and increased the uncertainty over how oil payments would be financed. However, toward the end of the year, financial markets calmed, partly because the international banking community began to understand the true impact and proportions of the oil transfer problem.

Large merchandise trade deficits did emerge in most oil importing countries, as expected, but the burden of oil financing was handled almost entirely by the private financial markets of the world. As a supplement, members of OPEC provided loans to some less developed countries as well as to Britain, France, and Japan. Other intergovernmental financing arrangements, such as the gold-guaranteed loan by Germany to Italy, and the establishment of a special account at the International Monetary Fund (IMF), were undertaken.





### Exchange Rate Developments During 1974 and Early 1975

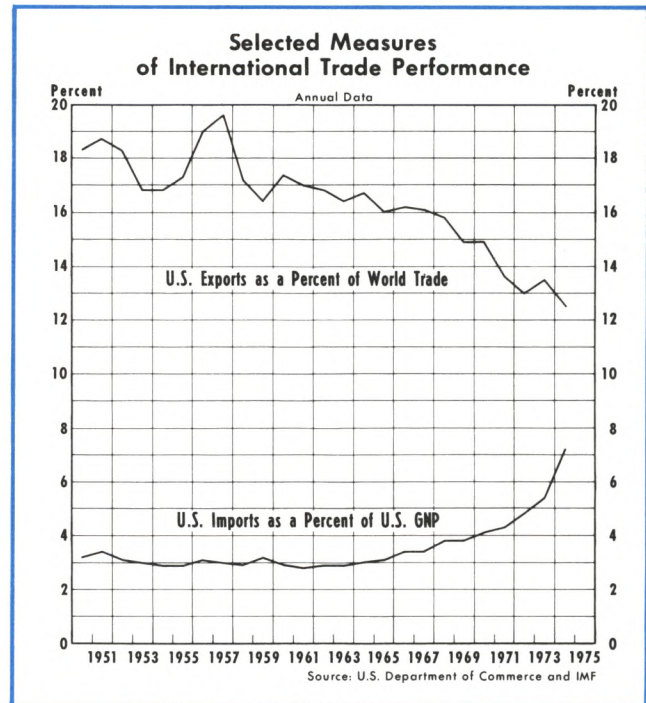
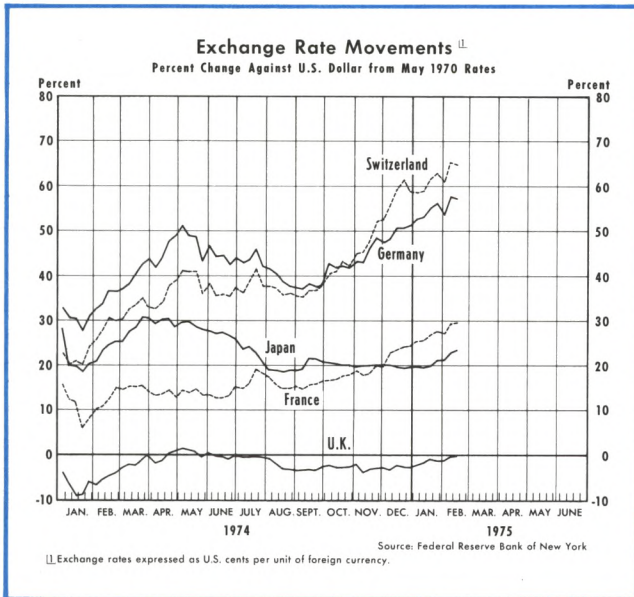
Unusually large capital movements occurred as a result of the oil price increases and the subsequent financing operations. Initially, many analysts both here and abroad believed that the U.S. economy was less vulnerable than other countries to a cutback in imported oil, making dollar denominated assets attractive to foreign buyers. In addition, there was expectation that the increasing receipts of oil exporting countries would be invested mainly in dollar denominated assets. As a consequence, there was a rise in the international price of the dollar early in 1974.

During the second quarter of 1974, after oil shipments had resumed, the U.S. trade deficit increased faster than initially expected, U.S. output declined more sharply than expected, and inflation accelerated.

These factors all contributed to a decline in the international price of the dollar after the first quarter rise.

In mid-May 1974, the dollar depreciation halted and began to reverse. Reduced rates of monetary growth, rising interest rates in the United States relative to other countries, and the continuing large accumulation of dollar denominated assets by OPEC in Euro-dollar and U.S. financial markets contributed to the renewed strength of the dollar. Beginning in September, however, the international price of the dollar declined again, probably in response to the marked slowdown in U.S. economic activity, declining U.S. interest rates, and reports that OPEC might shift from dollars and sterling into continental European currencies.





**International Trade and Finance in 1974**

The 1974 merchandise trade performance was greatly affected by the sharply increased oil import prices, despite the fact that oil import volume has declined slightly since 1973. In fact, if oil imports are excluded from these measurements, exports exceeded imports by \$19.2 billion in 1974.

A breakdown of U.S. international trade by countries reveals that while the volume of U.S. imports from oil exporting countries increased, so did exports to those countries. For example, U.S. merchandise imports from OPEC increased from \$5 billion in 1973 to \$17 billion in 1974. U.S. merchandise exports to OPEC, on the other hand, increased from \$3 billion in 1973 to \$6 billion in 1974.

The dollar value of exports exceeded the dollar value of imports for agricultural products, capital goods, and chemicals in 1974, but the quantity of agricultural exports declined by 9 percent. On the other hand, the dollar value of imports of consumer goods exceeded exports somewhat more than in 1973. On balance, in 1974, merchandise imports exceeded merchandise exports by \$5.8 billion.

**Net Investment Income and Special Transactions** — Net investment income increased to \$9.7 billion in 1974 from \$5.3 billion in 1973. A large portion of the 1974 increase resulted from inventory profits following oil price increases and receipts from a large volume of U.S. bank loans to customers abroad. There were also special bookkeeping transactions such as the \$2 billion U.S. Government grant to India which was used to repay previous loans.

**Long-Term Capital** — Long-term capital outflows increased significantly in 1974. U.S. direct investment abroad amounted to \$6.8 billion in 1974, as compared to the 1973 investment of \$4.9 billion. At the same time a reduction of foreign purchases of U.S. stocks and bonds significantly reduced inflows of long-term capital. Inflows of foreign capital for direct investment in the United States fell slightly to \$2.3 billion in 1974, compared to \$2.5 billion in 1973.

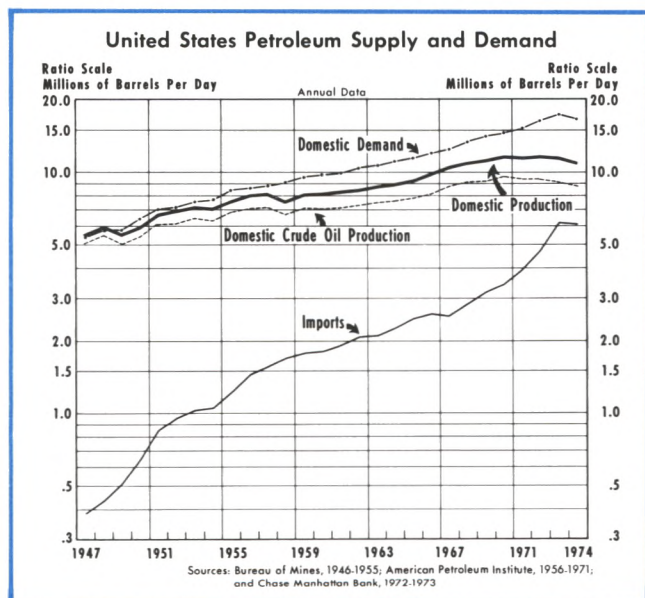
**Short-Term Capital** — Net outflows of nonliquid short-term capital, mainly U.S. bank loans to foreigners, increased rapidly during the first half of 1974. A number of factors contributed to this development: increased loan demand to meet oil import payments, the removal of U.S. controls on capital outflows early in the year, and higher interest rates in many foreign countries relative to those in the United States. During the second half of 1974, however, U.S. bank loans to foreigners were considerably smaller than in the first half. This may have been related to a narrowing of the differential between U.S. and foreign interest rates and a leveling-off in foreign loan demand as the volume of oil shipments returned to more normal magnitudes following the post-embargo rebuilding of stocks.

It is apparent from this discussion that virtually all major international transactions were influenced by the greatly increased oil import prices. For this reason, a more detailed analysis of the oil situation is presented in the next section.



## The Oil Situation

In spite of all the rhetoric about reducing our dependence on foreign sources of oil, during 1974 the United States actually increased the proportion of oil acquired from foreign producers. During 1974 U.S. oil consumption averaged 16.8 million barrels per day (MBD) while domestic production was 11 MBD. Imports amounted to 6.1 MBD, or 36 percent of total domestic consumption.<sup>1</sup> In 1973, for comparison, oil imports amounted to 35 percent of domestic consumption. In order to put this development into perspective, U.S. oil consumption, production, and imports are examined for the period 1950-1974.



**U.S. Oil Consumption** — In terms of the pattern of U.S. oil consumption, there are four distinct periods between 1950 and 1974. Between 1950 and 1964, U.S. consumption of oil grew at an annual rate of 3.8 percent. From 1964 to 1971, consumption increased at an annual rate of 4.7 percent and from 1971 to 1973 accelerated to a 7.2 percent annual rate. In response to the oil embargo, sharply higher oil prices, and the economic contraction experienced by the U.S. economy, oil consumption in 1974 decreased at a 3.9 percent annual rate.

**U.S. Oil Production** — Again, the period 1950-1974 can be divided into four subperiods in terms of oil production. Total production of *crude and refined* oil in the United States between 1950 and 1964 increased at an average annual rate of 3 percent. From 1964 to 1966 the rate of production briefly accelerated

to a 4.6 percent annual rate of increase. Beginning in 1966 and continuing through 1972, however, the rate of production increased at only a 2.8 percent annual rate. Finally, since 1972 domestic production has *declined* at a 2.8 percent rate. Thus, from 1966 through 1973, the difference between domestic oil consumption and domestic oil production widened. In 1974, the differential narrowed as consumption declined more than production.

This state of affairs is partially attributable to the fact that the expansion of oil production facilities was hindered by a number of factors. Among these factors were environmental and safety regulations which hampered attempts to construct new, and expand existing, drilling and refining facilities. General price controls, which affected the oil industry both directly and indirectly, created bottlenecks in the production of materials utilized in the construction of new facilities. In addition, the existing dual price system for oil — different prices for “new” and “old” oil — certainly was not conducive to providing the necessary incentives for increasing production in 1974.

**U.S. Oil Imports** — During the period 1950-1964, U.S. imports of oil increased at a fairly steady 7.2 percent annual rate. From 1964 to 1967, reflecting the increase in domestic crude oil production, U.S. oil imports slowed to an annual rate of increase of 4 percent. Beginning in 1967, however, U.S. oil imports increased at a very sharp rate. For example, from 1967 to 1970 imports rose at a 10 percent annual rate and between 1970 and 1973, as a result of absolute declines in domestic oil production, and cyclical increases in economic activity, accelerated to a 22 percent annual rate of increase. Finally, in 1974, oil imports declined 1.7 percent from 1973.

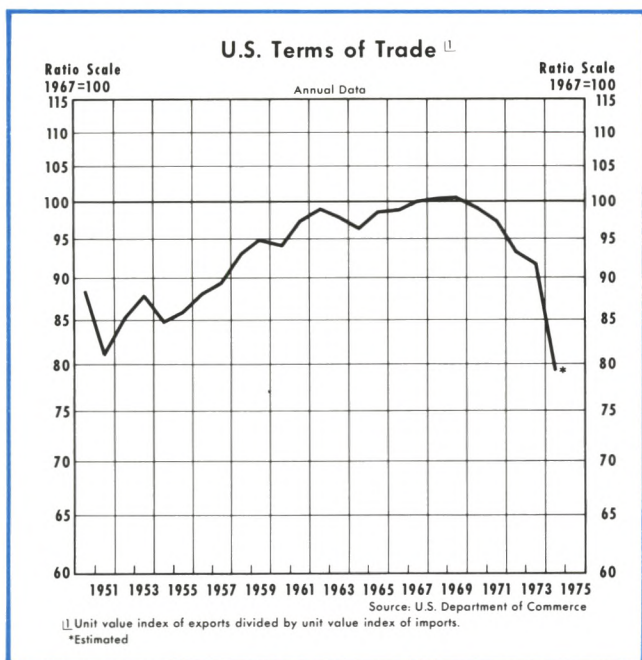
## Oil Developments in 1974 and Beyond

As was expected at the beginning of 1974, gross receipts by OPEC for oil exports amounted to \$90 billion last year (receipts for other exports amounted to an additional \$5 billion). However, OPEC expenditures on imports amounted to \$35 billion, or about one-third of total receipts.

Net OPEC receipts (total receipts minus expenditures for imports), amounting to \$60 billion, were disposed of somewhat differently than initially expected. For example, direct placement of OPEC funds in the United States amounted to only \$11 billion. Placements in the (more anonymous) Eurocurrency market, on the other hand, amounted to \$21 billion. It is probable, however, that some OPEC Eurocur-

<sup>1</sup>The difference between domestic production plus imports and domestic consumption is due to the rebuilding of oil stockpiles.





rency placements were eventually channeled to U.S. financial markets also.<sup>2</sup> The remainder was composed of loans and investments to other countries and to international institutions.

With respect to the absorptive capacity of OPEC countries, it is now apparent that far more oil revenues than had been initially expected will be expended in the near future for the purpose of establishing or improving industries in oil exporting countries. OPEC imports from the United States increased by 90 percent during 1974 and, while such a rate of increase is not sustainable, the level of OPEC imports will surely exceed that of years prior to 1974.

With respect to the consumption of oil in both the United States and abroad, it seems reasonable at this time to expect little or no growth in the next few years. For one thing, high oil prices and temporary reductions in the growth of aggregate demand, both in the United States and other countries, have reduced oil consumption in general, and imports from OPEC in particular. Moreover, new sources of oil have been discovered in many non-OPEC countries and prevailing world prices are conducive to continued intensive exploration. The upshot of this argument is that the quantity of oil demanded from OPEC may not increase as fast as previously expected

<sup>2</sup>For a discussion of this development, see the December 1974 issue of this *Review*, p. 14.

even when economic growth resumes. The accruals of oil revenues by OPEC may therefore not rise, and may even decline over the next few years. Considering that OPEC imports from the oil importing countries will grow, the previously predicted accumulation of OPEC reserves is not likely to materialize. In fact, some studies taking the above factors into consideration now project OPEC balance-of-trade deficits as early as 1978. It should be pointed out that such projections do not consider the possibility of a break-up of the OPEC cartel which would result in further reduction of oil revenues.

### *Summary and Outlook*

Sharply increased oil prices have significantly influenced the 1974 trade performance. Excluding petroleum imports from and general merchandise exports to OPEC, U.S. exports exceeded imports by \$5 billion. Even though U.S. merchandise exports to oil exporting countries can be expected to increase in 1975, both the value and the volume of total agricultural exports can be expected to decline. In fact, some export orders for agricultural commodities have already been cancelled.

With respect to the emerging international economic climate, the following observations may be made. For some countries rates of inflation have already moderated, and for other countries the rates of inflation can be expected to moderate at least in the near term. For example, world commodity prices, except for food and oil, have declined since May 1973, the world food price index has declined since late November 1974, and U.S. wholesale prices have declined since December 1974. It is also likely that in the second half of 1975 real economic growth in the major industrial countries will resume.

A review of past and present economic policies lends support to the prospective developments outlined above. For example, the response of an economy to reduced monetary growth is first a slowdown in real output and subsequently a reduction in prices. At the same time, increased rates of monetary growth, which are presently being experienced in the major industrial countries, can be expected to lead to an expansion in real economic growth. If the present monetary stimulus is not too great, it is possible that the expectations of both increased real economic growth and reduced inflation may be realized.

