Committee Chairpersons and Area Representatives

A. COMMITTEES
1. Committee on Economic Education: William B. Bennett, State University College at Buffalo, NY 14222
2. Committee on Awards: Grant N. Farr, Penn State University, University Park, PA 16802
3. Finance Committee: Tilden C. Gates, Manufacturers' Hardware Trust, 330 Park Avenue, New York, NY 10022
4. Nominations and Election Committee: William N. Lonsard, Hofstra University, Garden City, NY 11530
5. Committee on the Status of Minorities in the Profession: Carol C. McDonough, Lowell Technological Institute, Cambridge, MA 02139
7. Local Arrangements Committee: Louis R. Sulkiewicz, State University of New York at Albany, NY 12220
8. Membership Committee: Vacant

B. AREA REPRESENTATIVES
Canada:
Eastern Canada: U. L. G. Rose, Dalhousie University, Halifax, NS
Western Metropolitan Area: Vacant

Eastern U.S.:
Northern Ontario: Joseph E. Nelson, Laurentian University, Sudbury, Ont.
Quebec Metropolitan Area: Claude Desjardins, University of Ottawa
Connecticut: John G. Walter, Fairfield University, Fairfield, CT

New England:
New York:
Eastern: Stanton A. Warren, Plattsburgh State University College, Plattsburgh, NY
Western: Francois J. Collard, State University College at Buffalo, Buffalo, NY


Northeastern U.S.:
Pennsylvania: R. Srinivasan, Pennsylvania State College, Allentown, PA
Southwestern: Kenneth L. Friesen, Northwest University, Evanston, IL

New England:
New York:
Eastern: Stanton A. Warren, Plattsburgh State University College, Plattsburgh, NY
Western: Francois J. Collard, State University College at Buffalo, Buffalo, NY


Rhode Island: Vacant

South Carolina:
Hofstra U. Ulrich, Hofstra University, Clifton, NJ

Tennessee:
Larry M. Blair, Oak Ridge Association, Inc., Oak Ridge, TN

Virginia:
Max M. Motzkin, Virginia Commonwealth University, Richmond, VA

West Virginia:
Terry W. West, West Virginia University, Morgantown, W.V.

West Virginia: Vacant

Worcester:
Richard Rosemburg, University of Wisconsin-Parkside, Kenosha, Wisc.

NOTE: Area Representatives are needed for: Massachusetts, New Hampshire, North Carolina, and Rhode Island.

The Possibilities and Limits of Aggregate Demand Management

CHARLES L. SCHULTZE

1. Introduction

Good Afternoon.

In the last five years the world economy has gone through a time of troubles previously unparalleled in the postwar period. The virtually simultaneous appearance a few years ago of a worldwide crop shortage, a quadrupling of world oil prices, and a worldwide economic boom led to double-digit inflation immediately followed by a worldwide recession that in the United States was the worst recession in forty years. The ensuing recovery has been sluggish in many countries, and accompanied by the phenomenon of high inflation persisting alongside high unemployment. The recovery has also been characterized in most nations by a less than expected pickup in business investment.

The events of those past five years have led some economists, and more particularly a large segment of the financial and business community here and abroad, to question the usefulness of the traditional tools of macroeconomic policy. I would like to discuss with you today the major elements of those criticisms, and state what I believe to be both the potentialities and the limits of macroeconomic policies.

In a recent paper, your President, Jim Tobin, examined and rejected the proposition that the theoretical contributions of John Maynard Keynes are no longer relevant. I concur with Tobin’s view. The broad economic policy implications of the neo-Keynesian view of the world, as expounded by Tobin and others, are also still relevant. Aggregate economic policies must, of course, be designed and implemented in ways that take into account the economic circumstances in which we find ourselves today. And there are some important aspects of our economic problems that are not amenable to solution by demand-management measures. But my central message is that there is still a valid and constructive role for aggregate demand management to play in maintaining and improving our macroeconomic performance.

The fact that such a topic is still appropriate to today’s gathering of economists signifies the considerable change we have experienced in our own perspectives on the effectiveness of standard fiscal and monetary tools.

Twenty or thirty years ago, optimism was widespread that macroeconomic instability could largely be eliminated through careful and innovative use of monetary and fiscal instruments. Of course, we had yet to estimate stable and dependable models of the economy. But we were confident they would come and would equip us with the technical apparatus needed to eliminate all but minor variations in levels of real output and employment and to do so in an environment of reasonable price stability.

Today, the pendulum has swung in the other direction. The recent deep recession, and our apparent inability to affect rapidly and directly the rate of inflation, has led to widespread doubts that management of aggregate demand is very effective in the modern economy. The
issues are being debated both within and without the economics profession and throughout the industrial world, as well as in the United States. In the extreme, some economists have argued that monetary and fiscal policies are entirely unable to affect real variables. Instead, this line of argument runs, their effects are concentrated principally—and very quickly—on prices.

Fundamentally, I believe that issues raised by the critics of neoclassical theory can be reduced to three questions:

First, have developments within the economy blurred our macroeconomic policy instruments and caused demand-management policies to become less capable of affecting output and employment?

Second, what obstacles exist to the achievement both of reasonable price stability and high levels of employment through the use of macroeconomic policy tools?

Third, is it necessary, in today's economy, to supplement aggregate demand policies with supply-oriented and structural measures in order to achieve stabilization objectives?

In the course of this talk, I will review each of these questions in turn.

II. Criticisms of the Neo-Keynesian Model

Among the general public, doubts about the efficacy of traditional macroeconomic tools have become visible through frequently expressed fears, regardless of the level of unemployment and slack capacity in the economy, that budget deficits will "crowd out" private borrowers or that they are intrinsically inflationary. Similarly, accommodative policies by the Federal Reserve Board, even when there is a monetary drag in the economy, to excite substantial slack in the economy tend to excite worries that "loose money" policies will spark new inflationary pressures.

Within the economics profession, these concerns have received theoretical support from the analysis who argue that fiscal or monetary stimuli give rise to inflationary expectations that substantially reduce, or perhaps eliminate, the response of the real economy to stimulative measures.

The most extreme form of this view is found in the "rational expectations" doctrine. This theory of macroeconomic behavior leads to the apparently damaging criticism that fiscal and monetary tools have an impact principally, if not solely, on prices. Expectations of the "rational expectations" view of the world begin from two basic premises:

First, they believe that the aggregate economy operates within a neoclassical environment of highly flexible wages, prices and interest rates.

A shock that dislocates the economy from a full-employment equilibrium becomes rapidly evident. Equilibrium adjustments in wages, prices, and interest rates that restore full employment without the aid of discretionary policy tools. Any stimuli to aggregate demand designed to reduce unemployment, therefore, will impinge on an economy already returning to high employment and will ultimately prove inflationary.

The second element in the rational expectations view is that market participants forecast and quickly adjust their prices and wages to their expectations. As a consequence, stimulative measures will not result in temporary real output gains. Instead, prices and wages adjust very quickly to the inflation anticipated to result from stimulative measures. Even in the short run, the gain in nominal GDP is translated into higher prices, not greater real output.

I have outlined an extreme version of the model. But even with modifications to allow for time lags, multi-year wage bargains and administered prices, its central message is clear. Discretionary monetary and fiscal policies will produce only modest and short-lived changes in output and employment. Their principal effect will be on prices.

It is important to recognize that this conclusion does not stem principally from the assumption that producers and consumers possess and act on "rational expectations." Rather, it is the result of the neoclassical model of the economy underlying this view. In a strictly neoclassical world, wage, price, and interest rate adjustments rapidly return an economy to full employment after a deflationary shock. Stimulative macroeconomic policies can, at best, speed up the adjustment process a little, and they do so at the cost of higher prices. The element of rational expectations injected into this scenario only accelerates the inflationary response that would be forthcoming in any event, so that even the temporary gains in real output and employment are kept to a minimum.

If one instead introduced rational expectations into a world of relatively inflexible wages and prices, the outcome would be quite different. In this case, it is the response to stimulative measures of output and employment that will be quickened as a result of the rational expectations of participants in various markets. In short, rational expectations merely shorten, and at the extreme eliminate, the lags in whatever model of the world you hold—the basic nature of the model is not altered.

If the real world were indeed highly neoclassical, so that demand management policies in a recession ultimately led to price increases rather than output gains, simple reduced-form forecasting models would be fairly accurate, as regards the direction of inflation, even if somehow less so with respect to length of lags and precise magnitude. An increased rate of growth in the money supply can be a rise in the high employment deficit would lead to an increase in the rate of inflation. And so it would be relatively easy to form expectations with a fairly high degree of certainty.

But the evidence for the neoclassical view is extremely weak. The behavior of quit rates and layoffs over the course of the business cycle persuasively argues that increased unemployment in a cyclical downturn is not voluntary. The empirical evidence is very strong that wages and prices are far less sensitive to the appearance of slack in labor and product markets than the neoclassical view requires. And almost every study shows that the interest rate is an argument in the demand for money function, so that interest rate flexibility alone cannot restore equilibrium. The use of discretionary monetary and fiscal policy, in periods of high unemployment, does not, therefore, impinge upon an economy which is only a short time lag away from full-employment equilibrium, and future inflation is not the inevitable consequence of aggregate demand measures taken in periods of economic slack.

Once the highly flexible adjustment mechanisms of the neoclassical view disappear, the assumptions required to validate a rational expectations hypothesis disintegrate. Market participants, for example, would have to predict fairly closely the impact of changes in the monetary aggregates on the major economic variables, in order to separate the output from the price response. But that impact is strongly influenced by autonomous changes in the demand for money. Forecasting such changes is not a trivial task. The velocity of the basic money supply, M1, varies considerably not only in a regular cyclical way, but in response to changes in institutions and in the habits of users of money. In the years following the trough of the most recent recession, velocity has increased at an average annual rate of 4% percent. The variance around that average, however, is very wide. For example, the increase in the first year was 8 percent; the increase over the second year was 3 percent, while the increase in 1977 was 2 1/2 percent. These differences in the behavior of velocity over the three years, moreover, are not explained by changes in interest rates. Forecasting the consequences of monetary developments, therefore, cannot be done through an application of a regular and easily applicable set of past relationships.

Market participants also are required by the rational expectations view to comprehend the implications for the economy of deficits in the Federal budget. Here, too, simple reduced form relationships are likely to prove highly misleading.
increase in the full employment Federal budget deficit—should increase output, not prices, in an economy operating well below potential. However, if market participants come to believe that fiscal stimulus is irreversible—that it cannot and will not be withdrawn as the economy returns to high employment—they would reasonably expect that inflation would accelerate in the future. That expectation could prompt market participants to either of two sorts of responses that would reduce the output-raising consequences of economic stimulus.

First, they could mark up prices and wages in anticipation of future inflation induced by excessive government stimulation of aggregate demand. If all markets were auction markets, this might be the outcome. But the institutional rigidities in large sectors of the labor and product markets make it unlikely that these administered prices would respond quickly to such expectations of future inflation. And sluggish responses in these markets would, in turn, reduce the likelihood of substantial anticipation markups in auction markets, unless the expected increase in the inflation rate were quite large. I expect that the possibility of any influence of such expectations on the rate of inflation, but suggest that it is likely to be small. The second potential consequence is less easily dismissed. Market participants who fear that economic stimulus will be carried far into the future could reasonably conclude that the resulting inflation would cause nominal GNP to grow at a faster pace than can be accommodated by more slowly growing monetary aggregates. The result would eventually be rising interest rates, possibly a financial crunch, and a subsequent recession. Those who fear that this scenario would be played out in the future—particularly business firms—could respond by reducing their investment plans in the near term. As a result, the response of output to any particular degree of fiscal stimulus could be significantly reduced.

We have experienced three periods in recent years in which the rate of nominal GNP growth ran up against monetary constraints. In 1966, 1969, and between 1973 and 1974, financial markets tightened severely. Those experiences have made businesses and financial market participants more sensitive than ever before to the possibility that similar situations could be repeated in the future. The prospect that businesses will mark down their investment plans out of fear of irreversible government stimulus is not a reason to abandon fiscal policy tools. However, the possibility that such reactions could take place underscores the importance of convincing the private sector that fiscal measures taken in periods of economic slack will not continue as the economy returns to high employment.

This is the underlying rationale for President Carter's long-range budget strategy. Expenditure commitments tend to be very hard to reverse, and aggregate demand management which emphasizes such measures does run the risk of being irreversible. And so the President has chosen to rely principally on tax reductions to promote stable recovery. Moreover, the Administration has fixed, and is determined to adhere to, very tight expenditure targets in the years ahead. In 1979, real outlays will grow only about 3 percent and similar restraint will be shown in later years. Thus, GNP will be growing in the coming years more rapidly than budget outlays. Together with the fact that average tax rates have been cut significantly, but nominal GNP growth, the constraint on spending promises to reduce the budget deficit as high employment is approached. This strategy enables the Administration to ensure that fiscal stimulus will not continue indefinitely, while providing the flexibility to determine by year whether further tax reductions are required to keep the economy on the path to full employment.

One sometimes hears that the lagging investment performance in this recovery makes the use of traditional fiscal tools less effective. It is true that business firms have been deeply scarred by the traumatic events of 1972 to
1975—the effects on prices of worldwide food shortages, the sudden and sharp increase in the price of oil, a worldwide commodity boom that precipitated shortages in all nations, followed by the worst recession in forty years. As a result of these events, uncertainty about the future has increased. Econometric analyses performed at the CEA indicate that investment in equipment, given capacity utilization rates and the cost of capital, has grown during the recovery about in line with expectations. Investment in longer-lived structures, on the other hand, is lagging considerably behind the pace that would be expected on the basis of the determinants of investment. Moreover, a larger than usual proportion of new investment in equipment is being poured into trucks, autos, and other time-limited machinery. Such a pattern is what might be expected in response to an increase in uncertainty. This does not imply, however, that the response of investment to traditional tools of demand management has been sharply weakened. A downward shift in the investment demand function does not necessarily mean that its slope has been reduced. At any given level of expected output and profits, investment may indeed be lower than prior relationships would have suggested. But increased uncertainty premium can be offset by measures that raise after-tax rates of return on investment, and such measures are part of the normal tool kit of aggregate demand management policies. The $5 billion reduction in business taxes, included in the Administration’s 1979 tax program, is addressed to this problem.

To summarize briefly the response to the first question posed at the outset of this talk, I believe that aggregate demand management tools are not the impotent. The evidence from the economy in recent years clearly is to the contrary. But after ten years of substantial inflation, fears that current stimulus will prove irreversible could significantly weaken the effects of stimulative actions. It is important, therefore, to pursue a demand management policy within the context of a longer run budget strategy that permits reversibility, and guards against the development of excess demands at recovery proceeds.

V. Achieving Price Stability

If we are assured that demand management policies still do have an impact on the real economy—and output and employment—the second question I posed earlier remains: How useful are macroeconomic tools to achieve simultaneously both high employment and price stability?

No one would doubt, I suppose, that traditional microeconomic policies are capable of preventing a significant acceleration of inflation brought about by excess aggregate demand. Our forecasting models by inference, and our judgments sometimes wrong, but the tools at our disposal are clearly good enough to avoid a reemergence of excess demand.

However, the large—and perhaps growing—incentivity of wages and prices to slack in labor and product markets creates serious obstacles to the use of aggregate demand management in dealing with other kinds of inflation problems. Data on changes in bonusy wages and unemployment indicate that the rate of wage increase is not very sensitive to increases in the rate of unemployment (Table 1), and that wages may have become increasingly insensitive over the postwar period. From the cyclical peak the 1948-49 recession to two quarters following the trough, the unemployment rate in manufacturing increased by 4 points and the rate of increase in average hourly earnings in manufacturing declined by 7.2 percentage points. Increases in unemployment of similar magnitudes in the two succeeding recessions elicited far less deceleration in wage rates. By our judgmental decline did not fully explain the manufacturing unemployment rate rose from 4 to over 10 percent—but wages did not

show significant signs of moderating. None of our previous inflation has been inaugurated by wage-push factors; wages in general and union wages in particular cannot be blamed for the initiation of inflation. But downward inflexibility of wages has been a major problem in perpetuating inflation once began.

The downward insensitivity of the rate of wage and price increases to slack in labor and product markets causes two related kinds of problems. The first of these has to do with the economy’s response to large supply shocks. This was driven home by the experience of 1973 and 1974 when the supply prices of food, energy, and other imported materials rose dramatically. When shortages force up the price of particular commodities, the objective of economic policy ought to be to limit the effect as much as possible to a one-shot increase in the price level. If the rate of wage and price increases were highly sensitive to conditions in the labor and product markets and less sensitive to prior increases in wages or prices, this objective could be achieved—at relatively small cost in terms of output and employment—through moderately restrictive aggregate demand policies.

Unfortunately, however, wages are both insensitive to moderate slack in labor markets, and are sufficiently responsive to past inflation to set in motion significant second- and third-round inflation as a result of supply shocks. The coefficient of prior price increases in most wage equations is below unity. But it is sufficiently large that in the absence of much downward sensitivity to labor market conditions, large reductions in output and employment are required to prevent exogenous supply shocks from setting off a significant increase in the rate of inflation. And the cost of such policies—in reduced output and employment and in human hardship—is very substantial.

From the standpoint of current economic policy, it is even more important to recognize that the downward insensitivity of the rate of wage and price increases to slack in the labor and product markets has sharply reduced our ability to unwind an inherited inflation through reliance on aggregate demand policies alone. The current inflation largely represents an inertial process of wages responding to prior price and wage increases and prices responding to cost increases, and both together responding to expectations of continued inflation. This process gained momentum during the 1973-74 period of excess demand and price shocks. In an environment of downward flexibility in the rate of wage and price increases, economic slack would quickly be translated into a deceleration of wages, costs and prices that would start...
the expectation of continuing inflation and reduce the underlying rate of inflation. In an environment of wage insensitivity, on the other hand, reliance solely on aggregate demand policies implies that the momentum of wage and price increases can be broken only through extended and very deep economic slack.

Casual empiricism supports this assertion. As I noted earlier, little deceleration in wage and price increases has occurred since the middle of 1973 despite the fact that the unemployment rate continuously stood well above the level that almost any economist would associate with full employment. A survey of economic research in recent years suggests that it would take somewhere between six and fifteen years, holding the unemployment rate at 6½ percent, to cut the inflation rate from 6 to 3 percent.

To put it another way, in order to cut the current inflation rate in half, the lost output would amount to at least $600 billion in 1977 prices, using the optimistic end of the survey range. Moreover, to the extent that such a policy reduced the rate of investment, any attempt to restore high employment later would probably soon encounter inflationary shortages of plant capacity.

In short, I answer my second question as follows: The rate of inflation is responsive to the appearance of excess demand, and macroeconomic tools can address that problem. However, the downward insensitivity of the rate of wage and price increases causes major problems as we attempt to reduce an inherited inflation rate or stop the spread of a supply-side price shock. The economic and social cost of trying to solve these problems through sole reliance on macroeconomic measures is simply too high, and we must find alternative solutions.

That is the reasoning behind the President’s program to decelerate the rate of wage and price increase through voluntary action. To break the momentum of inflation, both wage and price increases must be moderated simultaneo- usly on a broad front across the economy.

Accompanied by a long-run budgetary policy which gives assurance that excess demand infla-
tion will not be permitted as the recovery proceeds, the program should have a beneficial effect on expectations, thereby strengthening the forces working toward a reduction in the inflation rate.

VI. Targeted Structural Policies

The third question I raised at the outset of this talk was whether certain problems in the economy require targeted solutions, rather than strict reliance on monetary and fiscal policies. My answer is yes. I believe that we face two, somewhat related, structural economic problems that require such a response. While time constraints preclude a detailed consideration of each, I would like to touch briefly on both before closing.

The first problem is the existence within the labor force of pockets of workers experiencing very high rates of unemployment that are not really reduced to acceptable levels through macroeconomic policies. Young black Americans today suffer an unemployment rate of almost 40 percent. Among black and minority adults, the unemployment rates run near 10 percent. Unemployment among blacks has declined only a little during the course of the recovery; the black unemployment rate is more than twice as high as that for whites and will remain unacceptably high, even during periods of high employment, in the absence of direct actions to reduce it.

A similar problem exists among groups of differently skilled individuals within the labor force. For prime-age adults with job experience, unemployment rates are substantially lower than their untrained counterparts of any age. Macroeconomic policies can be successful at reducing the overall unemployment rate. As unemployment declines generally, differentials among the unemployment rates of various groups within the labor force will also decline. Past a certain point, however, it is not possible through macroeconomic policies to reduce the unemploy-ment rate among the unskilled and among minorities without causing wage pres-
sures to build in markets for highly skilled individuals in short supply.

As a result, efforts to achieve high employment goals through macroeconomic policies alone would encounter structural barriers in labor markets that would frustrate progress and generate inflationary pressures. If we are to continue to make progress against structural unemployment, we must do so through targeted programs undertaken in the context of macro- economic policies to promote sustained growth. The second structural difficulty we face is that over the past four years the rate of growth in the labor force in the United States has been so slow that our present labor force has actually slowed up, while the growth of the capital stock has declined. From 1973 to 1977, the labor force grew at an average annual rate of 2.4 percent, while the nation’s capital stock expanded at an annual rate of 2.5 percent. By comparison, from 1963 to 1973, the annual rate of labor force growth amounted to 2.1 percent and the stock of capital grew at a 4.7 percent rate. To find the potential for capacity shortages later on, and to maintain a reasonable growth of productivity, it is clear that we must put a high premium on the promotion of investment relative to the other components of overall demand. Just any expansion in aggregate demand will not meet longer run stabilization objectives.

The possibilities and limits of aggregate demand management

The normal processes of economic growth will generate a substantial increase in investment during the next several years. Because capital formation has lagged behind the growth in the labor force recently, however, the normal flow of investment induced by expansion will not be sufficient. Unless we experience a greater-than-average pace of investment, we would face overall capacity constraints by late 1980 or by 1981. Even if capacity constraints did not arise, however, the very slow growth of productivity in recent years would be likely if the capital/labor ratio does not begin to rise strongly. Macroeconomic policies to promote steady growth are thus not sufficient. We must supplement these policies with additional incen-
tives to encourage capital formation. This is another reason that the President has included in his tax proposals substantial incentives for business investment.

VII. Conclusion

In summary, we should not and cannot give up on the traditional tools of macroeconomic policy. They remain vital and very powerful levers at the hands of government in our efforts to utilize fully the resources of our economy and to maintain steady economic expansion in an atmosphere of reasonable price stability. They are imperfect tools, to be sure; there are limits to what they can accomplish; and they have to be supplemented by other measures. But they remain essential.