The Economics of the Carter Administration

by

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"iatrogenic (adj.) Induced in a patient by a physician's words or actions." [The American Heritage Dictionary of the English Language]

In the case at hand, the patient is the United States economy, the physicians are economists who advise and serve the Carter Administration and the "words and actions" are determined by economic theory. The neoclassical synthesis is the economic theory of the economists who advise and serve our Administration, regardless of whether the administration is Democratic or Republican. However, as Mr. Carter and his Georgian phalanx have no independent knowledge of economics and no prior exposure to national and international economic problems, they are, to a larger extent than was true of prior administrations, prisoners of their advisors. The problems as defined for the Administration and the policy options which are considered reflect the tunnel vision imposed by the neo-classical synthesis.

The failures of the economy and of policy in the last decade should force economists to consider whether the definition of problems, the analyses and prescriptions put forth by the policy advising establishment are responsible, at least in part, for what is wrong. The appearance of the Journal of Post-Keynesian Economics is evidence that a cadre of
economists question the validity, and thus the usefulness, of the neo-classical synthesis. True, there is no unanimity among these dissenters about the theory they prefer, but there is a wide agreement that today's orthodox theory cannot explain significant facts about the American economy, that establishment theory is a poor guide to policy and that, if the policy advice of those who adhere to standard theory is followed, the economy will deteriorate, not improve.

Nowhere is the intellectual bankruptcy and the perversity of the policy implications of the neo-classical synthesis more in evidence than in treatment of inflation. The analytical content of Carter's speech of April 11th, which was heralded as initiating a tough stance on inflation, comes down to the view that inflation can be stopped if the President makes it clear that he is against inflation. One reason for the bankruptcy of policy and the paralysis of action on inflation is the belief, induced into our political leadership by their economist advisors, that a trade-off exists between unemployment and money wage rate changes.

Under both Republican and Democratic administrations, the economist advisors have recommended monetary or fiscal constraint to stop inflation. Such aggregate constraint first generates unemployment. The advisors have instructed the political leadership to hold that unemployment and excess capacity are good because they lead to a decrease in the rate of increase of wages and prices. Even though this 1984ish prescription that less is more did not work in 1966, 1969/70 and 1974/75, it remains the preferred "neo-classical" treatment of inflation.
Monetary and fiscal constraint do not work in the manner envisaged by the neo-classical synthesis because ongoing and increasing investment requires ever larger amounts of short-term financing as investment in process progresses towards completion. In these circumstances, interest rates increase rapidly when monetary constraint is applied to halt an inflationary expansion. Rising interest rates increase costs for business and holders of capital and financial assets who use debt. This raises the supply price of investment output even as rising interest rates tend to decrease the value of capital assets. This leads to difficulties in financing and refinancing activity, which escalate until the weakest financial link breaks. The weakest links were banks that tried to make position by using municipal securities in 1966, the commercial paper market in 1969/70 and commercial banks and the Real Estates Investment Trusts in 1974/75.

The Federal Reserve's response to financing difficulties has been to increase high-powered money. The economy's response to financing difficulties has been a fall in output and a rise in unemployment. The government budget's response to falling output and increasing unemployment has been a huge increase in the deficit, because of both the 'fiscal policy' response to unemployment and "built-in" stabilizers. As a result, embryonic financial crises, which result when monetary and fiscal constraints are used in a fragile financial environment, are first aborted by the Federal Reserve and then floated off by inflation.

The price level of consumer goods is a product of two ratios: one is the ratio of money wages rates in the production of consumer goods to
the average productivity of labor in the production of consumer goods and the second ratio is that of the incomes spent on consumer goods to the wage bill in consumer goods production. As a result, the higher the wage bill in the production of investment goods and the higher the deficit of the Federal Government due to government employment and transfer payments relative to the wage bill in the production of consumer goods, the higher the price level for any given money wage rate and labor productivity.

Our establishment policy advising economists tell the political leadership that to increase employment and to increase the rate of growth, they should offer inducements to investment. They also favor various complex packages of transfer payments as anti-depression and pro-equity devices. But, increased investment and transfer payments are inflationary, for they increase the mark-up on wage costs that can be realized in the prices of consumer goods. Furthermore, the inducements to invest encourage debt financing and thus increase the likelihood of financial instability. Since economic policy has aimed to achieve growth through investment à la the neoclassical prescription, our economy has been more inflationary and more crisis-prone.

As long as the Economist advisors are wedded to the neo-classical view which allows them to ignore the financial characteristics of our economy even as they prescribe for our financially sophisticated economy, then the demonstratably futile charade of monetary and fiscal constraint being followed by an inflationary floating-off of a threatened crisis will continue. As long as investment goods production and the provisions of income or
services by transfer payments are the primary objective of policy, inflation, threatened financial crises and periodic slumps are inevitable.

Many of the ills of our economy are due to beliefs about the nature of our economy induced into the political leadership by neo-classical theorists. Some beliefs that lead to policies that induce malfunctioning are: (1) that our economy can achieve -- or be set upon -- a stable, self-sustaining and non-accelerating growth path; (2) that the short-run changes in the rate of growth of the money supply are causes, not effects, of variations in overall economic activity; (3) that the overall balance, rather than the particular dimensions, of the government budget determines its effect upon inflation and employment; (4) that the evolution and adaptations of the financial system can be safely ignored; (5) that the institutional structures of product and labor markets are largely irrelevant. These neo-classical propositions lead to policies that make our economic malaise at least in part "iatrogenic." Only as an economic theory that takes into account the financial and structural characteristics of our economy becomes the basis of policy can we hope to do better than we have in the past decade.