Controlling the Economic Future

Policy Dilemmas in a Shrinking World

Michael Stewart

READER IN POLITICAL ECONOMY
UNIVERSITY COLLEGE LONDON

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Preface

I am grateful to a number of people for their help and encouragement in the writing of this book. Partha Dasgupta, Lynette Kemp and John Spraos provided valuable comments on various sections of the draft, and Frances Stewart on the draft as a whole. If I have not succeeded in incorporating all their suggestions, the fault is mine and not theirs. I am also indebted to Joe Pechman and the Brookings Institution for providing me with the facilities to undertake some of the study on which the book is based.

To the memory of Anna

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1 Introduction

This book represents an attempt to put flesh and blood on a simple but important perception. The perception is that when governments make macroeconomic decisions they do so in a thoroughly myopic way. They look at the effects of their decisions on their own country, but not on other countries. They look two or three years ahead, but no further.

This limited horizon—both spatially and temporally—may once have been legitimate, but is so no longer. The world has become much more interdependent, and the decisions made by major industrial countries can have effects around the world. At the same time, man's activities have begun to have a serious effect on the environment: decisions determined solely by the needs of the next few years can impose unwanted and irreversible constraints on future generations.

The aim of the book is to explore the nature of these problems, and to discuss the new directions economic policy will need to take if they are to be effectively tackled.

The plan of the book is as follows. Chapter 2 discusses traditional macroeconomic policy—both Keynesian and monetarist—and two key presumptions on which it is based: that in making their policy decisions, governments are concerned only with the interests of their own citizens; and that these policy decisions relate to no more than the next two or three years.

Chapter 3 briefly documents the growth of interdependence in the world economy over the past ten or fifteen years, with particular reference to the growing importance of international trade and capital flows.

Chapter 4 traces in some detail how fiscal and monetary policies pursued in one country affect key variables in other countries. (This is a relatively technical chapter, and pages 30–40 in particular may be omitted by the general reader prepared to take on trust the fact that *any* macroeconomic decision in one country will have *some* effects on any other country to which it is linked by trade and capital flows.)

Chapter 5 argues that the general consequence of macroeconomic policies which take no account of effects on other countries is, given the attitudes and activities of the world financial community, a deflationary bias in the working of the world economy as a whole; and that this process has recently been intensified by a newly-resurrected and frequently inappropriate hostility to budget deficits.

Chapter 6 examines in some detail the way in which the deflationary bias has operated in a number of OECD countries over the past decade, reinforcing restrictive policies and discouraging expansionary ones.

Chapter 7 discusses two different strategies which countries might adopt in order to avoid the effects of this deflationary bias: de-linking from each other by imposing import and exchange controls; and co-ordinating their macroeconomic policies more closely.

Chapter 8 moves on to consider the temporal dimension, asking whether traditional short-term demand management policies are capable of creating and maintaining full employment in a world in which rapid technological change is eliminating large numbers of existing jobs, and suggesting that among other things there will need to be an increase in the size of the public sector.

Chapter 9 introduces a more fundamental aspect of the time dimension, noting that traditional macroeconomic policy takes no account of the long-term problems of resource depletion and environmental pollution.

Chapter 10 focuses on the energy question, arguing that although there is no prospective difficulty about generating virtually unlimited amounts of energy, existing technologies only permit this to be done in ways that will create increasing risks to the environment.

Chapter 11 examines the prospects for energy conservation, and for the generation of energy in non-polluting ways, and argues that these and other environmental problems can only be solved by radical, internationally co-ordinated action.

Finally, Chapter 12 attempts to pull the various threads of the argument together, discussing the approaches which hold out the best hope of successfully tackling both spatial and temporal problems.

2 Traditional Macroeconomic Policy

Macroeconomic policy, the most important legacy of the Keynesian revolution, is policy designed to influence a country's main economic variables. These can be regarded as the level of output and employment, and hence the rate of unemployment; the rate of inflation; and the rate of growth. In a centrally-planned or command economy these variables may be determined—or purport to be determined—by decision of the central authority. In capitalist or mixed economies of the Western European, North American or Japanese type the situation is more complicated. The level of output and employment will be determined by the level of effective demand—i.e. the expenditure on goods and services of the government, businesses, households and (in the case of exports) foreigners. The level of output and the rate of unemployment, together with the associated return on capital, are likely to be major determinants of the level of investment, itself an important determinant of the rate of growth of the economy. The balance of payments on current account will be heavily influenced by the level of effective demand in the economy. Even inflation, though nowadays clearly not simply the consequence of an excessive pressure of demand in the economy, and thus not susceptible to treatment by demand management alone, will be affected by what is happening to the level of demand.

This emphasis on the management of demand as the central feature of macroeconomic policy in no way detracts from the importance, in improving the performance of the economy, of the microeconomic or 'supply-side' measures of which a good deal has been heard in recent years. In Britain, for example, numerous steps could in principle be taken which would permit the level of output to be higher, the unemployment rate to be lower and, in all probability, the underlying growth rate of the economy to be increased. Such steps might include the provision of more effective facilities for training and re-training; increased subsidies for research and development; measures to discourage restrictive practices in industry and the professions; changes in housing policies so as to promote the geographical mobility of labour; changes in the structure of the tax and social security system so as to reduce effective marginal tax rates at both the top and the bottom of the scale; and many others. But supply-side policies of this kind, valuable—often essential—though they may be in promoting a more efficient economy, can in no way be a substitute for macroeconomic policy and its concern with the level and pattern of effective demand in the economy.

The essence of Keynesian macroeconomic policy is the use by government of a variety of instruments—fiscal policy, monetary policy, exchange rate policy—in order to achieve its economic objectives. These instruments will usually have their effects on the main economic variables by changing the level and pattern of effective demand; though in the case of one important instrument of macroeconomic policy—incomes policy—the effect on the target variable—the rate of inflation—is intended to be direct.

In employing various instruments in order to achieve their main economic objectives, governments face three different kinds of problem. First, there is the need for reasonably accurate forecasts of what is likely to happen in the economy over the next two or three years on the basis of existing policies. Without such information, the government is working in the dark: it has no basis for deciding whether, or how, to use the instruments at its disposal. Although forecasting is now carried out with the assistance of very sophisticated econometric models, the economy is so complex and the occurrence of major and minor shocks to the system so inherently unpredictable that there will always be a considerable degree of uncertainty about the behaviour of the economy even in the short run, and hence about the appropriate action for the government to take.

The second kind of problem lies in the fact that the achievement of one economic objective may conflict with the achievement of another, or may be constrained by other factors. One example of this is the conflict that is often said to exist between inflation and unemployment. Few would now argue—as some did twenty years ago[1]—that there is a close and predictable trade-off between these two variables. Nevertheless, the notion that a low unemployment rate, associated with a tight labour market and a seller's product market, is likely to lead to a faster rise in wages and prices than is a high unemployment rate, slack labour markets and a general difficulty in selling goods, is supported by both historical experience and common sense. There is accordingly likely to be some conflict between the objectives of low unemployment and low inflation, though the parameters of the conflict may vary widely at different times and places.

A different example of the same kind of problem that faces governments in formulating macroeconomic policies arises if a high rate of growth requires—as it often seems to—a high proportion of the gross domestic product (GDP) to be devoted to investment. This calls for either a sacrifice of current consumption (public or private)—broadly speaking the solution adopted by the centrally-planned economies of the Soviet Union and Eastern Europe; or a balance of payments deficit financed by borrowing abroad—broadly speaking the solution followed by developing countries. The first course can lead to acute internal discontent, the second to mounting overseas debt-service difficulties.

A second set of problems confronting governments in the formulation of economic policy, then, is that greater success in achieving one economic objective may have to be balanced against the costs of less success in achieving another, or in terms of strains of other kinds set up in the system. An obsessive concern with any one objective of policy—whether it be inflation, unemployment or growth—is likely to lead to trouble. In this field, as in others, the task of government is to strike compromises between conflicting objectives, and reconcile the often incompatible aims and interests of different groups in society.

The third set of problems is more technical, and arises from the fact that the instruments of economic policy tend to affect more than one target variable, or—to put it the other way round—that target variables are affected by more than one instrument. Thus particular objectives can be attained by different combinations of instruments; and different combinations of instruments will have different effects on other objectives. An anti-inflationary policy which relies exclusively on a reduction in the level of demand through fiscal and monetary policy, for example, may involve a higher rate of unemployment, for any given reduction in the inflation rate, than if some reliance is also placed on an incomes policy. Similarly, a rise in output and employment brought about by a reduction in the exchange rate which raises exports and reduces imports may be associated with more inflation than an equivalent expansion of output and employment achieved by a reduction in indirect taxes; but the effect on investment, and hence on the growth rate, of a rise in export demand and a stronger balance of payments may be more favourable.

The art of successful macroeconomic policy-making lies in using the different instruments available to the government in a combination which secures the most acceptable mix of objectives that can be attained. The trade-offs between different objectives will vary at different times and in different places, as will the coefficients which link instruments to target variables; and knowledge of what these trade-offs and coefficients are will always be far from perfect. The essential nature of Keynesian economic policy-making will, however, remain the same. Governments will endeavour to influence the level and pattern of demand so as to maintain output at a high level—high enough to preserve full employment, though not so high as to create inflationary shortages in the markets for goods or labour. Incomes policies may be used to moderate cost-inflation. The high level of output, employment and capacity utilisation (supplemented perhaps by subsidies or tax allowances) should provide business with an incentive to invest, and from this new investment, coupled with other, less tangible, factors will spring sustainable economic growth.

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During the 1960s, some doubts began to be expressed about the efficacy of Keynesian macroeconomic policies. This applied particularly in Britain—the country in which the *General Theory* had been written and in which, in the famous 1944 White Paper on *Employment Policy*, the government's responsibility for managing effective demand so as to maintain full employment had first been explicitly recognised. One observer suggested that Britain had had full employment since the war not because of Keynesian demand management policies, but because of the buoyant behaviour of exports and private investment—two categories of expenditure over which the government had little or no control.[2] Another argued that because of a failure to understand the structure of time-lags in the economic system, government macroeconomic policy in Britain had sometimes exacerbated rather than smoothed out cyclical fluctuations, and thus been destabilising rather than stabilising.[3] These comments, though disturbing to the conventional wisdom according to which Keynesian policies had been followed since the war, and had worked, were nevertheless made from within a Keynesian framework of reference. The fact that expansionary Keynesian policies to stimulate demand might not in practice have been needed in Britain in the 1950s and early 1960s carried no implication that they might not be needed in the future. Similarly, the fact that macroeconomic intervention might in practice have been destabilising carried no implication that this was inevitable; and indeed there was evidence that Britain was the only one among a number of OECD countries[4] in which interventionist policies had been destabilising rather than stabilising, and that in these other countries Keynesian policies had been successful in maintaining a high and stable level of economic activity.[5]

In the 1970s something quite different happened: the whole concept of interventionist macroeconomic policy came under attack. By the early 1980s the rationale of the economic policies being pursued by the Thatcher government in Britain, the

Reagan Administration in the US, and—though in a more muted way—a number of other OECD governments, was totally different from what it had been twenty years earlier.

The basic reason for this dramatic change lay in the re-emergence of the belief—almost universally accepted in the nineteenth century—that the economy, if left to itself, is self-stabilising. There are, according to this doctrine, powerful forces at work which ensure, in the wake of any shocks impinging on the system, that the economy is brought back fairly quickly and smoothly to full employment equilibrium. Any attempt to improve on this process by macroeconomic intervention is likely to do more harm than good.

This doctrine is fundamentally anti-Keynesian. The central tenet of Keynes' *General Theory* is that the economy can get stuck for a long time at an equilibrium involving a high level of unemployment, and that only government intervention to increase effective demand will set in motion forces which will bring the economy back to full employment. More generally, Keynesian economists have stressed the importance of de-stabilising elements in the economy, and the cumulative forces which come into play once the economy starts moving away from equilibrium, driving it towards the extremes of depression or rapid inflation. These forces—they argue—are often more powerful and more persistent than the forces which automatically encourage stability in the economy.

The main anti-Keynesian, or monetarist, view of how the economy works, which became increasing widely-held during the 1970s, is associated particularly with the name of Milton Friedman. According to Friedman, the economy, if left to itself, will gravitate towards its 'natural' rate of unemployment. At this natural rate of unemployment—which may vary at different times and in different countries, depending on institutions, attitudes, the structure of labour markets etc.—the inflation rate will be stable. Macroeconomic policies designed to increase effective demand and thus to reduce unemployment below this natural rate may be successful in the short run, but only at the cost of increasing the rate of inflation. This increase in the rate of inflation will soon result in unemployment moving back up to (or temporarily above) the natural rate; any attempt to frustrate this process by further injections of purchasing power to increase effective demand will merely lead to a further acceleration in the inflation rate. In other words, only in the short run can macroeconomic policies affect *real* magnitudes, such as the level of output or the rate of unemployment; in the longer run all they can do is affect the rate of inflation. (Indeed the 'rational expectations' school of economists, from whom much was also heard during the 1970s, claims that not even in the short run can macroeconomic policies affect real economic variables.) It is therefore misguided to use fiscal policy (variations in the budget balance) or monetary policy (changes in the money supply or interest rates) in a Keynesian way, as discretionary instruments of economic policy designed to maintain or restore full employment. Fiscal policy should be confined to raising enough taxation to pay for whatever level of public expenditure the government is committed to—i.e. balancing the budget. Monetary policy should recognise that over time there is a close correlation between the growth of the money supply and the growth of the *money* GDP, and should be confined to ensuring that the money supply grows steadily, and in line with the trend growth of the country's *real* GDP. The result of this will be a stable price level, or a zero inflation rate. So much importance is attached by some supporters of monetarism to the balancing of the budget and the control of the money supply that they advocate removing decisions on these matters from the hands of governments. A powerful movement developed in the United State in the 1970s in favour of amending the Constitution to exclude the possibility of unbalanced federal budgets; and in Britain it has been suggested that the control of the money supply be vested in a permanent, unsackable Currency Commission.[6]

Three things need to be said about this doctrine that the economy is self-stabilising, that macroeconomic intervention does more harm than good, and that governments should confine themselves to balancing the budget and controlling the money supply.

First, it simply does not appear to be the case that advanced industrial economies are self-stabilising, at any rate in a time scale shorter than a decade or two. The heavy unemployment which persisted in Britain throughout virtually the entire interwar period, the great world depression of the 1930s, and even the more recent recessions of the mid-1970s and early 1980s, cannot easily be reconciled with such a doctrine. Nor can the observed fact that government action to increase or reduce effective demand does have effects on output and employment. These effects, moreover—because of the interaction which takes place between the level of output and the level of investment—can in turn have a significant influence on the longer-term growth of the economy.

Secondly, even if it is true that the economy is self-stabilising and intervention is pointless or even harmful, politicians do not behave as if it is true. Politicians—even conservative politicians—live and operate in the short run; every four or five years they have to face the electorate. President Nixon, for example, took office in the United States at the beginning of 1969 pledged 'to balance the Federal budget so that you can balance the family budget' and to stop inflation by cutting back the increase in the money supply. Two years later, however, after congressional mid-term elections which were widely interpreted as an adverse judgment on his economic policies and the rising unemployment to which they had led, Nixon had dramatically changed direction: taxes were cut, public expenditure increased, the money supply was rising fast and interest rates were falling. A little later on a formal incomes policy was introduced. Not surprisingly, in view of all this, Nixon described himself, early in 1971, as 'now a Keynesian'. A decade later, something similar happened to Ronald Reagan, the most conservative American president for fifty years, elected in November 1980 on a pledge to balance the federal budget by 1983–84 and to endorse the Federal Reserve Board's policy of tight control of the money supply. By the time of the mid-term elections two years later all talk of balancing the budget had been abandoned, and heavy pressure had successfully been brought to bear on the Federal Reserve Board—formally independent of the Administration, though not of Congress,[7] and itself increasingly worried by falling output, rising unemployment and bankruptcies and the spectre of defaults by both domestic and foreign borrowers—to ease its monetary policies.

In Britain the story was not very different, at any rate in the early 1970s. Edward Heath took office as Prime Minister in June 1970 on an essentially monetarist platform, but a couple of years later, in response to mounting unemployment, did a complete U-turn, cutting taxation, increasing public expenditure, permitting a rapid rise in the money supply, and introducing a statutory incomes policy. Mrs Thatcher, the next Conservative Prime Minister, who took office in May 1979, was made of sterner stuff, and had conceded relatively little to the critics of her hard-line monetarist policies by the end of 1982—though in fact the money supply had increased significantly faster during the previous three and a half years than she had planned for. But her ability to persist with policies which had led to a fall of some 20 per cent in manufacturing output and a near-trebling of unemployment since she had taken office[8] owed much to two adventitious circumstances: the establishment of a new political party by Labour's right wing—under Britain's first-past-the-post electoral system a completely fatal splitting of the opposition to her government; and the patriotic fervour aroused by the successful military reoccupation of the Falkland Islands, of which Mrs Thatcher was the main beneficiary. It seems likely that it was only the power of these two factors which, in the June 1983 general election, saved the Conservative government from the fate that usually overtakes politicians who continue, in the face of the evidence, to insist that the economy is self-stabilising and that government intervention is unnecessary or harmful.

Thirdly, even if politicians *were* to confine their economic policies to controlling the money supply and balancing the budget, they would still be affecting the economy. In fact, a balanced budget is consistent with a wide range of effects on the economy, depending on the composition of the government's expenditure and revenue.[9] But even if one assumes that a balanced budget does have a neutral impact on the economy, this impact is different from what it would have been if the government had budgeted for a surplus or a deficit. What happens to the economy as a whole depends not only on the balance between government expenditure and government revenue, but also on the balance between private saving and private investment, and between imports and exports. A balanced budget represents only one among a number of