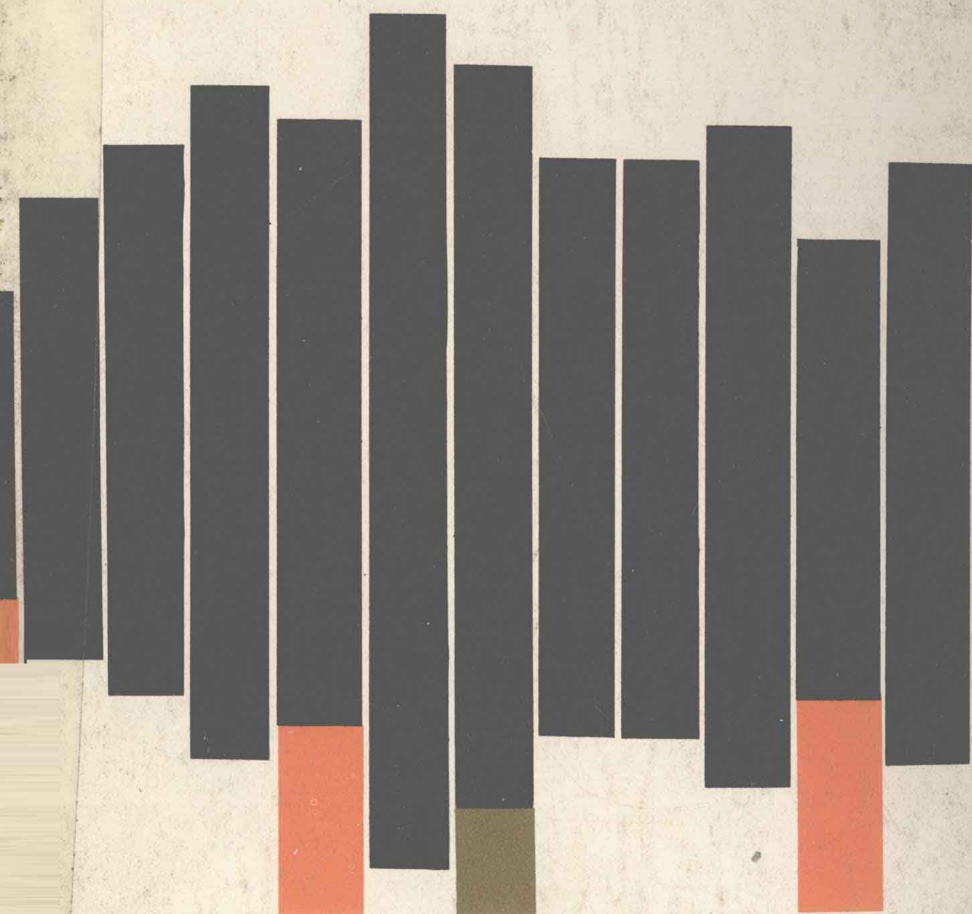
Toward Economic Stability

MAURICE W. LEE



Introduction to Economics Series

Toward Economic Stability

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John Wiley & Sons, Inc. New York · London · Sydney

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Library of Congress Catalog Card Number: 66-25227
Printed in the United States of America

Introduction to Economics Series

Teachers of introductory economics seem to agree on the impracticality of presenting a comprehensive survey of economics to freshmen or sophomores. Many of them believe there is a need for some alternative which provides a solid core of principles while permitting an instructor to introduce a select set of problems and applied ideas. This series attempts to fill that need and also to give the interested layman a set of self-contained books that he can absorb with interest and profit, without assistance.

By offering greater flexibility in the choice of topics for study, these books represent a more realistic and reasonable approach to teaching economics than most of the large, catchall textbooks. With separate volumes and different authors for each topic, the instructor is not as tied to a single track as in the omnibus introductory economics text.

Underlying the series is the pedagogical premise that students should be introduced to economics by learning how economists think about economic problems. Thus the concepts and relationships of elementary economics are presented to the student in conjunction with a few economic problems. An approach of this kind offers a good beginning to the student who intends to move on to advanced work and furnishes a clearer understanding for those whose study of economics is limited to an introductory exposure. Teachers and students alike should find the books helpful and stimulating.

Kenyon A. Knopf, Editor

Preface

This small volume is intended to provide the student and the interested layman with, more or less, a handbook on economic stabilization. As such, it is quite specifically not a monograph for my professional colleagues who specialize in this area of economics. However, even they might find the skimming of these pages interesting as a reminder of the pace at which progress on the theoretical front has been translated into action on the policy front.

I think, perhaps, these chapters will give the layman an appreciation of the pace at which economic science has evolved in a single generation. Even in comparison with the center-stage space sciences, economics seems no laggard. That unresolved problems still remain will be evident to all who read these pages. Such a reading should also convey something of the strides that have been made in our purposeful efforts *Toward Economic Stability*.

MAURICE W. LEE

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1

Introduction: Stabilization and the Constancy of Change

Within the experience of a single generation of Americans, public opinion about the science of economics has surely undergone a revolution as startling as that in the more spectacular space-age sciences. By the end of World War II, the average person, if he thought at all about economics, regarded it as a field in which the experts were at odds. For the few who gave economics and the people who practiced it any thought, an "in" saying of the period, "If all the economists in the world were laid end to end they still would not reach a conclusion," seemed apt. This attitude of bemused toleration was about as favorable a verdict as economists seemed destined to attain from a practical citizenry. Under the circumstances it was not surprising that little, of a practical sort, was expected.

Within an incredibly short span of two decades, by the mid-sixties, economics had become not only accepted but taken for granted in ways which could not help but cause concern among professional economists. This degree of acceptance was found even among the members of the scientific community which had exploded the bomb and carried the country into the space age. By the mid-sixties these same scientists were lobbying for a council of scientific advisers that could give their fields the status the Council of Economic Advisers had given economics. Economists were in their own turn bemused by the speed with which their field had attained such uncritical acclaim.

It is the purpose of this small volume to explore the central area of this postwar economic revolution. Revolution, indeed, is not too strong a word. The pace at which economic thought itself has evolved is only exceeded by the greater speed with which noneconomists have moved, unconsciously but demonstrably, to matter-of-fact acceptance of the view that the economist can now tell us how to do just about anything we want done to and with our economy.

For all the years the economy of the United States has known, the business cycle has been an omnipresent phenomenon. At times economic instability has assumed acute proportions. But now in the two postwar decades the ever-present business cycle assumed the damped proportions of a minor fluctuation and the rate of economic growth surpassed previous experience. It was not particularly surprising that the average citizen accepted this pattern of reasonable stability with growth as symbolic evidence that economists had at long last become masters of their science.

In the summer of 1965 the economy of the United States had experienced the longest period of sustained expansion it had ever known outside of war. By that time it had also lived through more than 35 years since the onset of the last great depression. The Chairman of the President's Council of Economic Advisers told a convention of mortgage bankers, "I think it is safe to say that the unprecedented duration and strength of our current expansion didn't just happen. Rather, it was the product of policies, public and private, that created a favorable climate for expansion, and which avoided the development of strains and imbalances that have triggered past recessions." [1]

High level stability is both a national goal and an assigned responsibility of the Federal Government. This responsibility for maintenance of high level stability was given to the government under the Employment Act of 1946. By the middle of 1965 there was a considerable amount of support for the view that we had somehow or other learned to cope with the business cycle. There were indeed some who were prepared to announce that business cycles were, like passenger trains on Eastern railroads, a historical

[1] Gardner C. Ackley before the National Mortgage Conference of the National Mortgage Bankers Association, New York, N.Y., March 8, 1965.

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phenomenon which one would do well to observe closely before they became literally extinct. There were, of course, some who remembered that similar statements had been made in the spring and summer of 1929. Indeed the Chairman of the Board of Governors of the Federal Reserve System did make note of the presence of many "disquieting similarities" between the 1965 economy and that of the 1920s.[2] For this statement he was criticized.

What is certainly clear is that the economy of the United States, for all its mighty force and vigorous upward thrust, has been, over its life span, a constant host to recurring periods of economic instability. At times it has enjoyed bountiful prosperity. At other times it has been ravaged by serious depression. In fact our great depressions have generally come upon the heels of our most munificent prosperity episodes. At such times the "permanent-prosperity-prophets" have gone into deep hibernation only to be succeeded by their depression-time counterparts, the stagnation theorists, with a propensity to offer foreboding words about secular decay.

Roy Harrod, a distinguished British economist, has written, "No economy ever stands still. One may take a snapshot of it at a given moment, but one gets a better understanding of it if one reviews its progress over a certain space of time."[3] Any such review of the course of the economy of the United States would show that progress has come with an uneven pace. Fluctuation, and not stability, has been the prevailing characteristic. The economy is constantly beset by one or another of the various kinds of fluctuation which affect economic systems.

I. THE CONSTANCY OF CHANGE

As we examine the actual performance of the American economy, we notice that the only real constant it has shown is change. This constancy of change derives in part from random shocks which at irregular times and in unpredictable degree strike the

[2] As reported in the *Wall Street Journal,* June 2, 1965, p. 3.
[3] Roy Harrod, *The British Economy* (New York: McGraw Hill Book Company, Inc., 1963), p. 15.

economy. But it also derives from other kinds of systematic fluctuation which can be separately classified and identified. We note, for example, the regular impact of seasonal fluctuations that recur one or more times a year, at predictable times and in generally foreseeable magnitude. Such fluctuations are caused either by forces of nature as, for example, the regular change of seasons, or by customs, manifested in the Christmas season, Mothers' Day, and the like. Since by their nature seasonal fluctuations can be foreseen, adjustment to them, although costly, is not uncertain.

Less predictable, both as to timing and magnitude, are the cyclical fluctuations that are continuously evolving within the economy. These carry the system alternately into periods of expansion and contraction. But the emphasis here, it needs to be stressed, falls on the word alternating, without any implication of regularity. It is true that the average business cycle, from trough to peak to trough, has had a duration of approximately four years in this country. However, the longest business cycle lasted 99 months, starting with an expansion from 1870 to 1873 and concluding with a contraction of 65 months stretching from October, 1873, to March, 1879. At the opposite extreme, the shortest cycle the economy of the United States has known lasted only 28 months and occurred in the early 1920's. These are the extremes. Between these outside variations of from 28 to 99 months we find the average cycle of approximately 4 years.

Table 1-1 provides evidence about the duration of business cycles in this country.

Without further information we should be well advised to refrain from drawing many conclusions on the basis of the information contained in this table. We simply note that business cycles in this country have averaged approximately four years in length over the past century and more. Over this period since 1854, the time spent in expansions as compared with time in contraction has run very close to a three-to-two ratio. But more recent experience, from World War I to the present, shows a ratio somewhat more favorable to expansions, standing at seven to three. Furthermore, if experience is confined to the post World War II era, the change is even more striking with expansions running at more than a three to one ratio to contractions. Al-

Table 1-1. Duration of American Business Cycles

	Duration in Months			
	Contraction (Peak to Trough)	Expansion (Trough to Peak)	Cycle	
			Trough to Trough	Peak to Peak
Average, all cycles				
26 cycles, 1854–1961	19	30	49	49
10 cycles, 1919–1961	15	35	50	54
4 cycles, 1945–1961	10	36	46	46
Average, peacetime cycles				
22 cycles, 1854–1961	20	26	45	46
8 cycles, 1919–1961	16	28	45	48
3 cycles, 1945–1961	10	32	42	41

Source. Taken from Maurice W. Lee, *Macroeconomics: Fluctuations, Growth and Stability* (Richard D. Irwin, Inc., Homewood, 1963, third ed.), p. 35, based on Chronology of National Bureau of Economic Research.

though business cycles appear not to have changed greatly in overall duration within this long span of time, expansion phases of the cycle have come to occupy a greater portion of the total cycle in recent decades.

One conclusion is clearly warranted at this time. Within a period of just over a century this dynamic economy has completed 26 business cycles. Alternately over the life of the economy, periods of expansion and contraction have followed each other in an unending series of fluctuations. At one time or another current writers have extolled the arrival of permanent prosperity. They in turn have been succeeded by other prophets who announced the appearance of permanent stagnation.

The economy, with little regard for such forecasts of permanent prosperity or chronic depression, has persistently traced a path of continuous cyclical movement. For as far back as our records of the American society can be carried, this approximate four-year business cycle has been a prevailing force. There has never been a time when the economy was not moving through some phase of the business cycle. In view of this evidence our phrase, "the constancy of change," seems not inappropriate.

II. LONG TRENDS IN THE ECONOMY

Business cycles, and the even shorter seasonal type of fluctuations, weave their evolving path around an underlying long-run movement, known variously as the secular trend, or the growth path of the economy. If we were to use certain standard indicators of performance for the system we would note, by way of illustration, that the total output of the economy has grown at a rate of 3.66% per annum in price-adjusted terms over the period 1839 to 1959.[4]

This is not to suggest that there is anything consistent and regular about the rate of long-term economic growth. At times, year-to-year changes in total output have run well above this average 3 to 4% range. And then again, as in the 1930s, year-to-year growth has been sluggish or even negative, and experts have spoken of economic stagnation.

Indeed, here again, in the case of long-run growth patterns, anyone who studies the course of the American economy from its early days to the present cannot help but be impressed with the constancy of change in the growth rate. We have grown accustomed to speaking of a long-run growth rate of 3 to 4% as though this were some kind of product which the economy automatically ticks out year after year. But this average is like that of the rare disease which, on the average, killed males 45 years of age. Closer examination disclosed that there had been only two instances of the disease, one resulting in the death of a newborn boy and the other in that of a 90-year-old great-grandfather. On the average the disease did kill males aged 45. And, on the average, the United States economy has grown at a 3 to 4% rate per annum. But there have been fairly long periods of little or no growth as in the thirties, or damped growth as in the late fifties, and then periods of abnormally strong growth as in the mid-sixties. Neither growth rates nor cyclical fluctuations show any constancy except that of the constancy of change.

In fact, in ways which are not entirely clear even to those who

[4] From Raymond Goldsmith, "Historical and Comparative Rate of Production, Productivity and Prices," Part 2, p. 271, in *Employment, Growth and Price Levels*, Hearings before the Joint Economic Committee, 86th Cong., 1st Sess. (Washington, D. C.,: U. S. Government Printing Office, 1959).

have devoted a lifetime to the study of such processes, there seems to be an inescapable link between these cyclical economic fluctuations and economic growth. Out of the processes of cylical fluctuation flow the forces that make for economic growth. And economic growth itself sets off uneven reactions in the economy so that demand and supply may appear out of line with one another. At times there may be too much money for the available supply of goods and services, and then prices will be bid up and the economy become overheated. At other times the reaction may run the opposite way and there may be an inadequate supply of purchasing power to take off the market all the goods and services the economy is capable of producing. Then we have idle men and machines.

III. OBJECTIVE: ECONOMIC STABILITY OR INSTABILITY?

In a book dedicated to the study of economic stabilization, it may seem strange to start with an implied question about whether the objective might better be stability or instability. In fact there is some justification for raising the question. In a day when words like "stability" and "stabilization" occupy about the same unquestioned status as "motherhood" and "the American way," there really is point to our asking whether some sort of case might not be made on behalf of economic instability. Perhaps so, even as there is something which can be said for pneumonia, which the doctors can often cure, as against the common cold, for which they have no cure.

In a certain sense quite a bit can be said in opposition to economic stability. The avoidance of all instability implies such a freeze of the economy that nothing changes. But such a freeze, among other things, would eliminate economic growth. In the absence of economic growth our society, by way of illustration, with its growing population, would actually experience declining standards of living. Presumably none of us would cast a vote in favor of a rigidly defined kind of stability which would involve a freezing of the economy.

If, however, we vote for instability in even this limited sense of a changing economy which changes upward, that is, a vote for economic growth, we must realize that such upward coursing

of the economy has never come smoothly and steadily. In a later chapter we shall take time for an extended look at the processes of economic growth. Here we may only go so far as to note that the kind of change associated with growth involves questions of the resource base, the quantitative and qualitative aspects of population, technology and investment.

Economists who have studied economic fluctuations intensively have shown us how erratic is the course of a developing economy. Resources, people, capital, and know-how must be combined effectively for the economy to work. And the processes by which this combining takes place are never smooth; they are the processes which make up the business cycle, the economic fluctuations which are central to the matter of economic instability.

Experts who have studied these economic fluctuations have shown how periods of abnormally high investment have produced strains and stresses in the economy which induced reactions and periods of underinvestment. Others have shown how consumption and investment levels have grown out of balance with each other. Other explanations center around imbalances between saving and investment.

And so there is an inescapable link between cyclical economic fluctuations and economic growth. Out of the fluctuation process flow the forces that produce economic growth. If such growth is the product of those forces which lie at the heart of the process of cyclical fluctuation then we are on the horns of another of those contradictions often found in our real world. We can have growth only if we accept a measure of economic instability. If we press too hard against the forces that result in cyclical instability we run the risk of drying up the very processes which lead to economic growth. In some degree the price of growth is a certain amount of economic instability.

If we accept the idea—as indeed we must—that we need economic growth for the survival of the system, then we must also accept the fact that some measure of economic instability is also necessary. But too much instability may destroy the capacity of the system to grow and discharge its functions effectively. Excessively rapid upward surges of the economy carry it into conditions of overfull-employment where more and more money is bid for an output that is not capable of so rapid an expansion. Labor, materials, and productive facilities move into

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