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# POLICY ISSUES FOR THE NATIONAL ECONOMY

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Two years ago at this time, the economy still had not reached the trough of the recession. Most people were concerned over whether, rather than when, the bottom would be reached. We were experiencing double digit inflation. The energy crisis was fresh in our minds. Unemployment rates were rising rapidly. The Federal Reserve system as much as any other institution in Washington, responsible for policymaking, came in for its share of criticism.

In many ways, the questions regarding inflation, recession, and the like, have been resolved satisfactorily. At the same time, these may not be the questions we should now face. Our major concern may be with questions we have not addressed, simply because we might have thought it beneath our professional dignity to do so, or beyond our capacity to reduce them to quantitative and scientific terms.

## THE CURRENT PICTURE

We are more than five quarters past the recession of 1973-74-75. It is probably no longer appropriate to refer to the current period as one of economic recovery, because recovery implies making up that which has been lost in the past. It is now clear, certainly in terms of real Gross National Product, that we have not only recovered the losses of those preceding quarters, but we have now moved into the phase of the business cycle described as the growth phase.

Since the trough of the recession, this phase has brought us a more than 3.5 million increase in total employment, significant reductions in the rate of price inflation, and a significant increase in business profitability. It also has brought us, miraculously, a structure and level of interest rates and money and capital market conditions that no economist would have been willing to forecast a year ago, six months ago, or perhaps even three months ago.

Just as the question asked two years ago was, how long will the recession last, now the question is, how long will growth continue. Just as the question asked two years ago was, how high will the unemployment rate go, now the question is, how low can we get that rate and still reduce the rate of price inflation. And again, just as concerns were expressed in 1973-74-75 as to how high prices

would get, we now ask realistically, how low can we get the rate of price increase, consistent with increasing levels of employment.

In a presidential election year, a great deal is said about the state of the economy. Those responsible for policies will stress the merits of the present situation and take credit for the benefits. Those who are out and would like to get in would rather focus on the negative aspects of the current economic conditions, and on the rather weak approaches taken to improve the situation. Neither is wholly inappropriate. We should remind people where we are, but never be too smug to acknowledge that at almost any time we can and ought to do better. These kinds of considerations are now being brought before the American people. The “ins” suggest that we have indeed made tremendous progress, and if you stick with them, we will do better still. The “outs” suggest that much of the progress is not as real as it might appear, and that the policies presently contemplated by those who have authority are not adequate to the task.

Well, what is the task? As viewed in the current contest, it is relatively simple, because the time horizon is relatively short. The task is how to get fuller employment of resources and more price stability. In the final analysis the question has just those two dimensions. It does not ask where we are going to be 10, 20, or 50 years from now. It does not ask if we are going to rectify our short term problems with impermissible or excessive long run costs. Rather, it is a task to which politicians and policy makers regularly address themselves, without reflecting whether the questions are meaningful over the longer haul. In fact, the economic profession, to its discredit, has also tended to ignore the long run, accepting almost with relish Keynes' remark “in the long run we are all dead”.

The universal question addressed to Federal Reserve economists is, What is going to happen to interest rates? A year ago the response was: interest rates are going up. And what happened? They went down. Six months ago the question was the same. Again the answer was, interest rates are going up. Obviously when demand pressures stimulate money and capital markets, interest rates will go up. Interest rates went down. Three months ago, we got the same question and the same answer. With the big first quarter of growth behind us, it was obvious that demand pressures were building up. Given the fact that the Fed was opting for moderation and accommodative monetary policy, it was pretty apparent that interest rates were going up. Interest rates have not gone up. I am tired of suggesting that interest rates are going up

without attaching a time dimension to my answer. So let me give you a fearless forecast: at some point, interest rates are going to go up. But, having said that, I really haven't said much.

If our economic growth does not bring fuller utilization of resources, or leads to unacceptable rates of price inflation, are there things that can be done? The answer, within limits, is yes. But I stress that "within limits".

In the short term, we have the capacity to take a great many policy initiatives, but one always has to deal realistically with the problem of leads and lags. Don't expect instantaneous response to any policy initiative. First, it takes a long time to recognize the existence of a problem, and a long time to debate the appropriate policy course. Finally, it takes a long time after executing a particular policy to see the results in our dynamic and diverse economy.

Many people say that the American economy really hasn't recovered and that we are still in a recession. In the aggregate that is not true. However, aggregate figures can disguise a variety of ills within the society. The process of aggregation permits us to make comforting statements about the state of our society and the quality of our lives. We have grown. We have turned around from recession. We are moving into a growth period.

I can say this although the rate of unemployment in August was 7.9%, the unemployment rate for nonwhites is more than double that figure, and the unemployment rate for nonwhite teenagers is close to 40%. We have made some progress but we still have a long way to go before we can or ought to be satisfied with the fruits of this economic system.

The economy still has some distance to proceed. The distance can be measured by a number of indicators, including potential GNP. We are from 125 to 175 billions of dollars short of that potential. Our manufacturing rate of capacity utilization in the second quarter was about 73%. Another gap is measured by the unemployment rate of 7.9%

This gap, conventionally defined, excludes consideration of so-called discouraged workers. If they are added, the level and rate of unemployment is higher. It is not easy to discern how many people are discouraged workers. By definition, they are outside the labor force and largely untouched by household surveys. Even though one cannot readily determine the number of discouraged workers, this does not mean that they do not count. They represent the most visible sign of the shortfalls of this economic system which

we are trying to improve. Because they can't be counted easily, we tend to exclude them from consideration in public policy making. Unfortunately, it is only during election campaigns that this very serious issue arises.

## **FUTURE PERFORMANCE OF THE ECONOMY**

### **The Pause that Refreshes?**

We are in a pause. The question which the president, Allen Greenspan, Jimmy Carter, and Professor Klein of Pennsylvania are pondering is: Is this the pause that refreshes? There are two answers. One is that it is indeed the pause that refreshes. The other is that it is the pause before a return to those rather sad economic circumstances which preceded the recovery in the spring of 1975. Neither is wholly true. As I see it, this is not a pause that will refresh. Nor is the economy likely to take off to new, higher, sustainable levels of growth. Neither are we confronted with a turn-around in economic activity, which will plunge us back again into declining rates of real growth, and dramatic increases in unemployment.

Rather we are seeing the pause that precedes a period of continuous growth, perhaps for the next 6 to 12 to 18 months. But in the absence of some initiatives, this growth will probably be only steady. It will be rather lackluster. It will not lead to significant reductions in the rate of unemployment. Nor will it significantly increase the rate at which we utilize our nation's capacity.

Given labor force developments and productivity trends, the American economy must have real growth in the rate of 4% to 4½% to keep from witnessing rising unemployment and declining rates of plant capacity utilization. This is the minimum rate of growth. Given productivity trends and labor force participation rates (and labor force participation has grown more rapidly in recent months, particularly for women and teenagers), we should ask if future growth will not only be positive and continuous and sustainable, but whether it will occur at rates high enough to redress the present poor resource utilization levels. I am not at all sure. I am not as concerned about another recession as that we might settle down into a rut.

As is always the case, the unemployment rate is a very small fraction of the civilian labor force. You can talk about a 6½% unemployment rate, but certainly a 93½% employment rate is a much bigger number. And it makes some happier to stress that employment rate. We will always have employment rates higher than 50% and therefore, higher than the unemployment rate. But

we should not blithely accept high unemployment rates as the only possible way to bring about the kind of price stability that most Americans yearn for. If indeed, the only thing we can come up with is to plunge the economy into recession, and to live permanently with a vast number of unemployed to generate price stability, then I would have to judge this system very harshly.

#### **Structure—The Neglected Issue**

High unemployment as a precondition for price stability ignores a simple fact: we have, in our life time, seen considerable structural change in the American economy. As a result, too many of us now readily believe that unemployment rates have to be rather high if we are to curb inflation. High employment is a desirable end in itself. Price stability is a desirable end in itself. High employment and price stability were once quite consistent. It was only when we had excessive aggregate demand conditions, “over full employment”, that we talked about the incidence of demand inflation, which could then be aggravated by a relatively new phenomenon called cost-push inflation. I do not recall a time when I defined high employment or full employment as 5% or 6% unemployment. The Economic Report of the President for 1962 suggested that 4% was an interim full employment target. It was a target to be pursued on the road to something better. Obviously that something better was less than 4% unemployment.

Today, we are told by people, who should know better, that given the structural changes that have taken place in the composition of the labor force, the best we can expect is full employment, defined as 5% to 5.2% unemployment. That may be the case if we accept our institutions as they exist, and resort to traditional monetary and fiscal policy initiatives.

There probably isn't very much we can do to cut unemployment much below 5% by aggregative policies alone without precipitating a resurgence in price inflation. But if traditional tools are inadequate, then we should utilize other tools. If the problem is the structure of the economy, then we should be addressing ourselves to questions of structure.

Competitive theory tells us that output levels are higher, input levels are higher, and prices are lower when you are operating under conditions of competition than under either monopoly or oligopoly. In a sense, one of the most costless policy alternatives that we could use to realize fuller employment and price stability has lain in disuse almost since its inception in 1890. That is anti-trust policy.

If there is anything that is universally acclaimed, it is the free enterprise system. You cannot go wrong if you make appeals to preserving, enhancing, and improving the free enterprise system—unless you are addressing the union of radical political economists or a gathering of Yippees. But be careful. If you make that appeal to a group from the trucking industry who have gathered for their regular rate making conference (a function which any group of businessmen, were they to indulge in it, would probably be jailed for conspiracy to fix prices) you will be deafened by the applause. But, if you go on to suggest that perhaps one of the things we might do to improve the free enterprise system is to examine the regulatory policies by the Interstate Commerce Commission for the trucking industry, you will be drowned out by cat calls.

No, they will say, you do not understand. The ICC does not impede competition. What it does is remove chaos from the industry. The ICC was applied to the trucking industry during a time of great economic chaos. It imparts a measure of stability to an industry which would disappear if we were to restructure our legislation or regulatory policies toward more competition, they say. You know as well as I do that this is sheer nonsense.

Everyone who has some form of monopoly loves it. The former chairman of the Federal Trade Commission, Louis Engman, was absolutely right when he said that the average American businessman loves the free enterprise system; he just hates competition.

Can you have a free enterprise competitive system that has no risk? The answer is obviously no, you can not. Risk is one of the elements that identifies the free enterprise system, and it certainly should determine the returns that you get from the system.

Prudent management of risk should earn profits for the risk taker. Imprudent management of risk means that you generate losses, and ultimately if you can't take losses, out you go. That is the way the system is supposed to work. Does it?

For a large measure of our society, the answer is yes. It works for those who are without any particular measure of economic power. It works for those who are rather disorganized and have no access to the legislative process and for those whose interests are not represented in the legislative process. For the small, for the moderate size, for the powerless, we have as free an enterprise system as we have ever had.

But, we also have another segment of the economy which is far

less free and in which risks are far less certain. Paradoxically the rewards here are typically far greater than those which tend to be identified with high risk areas. In fact, we have two economic systems that are discussed under the aegis of free enterprise capitalism.

Those who pound their fists at the demise of free enterprise capitalism should recognize that one way to hasten its demise is to bail out the Penn Central Railroad, Grumman Aircraft, or Lockheed. The good health of that system is not furthered by legislation or initiatives designed to remove risks from large and powerful economic interests, whether they be business or labor interests.

Sometime ago an article appeared in *Business Week* titled "When Companies Get Too Big to Fail". Whether or not the writers recognized how paradoxical it was to ask such a question is another matter. We have come a long way from our textbook model of competition.

We assert that competition is a circumstance described by large numbers of decision makers and producers, each of whom has so little control over output and pricing decisions that for all practical purposes they can't make any difference. We have come a long way to a situation where, for example, in the fourth quarter of 1970 a strike by General Motors could reduce nominal GNP for the entire United States economy. The question of when companies get too big to fail is a gross understatement of how we permitted our economic system to evolve into two parts—one that is highly powerful and organized, and another that is relatively powerless.

That we have permitted such a situation to come about says a great deal about the kinds of questions raised. I am often asked, what are interest rates going to be like six months from now? What will be our real GNP next year? Can you tell me what the prime rate will be 15 months from now? These are interesting questions. I spend most of my time addressing them. But the answers almost always take the economic structure as given. It seems to me that the response should include an additional dimension if we are truly concerned about the long run. Far too little attention has been directed to policy alternatives with regard to the structure of our economy and the consequences for economic activity not only 12 to 18 months from now, but over a much longer time horizon.

For those of us nurtured on classical economics, the changes we have seen are not always agreeable. In his presidential address to



the American Economic Association last December, Professor Robert Gordon said:

We have been witnessing a significant extension of government control of the market mechanism in all of the advanced economies, more so in some than in others. This intervention ranges from conventional forms of regulation of particular industries...to outright nationalization of particular firms or industries. What combinations of pressures have caused this extension of government intervention? What forces will extend it further? What forms will such intervention take? And what are likely to be the effects on the allocation of resources, the distribution of income and wealth, the rates of inflation and of growth in total output—not to mention the possible effects on the various dimensions of the institutional environment, including the institution of private property?

For economists, the basic question transcends short term economic forecasting: “What is the future of capitalism in the advanced economies, given the growing size and bureaucratization of business firms, the increasing strength of organized pressure groups, and the momentum from the increasing government intervention that has already occurred?”

We have not asked nor tried to answer the big questions. It would be comforting to suggest that there are many at work within the Federal Reserve System, or within our federal government, studying what has happened, not to GNP in the last quarter, but to the structure of the economy; what has happened to the classical assumptions which used to dictate the training of legions of economists; and what that implies for our society a generation or century hence. The sad fact of the matter is that few are probing into these questions.

#### **Can We Afford the “Uneconomic”?**

It is rather disappointing to me, as an economist, that the message that was delivered this morning was delivered not by an economist, but by an historian. It is from an historian that we have to hear that there really is a crying need for social reporting, even if the kinds of question to which those social reports are addressed are not readily reducible to rigorous quantification. It is distressing to me, that too often we have opted for what we perceived to be rigor rather than relevance.

The word “uneconomic” rings like a death sentence. When things are uneconomic they are obviously undesirable and are not

done. Certainly within my profession that would be a fair interpretation of the term uneconomic. But it took a British economist, E. F. Schumacher, to suggest that what is or was not economic has been narrowly defined by economists to mean that which produces private gain for the person or firm participating in that particular activity.

Is it fair to dismiss from realization in our society a wide range of activities or even consideration of activities which we have determined to be uneconomic? We have been told that increasing intrusion of government is not only uneconomic and extremely costly, but that increasing intrusion generates a loss of freedom. I continually ponder what freedom is it that the business community in the United States has lost as a consequence of government intervention? To be sure, costs have risen dramatically as bureaucrats disseminate forms that absolutely defy any reason. That is one of the very tangible costs of government.

But beyond that, what freedoms have been lost? The freedom to discriminate? That was lost as a consequence of government equal employment opportunity legislation. Has it been the freedom to pollute? That too was lost in the face of increased government intervention into our economic system. Has it been the freedom to monopolize or bribe? To be sure, those freedoms have been lost. But whoever expected them to be inherent freedoms consistent with the free enterprise system?

Many resent the intrusion of government into economic affairs. But if the system does not administer its own cures, then when grievances become evident, as imperfect as our political system may be, rest assured that government will propose cures. And to those who would be dissatisfied with government cures, I would offer the same advice that is frequently tendered to the medical profession, "Physician, heal thyself".

We have been told that there are a great many things which are uneconomic in the sense that they cost too much in dollars, impediments to decision making, and inflation. We are told, for example, that we cannot have adequate public transportation in the United States because it is uneconomic, and besides we are wedded to the private automobile. We are told that we can't afford national health care. We are told that we can't afford to consider redistribution of income, because this would impede the incentives which income distribution patterns serve to carry out. We are told that we can't afford to fully employ those resources that seek employment. And we are told that we can't afford as clean an

environment as we would like, particularly when considerations of energy resources are considered.

We are told all these things. I disagree. It is not that we can't afford these things, but rather, that we can't afford not to have these things. In the final analysis, that is as good a test of the merits of this economic system as any. If the quality of our lives is going to be defined in terms of increasing GNP and nothing else, then we may have succeeded admirably. But perhaps there are other ends.

This morning I saw pictures relayed from Mars on TV. They took 20 minutes at 186,000 miles per second to reach the earth. How much time will we need for a picture of conditions on earth to travel to the conscience of our society and to the perceptions of our policymakers who shape society? We have to get people as excited about inner space, defined as the hopes and aspiration of human kind, as about outer space. We always seem able to afford grand ventures in outer space. It is only these ventures into inner space—into jobs, greater equity in income distribution, and a cleaner and more healthful environment—that somehow are always restrained by cost. Most of these are self-imposed limitations.

Voter apathy might be interpreted as a sign of ready acceptance of or satisfaction with economic circumstances. I do not think so. Rather, it represents a sense of powerlessness on the part of the individual to cope with a system which has become depersonalized and is, in many respects, irrelevant and insensitive to individual needs. The institutional structure with which we live did not just happen; it developed by specific acts of commission and by acts of omission. We let it happen. And to a significant degree our economy functions by rules which came into existence by a process which I would regard as not terribly representative. In a very real sense, it is the political arena which has determined the structure of the society and the economy in which we live now. Regardless of how we may complain about government, that government is just about as good as we deserve.

#### **THE CHALLENGE TO ECONOMISTS**

If as Professor Graham has suggested, we are inexorably moving toward a system of more rather than less planning, then the question "Who will make the plans?", becomes increasingly important. If we fail to recognize that it takes participation to shape plans, then we will have no right to complain about the consequences if we fail to participate in the planning process.

The challenge to the economist, to all of us, is to be relevant as well as rigorous. It is to step out of the mold, and to think freshly

about how to transform our system into a more participatory, more humane, more compassionate economic system. We should do so not only for ourselves, but for the countless other nations who desperately need another alternative to contrast with authoritarianism. Many are resorting to authoritarianism as the only means by which to uplift themselves. We must recognize that freedom has to be made consistent with equity, and that freedom in the absence of equity is not real freedom.

We need to abandon our charade of positivism and begin to act like the normative human beings we are. Frequently we have not asked the right questions. As a consequence, we have been as guilty as those policymakers who have perpetuated a feeling of powerlessness and isolation on the part of a large portion of the American citizenry. A great many Americans are waiting for the right questions to be asked, and would be willing to participate in the process of resolving those questions. So, as Benjamin Franklin said in an essay he wrote on ethics and morality 200 years ago, "Resolve to perform what you ought, perform what you resolve"