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1963

Review of "Money Trade and Economic Growth"

Hyman P. Minsky Ph.D.

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identity of *ex post* investment and saving is further stressed with the use of this method. The debt to Morris Copeland is recognized and his "discretionary thesis" is discussed. Further theoretical implications of this use of the data are not explored, since "the technique is still very much in its infancy (and) the theoretical implications of the material are not very well developed." (P. 516.)

Part VIII, Monetary Policy, first discusses the aims of maximum production, full employment, and stable prices, and the compatibility of these goals. The author then turns to the development of Federal Reserve policy and its present actions, in order to explore the effectiveness of its policies in the past. In the two following chapters, the author offers a critique of the bases and tools of monetary policy. "Crackpot schemes," such as those presented by Major Douglas and others before and during the Great Depression, are appropriately exposed and disposed of. This section is followed by a discussion of the usual tools of the Fed, such as open market operations, changes in the discount rate, changes in the reserve ratio, and direct controls. While the use of the first three tools is generally accepted, the author feels that the consensus on the last is "not clear, and . . . promises to provide materials for debate for some time to come." (P. 634.) Although not part of monetary policy, fiscal policy is also discussed in this part of the text. After automatic stabilizers have been mentioned, the importance of debt management is more fully discussed.

Although this text is in general well organized and well presented, there are a few sections where the reviewer disagrees with the approach used by the author. For example, the author is quite outspoken on the evils of inflation. The reader is told that individuals who put money in fixed dollar investments are "defrauded by inflation" (p. 375). Also, its "insidious" nature "should not blind us to its disastrous results" (p. 557). Some of these results are that, "Inflation robs the saver. . . . Inflation feeds on itself. . . . Inflation can demoralize production. . . . Inflation leads to depression." Also (p. 560), "I believe that the appeal of inflation as a cure for our ills is a siren song, luring us to destruction of the sound base of our productive capacity." The author is not only talking about runaway inflation in these quotes. "At 3 percent per year prices will double in 24 years, quadruple in 48 years. . . . This is not an insignificant change." (P. 552.) Many noted economists, including the late Sumner Slichter, believe that a little inflation is a good thing. In a general textbook it is not necessary to remain neutral on such items as the effects of inflation, but arguments of the other side should at least be acknowledged. However, minor lapses such as these should not detract from a generally useful textbook.

MICHAEL K. EVANS
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Money, Trade and Economic Growth. By HARRY G. JOHNSON. Cambridge, Mass.: Harvard University Press, 1962. Pp. 199. $4.50.

Three topics are covered in this volume: developments in international trade theory; the present state of the Keynesian debate; and the impact upon economic theory and policy of the fact that advanced societies are "affluent" and, when functioning normally, grow. The purpose of the essays is expository, to delineate the present state of the art; however, in general, the papers are not dull academic exercises typical of review articles, for the exposition is leavened by Professor Johnson's perceptive comments both on unsettled issues and on the true nature of the problems under examination.

Three elements unify these essays: an emphasis upon economic policy; the general theory of the second best (which is a theorem of welfare economics that is directly related to economic policy analysis); and the proposition that much of economics can best be looked at as special problems in capital theory.

The emphasis upon and interest in economic policy is evident not only in the choice of subject matter, but also in the way in which problems are stated. For example, Johnson identifies the developments in balance of trade theory during the past twenty years as a change ". . . from the idea of a mechanism of adjustment to the idea of the balance of payments as a policy problem" so that the analytical problem has become the study of ". . . alternative ways of rectify-

ing the balance of payments disequilibrium." The paper on the balance of payments not only shows the progress that has been made in the recent past, it also makes evident the weakness of the tools with which analytical economists approach balance of payments problems, such as the United States is now experiencing. The material in the tool-box treats balance of payments problems as income-expenditure-trade rather than as financial-portfolio-investment problems. The American balance of payments problem is a liquidity problem, arising out of lending and investing long and financing a part of this long investment either by borrowing short or by decreasing cash balances. The adjustment mechanism and policy choices affect both trade and financial variables, but the analytical mechanism as presented by Johnson runs entirely in trade terms. Hence it is of limited usefulness for the analysis of the current policy problem.

The essays on commercial policy and customs unions center around the well known second-best theorem which can be stated as follows: If at least one of the conditions for maximum welfare cannot be obtained then there is a presumption that the achievement of maximum attainable welfare will require violations of other conditions of maximum welfare. Three important propositions dealing with customs unions and commercial policy are developed: (1) That if two countries are alike but can become complementary specialists there is a large potential gain from economic unification; (2) That the freeing of trade between two countries may generate losses if it leads to sufficient trade diversion; and (3) that the fundamental problem of a customs union is the determination of the height and pattern of the common tariff. This last proposition is, of course, the core of the policy problems now dividing the common market countries and the United States. An implication of the analysis is that the benefits to the common market countries of the common market is inversely related to the height of their external tariff.

A proposition to the effect that the benefits from freeing trade depends upon the extent that it is multilateral rather than discriminatory seems to be implicit in the argument. If this is true, then the interwar pattern of commercial policy, embodied in the reciprocal trade acts, was more beneficial than is the postwar pattern, in which trading blocs and customs unions are looked upon with favor.

The two essays dealing with monetary theory state the issues in the Keynes-Classics controversy and indicate some of the progress that has been made. Johnson perceptively points out that the underemployment equilibrium of Keynes is really not an equilibrium; rather, it is a representation of a dynamic process among markets with widely differing rates of adjustment, some of which are much too slow for practical purposes. He also argues that Keynesian economics would be improved if consumer demand and portfolio choices were analyzed as special capital problems. Aside from the fact that the Keynesian treatment of money as an asset is a capital theoretic view of money, Johnson neglects the view, embodied in the user costs doctrine, that the present value of future returns determines present supply. As Johnson views labor as a heterogeneous embodiment of investment in his essays on an opulent society, it should be noted that a consistent capital theoretic view of labor supply, as reflecting present value of future services, can lead to the Keynesian supply curve of labor.

The last two essays in this volume deal with the opulent (affluent) society. They are first rate; they are the best statement I have encountered of the analytical and policy issues brought forth by the fact of affluence. Johnson's economic analysis of an opulent society is based upon ". . . the role of capital in two contexts—consumption and the nature of labor," and the economic policy suggestions are based upon a recognition that the risks of labor rises as labor increasingly becomes differentiated due to the needs of technology and the increased investment in humans. As the opulent society grows when it is functioning well, and as its growth is mainly due to change rather than to accumulation, each laborer must carry risks of becoming technologically obsolete. The combination of risk aversion, as a characteristic of preference systems, and ever-increasing risks, due to the nature of the accelerating technical dynamism, implies that there is a large payoff in welfare from broad social insurance and expansion schemes. In addition, the way in which opulence and urbanism are related implies that an ever-expand-

ing set of economically significant external benefits and costs exists. From these two sources, risk and externalities, Johnson draws powerful arguments for intervention by way of welfare measures as well as by the provision of services.

To summarize, this is a collection of important and provocative essays which should be of use to students, professional economists and educated laymen.

HYMAN P. MINSKY
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Problems of the United States as World Trader and Banker. By HAL B. LARY. New York: National Bureau of Economic Research, 1963. Pp. xvi + 175. $4.50.

This study serves a number of useful purposes: It provides a review of the U. S. balance of payments since 1950; it presents alternative methods of measuring balance of payments deficits and surpluses; it examines explanations for the appearance of the deficit and evaluates policies which have been suggested in the current literature. Last, the book serves as the preliminary statement of a research program which the National Bureau has undertaken in this area. In light of this program, Mr. Lary emphasizes the preliminary nature of his findings, particularly in those chapters which deal with economic analysis and policy. The reader is inclined to agree and feels that the most successful parts of the book are those dealing with the measurement of deficits and surpluses. Included in the appendix are very useful comments on alternative presentations of the balance, suggested in the writings of Walter Gardner and Robert Triffin.

The author's main finding concerns the method of presenting surpluses and deficits currently employed by the Commerce Department. He writes:

> The most distinctive and debatable feature of the Commerce Department practice is the difference in treatment accorded American private short term capital compared with that given to foreign private short term capital, movements in the former being entered above the line and movements in the latter below. This practice has been criticized as asymmetrical, . . . if universalized it would lead to mutually inconsistent results in that, in a time of generally rising international financial transactions, several financial centers might simultaneously record an increase in foreign private claims on them without reporting any offsetting assets. (Pp. 144-145).

The author presents for comparison three measures of the balance of payments: (1) a balance on basic transactions, comprising exports and imports of goods and services, government grants and capital, and private long-term investment; (2) a balance on the Commerce Department's definition; and (3) a balance on Official Settlements Basis which shows the sum of gold movements and changes in official holdings of foreign exchange. Depending upon the problem, the author would choose balance 1 or 3 in preference to 2. At one point (p. 148), Lary suggests that the balance below the line might include all transactions sensitive in the short run to monetary policy, in which case the appropriate balance is that on basic transactions. The importance and usefulness of these distinctions becomes clear in Lary's skillful discussion of our recent experience. For matters may deteriorate under one definition and improve under another.

The author is much more conjectural in explaining the deficit and prescribing its cure. He comments wisely on the danger of overexplaining changes in the balance but leaves the reader in the dark as to which explanations he feels are valid. This omission weakens his treatment of balance of payments policy. For if the persistent deficit is an indication that our economic system is not working properly, the formation of policy requires that we know why the deficit has occurred and how it may be eliminated. In this regard the reader is hampered by the absence of any concept of a long-run equilibrium or a long-run process of adjustment to disturbances. Since we are not told what is normal, it's difficult to know what is regarded as abnormal.

Among the possible explanations which the author puts forth and examines are: the increase in the size of government grants; military expenditures, and private long-term investment; the growth of foreign capacity to produce substitutes for our exports; reduced U. S. tariffs; increased technological advances abroad; changing relative prices

of exports (a very good discussion); and increased European protection as a result of the common market. In this section of the book, entitled "Elements of Strength and Weakness," new data tabulations on U. S. and foreign prices and costs are presented. This information will be quite useful to others. The policies examined are: deflation; changes in exchange rates; moral suasion, i.e., encouraging the Europeans to inflate; increases in international liquidity; and changes in U. S. monetary policy.

One is left with the feeling that the policy solution to the deficit will be found in two areas: Federal Reserve actions to reverse the flow of short-term private capital; and a long-run improvement in the balance on current account due to restraint on domestic inflation. In this regard the author appears somewhat optimistic about the future of the basic balance even in the absence of any government policy. Continued growth of our overseas customers and our growing exports of technologically advanced goods suggest such a conclusion. In addition, he cites continued growth of income from foreign investments as an element of strength.

The most serious omission from the study is in the area of long-term capital movements. There is little examination of policies specifically designed to influence long-run movements of capital, and little analysis of the responsiveness of such transactions to differentials and variations in borrowing costs and rates of return. It is hoped that some light will be shed on this area in later National Bureau studies. The absence of such discussion in Lary's work leaves one with the feeling that public policy may operate on short-term capital or on the current account, but has no role to play in the movements of long-term capital.

George Borts
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Commercial Bank Loan and Investment Policy. By Donald R. Hodgman. Urbana, Illinois: Bureau of Economic and Business Research, University of Illinois, 1963. Pp. 181. $4.50.

Hodgman breaks new ground in viewing the bank as concerned with the acquisition of deposits, as well as with the purchase of assets. Hodgman argues convincingly that banks have a strong preference for industrial and commercial loans—a preference which is explained not by a higher net yield on such loans, but by the fact that they bring deposits and other business (stock transfer agencies, for example) to the bank. The key to an understanding of the bank is the customer relationship – loans bring customers, and customers bring deposits. According to Hodgman, services such as the safekeeping and transfer of money are not trivial appendages to credit creating institutions, but the "basic product" of commercial banks.

Since the capture of deposits is so important, Hodgman considers the limits of competition for deposits. First, there is the prohibition of interest on demand deposits. This would tend to make competition act through lowering interest rates on loans to large depositors. But, says Hodgman, the prime rate convention protects banks. Competition could also take the form of allowing a higher volume of loans per dollar of deposits—but here the compensatory balance requirement sets a limit (and *this* is the reason for the existence of a compensatory balance requirement). Finally, there could be competition in service charges, but these charges tend to be standardized.

There are many other noteworthy facets to this book. To cite a few examples, the customer relationship provides an interesting rationale of credit rationing, as well as an insight into the branch bank issue. In addition, there is a worthwhile discussion of the locking-in effect and the investment portfolio in general.

At several points the book is subject to criticism. It is based on interviews with eighteen large banks—and there is some question as to whether these are typical for the whole industry. Moreover, Hodgman's treatment of compensatory balances seems to ignore the fact that the percentage of the loan required (and hence the maximum loan volume corresponding to the deposit) varies among banks.

Nevertheless, this is an important book.

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