

The State of the Economy and of Economics

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The Annual Report of the President's Council of Economic Advisors is both an examination of the state of the economy and a statement of what can be expected. The 1974 report, which appeared early this year contrasted sharply in tone with the reports not only earlier in the Nixon years but during the Kennedy-Johnson era. Whereas the earlier reports were confident --if not arrogant-- in their assertion of what can be accomplished, the 1974 report was most humble in tone and content. And this is fitting, for given the state of the economy and the obvious failures of our attempts to manage the economy, economists have much to be humble about.

Over the past decade -- and most particularly in the past few years -- the economy has behaved in ways that are difficult to reconcile with the standard theory of economists. Policy actions that presumably are consistent with the advice of leading professional economists who have served as officials have often seemed to make matters worse, not better. These developments can be viewed as the equivalent of the experiments that are made in the natural and biological science; thus, recent experience indicates that in economics facts and theory are not consistent.

As a result of the disarray of the economy and the apparent inconsistencies between facts and theory, economists now have to question the validity of the standard economic theory. Standard economic theory reached its present form over the first decade after World War II. This is the theory that held sway as a guide to economic policy during the long expansion of the early 1960's. The apparent success enjoyed by economic policy based upon this theory at that time prompted members of the Council of Economic Advisors in the mid 1960's to announce that our

new knowledge and policy skills made the business cycle obsolete. In fact, it was asserted that economic science and the technology of economic policy were now so sophisticated that they were confident that the economy could now be "fine tuned."

The Origins and Nature of the Standard Economic Theory

The standard economic theory which is contained in almost all text books, the validity of which is now (or should be) questioned, is known as the neo-classical synthesis. This theory is the result of integrating some of the special insights and particular formulations introduced by John Maynard Keynes in the mid 1930's with the older so called classical economics.

Keynes wrote his seminal work *The General Theory of Employment, Interest and Money* in the early 1930's - at the very bottom of the Great Depression. At the time he wrote the accepted statement of the classical economics was that of Alfred Marshall in his Principles of Economics. Marshall's *Principles*, either directly or indirectly in various text books, dominated the teaching and practice of Economics from about 1870 until the late 1930's. Marshall's work was generally accepted as the culmination of the line of economic thought that descended from Adam Smith, David Ricardo, and John Stuart Mill. Although governments were not prone to use economists either as policy advisors or window dressing in the period prior to the 1930's, the generally "hands off" policy of the 1920's was validated by the weight of economic opinion.

The Great Depression of the 1930's was an anomaly to the ruling economic theory: the theory could not explain what was going on. In any discipline a relevant anomaly is the signal that the theory needs to be reformulated. Thus the Great Depression and the years that followed witnessed exciting battles of ideas among economists, as they first had to accept the facts of the Great Depression and then develop a coherent theory that explained such events.

John Maynard Keynes, a student and protegy of Marshall, was the key figure in the development of the new theory. His career up to the 1930's had been marked by some great public successes and by rather more modest success as a professional economist.

His Economic Consequences of the Peace, written in 1919, was a huge popular success and had a considerable influence upon the rejection of the Versailles Treaty by the United States. He was active in British public life during the 1920's, but as a Lloyd George Liberal, he was more of a gadfly than an effective influence upon policy. His major effort in economic theory prior to the Great Depression, A Treatise on Money, which was written in the late 1920's, received a luke warm reception and was adjudged a failure by its reviewers.

In his A Treatise on Money, Keynes attempted to improve upon the way in which money and finance were handled in the classical economics of Marshall. Classical economics emphasized the real exchange and production attributes of an economic system. The argumentation begins with the exchange at a "village market" in mind, and builds a model of exchange and production on the basis of simplified barter relations, the world of finance, speculation, and long lasting capital projects; of banks, stock markets, and corporations were added onto this picture in quite artificial and abstract ways. The typical conclusion of the theory was that these complicated institutional details really did not change matters; the propositions developed in the formal analysis of a barter economy remained valid in sophisticated, money using economy.

The fundamental propositions of the Marshallian or classical theory are that free markets are self equilibrating, that the equilibrium is at full employment, and that the equilibrium achieved by such free markets in some significant and meaningful sense the best that can be obtained. These propositions are derived as a result of arguments that are based upon an abstract simplified exchange and production model -- i.e., the economy of the theory barely resembled the economy of the real world. Nevertheless, it is an article of faith, more than the result of logical demonstrations, of the classical economics that results of the abstract theorizing are valid for the world in which we live.

Perhaps the most famous proposition in the classical economics about the irrelevancy of institutional detail is that "money is a veil". That is, it was held that money, banking and finance --the institutions that are essential to capitalism-- do not truly affect the workings of the economy. These institutional arrangements may obscure our perception but they do not really affect the underlying barter like exchanges of commodities for commodities or labor. To put it quite bluntly, for all the complexity and sophistication of the world, the reigning economic theory at the time of the Great Depression maintained that the significant behavior of the economy could be explained and understood by assuming the propositions derived for a primitive barter economy are relevant.

As long as the economy functioned well enough, the heroic assumption that money, finance and speculation did not really matter was not a serious defect. Once the Great Depression began, with the initial shock apparently coming from the stock market crash, and with recurrent blows from the breakdown of the banking system exacerbating the decline, it becomes quite evident that the classical economics could not explain what was happening. It was evident that what had been assumed to be irrelevant --money, finance, the valuation of capital assets- was of major importance and the economy, instead of seeking out a satisfactory equilibrium level, was often in transit away from the full employment of theory. The need was for an economic theory which made variations in employment, prices and income normal attributes of the system, not aberrations that were foreign to the theory.

Keynes in The General Theory filled this need. He constructed a theory of a capitalist economy which recognized the importance of the institutional details and usages. In Keynes' new theory, money and finance instead of being a veil really mattered. His theory gave primacy to the essential speculative nature of decisions that involve the future i.e., investment and holding of capital assets. He recognized that in a modern capitalist economy, investment, and the holding of capital assets

involved external finance. The major institutions involved in external finance are banks -- thus the behavior of banks and bankers instead of being peripheral to the operations of the economy become of central importance. Instead of starting his economic theorizing with village barter in mind, Keynes, very much the twentieth century man, started his theorizing about how modern economy works with the city of London and New York's Wall Street in mind.

Because the capital development of a country always involves present decisions made on the basis of future prospects, and because the future is always uncertain, Keynes emphasized the essentially speculative nature of investment decisions. In Keynes the particular form of speculation becomes the way in which investment and holdings of capital assets are financed. Keynes constructed an investment theory of employment -- so that deviations of employment from the full employment of Marshall resulted from variations of investment -- and a financial theory of investment. Because of uncertainty, the speculative nature of decisions, and the behavior of financial institutions the economy in this theory was essentially cyclical. Free markets could not guarantee full employment and the achievement of the best that is obtainable, in fact free markets lead not only to regular mild business cycles, but also to occasional inflationary booms and deep depressions.

One result of the analysis of The General Theory was the development of economic policies which would lead to a better result than was possible with free markets. What is now known as fiscal policy, the active use of government expenditures and taxation to steer the economy, is the novel policy device that came out of The General Theory. What is known as Keynesian economics in the popular press and in presidential speeches is not the sophisticated analysis of the behavior of an economy with a complex financial system, rather it is the active use of fiscal policy in order to stabilize income.

It is worth noting that Keynes in The General Theory did not promise that the policies consistent with his theory would guarantee sustained full employment. All that he asserted was that the apt use of monetary and fiscal policies would lead to a closer approximation to full employment that had hitherto been obtained. Fine tuning as promised by successive sets of presidential advisors was foreign to Keynes' views as to the nature of the economy and of man; not perfection but better was all that could be promised.

The Revolution Aborted

Keynes, while working on The General Theory, wrote to George Bernard Shaw that "...I believe myself to be writing a book in economic theory which will largely revolutionize...the way the world thinks about economic problems." Although it is true that his conception of economics as a policy science and the view that active policies are necessary if the economy is to perform satisfactorily are legacies of Keynes, today's dominant economic theory is more classical than Keynesian. The revolution that Keynes wrote of to George Bernard Shaw was aborted. The formulations of The General Theory dealing with finance, speculation, and uncertainty have been lost. Certain tools and formulations introduced by Keynes have remained in economic theory but they have been modified in a manner which makes them compatible with the older classical economics.

One reason the revolution was largely 'lost' is that The General Theory, like many seminal works in science, is not a polished work; much of the older classical thought is mixed in with the new formulations. After all, Keynes had been trained in and was an accomplished practitioner of the classical economics when the disturbing events of the Great Depression caused him to rethink his theory. As he built on the classical economics, much of the new resembled the older formulations, and in truth from time to time in The General Theory Keynes lapsed into the classical mode of thought.

Almost before The General Theory was published, a process of assimilating the advertised radical reformulation of theory to the older classical economics began. The formulations and the tools of analysis that were most compatible with the old theory were emphasized and the radically different constructs and ideas were played down. This means that the real production and exchange facets were emphasized and uncertainty, money, and finance were either ignored or treated in a most cursory fashion. In academic interpretations and in text book expositions Keynesian economics became another, somewhat different description of the economy in equilibrium. Keynes' view that it is in "the transition that we spend our lives" and his belief that he was showing how any equilibrium bred the "seeds of its own destruction" were eliminated from the theory that became a part of the standard theory.

By emphasizing the equilibrium facets of Keynes' analysis, the academic interpreters were able to show that a situation where less than full employment exists contained various forces which tended to lead to full employment. Whereas the monetary, financial, and speculative elements emphasized by Keynes may dominate in determining a temporary less than full employment equilibrium, economists in the 1950's and 1960's developed theories in which this temporary equilibrium was succeeded by full employment situations. Furthermore, it was demonstrated that the full employment situation exhibited the "best possible" characteristics of the classical economics. In fact, the money is a veil doctrine was resurrected as a characteristic of dominant full equilibrium situations i.e., as between positions of equilibrium the proposition that variations in the quantity of money relative to production capacity result only in variations in the price level was once again accepted as being valid.

The end result of the academic interpretation of Keynes' work was that in principle, the pre-Keynesian classical economics was valid. We may state the view of today's standard economic theory as asserting that the pre-Keynesian classical economics had arrived at basically the correct conclusion, but that their analysis had not gotten

the story quite right. Nevertheless, it was held by many that even though the market mechanism would lead to the best attainable full employment equilibrium, in fact the path taken by the economy and the time that would be spent in undesirable depressed circumstances if market processes were relied upon implied unnecessary and too great burdens upon the economy. Apt policy could achieve what the market would in time achieve, but do it more quickly and with smaller costs in the hardships of unemployment. Keynes' contribution in this view was not to economic theory but to economic policy.

The Theory of Keynes' General Theory and Our Present Inflation

The theory of Keynes' General Theory is not only different from the theory that is known as the neoclassical synthesis, but it is also more relevant for our understanding of our current economic problems. The inflation of our time is an outgrowth of the very success we have had in avoiding a serious depression since World War II ended. In fact, our success in avoiding even a mild recession in the years 1960-1968 may be considered a proximate cause of the current disarray.

As was mentioned earlier, Keynes in The General Theory built an investment theory of economic activity and a financial theory of investment. In particular, investment --and capital asset ownership-- is financed to a greater or lesser extent by debts. Furthermore, in our sophisticated financial system, specialized organizations exist -- such as banks, insurance companies, savings and loan associations, mutual funds, and pension funds -- which issue their own debt in order to acquire financial instruments. There is a vast layered debt structure alongside the production and consumption oriented units of the economy. The basic thing about liability structure of firms, households, and financial institutions is that they depend more upon conventions, hopes, and expectations than upon any technical constraints. Thus the extent of liability structures will evolve as views about the future of the economy change.

The post-war period began with the trauma of the Great Depression fresh in the memory of all - bankers, ordinary businessmen, and households. Private liabilities relative to income were very low, and business and banking finance was 'conservative!'. As the economy went through the 1950's and the first part of the 1960's without any financial strain and with only mild recessions, the conservative outlook in balance sheets was eroded; in fact, those who 'stretched' their liabilities to acquire capital assets turned out to be winners. The payoff from speculation in the whole turned out to be favorable.

The government policies to accelerate growth first adopted during the Kennedy years took the form of increasing the payoff to capital asset ownership and investment -- i.e., the payoffs from speculative finance were increased by government actions. As a result, the financial structure became increasingly fragile - more prone to disruption. The first time the viability of the liability structure was seriously threatened in the postwar era was in 1966. At that time, the Federal Reserve System intervened to protect banks, savings and loan associations, and mutual savings banks. The Federal Reserve validated the debt structure. Thus after a slight pause the expansion of debt-financed asset acquisition resumed.

The period of 1966-1970 was the period of 'conglomerates.' The conglomerate movement resulted in refinancing the ownership of capital assets so that the debt-financing used to control capital-assets increased. This debt expansion era culminated in the Penn-Central crisis in the commercial paper market. Once again, the Federal Reserve intervened to halt the liquidation of debt. Once again, after a slight pause, the expansion of the economy continued.

At this writing, another embryonic financial crisis is emerging in the plight of the Franklin National Bank.

It is interesting to note that in the four-five years prior to 1966, inflation as measured by the broadest index was in the 1.5% range; in the years between '66

and '70, it was in the 3% range, and in the years '70-'73, inflation averaged around 5% per year. Each time an embryonic financial crisis is prevented from escalating by Federal Reserve intervention, the rate of inflation seems to move to a higher plateau.

We now seem to be faced with a choice between accelerating inflation and a serious deflation of debt. Historically, deflations of debt -- such as happened in 1929-33 -- have been associated with deep depressions. The current economic malaise may reflect a view that the accelerating inflation cannot go on forever, combined with the fear that there is no way short of a serious depression by which we can get off of the back of the inflation tiger.

The current dilemma in policy, the current disarray of the economy were born out of the apparent success of the economy in avoiding any serious depression in the period since World War II.

Is There an Alternative to the Accelerating Inflation-Deep Depression Choice

The apparent conclusion that the country is faced with either accelerating inflation or a debt deflation is quite dismal. Economics was labeled the dismal science in the nineteenth century, because it articulated the limits of what is possible. Keynes in the twentieth century moved the frontier of what is possible forward; although he did not promise perfection, he showed how the most dismal of economic prospects, deep depressions, can be avoided.

In many ways, the lesson about policy preached by Keynes has been perverted in the economic policy techniques that have been adopted. Keynes viewed deep depressions as the result of too little investment, given the propensities to consume. His solution was to raise consumption -- both private and public. Public consumption are those items -- such as parks, schools, health, safety of person and 'culture' -- which in a civilized community are the birthright of all. In the Roosevelt recovery period, these public consumption and public employment thrusts took the form of W.P.A., C.C.C., and N.Y.A.

During World War II, the public employment of the recovery period was replaced by a government contract system, which has continued after the war. Ostensibly private firms exist which in fact are no more than modern high cost substitutes for government arsenals.

To government contract spending two items were added in developing today's policy strategy: a growth orientation which took the form of tax and subsidy devices to induce private investment, and an enormous increase in transfer payments, in particular, social security.

The tax and subsidy devices for private investment -- together with the success in avoiding 'serious depressions' meant that an accelerating pace of investment was being increasingly debt financed -- and as was pointed out, increased debt was built into the ownership of the inherited stock of capital-assets during the conglomerate boom. To sustain this debt, the profits of business has to keep pace with the growth of debt. Thus economic policy took various forms which tends to increase profits -- and if profits could no longer be increased as a share of income, the dollar volume of profits could be increased by inflation.

Transfer payments -- social security, government pensions, medicare, food stamps, etc. -- increased by some 70% over the past five years. These attempts to transfer increased proportion of total output from the active to the inactive members of the population are inflationary. Our entire Social Security and Retirement System was built in the pre-Keynesian depression era, where one way in which unemployment could be decreased was by getting people out of the job-seeking class. Now that we know we can create jobs for all, we should really rethink our social security and retirement philosophy.

The contract, growth and private investment, and transfer payments strategy of policy to achieve full employment has sired our current predicament where accelerating inflation or a deep depression seem to be the alternatives before us.

To increase the range of alternative outcomes that are possible we will need to abandon the contract, investment, and transfer payment strategy. The thrust of the present strategy is to get employment by making it profitable for firms to hire -- first profits then employment is the logic of this strategy. In the 1930's, when unemployment was the dominant problem, the government used a number of devices -- W.P.A., CCC, and N.Y.A. -- which directly attacked unemployment by creating jobs. A strategy of job creation, for the direct production of useful public facilities and services is a way in which we can break away from the vicious cycle of inflation and embryonic crisis, followed by an increase in the pace of inflation as the crisis is resolved by Federal Reserve action which does not allow that crisis to trigger a serious depression.

I have often quipped that I don't mind that Lucky Strike green went to war and never came back, but I do mind that the CCC was allowed to lapse and has never been reinstated.

The time has come for serious reforms in the way we manage our economy. Unfortunately, it may turn out to be true once more, that it will take an even more serious economic crisis than we now face to trigger these reforms. Meanwhile, we may well go through another cycle or two of accelerating inflation as the Federal Reserve floats off a debt structure that is crisis prone.