

4-2001

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Recommended Citation

Galbraith, James K., "Put Your Chips On 35" (2001). *Archives of the Levy Economics Institute*. Paper 75.
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PUT YOUR CHIPS ON 35

JAMES K. GALBRAITH

According to Federal Reserve Chairman Alan Greenspan, we live in a time “profoundly different from the typical postwar business cycle.” Our experiences have “defied conventional wisdom” and mark “veritable shifts in the tectonic plates of technology.” Evidently, the law of supply and demand *has* been repealed. This is the theme of “Put your chips on 35”—where 35 refers to the standard industrial classification code for machinery, of which 357, computers and office equipment, is the ground zero of the technological earthquake.

HOUSE CONCURRENT RESOLUTION 133 OF 1975 and the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978 together created a framework for regular reporting by the Federal Reserve to Congress.¹ It was, originally, a numerical framework, dominated by monetary targets and—after a memorable dust-up in the early hearings—the regular publication of a rudimentary macroeconomic forecast. The purpose was to permit routine comparison of predictions with outcomes, and therefore the exposure of systematic bias in targeting procedures.

The Humphrey-Hawkins requirements coincided with the rise of monetarism—the theory relating money supply growth to inflation—but they outlived monetarism’s demise in the early 1980s. They have since evolved, as institutions and processes will, into a forum for principally nonquantitative, even philosophical dialogue between the Federal Reserve and Congress—and, through Congress, between the Federal Reserve and the public. Indeed, the reporting requirements, though originally obscure, eventually became the only part of the Humphrey-Hawkins legislation to have enduring effect, and have spawned a degree of public communication unprecedented in central banking history.²

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It is one of the fine accidents of history that as this process matured in the late 1980s, the leadership of the Federal Reserve passed into the hands of a man with a philosophical bent and a bit of philosophical training—as close to a philosopher-king as a central bank is ever likely to see. Thanks to this confluence of volubility and reporting requirements, we have the opportunity to ask, by what sort of philosophy are we governed?

I don't propose to push that inquiry all the way back to the 1980s, but merely to pick it up in the late 1990s, as expressed in Chairman Greenspan's speeches. I will isolate only the most important elements relating to monetary policy, leaving aside, in particular, Mr. Greenspan's forays into fiscal policy advising. Apart from considerations of space, these require a deeper forensic talent than I can muster here.

A mainstay of Greenspan philosophy—indeed, a consistent theme over decades—has of course been fear of inflation. In a speech on December 5, 1996, to the American Enterprise Institute, made famous by its reference to “irrational exuberance,” he put it this way: “Although in the 1950s and the early 1960s there were short-lived bouts of inflation that caused momentary concern . . . these events did little to shake the conviction [that] America's economic and financial structure would indefinitely contain any inflationary forces. . . . That this view was profoundly wrong soon became apparent.” The counterrevolution in mainstream economic thinking at this time—the fear of inflation and more particularly the monetarist view that the Federal Reserve was “everywhere and always” to blame for inflation—profoundly seared the chairman. Fear is a powerful motivator, and remained Greenspan reflex long after the specific reference to quantitative control of the money supply disappeared. This has left the Federal Reserve with a mandate, but no way to achieve that mandate *ex ante*—no way to control inflation, *except* by reaction to rising prices with draconian increases in interest rates, or by running the economy continually at a huge margin of excess capacity and perpetual unemployment.

This dilemma appears to be the true origin of the appeal of the NAIRU (nonaccelerating inflation rate of unemployment, or, more generally, the natural rate of unemployment) doctrine. An intellectual scheme that John Maynard Keynes had already derided as “crazily improbable” back in 1929 could not have taken hold except as an instrument to provide the Federal Reserve with a margin of safety on its rightward flank. The difficulty was, where was it? Was the dangerous unemployment rate 7, 9, 5, or 4 percent? Although he accepted NAIRU in principle, Greenspan himself seems never to have been strongly committed on the question of fact—though many others lost their reputations by betting that inflation would accelerate as soon as unemployment dropped below 6 percent.

It is to Greenspan's great merit that he was willing to test the limits of how low the jobless rate could go without sparking hyperinflation. It turned out—surprise of surprises—that the economy could go at least to the original medium-term targets of the Humphrey-Hawkins Act—4 percent unemployment—with less than 3 percent inflation! Having achieved this

goal, albeit some 20 years late, will be Mr. Greenspan's enduring historical accomplishment. Or it will be if, as I intend, I have something to do with writing the history.

What Chairman Greenspan ought to have learned from this experience is another question. It would have been reasonable to draw a bold conclusion: that the monetarists and the accelerationists were profoundly wrong, and that an alternative tradition going back to Robert Eisner and even to the much-derided Leon Keyserling has been correct. As Alan Greenspan himself expressed it, perhaps “the conviction that America's economic and financial structure would indefinitely and effectively contain any inflationary forces” was not so far off the mark after all.

But Greenspan did not draw this conclusion. Instead, he retreated to a series of indefinite and nebulous inflation warnings—if full employment was not going to give us inflation acceleration, something else surely would. Some of these bordered on the bizarre. For example, on March 6, 2000, at Boston College, Mr. Greenspan said, “The pickup in productivity . . . tends to create even greater increases in aggregate demand than in aggregate supply [due to] higher expectations for long-term corporate earnings.” In other words, a phenomenon we know to be driven by price *declines*—by the peculiarly exaggerated deflators deployed in the computer sector—is . . . inflationary! And the act of purchasing corporate equities, which most would regard as an act of saving or, at the worst, an allocation of existing savings, becomes an act of . . . inflationary excess consumption!

As quickly as it had appeared, this rationale disappeared, to be replaced, on April 5, 2000 at the famous White House Conference on the New Economy, by the specter of a collapsing dollar: “[W]e do not know how long net imports and U.S. external debt can rise before foreign investors become reluctant to continue to add to their portfolios of claims. . . .” This was a peculiar self-effacement for the most powerful lender of last resort the world has ever seen. But what is particularly not addressed is how a loan that is essentially forced in the first place—the covering of the U.S. current account deficit with dollar credits—can be voluntarily withdrawn by those on whom it has been forced. If there were viable alternatives to dollar reserves, foreigners would have bought them long ago. It is precisely the removal and denial of those alternatives that the destruction of Bretton Woods brought about in 1971, and that U.S. policy has maintained assiduously ever since.

By July 20, 2000, this argument, too, had subsided. It was replaced by a collage of nebulous and subjunctive assertions:

- For some time now the growth of aggregate demand has exceeded the expansion of production potential.
- There has to be a limit as to how much of the world's savings our residents can borrow. . .

- Just as there is a limit to our reliance on foreign saving, so is there a limit to the continuing drain on our unused labor resources.
- [S]hort of a repeal of the law of supply and demand, labor costs eventually would have to accelerate to levels threatening price stability. . .

These are the musings of a wet in a dry county. “Any storm in a port!” had, by then, become the motto. And, of course, the law of supply and demand says no such thing.

Inflation never materialized. It was to cover this mortally embarrassing fact—which without the previous deep philosophical commitment might otherwise have been simply credited to wise and sober policy—that our philosopher developed, beginning in January 2000 or perhaps earlier, his now-famous New Economy arguments.

On January 13, 2000, at the Economic Club of New York, Chairman Greenspan assayed these ideas. We were beginning to realize that we lived, he said, in a time “profoundly different from the typical postwar business cycle.” Our experiences had “defied conventional wisdom”—that fine Galbraithian phrase!—and marked “veritable shifts in the tectonic plates of technology.” This declaration was hedged, of course: those tectonic movements could, conceivably, be just another speculative bubble. But the overall drift was one of enthusiasm. Evidently, the law of supply and demand *had* been repealed. This is the theme of “Put your chips on 35”—where 35 refers to the standard industrial classification code for machinery, of which 357, computers and office equipment, is the ground zero of the technological earthquake.

Why, if the enthusiasm was well-grounded, interest rates still needed to rise until May 2000, and then not be cut until after the election, was not made clear then or later. But I digress.

We know now that the New Economy was, in fact, mainly a bubble. Indeed, we ought to have known this by the late fall of 1999 at the latest. At that time, the Dow and Nasdaq diverged, and a few voices called for the Federal Reserve to act on its own authority—to raise margin requirements, among other steps—to quell the speculative singularity then developing. But no action was taken, and in April 2000 the bubble popped.

By the time of the February 2001 Monetary Policy Report (Humphrey-Hawkins had expired, but the hearings went on), he was back to an ordinary analysis of a developing slump, precisely the event *least* foreseen in any previous testimony. Efforts to make the slowdown appear “inevitable” now appeared, but these could not be squared with the hedged-every-which-way failure to predict it in advance. Mr. Greenspan appeared trapped, for the moment, on the horns of a philosophical dilemma. Either the future is contingent, or it is not. If not, then the future should be foreseen, and there is no harm in talking about it in advance. If the future is contingent, then it can be influenced by human and policy action, and in that case, the question of responsibility must necessarily be raised.

The New Economy debacle exposes a deeper flaw in Chairman Greenspan’s philosophical position: his core belief that capital markets are the best judges of capital allocation. Mr.

Greenspan has said this many, many times, going back to his days with Ayn Rand—if there is an enduring cornerstone to his worldview, this is it.

The current economy places us, with him, in a philosophical fork in the road. The dilemma: either the New Economy productivity miracle was really, really true, in which case capital markets are indeed all-wise and to be trusted, or it was truly a speculative debacle, in which case it was fueled, in part, by the Federal Reserve’s own deployment of the New Economy argument to excuse the prior failure of its own inflation predictions, indeed, of its own prior commitment to the view that prosperity was an inherently dangerous thing.

In the latter case, we must draw two conclusions. First, that the “Put your chips on 35” economic philosophy expressed in high places can have pernicious effects on the behavior of private capital investors. Now that the consistent reporting process and ancillary speeches have made a clear public record of the inconsistencies of this philosophy, our need is surely for a thorough clearing-out of the cumulative inventory of economic theory in these areas, from the New Paradigm to the NAIRU to the monetarism that still implicitly underpins much deeper theory. It was these ideas—wrong from the very start—and the struggle to escape from them without actually repudiating them, that have brought us to our present impossibly contorted position.

Second, we must conclude that the Old Objectivism is also wrong about capital markets. They hold, and should hold, no privileged position as the best allocators (at the margin) of scarce capital resources. Government might do better to invest in things that are scarce by any measure: more school buildings, trains and transit systems, air traffic control, environmental cleanup, public health, and cultural amenities, rather than fiber-optic cables and routers. If that’s the case, if we could have done better—and could we possibly have done worse?—then a true rethinking of our philosophy is very long overdue.

Notes

1. Under H. Con. Res. 133, the reporting was quarterly; it became semiannual under the Humphrey-Hawkins Act.
2. Indeed, the framework proved sufficiently durable to have survived the legislative mandate that gave rise to it; now the reports go forward without the Humphrey-Hawkins label.

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2001 / 4

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