

ECONOMIC STABILIZATION: PRINCIPLES AND POLICIES

1 February 1961

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NOTICE

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## ECONOMIC STABILIZATION: PRINCIPLES AND POLICIES

1 February 1961

**CAPTAIN MARZETTA:** General Mundy, Gentlemen: I'm pinching today for Dr. Kress, who was called out of town because of death in the family. I know, though, that he would want me to say a few words about the new unit of instruction upon which you are embarking this morning.

For practically the whole of this coming month, we will be looking into the field of economic stabilization, primarily in the domestic scene, but also in the international area. This is a field where we will explore the role of controls on our economy, and where we will study the influences that affect the stability of our economy. It's a broad area, an interesting one, and one which will contribute materially to the solutions which you are going to work up on your final problem.

Now, normally, as you have seen, we don't introduce the members of the faculty here on the platform. Today, however, I would like to say a few words about our speaker, because he's a newcomer to the faculty, and this is his first lecture to the College.

Dr. Poppe is an economist with an international flavor. He was born in the Netherlands, and during the war was a Dutch naval aviator. He also served his country as a representative to the Combined Chiefs of Staff and to NATO.

He really got into economics in a big way, though, following the war and earned his doctorate at Georgetown. He taught in several universities at the graduate level. And just prior to coming to the Industrial College this last fall, he was the Assistant Director and Comptroller of the University of Maryland extension course in Japan.

He is no stranger, however, to the Industrial College, as he taught here as a guest section instructor in the Foundation Unit for five straight years back in 1953 to 1958.

To tell us, then, about "Economic Stabilization: Principles and Policies," it's my pleasure to present Dr. Janus Poppe.

**DR. POPPE:** Thank you, Captain Marzetta.

General Mundy, Gentlemen: This morning we start Unit V, which considers the subject of economic stabilization. For the next three weeks we will have a number of eminent scholars and practitioners discuss the practical applications and the realities of economic stabilization policies. In this lecture this morning I hope to cover some of the basic theoretical concepts involved, so as to complement the subject material or our guest speakers to come. I propose to define economic stabilization and discuss the need for economic stabilization controls. In addition I will touch on monetary controls, fiscal controls, and the direct controls available to our authorities. This will be followed by a discussion of some of the international economic stabilization problems which face the United States.

In the Orientation Unit last September, we reviewed the principles of economics. The Economic stabilization Unit will cover the application of many of these principles to national and international economic stabilization problems facing us today. It is somewhat of a controversial subject, and we invite you to read and to think about these matters, to discuss them, and then to form your own opinion and conclusions.

Let's now turn to the definition of economic stabilization. (Chart 1). By going through the literature on the subject, I find that Colonel Roy V. Porter, a member of this faculty until last year, probably gave the closest approximation by defining economic stabilization as "those actions taken by a government or a community, alone or in conjunction with other governments or communities, which tend to prevent or reduce excessive or unnecessary fluctuations in the conditions affecting the production, distribution, and consumption of wealth."

In other words, we are aiming at what the economist calls a state of general equilibrium. But we know that an economy does not stay in equilibrium. Numerous forces are at work to cause instability. One of the problems we must concern ourselves with is the problem of recurring unemployment and how to cope with it. Another problem is the persistent threat of inflation and its impact on society. Prior to the New Deal we adhered generally to the principles of classical economics in attempting to solve these two major problems or a prevailing capitalistic system.

CHART 1

ECONOMIC STABILIZATION

THOSE ACTIONS TAKEN BY A GOVERNMENT OR A COMMUNITY,  
ALONE OR IN CONJUNCTION WITH OTHER GOVERNMENTS OR  
COMMUNITIES, WHICH TEND TO PREVENT OR REDUCE EXCES-  
SIVE OR UNNECESSARY FLUCTUATIONS IN THE CONDITIONS  
AFFECTING THE PRODUCTION, DISTRIBUTION, AND CONSUMPTION  
OF WEALTH.

Classical economic theory rests on the assumption of full employment of labor and other resources. The classical theory asserts that there is always a tendency toward full employment. The normal situation is general equilibrium at a level of full employment. Disturbances in the economic level are attributed to interference by Government or private monopoly in the free market.

The classical theory holds that by following a Government policy of laissez faire and a complete absence of Government interference in private business, a normal full employment can be maintained. Classical theory considers the use of a given quantity of resources by private enterprise within an economic system. If one industry uses more resources, it will have to do so at the expense of another. The choice is between employment in one sector of the economy or employment in another sector, and not between employment and unemployment. Thus classical economics is a study of the alternative uses of a given quantity of employed resources.

In the classical system it is assumed that supply creates its own demand. By this is meant that every producer who brings goods to the market does so only in order to exchange them for other goods. It is assumed that the only reason people work and produce is in order to enjoy the satisfaction of consuming. In an exchange economy, whatever is produced represents the demand for another product. Additional supply is additional demand. A product produced means income paid to those who contribute to its production. The proceeds which an employer can expect to receive for the articles he produces should cover the cost of manufacturing the output.

This is only valid if the contributors of resources are willing to accept rewards commensurate with their productivity. As long as production is directed into proper channels, whatever is produced can be sold. There can be no general overproduction as long as supply creates its own demand. Excess output is the result of misdirected production. This will be corrected by a shift from goods they cannot sell at a profit to the production of things that can be sold at a profit. The classical school, therefore, denies the possibility of a deficiency of aggregate demand, and thus the existence, or the possible existence, of unemployment.

Employment of more resources will take place up to the point of full employment, subject to the limitation that the contributors of resources are willing to accept rewards no greater than their physical productivity justifies. There can be no general unemployment,

according to this view, if workers will accept what they are "worth." The classical justification of full employment as a "normal situation" rests on the assumption that there will always be a sufficient rate of spending, and that income is spent automatically at a rate which will maintain full employment.

The classical doctrine holds that unemployment is voluntary, in the sense that accepting a lower wage rate by the unemployed would create a demand for more employment. If wage rates were lowered sufficiently, all unemployment would disappear. Labor unions in demanding higher wages are guilty of causing many fellow workers to suffer unemployment, and the responsibility for unemployment is therefore with labor itself. Under classical theory the solution is clear. Unemployment, apart from the frictional type, is caused by wages being too high. The cure to the problem lies in lowering the wages.

The classical theory is misleading and disastrous if we attempt to apply it to the facts of experience. The cutting of wages and salaries is both demoralizing and unsound, since it will further affect the total effective demand downward. For instance, under the impact of industrywide wage cuts in the early thirties, unemployment increased further from 8 million to approximately 13 million people in 1933, or about 25 percent of the civilian labor force. At the top of the business cycle in 1937 there remained more than 7.7 million people unemployed. The economy was operating at a low level of performance and had reached a general equilibrium, which is quite possible, at a level far less than full employment. It was not until 1942, under the impact of war spending, with the resulting increased wages and increased effective demand, that a full-employment level was reached again.

There are several objections to the classical theory. Labor unions are an integral part of modern democratic and economic society. Labor unions are here to stay, minimum wage laws are not likely to be repealed, unemployment compensation is not bound to be lowered, and public opinion as to what constitutes a reasonable living wage is not likely to be revised downward.

The great shortcoming of the classical theory is its irrelevance to conditions of the contemporary economic scene. Personally I have no illusions about the invisible hand that is supposed to guide men in

the right direction if they only will pursue their own self-interest. The economic forces of a private property economy do not bring about the employment of all who wish to work at the prevailing wage rates. The great depression of the 1930's involved tremendous loss of human and material values. Mass unemployment is second only to war in the magnitude of its human degradation and physical wastefulness. The world of the thirties was poor, not because it lacked material resources, technical skills, or the will to work. It was poor because something went radically wrong with the way men thought and conducted their economic affairs.

A possible suggestion for a solution of the depression and a clear and straightforward explanation of the national economy came from a British economist, John Maynard Keynes, who probably ranks as the most influential economist of the 20th century. In a study published in 1936 and entitled "The General Theory of Interest, Employment and Money," which has become a classic, meaning that everybody has heard of it, but few read it, he maintained that in a free enterprise system, leaving the government out of the picture altogether, we have an equation which states that the total income of all people in the economy is equal to what they spend on consumption goods and services plus what they save. This total income may be stated another way, as equal to total consumption expenditures plus total capital expenditures, that is, investment, and that is the equation  $Y = C + I$  which is equation number 2 in our appendix.

From these equations, then, we arrive at the equation, savings equal investment. Thus in Keynesian economics, savings are defined in such a way that they cannot deviate from investment.

In a money economy, savers turn over their purchasing power to others for investment. The savings function is divorced from the investment function, but in a given period savings always equal investment. For example, suppose that the savings in our economy are \$80 billion and the investors want only \$70 billion of the savings for investment purposes, then the remaining \$10 billion will be invested anyway. The investment will take place because \$10 billion worth in goods, which have been produced and which now exist as circulating capital, will not be sold. We have \$10 billion in additional inventory, which is held by raw material producers, manufacturers, wholesalers, and retailers. We may thus restate the equation--savings equal investment, and modify it to-- $S = I_v + I_j$  savings equal voluntary investment plus involuntary investment; and the involuntary investment is synonymous to inventories. You remember, in our Foundations Unit we paid careful attention to the increase or decrease in inventories as an economic indicator.

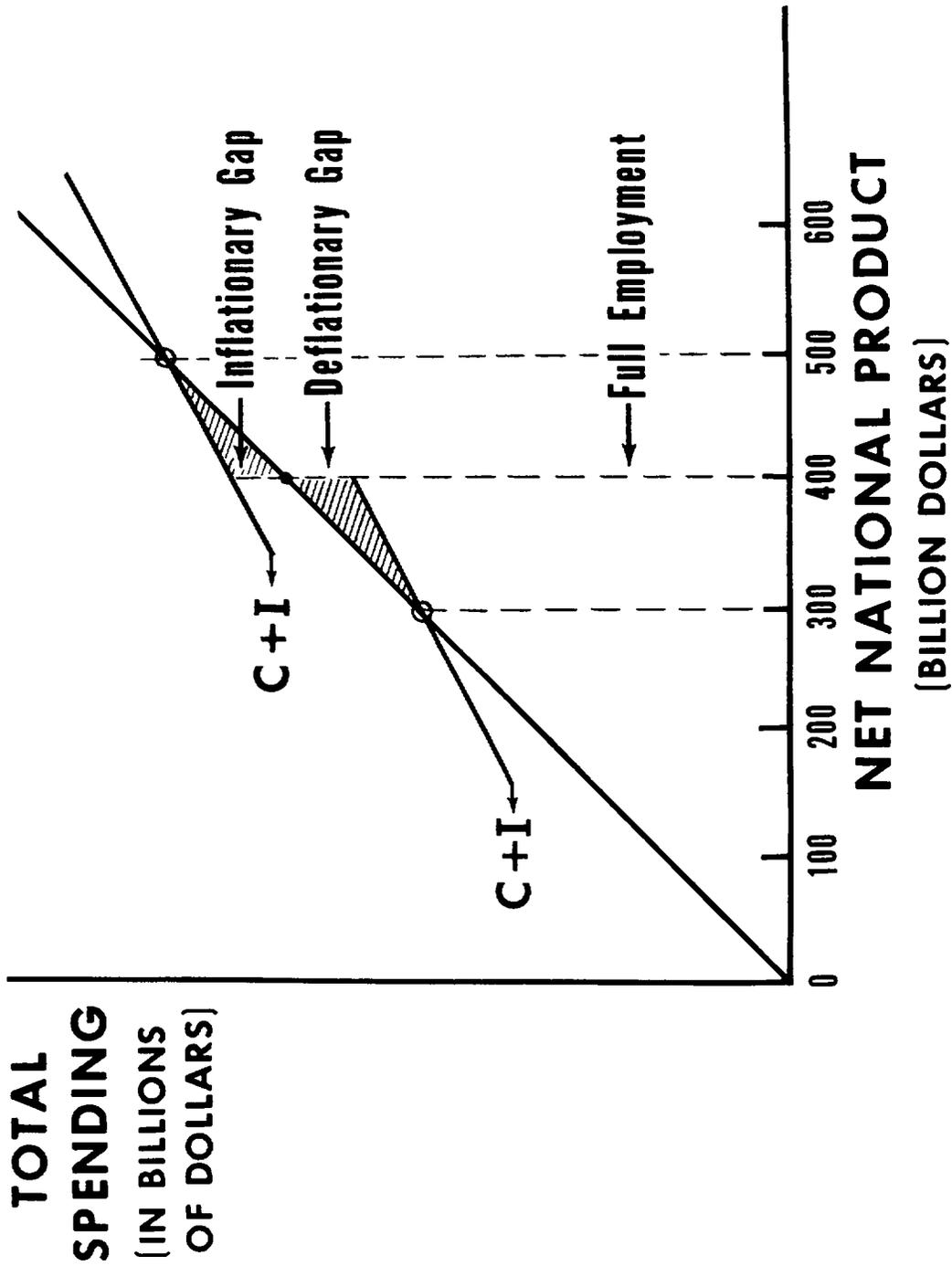
An interplay within this equation is going on all the time in the economy. People are saving part of their income. Others will invest this money in factories, machines, materials, and housing. If total savings are just equal to voluntary investment, the involuntary investment will be zero. If this occurs when there is a high level of employment, all is well. Everyone is working who wishes to work, production is going ahead at full speed, and the economy is in balance or in a state of equilibrium.

Chart 2, page 8.--When the rate of consumer and investment spending that would be generated at full employment differs from the full-employment income--and that is at the level of \$400 billion--and if it is smaller, then we speak of a deflationary gap. In such a situation the volume of savings has grown larger, and opportunities for profitable investment fail to keep pace with savings. ( $S < L_v$ ).

Involuntary investment must make up the difference. Circulating capital in the form of inventories held by retailers, wholesalers, manufacturers and raw material producers begins to build up. Output is then cut back to prevent further unwanted accumulation. Production is curtailed. Workers are laid off. When workers are laid off, the total volume of wages in the Nation decreases. Total income in the economy decreases. When income shrinks, consumption expenditures will also decrease, resulting in further decrease in production. Voluntary investment will decrease as opportunities for profitable investment disappear. Savings will also decrease in volume until they reach the point where total savings equal voluntary investment. At that point the decrease in production and employment stops. Production is now at a low level. Unemployment is in existence and equilibrium is reached at a level less than full employment. In the 1930's the economy got in such a position. A depressed equilibrium continued from 1932 till 1942.

When consumption plus investment spending is in excess of the full employment income, we call any spending excess an inflationary gap. The economy now moves in an opposite direction. Profitable investment now causes voluntary investment to increase faster than savings. Savings are smaller than investment. But savings are defined in such a way that they cannot deviate from investment. This means that circulating capital--that is, inventories, goods in the pipeline production--will shrink as buyers seek to buy goods faster than they are being produced. If there are unemployed workers in the economy, they will soon be absorbed back into employment.

CHART 2



However, there is a limit to the extra production that can be turned out. At a high level of employment, labor is beginning to become scarce and wages are beginning to rise. Buyers start bidding against each other for available goods and force prices up. The upward movement continues until savings reach the point of voluntary investment. The involuntary investment has diminished to the point of zero, and a new equilibrium at the existing price level has been reached, but price inflation has taken its course.

Keynes assumes that due to psychological propensities, people will not spend all their income, nor all their increase in income. People will spend proportionally less when their incomes increase. An outstanding authority on consumer behavior, Dr. George Katona, will touch upon that aspect next Wednesday, February 8.

Total income depends on the volume of total employment. According to the propensity to consume, the amount of expenditure for consumption depends on the level of income, and therefore on total employment. Total employment depends on total effective demand, which is made up of two parts: consumption expenditures, and investment expenditures.

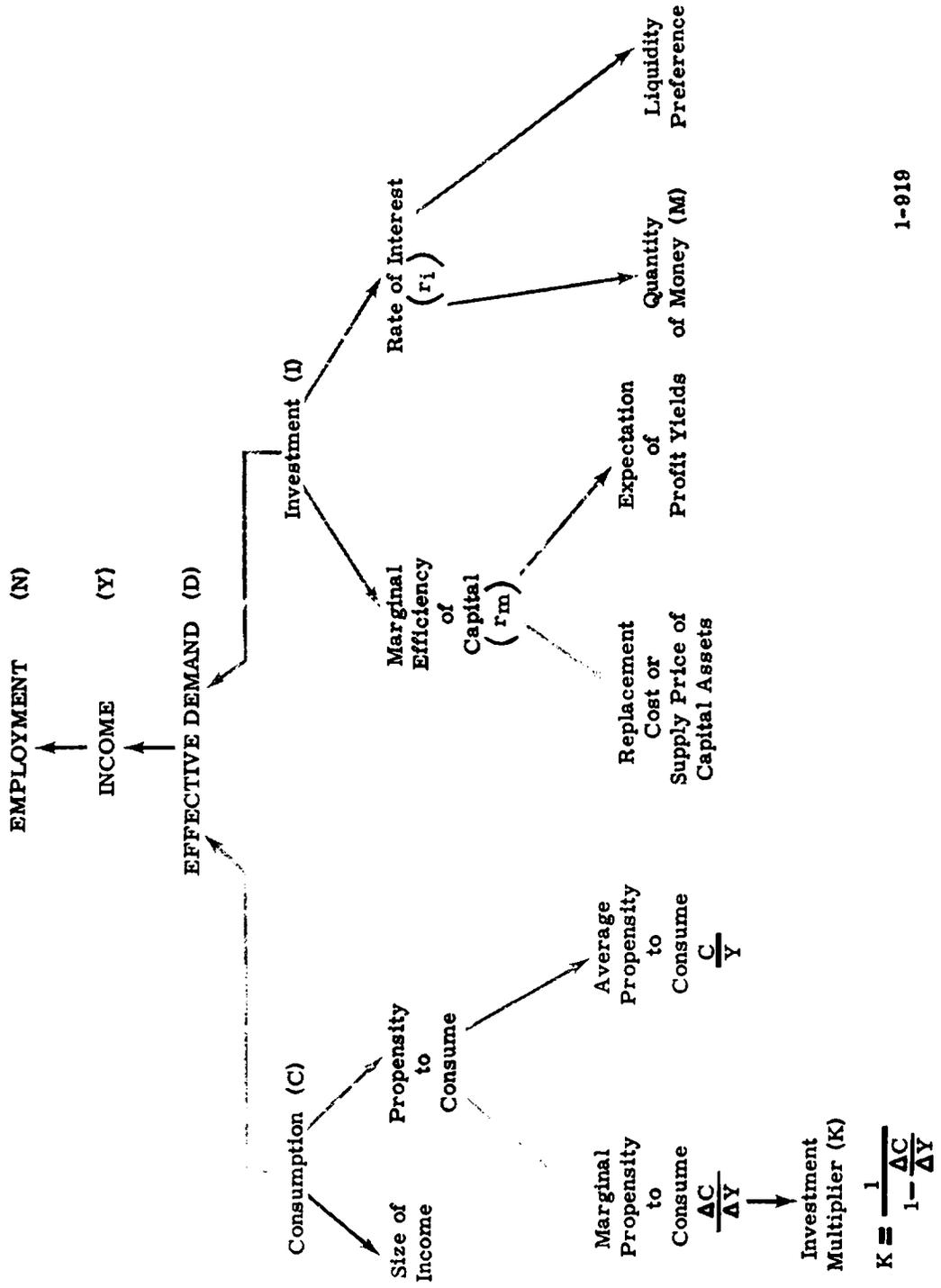
In equilibrium, the aggregate demand is equal to the aggregate supply. The aggregate supply exceeds the effective demand for consumption by the amount of the effective demand for investment. The aggregate demand, then, is determined by the propensity to consume and the volume of investment. Therefore, according to Keynes, the volume of employment depends on:

- a. the aggregate supply function,
- b. the propensity to consume, and
- c. the volume of investment. ( $G_e - G_r + I_v + I_j$ ).

The volume of investment is made up of Government expenditures minus Government revenues plus voluntary investment plus-or-minus involuntary investment. See equation VIII of the appendix.

The aggregate supply function and the propensity to consume are relatively stable; therefore fluctuations in employment depend mainly on the volume of investment. In chart 3, (page 10), we have a short outline of the system as Keynes outlined it for us. Notice that, depending on the volume of employment, we have the volume or the size of income. Depending on the size of income, we have the effective demand.

CHART 3



The effective demand is influenced by consumption, and it is influenced by investment. Consumption depends on the size of income. It also depends on the propensity to consume. The propensity to consume is inherent in a nation. It is different for the United States than it is for India. The propensity to consume is divided into the marginal propensity to consume and the average propensity to consume. For the American people in 1959, the average propensity to consume was 93 cents per dollar expended. The marginal propensity to consume is a ratio between a change in consumption as a result of a change in income; and from that we arrive at the so-called investment multiplier, which I will not elaborate on this morning.

Effective demand is also influenced by the volume of investment. Investment is influenced by the marginal efficiency of capital and the rate of interest. The marginal efficiency of capital is influenced by the replacement cost or supply price of capital assets, and the expectation of profit yields. For instance, consider the marginal efficiency of capital. Assume that we have a building, a piece of real estate, which has, let us say, four apartments, and that I am able to build a new apartment building at, let us say, 80 percent of the cost but can get the same revenue from that building. Then the replacement cost in this instance affects the marginal efficiency of capital in such a way that it is higher for me. Consequently, I will be induced in investing in such a piece of real estate, that is, I am interested in building new real estate; and, consequently, I will affect the effective demand.

In a similar way, the expectation of profit yield will influence the marginal efficiency of capital. For instance, this new piece of real estate, with the four apartments, will be able to give me a better yield. But if in the area where I am building the apartment house there is, let us say, only 60 percent occupancy of apartments, then I know that the expectation of profit yield is small; and, consequently, there is an offsetting factor, and the marginal efficiency of capital may not be large; and, consequently, the investment may not be made.

Investment is also influenced by the rate of interest. The rate of interest can be influenced by the monetary authorities through the quantity of money. We are familiar with the Federal Reserve operations. An increase in the quantity of money, will effect a decrease in the rate of interest. The rate of interest is a price paid for the use of money. If the rate of interest is low, then the volume of investment

will be high. Consequently, an easy monetary policy, creating a low interest rate, will induce investment and thus the total volume of effective demand and thus the volume of employment.

In a similar way we have the liquidity preference, which is a state of mind of the public. It pertains mostly to the working capital of investment. It pertains mostly to the money market, at least, the prime paper, i. e., the bills and notes of the Federal Government. We find that if people have a high liquidity preference, they want to hold these short-term notes; and, consequently, the rate of interest in this case will be low, and the investment will be higher or will be favorably affected.

The aggregate supply function and the propensity to consume are relatively stable. Therefore, fluctuations in employment depend mainly on the volume of investment.

A volume of investment high enough to sustain full employment should be maintained, and the prime mover in determining the volume of investment in our society is private business. It is important to note that if a volume of investment is not high enough to maintain full employment, the Government should step in, because it is the only authority that can create policies to supplement the going rate of investment. It is this feature of Government interference which was considered distasteful, socialistic, and alien to our thinking in the thirties. With the evolution of our industrial economy, the role of Government in regulating and influencing our free enterprise system to achieve social and economic ends has gained general acceptance. It may be stated that the general theory of Keynes deserves much of the credit for the fact that the maintenance of high and stable employment is now accepted as a governmental responsibility, and that Keynes's theory of effective demand is the origin of the modern theory of economic policy.

The other major problem we have to cope with in our modern capitalistic society is inflation. It used to be that a speaker interested in the subject of price behavior could explain the meaning of the term "inflation" in a few well-chosen sentences. This is certainly not true any more. The recent and rapid proliferation of inflation types has made it unfashionable to speak simply of "inflation." Instead, one must specify whether he means cost inflation, demand inflation, money inflation, hyper-inflation, or one of the whole series of inflation types listed on page 3 of the appendix.

For the purpose of this morning's discussion, inflation is defined as an increase in the general level of prices, as measured by some composite statistic, such as the Consumer Price Index, since this definition seems to be in accord with common usage.

Some of the principal factors, then in American society which are contributing to inflation are price increases induced by excess demand and administered pricing. The cold war necessitates huge national security outlays and large international aid programs, which may increase aggregate demand without increasing production. Dr. Gabriel Hauge probably will discuss this aspect tomorrow.

A second important factor in the creation of upward tendencies of the price level is the economically unjustified wage increase demand, the so-called "wage push." Labor unions have become so powerful that they are able to get periodic wage increases (including fringe benefits) greatly in excess of the overall average increase in output per man-hour. Even if in some industries the wage increase is not greater than the increase in productivity of that particular industry and could possibly be granted without raising the price of the products of that industry, these wage increases, to the extent that they exceed the overall increase in productivity for industry as a whole, must lead to inflation if the level of employment is to be maintained.

In addition to the inflationary pressures, unjustified wage increases may affect our competitive position in the world market. For a comparison of total cost per hour in the manufacturing industries of nine nations, I refer to page 12 of the appendix. Note that this cost averages \$2.68 per hour in the United States and is by far the highest in the world. It should be noted that these employment cost figures do not reflect actual unit labor cost, which, of course, depends largely on developed skills and productivity. Not necessarily do high labor costs put us in a noncompetitive position in the world market.

A third factor is mark-up or administered price policy, which results in cost and price increases brought about by business monopolies and oligopolies. Business has a great responsibility in maintaining the price line. Business is not willing to accept that responsibility. What is good for business does not necessarily coincide with the social good. There is only one answer to this problem and that is continued vigilance and aggressive antitrust measures, rigidly enforced.

Another important source of inflationary pressure is continued Federal deficit financing. The Federal budget has been unbalanced since 1931. During the war years the deficit exceeded \$50 billion a year. We have not had a single surplus Administration since Herbert Hoover. The total deficit for the last eight years amounted to approximately \$18 billion. On Monday, February the 6th, Mr. Daane, who is the Assistant to the Secretary of the Treasury, will discuss the problems in financing Federal deficits and the constant refunding of the national debt, which in itself creates features of instability.

On all sides, demands are being made for new spending by the Government: Public works, Government housing, health insurance programs, veterans' bonuses, loans to foreign countries, and spending to implement the full employment policy. Congress is under constant pressure for more spending. The legislators are exposed to pressure for lower personal income taxes in the years ahead, thereby adding to the difficulties of balancing the budget, and thus enhancing the possibility of inflationary tendencies.

In a series of articles appearing in 1951 in the "London Economist," a correspondent argued that this may prove to be the age of inflation. This author stated that inflationary forces of the cold war are reinforced by the bargaining strength of labor unions, by emphasis on full employment, by acceptance of the thesis that cheap money is always desirable, by mounting social costs, by the trend towards the equality of incomes, by the habit of relying upon price controls as a device to check inflation, by the existence of barriers to international trade, and by the end of the gold standard. He pointed out that the rearmament inflation is simply a bulge on a long-term upward price movement.

If this thesis proves to be correct, the future is ominous. The thesis need not be correct, however. Personally, I am willing to accept the thesis, mainly because I feel that we are not willing to make the necessary sacrifices to prevent inflationary tendencies.

We have thus located the two major problem areas of instability--unemployment and inflation. Since the end of World War II, United States economic policy has been aimed primarily at restraining inflationary forces, that is, those forces that influence the upward tendency in the general level of prices.

In the United States, stabilization controls fall into two broad categories: indirect controls and direct controls. The indirect controls may be classified as fiscal controls and monetary controls. Monetary controls in turn may be divided into discretionary and selective controls.

The standard monetary and fiscal policies can be depended upon to a considerable extent, so long as we have either unemployment or inflation alone. When they both come together, they can only work in one direction, not against both at once.

We are familiar with the operations of the Federal Reserve System. The discretionary monetary controls available to the System are the change in reserve requirements, open market operations, and the power to change the discount rate. The selective controls available to the Federal Reserve System are stock market credit control and consumer and real estate credit control. These types of indirect control deal with the sources of purchasing power, and the amounts and uses of credit and money in the economy. The direct controls available to the Government are the wage and salary controls, price controls, rent controls, consumer rationing, and the allocation of priorities. These types of control are primarily for the purpose of checking prices directly and for the reallocation of resources.

To give an idea of the extent of interference in business through direct controls during World War II, I refer to pages 9, 10, and 11 of the appendix, which gives a partial list of Government controls at that time and the agency that administered the control.

On Tuesday next week, Mr. Phelps, Deputy Assistant Director for Economic Stabilization of the Office of Civil and Defense Mobilization, will discuss the use of economic controls under conditions of national emergency.

It is possible to sum up the difference between monetary and fiscal instruments of control quite briefly. Fiscal instruments of control can do much more than monetary instruments, especially in lifting the economy out of a depression. Monetary instruments are more sensitive and are useful in the delicate task of maintaining a situation of stability in the level of prices.

Direct controls suffer much more than the other two instruments from politically based limitations on the range within which they can be used. Direct controls may be particularly advantageous as weapons for controlling the economy, if they can be effectively enforced. This

matter of enforcement is an important one. Direct controls need a cumbersome administrative organization. Direct controls can be introduced or changed quickly, and the effects of these changes can be rapid. This is a consequence of the fact that direct controls are invariably negative. They stop someone from doing something he would otherwise do.

The fact that direct controls are negative lies behind another feature they possess which may be very valuable--that these controls can be more discriminatory than monetary and fiscal controls. This may be particularly important at times when big structural adjustments are taking place, such as during or after the Second World War.

There are also strong economic arguments against too much use of direct controls. They tend to inhibit innovations, and to freeze activity into existing channels, because it is only with existing channels that the bureaucrat can deal.

Direct controls may induce speculation, which may be destabilizing. For example, if it is expected that certain item will be rationed, consumers may try to accumulate larger stocks, which in turn may aggravate the existing shortages.

Another weakness in direct controls is that they may cause increased strain in other parts of the economy. This is most likely the case in consumer rationing. If one commodity is rationed, then consumers have so much more of their income left over with which they will probably attempt to buy more of other goods, thus contributing to existing inflationary tendencies. These dangers are less likely in the use of investment controls. If a firm is forbidden to build a factory, it is not very likely to plan to build a bowling alley which it would not otherwise have considered building.

There remains to be discussed some of the problems in international instability. It is generally recognized that stability in the major economies has in itself a stabilizing effect on the smaller nations. It is important, therefore, that we maintain stability in this country and give leadership and promote stability in the world market.

The three forces that may cause instability in international trade and affect the balance of payments of a country are real income level changes, relative price changes, and interest rate changes. The Government can indirectly control all these by appropriate expenditure

and taxation policies, by controlling the banking system, and by controlling the exchange rates.

The Government has also available a series of direct controls to influence the balance of payments, mostly by influencing the volume of expenditures abroad. We can classify these direct controls broadly into exchange controls, physical controls, and fiscal controls. Exchange controls are controls over payments to foreigners, whether for goods, services, or capital items. Physical controls are controls over the movements of goods, as distinguished from the movement of money. For example, a quota system may forbid the importation of certain goods or allow only a certain quantity to enter the Nation.

Mr. Lary, of the National Bureau of Economic Research, will lecture on Monday, February the 13th, and will concern himself mostly with the exchange rate problem and the allied problem of gold and the balance of payments. On Thursday, February the 16th, Mr. Herrera, President of the Inter-American Development Bank, will lecture on problems and possible solutions for a chronic disequilibrium, with special reference to Latin American nations. On Monday, February the 20th, Mr. Robert Garner, President of the International Finance Corporation, will lecture on "International Economic Stabilization Problems."

Thank you.

CAPTAIN MARZETTA: Dr. Poppe is ready for your questions.

QUESTION: If we can change the slope of the C plus I curve to eliminate both the deflationary and the inflationary gap, don't we arrive at pure socialism and eliminate the incentive that has been a cornerstone of the American economy?

DR. POPPE: No. The slope of the C plus I curve indicates the ratio between consumption and income. In other words it indicates the average propensity to consume. That's all it indicates.

If you would like to rephrase your question, you might get a better answer.

QUESTION: I'm not sure I'm able to.

DR. POPPE: It's difficult.

QUESTION: Are we chasing moonbeams to try to control inflation? I refer to the experience of the Russians, who exercise all elements of control; and yet, when they get into any type of incentive, they seem to generate inflationary pressures.

DR. POPPE: Yes. The question is, What is more important to us--the maintaining of full employment or the maintaining of stable price levels; and I think the consensus of opinion is that full employment is a more important subject, a more important goal; and consequently may go somewhat at the expense of inflation.

Now, the attempt, of course, will be to maintain relatively reasonable levels of full employment and keep inflation down as much as possible. We must not forget that inflation is relatively painless, that it takes place and of course, as you realize, many people do not realize that it is going on. You buy an \$18.75 war bond in 1939, and in 1949 you get \$25 back. Well, you think in terms of \$25. You do not think in terms of \$12.50 worth of purchasing power. We are quite happy with the \$25. As long as you have that, it is relatively painless.

QUESTION: Is it possible that we will develop into a socialistic economy?

DR. POPPE: No. I do not think so. I think the prevailing system will be capitalism. I should not use "capitalism." I should say "a free enterprise system." When you refer to a socialistic economy, you are referring to the means of production owned by the Government, and I do not think that that will ever take place. What I think will take place is that we will get increased welfare. In other words, we still have elements of welfare, trying to benefit the social good generally speaking.

I also do think that there will be consistent tendencies towards trying to solve the distribution of income. That is our problem of the future. It has not been touched upon very much. But our problem is not so much inflation or unemployment. It is the distribution of the income, the question of, How are you going to divide the fruits of production?

As you know, some schools of thought hold that there is no such thing possible as overproduction. We visited one plant in St. Louis and the management there indicated that that one plant could produce all the matches for the use of the whole world. In other words, there was no other plant necessary. Well, if you can do that, you have an overproductive capacity.

There is also the element of automation. The direction is towards a smaller workweek, maybe a four-day or even a three-day week--the eventual heaven on earth idea, whereby we have more leisure, more time for culture, and we are able to distribute the fruits of production in a reasonable way. It's a difficult thing to do.

QUESTION: We have heard and read much about frictional unemployment. How is this calculated or computed? What does it consist of? And what percentage should we bear in mind when we try to evaluate how we stand at any given time?

DR. POPPE: As you know, that frictional unemployment mostly refers to those people that are switching over one job to another. Nowadays the largest part of our labor force will report for unemployment compensation, and you find that statistical estimates have to be made. If the compensation for unemployment increases beyond a certain level, they say, "All right. That is more than frictional unemployment." We make a guesstimate as to the percentage of the labor force that is unemployed. You have approximately 1 million people that are unemployable. They come first, then your frictional unemployment, and beyond that is your less than full employment. It's mostly a statistical problem.

QUESTION: Doctor, in part the volume of the credit depends on the interest rate. Some people argue that we can correct this situation by lowering the interest rate and thereby making more money available. But if we do this, it will stimulate the gold outflow. What do you think some of the remedies are?

DR. POPPE: That is one of the inconsistencies of the present methods, whereby you desire to lower the interest rate and at the same to prevent the outflow of gold.

Well, the answer to the problem is not a one-shot affair. As you know, there are many measures necessary in order to alleviate the gold problem. We maintain that the interest rate lowering, at least the Samuelson report maintains, that that is the more important one--putting our house in order full-employment-wise, and then consider the gold problem.

The solutions to it are mostly outside of the United States. They will have to be faced within the countries with which we are dealing and less within our own country.

QUESTION. Doctor, will you relate our current situation, with unemployment but not falling prices, back to your Keynesian model formulas? In other words, how is this accounted for and explained in Keynesian terms?

DR. POPPE: Well, you will have to go back not to the general theory of Keynes, but to his monetary theory, which is much more applicable to our present-day circumstances than his general theory. You will find that the rising prices and at the same time developing unemployment is one of the things that Keynes most feared. And he indicated that in a deficit situation there is always room for a devaluation of the currency; and, as I pointed out, the more desirable way would be to bring up the standard of living of the nation. Up till now we either had to deal with unemployment or we had to deal with inflation. Now we have the situation developing whereby we have both--inflation and deflation.

If you consequently take the measures to solve unemployment, then you really aggravate the other. And this is a difficulty that we will have to face. Again, we will have to make a decision, which do we consider more important? I think the answer partially lies in Mr. Kennedy's program for more growth, the ultimate growth, through which he may be able to solve his unemployment problem, but not necessarily level off his prices.

And then remember, it's a big economy. If you start today, don't expect results tomorrow. Give it one or two years at least before you find an impact on it. In other words, give it time. Let it develop. And then, if you will apply the right measures, you will get the right results.

QUESTION: Doctor, there has been a lot of comment during the last few years that we won't go through another major depression, because of built-in stabilizers in the American economy--price supports, the heavy defense spending, spending on veterans, and so on. Would you care to comment on the usefulness of these?

DR. POPPE: Yes. It's one of the great improvements we have made over the thirties. Of course we are able to solve the depression of the thirties. We do not know what is going to come up in the future and how it will be solved. But, indeed, we have these stabilizing factors, in other words, built-in stabilizers. One of them is unemployment compensation. At one time in the thirties, when a man was

thrown out of work, immediately his consumption would stop. Multiply that times 8 million and you see that consumption expenditures decreased tremendously. Nowadays, if a man is fired or laid off, he will have for a number of weeks a certain percentage of his wage. That means he's cutting out on the luxuries, but not on the essentials. Consequently there is that element of stability right there.

Other elements, of course, are through Government interference, and when Mr. Kennedy said: "We must decrease taxes," again, he was referring to the stabilizing effect of the decrease in taxes, because that will bring more purchasing power into the hands of the masses of the people; which will stimulate production and employment.

Similarly, we have the support of farms and farm prices. Supporting the farmer means also sustained purchasing power of the farmer for many of the goods that are produced by industry.

These are all great improvements. Notice that one of the first things that has been suggested is that we increase the length of the unemployment compensation. We are very anxious to keep the volume of unemployment at the level it is; or make it smaller and not to let it deteriorate further, leading the U.S. economy in an untenable situation and then not to be able to get out of a deep crisis or depression.

QUESTION: One reason for asking the question was because this same element of stabilization was made in connection with the stock market too. You remember, in 1950 a lot of people were saying that this was going to be a shoring period in the economy in stock prices, and it was mentioned that because of the stabilizing effect of neutral funds of investment companies on the New York stock market, there would be no substantial breaks in the market. But look at what happened to the indexes. There has been a substantial break despite this alleged stabilizing factor. I was wondering whether we aren't overrating actually psychological factors quite apart from these built-in stabilizers that affect your level.

DR. POPPE: Psychological factors are a very important aspect of our modern world. In the stock market--what people believe to be true is not necessarily so. You may have favorable financial conditions and there will be a downward trend in the stock market. There may be conditions whereby all the financial reports indicate that there will be a cut in dividends and there's an upward trend in the stock market.

In many cases the book value of stocks is high and the market value of the stock is much lower than the book value. Highly unreasonable. Why is that?

Of course you have millions of individuals, each operating on his own, each making his own decisions. If the majority purchase common stock, then you will have an upward trend in prices.

Indeed, these psychological aspects or propensities are very important, but not necessarily is the stock market an indicator of economic well being. We had to refine considerably on that, and some of the great improvements made are the economic indicators and the researches of the National Bureau of Economic Research.

CAPTAIN MARZETTA: It looks like time has run out on us. I know there are quite a few more questions. I'm sure Dr. Poppe will be glad to see you in his office any time to talk over anything that might be in your minds.

Thank you, Doctor.

## APPENDIX

The following definitions and terms will be used in the first lecture on Economic Stabilization. Please study them carefully.

### GENERAL EQUILIBRIUM

As applied to theoretical economic analysis, the conception of a balance among interdependent economic forces, each activated by individual decisions based upon self-interest. Assuming free competition, private property and freedom of contract, forces of supply and demand acting upon economic goods are held to be equated at prices that offer the greatest number of traders maximum satisfactions and that are mutually consistent with one another in that respect. A general equilibrium is never absolute in a developing economy because of changes in consumer demands and dispositions to spend, save and invest; new technological developments; shifting competitive relationships; depletion of existing and discoveries of new natural resources; and other similar factors. The study of general equilibrium, considered in the light of the effects of change-producing factors on the economy as a whole, consequent disequilibriums, and the process by which simultaneous adjustment tends to restore a new equilibrium, is called dynamic economics, as opposed to static economics, which might be defined as the study of a particular economic relationship under certain prescribed conditions assumed to be constant.

### EFFECTIVE DEMAND

The desire to buy coupled with the ability to pay. When the word "demand" is used in economic writings, effective demand is usually assumed.

### FRictionAL UNEMPLOYMENT

Unemployment caused by imperfections in the labor market. Lack of information regarding where work is available, inability to get there, or time consumed in changing jobs are causes of frictional unemployment.

### INVISIBLE HAND

A term used by Adam Smith in setting forth the thesis that when each person acts in his own self-interest, the welfare of society is assured. Hence, according to Adam Smith, society is governed by an "invisible hand" which insures the social welfare, even though individuals seek their own interests.

### KEYNESIAN ECONOMICS

Economic theories and policies advanced by the British economist, John Maynard (Lord) Keynes (1883-1946), and his followers, or attributed to them.

### KEYNES' LAW OF CONSUMPTION

At every level of income a certain proportion of that income is spent for consumption goods, the proportion decreasing as the income increases.

### "EXHAUSTIVE" EXPENDITURE

Spending by the government in the form of purchases of goods and services from business and households. Government purchases of equipment, aircraft carriers, tanks and combat planes, and the payment for services performed by military personnel and civil servants fall under this category. This type of expenditure is a measure of the net claim of government on current production and indicates the volume of output not available for personal consumption and savings.

### "NONEXHAUSTIVE" EXPENDITURE

The type of spending by the government that redistributes the income. Examples of such expenditures are the interest on the public debt, transferpayments such as unemployment compensation, social security payments and federal grants-in-aid to state and local governments.

TYPES OF DIRECT CONTROLS:

- wage and salary controls
- price, rent and profit controls
- consumer rationing and allocation of resources

TYPES OF INDIRECT CONTROLS:

- fiscal controls
- monetary controls — {
  - discretionary controls
  - selective controls

DISCRETIONARY CONTROLS:

- reserve requirement changes
- open market operations
- changes in the discount rate

SELECTIVE CONTROLS:

- stock market credit control
- consumer and real estate credit control

TYPES OF INFLATION :

- |                         |                              |
|-------------------------|------------------------------|
| cost inflation          | mark-up inflation            |
| demand inflation        | seller's inflation           |
| excess-demand inflation | administered price inflation |
| wage inflation          | profit inflation             |
| money inflation         | creative inflation           |
| structural inflation    | chronic inflation            |
| log-rolling inflation   | demand pull inflation        |
| speculative inflation   | cost push inflation          |
| bottleneck inflation    | hyper-inflation              |
| buyer's inflation       | creeping inflation           |

PROPENSITY TO CONSUME:

A keynesian statistical phrase denoting the relation expressed as a percentage, between total income and total consumer expenditures.

The relation is expressed in the equation:

$$P = \frac{C}{Y}$$

P equals propensity to consume

C equals consumer expenditures

Y equals income (disposable income)

Thus, in 1959 disposable personal income was 337.3 billion dollars, and consumption expenditures were 313.8 billion dollars. The propensity to consume for that year was, therefore,

$$\frac{313.8}{337.3} \text{ equals } 93.1 \text{ percent.}$$

It means that for that year an average of 93 cents was spent out of every dollar.

#### MARGINAL PROPENSITY TO CONSUME:

A ratio of change between consumption expenditure and a change in income. For example, the disposable personal income in 1958 was 9.1 billion dollars more than in 1957. The consumption expenditures were 8.3 billion dollars more. A marginal propensity to consume of  $\frac{8.3}{9.1}$  or 91.2 percent is thus indicated.

SUMMARY OF THE GENERAL THEORY OF EMPLOYMENT:

The essence of the general theory of employment may be stated in the following propositions:

1. Total income depends on the volume of total employment.
2. According to the propensity to consume, the amount of expenditure for consumption depends on the level of income, and therefore on total employment.
3. Total employment depends on total effective demand, which is made up of two parts:
  - a. Consumption Expenditures
  - b. Investment Expenditures
4. In equilibrium, aggregate supply is equal to aggregate demand.
5. Aggregate demand is determined by the propensity to consume and the volume of investment. Therefore, the volume of employment depends on:
  - a. The Aggregate Supply Function
  - b. The Propensity to Consume
  - c. The Volume of Investment  $\equiv G_e - G_r + I_v + I_i$
6. Both the aggregate supply function, which depends mainly on the physical conditions of supply, and the propensity of consume are relatively stable, and therefore fluctuations in employment depend mainly on the volume of investment.

<sup>1</sup>Cf. Dillard, Dudley, The Economics of John Maynard Keynes, New York, Prentice-Hall, Inc., 1948.

SOME KEYNESIAN EQUATIONS:

$$Y=C+S \quad \text{Income equals consumption plus savings ..... ( I )}$$

$$Y=C+I \quad \text{Income equals consumption plus investment ..... ( II )}$$

$$S=I \quad \text{Savings equal Investments ..... (III )}$$

$$S=I_v + I_i \quad \text{Savings equal Voluntary plus Involuntary Investment.. ( IV )}$$

minus

In the above equations Government revenues and expenditures were lumped together with private incomes and expenditures. In the following equations the role of Government has been indicated. Incomes may be used for three purposes:

- a. Consumption expenditures
- b. Payment of Taxes
- c. Savings

$$Y=C+G_r+S \quad \text{Incomes equal Consumption Expenditures plus Government Revenues plus Savings..... ( V )}$$

$$Y=C+G_e+I \quad \text{Incomes equal Consumption Expenditures plus Government Expenditures plus Investment..... ( VI )}$$

Therefore:

$$S=G_e-G_r+I \quad \text{Savings equal Government expenditures minus Government Revenues plus investment..... ( VI )}$$

Since Government expenditures are always voluntary, we have:

$$S=G_e-G_r+I_v+I_i \quad \text{Savings equal Government expenditures minus Government Revenues plus Private Investment plus minus circulating capital in the form of inventories..... (VII)}$$

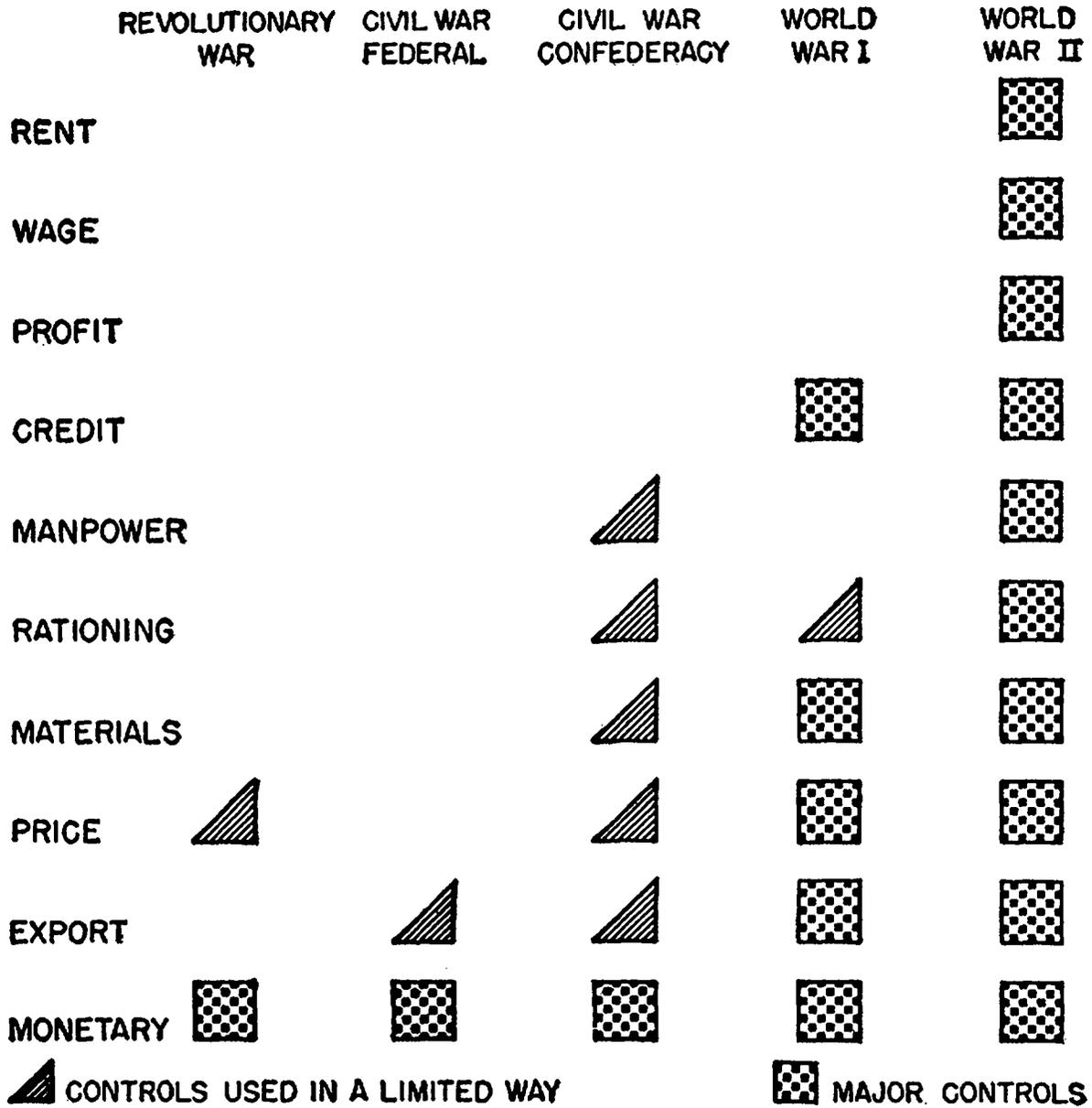
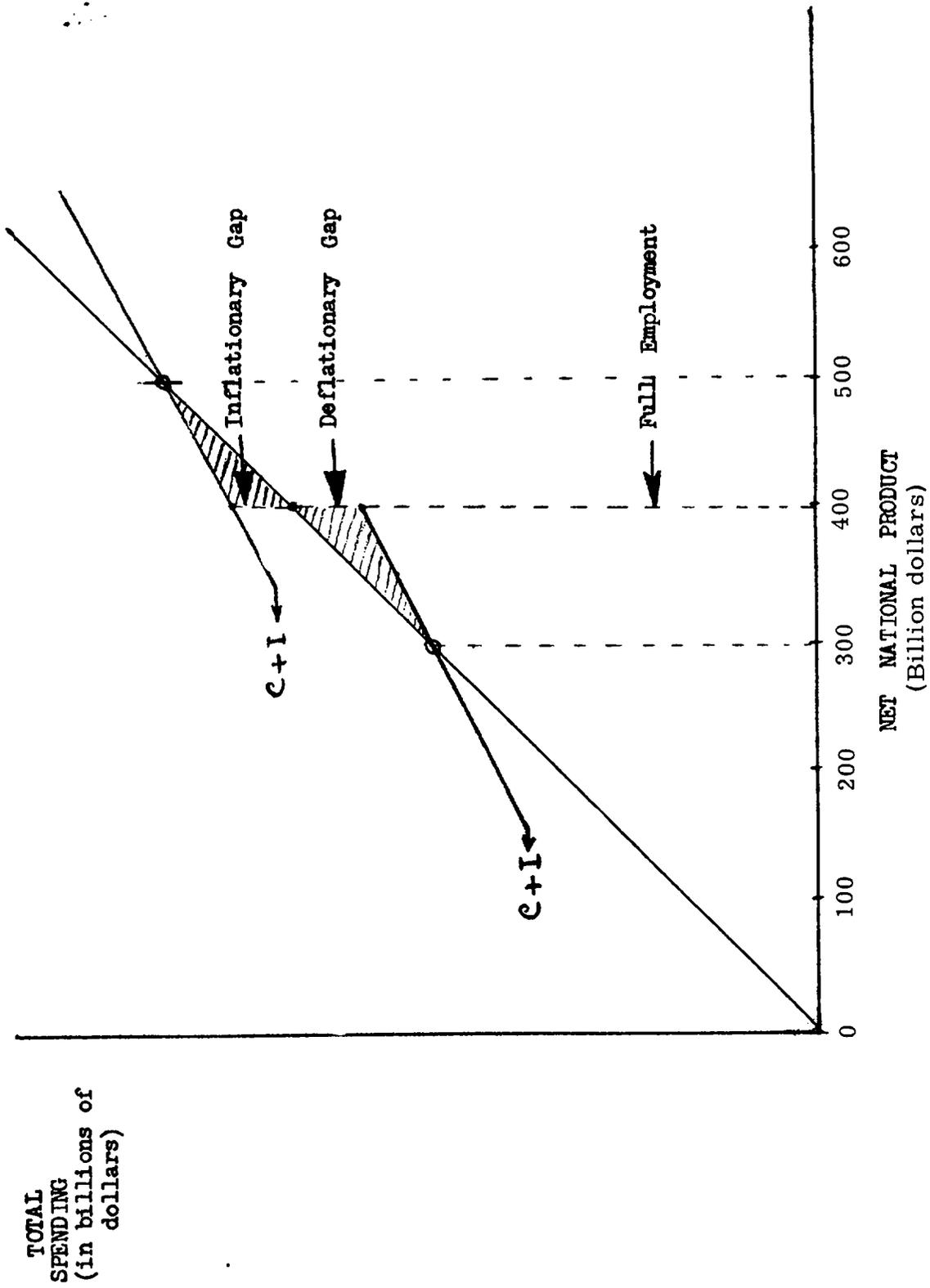


Figure 2. Economic controls exercised by the Government in wartime.



A PARTIAL LIST OF WARTIME GOVERNMENTAL CONTROLS<sup>1</sup>

<u>Area of Control</u>	<u>Agency of (Direct) Administration</u>	<u>Reasons for Its "Necessity," and Scope of Control</u>
Prices <sup>2</sup>	Office of Price Administration	Operates to prevent inflation and rising prices by establishing ceilings on prices of individual products; "Semi-control" over wage increases affecting prices
Wages	National War Labor Board	To stabilize wages; charged with responsibility of settling labor disputes certified by the Secretary of Labor
Manpower	War Manpower Commission	Establishes policies and prescribes regulations concerning mobilization, training, and allocation of manpower; formulates legislative programs concerning manpower; Selective Service
Production	War Production Board	Over-all control of war production by allocating materials and facilities; schedules various production programs; (see also "raw materials and facilities," "inventories," and construction")

<sup>1</sup>Based on information supplied by courtesy of the National Industrial Conference Board.

<sup>2</sup>Used here in its popular sense, exclusive of rents, wages, etc., considered separately.

A PARTIAL LIST OF WARTIME GOVERNMENTAL CONTROLS, cont'd.

<u>Area of Control</u>	<u>Agency of (Direct) Administration</u>	<u>Reasons for Its "Necessity," and Scope of Control</u>
Profits	War Department, Price Adjustment Board, War Contracts Price Adjustment Board	Establishes principles, policies, and procedures on renegotiation; issues regulations "to determine and eliminate by renegotiation excessive profits from War Department contracts"
Rationing	Office of Price Administration	Rationing of commodities; enforcement
Rent	Office of Price Administration	Establishes maximum rents in "defense" areas
Raw Materials and Facilities	War Production Board	Assigns priorities to deliveries of materials; allocates materials and facilities
News	Office of War Information (Office of Censorship; Federal Communications Commission)	Disseminates all public information on the war effort
Communication	Board of War Communications (formerly Defense Communication Board)	Coordinates all branches; reports findings to President for final action
Transportation	Office of Defense Transportation (War Shipping Administration)	Control of all domestic transportation by directing and coordinating traffic movements; priority power
Credit	Board of Governors of the Federal Reserve System	Restrictions of consumer credit by limiting kinds, amounts and character; measures affecting interest rates

A PARTIAL LIST OF WARTIME GOVERNMENTAL CONTROLS, cont'd.

<u>Area of Control</u>	<u>Agency of (Direct) Administration</u>	<u>Reasons for Its "Necessity," and Scope of Control</u>
Foreign Trade (exports)	Foreign Economic Administration	Power to prohibit or curtail commercial exportation of materials, supplies, and technical data
Shipping	War Shipping Administration	Control of ocean vessels (except combatant vessels); auxiliaries and transports of the Armed Forces; coastwise, intercoastal and inland waterways transportation vessels
Construction	War Production Board	Building chiefly limited through control of materials and supplies; maximum expenditures set for unessential construction
Inventories	War Production Board	Reporting of inventories of controlled items, which subsequently is basis for allowances authorized by WPB

HOURLY WAGES AND FRINGE BENEFITS IN  
MANUFACTURING INDUSTRIES, APRIL, 1959  
(In U. S. Dollars\*)

	Hourly Wages	Fringe Benefits	Total Cost Per hour	Fringes As Per Cent of Hourly Wages
Italy .....	\$ .35	\$.26	\$ .61	74.0%
Netherlands.....	.44	.13	.57	30.1
France .....	.47	.24	.71	51.5
West Germany.....	.54	.24	.78	44.3
Belgium.....	.56	.17	.73	31.0
Switzerland.....	.67	.10	.77	15.4
United Kingdom.....	.68	.10	.78	14.0
Sweden.....	.94	.14	1.08	15.3
United States .....	2.22	.46 <sup>†</sup>	2.68	20.5

\*Converted at official exchange rates.

<sup>†</sup> Excludes 7.3 cents in paid lunch and rest periods, travel and make-ready time, which are not considered social charges in other countries.

Sources: French National Institute of Statistics and Economic Studies; United States recalculated to include 1959 survey data of the U. S. Chamber of Commerce.