A Conversation with Wallace Peterson*

EEJ: The dominant force shaping the transnational economy today is the flow of money and finance, not trade in goods and services. The traditional economic factors of labor and real capital are increasingly overshadowed by the new supranational banking system that grew out of the Eurodollar system. Can you identify for us some of the important implications which these changes are likely to have for macroeconomic policy, both within the national economy and on a global basis?

Peterson: Policy-makers in many nations still believe that if they can control interest rates, the inflation rate, and even the level of employment through domestic monetary management. They also believe they can protect their national currencies and their domestic economy from exchange rate fluctuations, chiefly by the mechanism of intervention in foreign exchange markets. I think this is largely illusory. The growth of a gargantuan, world-wide capital market makes such protection all but impossible. In this day of the near-instantaneous movement of money and finance across national borders, even the definition of money is unclear. The financial world "invents" new forms of money faster than we can catalogue them! To believe that central banks can exercise direct control over "money" is to pursue a will-of-the-wisp. In other words, national economies have lost a significant amount of their power to pursue policies oriented strictly toward the domestic economy.

EEJ: But does this mean that national governments must simply abdicate, give up the pursuit of policy in the face of global economic forces over which they have little control?

Peterson: By no means. That is not the case. What it does mean is that it is no longer possible for any nation—even the largest—to pursue policy in a vacuum, without regard for actions that are being taken in the rest of the world. On a practical level, this underscores that the need is greater than ever for close policy cooperation and coordination between nations. Today I see us in a situation with respect to the global economy that is analogous to the situation of the national economy on the eve of the "Great Depression." On the global scene we find ourselves in a regime of near-unrestricted laissez-faire, one in which financial forces dominate. They lay beyond the control of any single nation. In the 1930s, classical theory, the prevailing body of economic theory, could neither explain what was happening nor provide a means to exercise social control over the domestic economy. So it is today with the transnational economy.

EEJ: How does this affect what the leading industrial nations of the world will have to do?

Peterson: At a minimum they will have to coordinate to a far greater extent than heretofore their macroeconomic policies in both the fiscal and monetary realms. There have been some hopeful beginnings in this direction, ranging from the agreement among the main industrial countries after the 1973 oil shock to refrain from restrictive policies that would hurt each others imports to the most recent meetings of the "G-7" countries (France, Japan, the United States, the United Kingdom, West Germany, Italy, and Canada) at which they agreed to coordinate national policies aimed at noninflationary growth and job creation. But this is just a beginning. If there is any single, powerful lesson to be learned from the debacle of the 1930s, it is that a regime of unregulated laissez-faire did not work for the domestic economy. It will not work on a global scale, either.

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EEL: How come we are talking about a macroeconomic theory of global relevance?

PETERSON: We are still a long way from having a full-blown macroeconomic theory of global relevance, but we are further ahead of the game today than economists were in the 1930s. The “Great Depression” caught economists without any theoretical framework whatsoever to cope with some unprecedented economic changes. The chief message I would like to leave with my colleagues in the profession is that we take advantage of the more favorable situation we confront today. We have a sound legacy of macroeconomic theory and policy experience through which we can begin to approach the problems of the global economy. Let’s get on with it!

EEL: Policy coordination is unquestionably both desirable and necessary. But what are the instruments and institutions through which a reasonable degree of social control can be exercised over the global market system?

PETERSON: We do not have any such instruments on a global scale, just as we did not have them on a domestic scale in the 1930s. For economists who care about the real world—not the mythical world of Walrasian general equilibrium—the task is clear. They should be at the forefront of the challenging, intellectual task of forging the ideas, the theory and the institutional arrangements whereby the transitional economy can be managed in the broad social interest. Perhaps in this way, another catastrophe on the scale of the 1930s may be prevented.

EEL: Your answer implies that you think economists, perhaps more than ever, are going to be confronted with the need to choose carefully among competing paradigms if they are to make headway in dealing with the problems of the transitional economy.

PETERSON: That is a thought worth pursuing further. But first, another new and unexpected change recently burst upon the scene which needs to be factored in. I am referring to the virtual collapse of the Soviet empire in Eastern Europe. The far-reaching political transformations now taking place within the Soviet Union is a “wild card” development now taking center stage in the global economy. Three comments are in order about this development. First, no one can foresee fully what the ultimate outcome of this will be, but it does present the West—and especially the United States—with an unprecedented opportunity for global leadership. Whether the Bush administration is up to this task remains to be seen. I am dubious that we will rise to this challenge! Second, the ending of the “Cold War” ultimately will free up vast material and technological resources. How we use these is crucial. So far our greatest shortage is imaginative ideas on how to use these resources. Finally, these astounding developments illustrate dramatically one of the essential ideas in Keynes’s The General Theory, namely that the uncertainty which dominates the social and economic world in which we actually live cannot be subjected to the calculus of probability. Who, indeed, a year or even six months ago could have foreseen the astonishing drama now unfolding in Russia and Eastern Europe.

EEL: Are you implying that this development substantially compromises the relevance of the new classical and monetarist paradigms for coming to grips with the theoretical and policy issues of the global economy?

PETERSON: You took the words right out of my mouth! But, seriously, let me tackle that question by noting that good theory ought to do three things: describe, explain, and prescribe. On the basis of these criteria, I think we can eliminate the new classical economics. Walrasian general equilibrium simply doesn’t offer even a minimally acceptable description of a world characterized by uncertainty, misinformation, power relationships, unemployed resources, and governments committed to economic intervention. Further, in a world where policy is going to be made by some means—intere state, especially on a global scale, is of no practical value. What of monetarism? Monetarism came to ascendancy in the United States in 1970s, when it was asserted that the combination of inflation and unemployment signaled the failure of Keynesian-based demand management policies. Personally, I think this is a misunderstanding of The General Theory in that it neglects Keynes’s important Chapter 21 on “The Theory of Prices.” But more to the point, monetarism has not worked as a policy. As we saw in the early 1980s, strong application of monetary brakes can push the economy into a deep recession. Since then monetarism has not fared well. Even Federal Reserve Chairman Alan Greenspan, an admitted monetarist, concedes this.

EEL: Yet, as we all know, the Keynesian view also has its imperfections and shortcomings.

PETERSON: That is certainly true. Still there are, I think, two reasons why it still offers the best paradigm through which we can approach understanding and analysis of the transitional economy. First—and this may be Keynes’s most important legacy—the Keynesian “revolution” gave the state major responsibility for the macroeconomic performance of the capitalist economy. On a