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Restoring a Healthy Economic Environment

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

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Restoring a Healthy Economic Environment*

by

Allan H. Meltzer, Maurice Falk Professor of Economics and Social Science
Carnegie-Mellon University

There is a growing interest in the problems caused by instability and change. The interest in change and the type of society in which we will live in the future reflects more than the general requirements of men in every period to plan for the future with the anticipation that there will be a future. The current concern about instability reflects more than the general interest of existing institutions or groups that find planning easier in periods of stability than in periods of marked instability. Many of the arrangements that we call society rest on the presumption that the frequency with which disasters have occurred in the past is a reliable guide to the future and that these frequencies can be expressed as probabilities of occurrence or reoccurrence in the future. If change is so frequent and changes are so disruptive that the past provides no reliable guide to the future, historic frequencies no longer provide a useful base for assessing the future.

For example, if the burning or bombing of private property or the taking of private property became accepted methods of social protest, fire, theft and what might once have been called trespass no longer have the same meaning or the same frequency of occurrence. The example brings out not only that a particular institutional arrangement -- private insurance -- increases the opportunity for people to remain secure in their property from internal or external threats but that the survival of the arrangement depends upon the maintenance

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of certain standards of behavior. Insurance contributes to economic and social stability by providing protection against loss of property, but the system of property insurance also depends on the social arrangements that maintain economic and social stability. The opportunity to purchase insurance gives individuals a means of joining together to pool risks and voluntarily maintain their property secure against hazards such as storms, fire, theft or other events with known or computable probabilities, but the price at which the service is offered depends upon the extent to which the occurrences are predictable.

None of the buyers needs to know about probability distributions, the advantages of pooling risks, or most of the other complexities of underwriting insurance. The provision of these services is an example of the way in which the search for profit leads to the production of the goods and services that consumers desire. No discussion of a healthy economic environment can afford to neglect the importance of sustaining and encouraging the system that rewards those who provide the goods and services that consumers demand.

The opportunity to insure against loss makes an important contribution to the development and maintenance of a healthy economic environment in a very different way. The opportunity to convert risky prospects into certain common known costs, encourages many to own property that they might not otherwise acquire. The ownership of houses, automobiles, furniture, and durable goods of all kinds could not have become as widespread as it has in developed economies if there were no insurance and no protection and if each man had to bear his own losses and could not insure against risks.
There is, however, a more basic sense in which the examples of insurance and risk reveal both the problems and prospects of providing a healthy economic environment. Certain risks are inherent in nature, given our knowledge and technology. Other risks are not a part of the environment but are increased or reduced by the actions of men or their governments. The risk of war and the risk of civil disturbance have for a long time been recognized as belonging to a special class and for that reason, damages arising from war or civil disturbance are not covered by standard forms of insurance. War and civil disturbance are only two of the more obvious examples of a general class of phenomena that I plan to illustrate more fully in later examples.

Before doing so, I want to discuss the general principle and the importance of risk-bearing and the distribution of risk for the maintenance of a healthy economic environment. In many parts of the world and within our own society, there are those who believe that the return to risk-bearing can be separated from the risk bearing and that the amount and type of risk that individuals and businesses will bear remains unchanged even if the returns to risk-bearing are greatly altered. One of the requisites of a healthy economic environment is that the return to risk-bearing be adequate to compensate for the risk and for the effort of organizing resources so that the probability of loss can be assessed. It is not surprising that in large parts of the world where revolution and the expropriation of property are commonplace, capital investment per man and the rate of progress are both low. In these societies, instability and the absence of progress are the direct consequence of the social and political arrangements.
What about western society? Despite the current set of disturbances we have had a period of more than twenty-five years that we can characterize as steady progress, improved living standards and increased opportunity. Does this record justify the belief that we have found a means of maintaining stability that we did not have in the 1930's or before? Or, is the absence of a major recession since World War II the result of superior policies that have promoted more stability? Or, to try a third alternative, have we distributed the risks differently so that a major source or major sources of instability have been removed?

Two Views of the Economy

There are, in fact, two very different views of the economy, and they provide two different answers to these questions. One view is that the private businessmen are one of the main causes of instability. This view is very old and in its most extreme form it leads to the proposition that capitalism is an inherently unstable system and that, left alone, capitalist societies would explode into inflation or collapse in depression. Karl Marx was by no means either the first or the last to make one or both of these claims.

So far the predictions have turned out to be false and those who make them have looked for explanations of their failures. In our own day, it is generally believed the dire predictions have failed because the government offsets the instability caused by the private sector of the economy. Modern proponents of this view argue that the private sector is inherently unstable and, left on its own, would at times generate a
a substantial reduction in output and employment, at other times a substantial increase in expenditure and a high rate of inflation. Fluctuations in prices and output, the kind of changes that we observe during business cycles, are seen as primarily the result of the decisions taken in the private sector. Among these decisions proponents of the view I am now describing single out investment decisions resulting from shifts in businesses' demand for capital goods. Changes in investment spending are said to generate expansions and contractions in output, employment, and the rate of inflation. Waves of optimism and pessimism are said to sweep over the business community driving them ever onward despite the accumulating evidence of falling profits and profit margins. (Superficially viewed, the U. S. economy in 1969-70 fits this description well. Businessmen reported plans to expand at a high rate despite falling profits and profit margins.)

But, we must not forget the other half of the scenario. Eventually, the wave of optimism is replaced by a wave of pessimism. Then, despite remarkable opportunities, capital seeks safety and low risk, low return, alternatives. The economy stagnates. Recession follows prosperity.

We can see the grounds on which such a theory rests. We live in precisely the kind of period when a wave of optimism was replaced by a wave of pessimism, so that much of what I have said seems to be an outline of current reality. Doesn't the stock market swing from price earnings ratios of 21 to ratios of 10 or 12? Don't investors swing from periods in which they are willing to pay for the profit
opportunities in companies that have never earned profits to periods in
which they are not willing to pay much for profit opportunities in
companies that have a sustained record of progress and growth? Don't
the journalists and the slick magazines periodically rediscover the
magic of compound interest and label as geniuses those who combine that
knowledge with a willingness to take the risks inherent in a highly
levered position? Doesn't the bond market reveal periods in which
business men are willing to borrow at ever higher market interest rates
followed by periods in which they are not willing to borrow very much
at lower and lower rates? Doesn't the economy show the swings in
investment in business plant and equipment predicted by the theory?

Those who interpret the periods of business expansion and
contraction as the result of waves of optimism and pessimism find support
for their interpretation in the events just described. Based on their
interpretation, they conclude that government policies -- including the
tax and spending decisions that are called fiscal policies, the
manipulation of interest rates and quantity of money that is called
monetary policy -- these policies are the principal means by which
stability is maintained. They see government policy as a means of
offsetting the waves of optimism and pessimism.

Have businessmen gone beserk? Let the government tax their profits
at higher rates and they will return to their senses, or let the government
tax the buyers of their goods and services so that they have less to
spend. Have businessmen fallen into a state of deep gloom? Reduce
taxes, increase the government's spending, and by careful manipulation
of the budget encourage an expansion.
It soon became apparent to the proponents of this system that their proposals are an inefficient type of management. Waiting for crises to occur is not a very responsible way of dealing with problems. Far better to manage an advance, to forestall an anticipated expansion, to offset an anticipated decline. By combining appropriate management with accurate forecasting, they expected to cut the peaks off the inflations and the bottoms off the depressions or recessions.

To more activist proponents of this view, counter-cyclical fiscal and monetary policies combined with careful planning and good forecasting are insufficient. They besiege us regularly with new remedies to supplement the old. Do we have inflation at the same time as unemployment? Let the government impose price and wage controls, temporarily or permanently. Do some businessmen raise their prices? Let the Chairman of the Council of Economic Advisors berate them. Do some labor unions threaten to go on strike in favor of higher wages? Let the President admonish them publicly. Do some groups refuse to go along with these policies? Coerce them or threaten to take away some special benefit that the industry has received. Do some businesses insist upon borrowing even at high interest rates? Put on credit controls and allocate the credit to the social purposes the government selects.

The proposals for wage controls, price controls, wage price guide posts, and credit controls are not made by members of the new left, or the far left, or even the old left. They come from bankers, central bankers and former central bankers.
I do not plan to take up each proposal separately. I mention them to point out that each of the proposals for new controls rests on the proposition that the main instabilities that we experience are the result of errors, bad judgments and waves of optimism and pessimism affecting the private sector. Each reflects a belief that it is the government that offsets the instabilities induced by mistaken private policies.

There is an alternative interpretation of the causes of inflation or recession. The alternative interpretation views much of the instability in the economy as the long delayed effect of previous government policies. When government monetary or fiscal policies are expansive, the initial effect is to stimulate the economy. Sales increase and employers observe the increase not by watching the government but by observing their own sales, inventories and orders. Typically, they respond to increased sales by trying to rebuild inventories, at first, by working the labor force more hours and later by hiring additional workers. As output expands to replace and build inventories in anticipation of still greater sales, more spending is generated. Older machinery is brought into service, and pressures on existing plant capacity increase, generating demands for additional capital equipment.

The initial policy of monetary expansion reduces market interest rates, thereby encouraging additional borrowing to build inventories, expand production and capital spending. Each of the subsequent changes in output generates more borrowing and more spending that in turn stimulate additional increases in output and increases in market interest
rates. As pressure on capacity increases, prices or rates of inflation start to rise. At first, wages rise most in the non-union sector. Later, as union contracts come up for renewal, wage demands in the unionized sector increase also.

At first, higher prices and expanding production mean that reported profits increase. Following the increase, come the announcements of increases in corporate earnings and dividends that the stock market uses as a basis for higher stock prices. The fact that wages, particularly in the unionized sector, are set in long-term contracts means that at first reported profits increase at a much faster rate than wages. If the government continues its expansive monetary policies, the expansion of the economy continues for a time, and there are further increases in the demands for credit, goods and services that produce even higher prices and interest rates. With rising sales, profits, incomes and hours of work, consumers and businessmen become more optimistic about the future. They revise their plans and begin to extrapolate the higher rates of growth of income. On this view, rising output, rising prices, rising interest rates and improved anticipations of the future reflect the adjustment of the economy to the more expansive government policies.

Initially, prices rise only slowly. Since the increased demand for output and the increased expenditure by business and households is spread over a large number of commodities, sellers cannot be certain whether the additional demands for their goods and services arise from their own
competitive efforts or from the more pervasive effect of expansionist and inflationary government policies. For most of us, the two are inter-twined and mixed up with the random changes that we all experience. Once it becomes apparent that the increase in demand is not a transitory phenomenon, price increases become larger and more frequent.

Once this process gets underway, consumers and businessmen are confronted with announcements of rising prices much more frequently than in the past. Where price changes have been less frequent and more or less evenly distributed between revision upward and downward, announcements of price increases tend to exceed announcements of price reductions. Others are led to examine the prices they charge for the goods and services they sell and to question whether their prices should be adjusted upward. As loan contracts come up for renewal, interest rates rise and compensating balance agreements become more costly. As wage contracts come up for renewal, wage and salary demands come to reflect more fully the maintained rate of inflation. Workers and their unions find that wage increases, adjusted for the decline in the purchasing power of wages, fail to keep up with productivity.

The process I have described is the process by which an economy adapts to an expansive monetary policy. A more subtle adjustment accompanies the price adjustment; businessmen and consumers learn to anticipate price increases. Each new announcement of an increase reinforces those anticipations. Where there was a prevailing belief that there would be no inflation or a continuation of the prevailing
rate of inflation, there is now a growing anticipation that prices will rise at a faster rate in the future. The anticipation of a rising rate of inflation replaces the anticipation of price stability or a constant rate of inflation.

Individuals and businessmen attempt to protect themselves against the consequences of future inflation or to profit from those consequences. They sell bonds and spend money balances, thereby reducing the amount they lose in real terms when prices rise. They attempt to borrow to take advantage of the fact that contracts calling for fixed nominal payments require a smaller real sacrifice in the future if prices rise. Those who are least sophisticated about the workings of inflation may rationalize or explain these adjustments as the response to an increase in their sales, an attempt to maintain their "share of the market," or a desire to offset higher labor costs by using more capital.

The explanations and statements about motivation are unimportant. Whatever the reason, the anticipations of inflation are translated into an increase in the demand for borrowing, and market rates of interest rise. If the expansive monetary policy is maintained, the economy can be stabilized at the higher rate of inflation and the higher market rates of interest by devaluing the currency.

But we know from current and past experience, that neither the public nor the policymakers are willing to stabilize the economy at the higher rate of inflation. As the effects of inflationary policy become more apparent, the opposition to inflation grows. Demands for an end to inflation become more widespread. The expansive monetary policy ends and is replaced by a contractive policy.
We do not need to trace the effects of the anti-inflationary policy -- the less expansive monetary policy -- with the same detail that we traced the expansion. As before, the initial effects are on interest rates. The sudden effects of a reduction in money and bank lending in the face of a rising demand to borrow raises interest rates above prevailing levels. Gradually, the slow rate of growth of money is translated into a slower rate of growth of sales. Businesses find inventories accumulating, attempt to cut them, reducing output, sales, and by layoffs, furloughs, and other reductions in employment spread the effect from their firm to others. At first, the effects are felt only in one or two industries. Elsewhere prices continue to rise. But as the expansion of output slows, price increases become smaller and less frequent and the rate of inflation begins to decline. With these changes comes a reduction in the demand for borrowing. The future no longer looks as promising or as inflationary as it did only a few months before. Pessimism replaces optimism.

On this interpretation of events, the changes in anticipations of the future are not the result of waves of panic or euphoria that sweep over the business community. They are primarily the result of destabilizing government policies. On this view, the main actions of the government are not a means of offsetting instability caused by the errors of businessmen. Sharp swings in government policy are the cause of later waves of optimism and pessimism. The waves of optimism and pessimism are the delayed results of sudden and sharp changes in the government's policies.
In principle, there need be no conflict between the two views. Both private and public instability can be major causes of the type of cyclical fluctuations I have described. But the evidence we have on the operation of the economy discriminates between the two explanations and suggests that in recent decades it is most often the government's monetary and fiscal policies that have been the main source of instability.

Inflation is an obvious example. Most inflations in the United States have occurred during and after wars. The reason is that the government runs large budget deficits to pay for the war, sells bonds to finance the deficit, and in the mistaken belief that it can prevent interest rates from rising by expanding the money supply, the government either permits or forces the money supply to expand. One government agency, the Federal Reserve, buys up the government bonds issued by another, the Treasury. When we clear away the complexity of the transaction, we find that the government has financed its budget deficit by printing money. The expanding money supply starts the inflationary process I described earlier.

Wartime inflation is the standard type of inflation in the U.S. Inflation has occurred during wartime because the government refused to finance its increased deficit entirely by borrowing. Because the budget deficits are clear and obvious indications of imbalance in the Federal government's operations and the monetary expansion occurs through a complex series of transactions, laymen and businessmen believe that the government's budget is the cause of inflation.
There is a grain of truth in this position. The allocation of resources to war activities and the financing of increased government budget deficits solely by issuing bonds are, in principle, inflationary acts. But they have not been the main causes of inflation, either in the United States or in most other countries.

Latin American experience shows that governments do not require wars to produce inflation. A few years ago Brazil maintained rates of inflation of 20 to 30% per month. The classic German inflation of the 1920's had nothing to do with wartime expenditures. The country was disarmed in the aftermath of World War I, and rearmament had not yet started. Likewise, recent inflation in the U.S. was not a direct consequence of the expenditures for Vietnam.

These examples of peacetime inflation establish that wartime expenditures are not a prerequisite for inflation. Other experiences, for example under the gold standard show that inflation occurs when the money supply expands even if the government's budget is balanced. There is, however, no example on record of serious inflation that was not preceded or accompanied by a sizable increase in the growth rate of money. Nor do I know any examples of inflations brought to an end without a fall in the rate of monetary expansion.

In short, the evidence we have largely favors one of the two explanations of expansion and contraction in economic activity. Far from being a counterweight damping the waves of optimism and pessimism that are said to sweep over the private sector, more often than not government policies contribute to the instability and foster the waves of optimism and pessimism. The highly variable policies of the
past few years, the wide swings in the budget and the sizeable expansions and contractions in the growth rate of money are only the most recent examples of destabilizing government policies.

One most important step toward a healthier economic environment is removal of the government's policies as a source of instability. This can be done by limiting the size of changes in government policy, by limiting the frequency of policy changes and by developing arrangements that reduce fluctuations. For example, by eliminating the present set of rigid exchange rates, I believe governments can contribute far more to stability than they can achieve by variable monetary policies designed to offset the consequences of variable budget policies and/or fixed exchange rates.

Inflation and Recession

I have emphasized the problems of inflation and recession because they are current problems. Let me make clear, however, that as serious as these problems are, I believe, they pose a smaller threat than some of the proposals for dealing with the problems. If our only choice was to impose wage or price controls or continue inflation, it would be far better to maintain an open inflation than to attempt to suppress it by wage and price controls.

There are two reasons. First, wage and price controls do not end inflation. They suppress the symptoms, but in so doing, they distort the allocation of resources, increase inefficiency, and encourage non-market and black-market arrangements. Attempts to avoid or
evade controls generates demands for new controls designed to make the
wage and price controls more "effective." Second, most of the demands
for controls come from those who believe the current inflation cannot
be ended by the standard prescriptions -- restrictive monetary and fiscal
policies. The sceptics who assured us in 1969 that the demands of
consumers and business for new goods and services and for new plant
equipment would not abate because monetary policy does not affect output
shifted their arguments in 1970. Once output declined, we were told
that monetary restriction can cause unemployment but cannot stop
inflation. This is a new type of inflation, they said. Inflation
is caused by excessive union demands, so it cannot be brought to an
end by the standard type of old anti-inflation policies that work on
expenditure. (Parenthetically, I should add, those who take this view
watch the government's budget carefully. Each new increase in expenditure,
however small, generates dire predictions of a new outburst of inflation.
Apparently, there is some asymmetry. Government policies can cause an
inflation but they cannot end it.)

First, it is important to look at the basis of the claims. If there
is any analytical substance, it must be that the combination of inflation
and unemployment is a new combination that cannot be dealt with by old
remedies. That claim is false. The combination of inflation and
unemployment in the late stages of a cycle is not a postwar or even a
twentieth century discovery. Almost 250 years ago, Governor Hutchinson
described the situation in the Massachusetts Bay Colony as a combination
of continuing inflation, declining business activity, and an intense demand for credit. Henry Thornton, a member of the British Parliament in the late eighteenth and early nineteenth century, and a distinguished economist of his day, described the spreading effects of a policy of slowing inflation. Among these effects, he included unemployment. His explanation was that the workers had signed contracts calling for higher wages than could now be paid. He interpreted the unemployment, correctly, as a temporary phenomena indicative of the fact that prices would either fall or rise more slowly in the future.

I know of no instance in which an inflation has been slowed or ended without either slowing the growth rate of the economy or causing a decline in output. The combination of inflation and unemployment that we currently experience is not a new phenomenon that requires new policies. The same combination has followed every other period of monetary contraction or sizeable decline in the growth rate of money. The first effect is on output. Prices decline only later.

I believe we can describe with reasonable accuracy the sequence of events during the rest of 1970. We have already experienced part of the decline in output. This decline will continue through the second quarter and probably into the beginning of the third. By mid-summer or early fall, past monetary policies, the slower monetary growth that has been in effect for more than a year, will have had their maximum effect on output. The bottom of the recession will be reached, inventories will be reduced and unemployment will have risen. The stimulative effects of the moderate monetary expansion that started about a month ago will replace the contractive effects of the very restrictive
monetary policy of last year. The economy will start to advance. But the advance will be moderate, if the present policy of gradual monetary expansion continues.

Profits will continue to decline or at least rise slowly from their present levels. Prices will continue to rise, but at a slower rate. Each businessman would like, under the circumstances, to increase his profits by passing on the price increases that he has experienced in the past year, by raising the prices of his products to offset the increase in the wages that he has granted, to change his prices to match his costs and to restore his profit margin. But many will find that raising prices and restoring profit margins has become an increasingly difficult task. Instead of passing on price increases that match the wage and cost increases of the recent past, businessmen will find that if they raise prices they must offset part of the increases with higher allowances, by absorbing freight, by providing additional services at no additional cost, and by other familiar devices. The more effective means of restoring profit margins will be to reduce costs, eliminate the least efficient employees, cut costs and reduce waste. This is the historic pattern, and there is no reason to doubt that it will recur if -- and that is an important if -- the government and particularly the Federal Reserve persists in its present program of moderate expansion.

The current inflation started slowly and only gradually gained momentum. If the present policies are continued, the inflation will end slowly and only gradually lose momentum. The start of the current inflation was in 1964, when the government maintained expansive policies at too high a level for too long a time. These policies continued in 1965,
despite the clear signs that inflation had started. The policies became even more expansionist early in 1966. After a brief pause, marked by a sudden, sharp contraction in monetary policy that produced the so-called mini-recession of 1967, the Federal Reserve resumed its inflationary policies in 1967 and in 1968. Some of those who were responsible for the policies of the period were so confident of their ability to control the inflation by increased taxes that they encouraged the Federal Reserve to shift to an even more expansive policy. These more expansive policies continued until the beginning of 1969. By that time, we had spent more than four years building anticipations of future inflation. Now 16 months after the start of an anti-inflationary program, we are just beginning to see the slower rate of price increase that marks a slowing of the rate of inflation. Over the next few months, we can expect prices to rise at a slower rate.

No policy action is more important for restoring a healthy economic environment than continuing the monetary policies now in effect, allowing the money supply -- currency and checking deposits -- to increase at about 3% to 4% per year on the average.

By now, you may have asked yourselves "Why did those responsible for monetary and fiscal policies allow the inflation to build up for four or five years without taking effective and consistent action"? There is, of course, no single answer to that question. But, we can gain some understanding of their reasons by looking at the kinds of policies they advocated and the kinds of policies they pursued.

The policies came to be known as "fine tuning." The essence of fine turning was, and is, that the responsible officials can make frequent, rapid adjustment to offset the undesirable consequences of past policies...
or private decisions. When the problem is rising unemployment they concoct a more expansive policy - tax cut or monetary expansion to eliminate the unemployment. Knowing that one likely side effect of the more expansive policy is a later inflation they reason, "when that problem occurs, we will shift to a slightly less expansive policy, a little lower interest rate, a little more tax." When inflation became more serious, they thought they could combine tax increases and interest rate increases to maintain employment and slow inflation. Furthermore, they believed that they could reduce inflation by talking to businessmen and union leaders, by twisting arms, by threatening various groups and cajoling others, by bringing public attention to bear on the people who raise prices or wages.

One of the main effects of the policy of fine tuning, the threats, the cajoling and all the rest was to increase, for a time, the uncertainty about the outcome of the inflationary policies that the government pursued. But, I do not know of any evidence that shows a sustained or lasting effect of a guidepost or guideline policy in the U.S. or anywhere else. The rate of inflation in the U.S. is not noticeably different from what it would have been if none of these policies had been tried. Or, to put the point in another way, the rate of inflation is not noticeably different from what should have been expected given the inflationary policies that the government pursued.

Many of the same people who endorsed the policies of the past, now urge us to try them again. Moreover, some urge us to extend the patchwork of controls on financial institutions that have developed in recent years. These include controls on the amount that individual
corporations can invest abroad, controls on the amount that
banks and other financial institutions can lend abroad, controls on
the rate of interest that may be paid to small savers, middle sized
savers, and large savers, special new controls on the amount of reserves
that banks must hold graduated according to type of deposit, size of
deposit and still others.

Each of the regulations I have mentioned was introduced to avoid
some specific consequence of the government's inflationary policies.
But the controls did not prevent or reduce inflation, and the suggested
controls on credit will not prevent inflation either. The main effect
of many of these regulations is to focus the attention of the regulators
away from the problem and to encourage the belief that they have taken
effective action when they have not. No clearer example of the
uncertainty generated by the resort to controls can be offered than the
alternative descriptions given by different members of the Federal Reserve
System. One describes controls on interest rates such as Regulation Q
as "the cutting edge of policy." Another suggests that the controls are
practically worthless.

I do not want to dwell on the errors of the past few years or the
details of policy. We have taken steps in the past year to restore
stability to the economy by reducing inflation. Effective policies to
slow the rate of inflation are now working their way through the system.
With persistence by those responsible for policy, the rate of inflation
will decline gradually for the rest of the year. Equally important,
if we persist in these policies, we will avoid a new outburst of
inflation in the next few months and will continue to reduce the rate.
of inflation next year. If the government continues the policy of keeping the growth rate of money within its present range, a main source of instability will be removed. The next important step toward restoring the health of the economy is to dismantle the system of controls on exchange rates, interest rates and financial transactions that has been built up or maintained in recent years.

Some Additional Steps

By this time you may have concluded that many of the actions needed to restore a healthy economic environment require an end to old programs and methods of operation, not the introduction of new controls. There are some positive steps that the government can take, and I shall mention some in a moment. But we have lived so long with the notion that each new social problem requires some new government program, that it is important to emphasize that the best solution to many problems that currently face us is a reduction, not an increase, in the government's activity. Several additional examples come readily to mind.

One is the problem of unemployed youth. The problem of finding a job if you are a young unskilled, untrained worker is greatly increased by the existence of minimum wage laws. If you have few marketable skills, on-the-job training provides one of the best opportunities to increase or acquire more valuable skills and thus increase your wage. High minimum wage laws discourage employers from training workers by increasing the cost to the employer of raising a worker's skill to
the level at which his productivity is enough to compensate the employer for his wage and his training. The higher the minimum wage the more profitable it is to substitute machinery for workers and to reduce the amount of skill training.

The result is that those who might have benefited from on-the-job training are forced to seek jobs in occupations that are not covered by the minimum wage laws. Or, they are forced into unemployment.

Entrance into some occupations that require few skills is restricted in other ways. Most states or cities in the U.S. limit the number of taxi cabs that may operate on the city streets. This type of licensing restriction, sanctioned and enforced by government, not only reduces the services available to the public, it reduces the job opportunities for those with the fewest opportunities. Barber licenses, beauty shop licenses, justified as devices for protecting the public's health and safety, are turned into a means of restricting profit opportunities or the job opportunities for many of those whose job opportunities are most limited. Government endorsed and sanctioned restrictions on construction work, agreements by local governments to employ only union workers on public construction, these are additional examples of government sanctioned restrictions that create or maintain monopolies and restrict opportunities.

Let me turn to some government programs that demonstrate both the creative use of insurance principles and the type of government action that removes instability and thereby improves rather than worsens the effective functioning of the market system.
One example is deposit insurance. Before the U.S. government offered small depositors insurance, each recession produced a wave of bank failures. Sometime during the recession, under conditions not too different from those we are currently (May 1970) experiencing, bank failures or rumors of bank failures would cause a run on the banks. As the news of bank failures spread, depositors in other banks demanded currency in exchange for their deposits, forcing liquidation of banking assets and additional bank failures.

Why did private insurance companies fail to offer depositors the opportunity to buy insurance? There is nothing very different about insuring the depositors of an individual bank than there is about insuring the passengers on an airplane or bonding bank employees to protect the bank's customers from theft or embezzlement. The important economic argument against a system of private deposit insurance is the possibility of multiple bank failures and the destruction of a large part of the nation's banking system in a short time. The probability of an event of this kind has usually been small, but the expected loss is large, so the cost of insurance would have to be very high if offered by a private system. Moreover, private insurance companies would themselves be depositors of the banks that failed. In the event of a collapse of the banking system, they would have difficulty arranging for the prompt payments that would be required to stem the financial panic.

The case for government insurance of deposits does not rest entirely on the fact that the government can insure deposits at lower cost than private companies. It rests on the responsibility of the government to
maintain the growth rate of the money supply at a rate that promotes the full use of resources without inflation. Destruction of the money and payments system through multiple bank failures is an indication that the government has not fulfilled its responsibilities. No private insurance company, or group of companies, can undertake to insure the rest of us against the errors of government policy-makers that have produced some of the major instability in our society. By providing deposit insurance, the government offers protection against the most harmful consequences of its destabilizing policies.

There are many ways in which the present system could be improved and extended. Discussion of proposals for change takes us away from the main subject of today's discussion. I cannot leave the subject, however, without pointing out that a serious weakness in the present system is that it denies individuals the right to make choices. Those who do not wish to have insurance cannot readily obtain banking services; those who wish to purchase insurance above the maximum limit fixed by Congress cannot do so.

A second use of the insurance principle to good advantage is the opportunity that the government provides to purchase mortgage insurance. The spread of the mortgage insurance system and with it the long-term, monthly payment mortgage contract reduced the risk of foreclosure. Perhaps more importantly, the system reduced the risk of loss by improving the lenders' information about borrowers and about the size of expected losses. The government's experience with mortgage insurance
encouraged private lenders to enter the business. The government's experience with long-term monthly payment mortgages encouraged private lenders to offer competitive contracts so that short-term, lump-sum, renewable mortgages have all but disappeared.

What do these two examples offer that many government programs do not offer? My answer must be partial. First, both programs offer examples of the way in which governments can reduce the risks which individuals must bear in our society. In both cases, much of the risk that is eliminated is the risk of losses caused by destabilizing government actions. I believe that is an important point, but it is not the main point. Providing accurate information and programs that reduce risks to the minimum level inherent in nature, technology and the environment has long been recognized by economists as one of the important functions of government. Second, neither program coerces individuals into accepting a solution they do not choose. Both are voluntary, although the deposit insurance system could be improved in this respect.

Conclusion

As we look at the task of restoring a healthy economic environment, and that must on any definition include a healthy social and political environment, one point seems very clear. On most of the social issues that divide us, there is no single solution that anyone has proposed -- or is likely to propose -- that will be satisfactory or even acceptable to the many interested parties. The problems that we call racial, educational, welfare, poverty problems to name only a few, are not
the kinds of problems that have single solutions acceptable to all
interested parties. They are the kinds of problems where beliefs,
attitudes and tastes differ markedly, where the solutions that are most
attractive to one group are least attractive to another.

Many of these problems are the kind to which no single solution is
required. They are the kinds of problems to which individuals, given
an opportunity, can find solutions that are acceptable, satisfactory,
or even desirable to them but not to their neighbors.

In the past forty years, we have taken many steps designed to achieve
particular social ends. However laudable the initial aims, however large
the initial benefits may have been, however serious the original problem,
many of these programs are not sources of instability and the refuge
for opponents of change. Government agencies become powerful monopolies
that reduce our ability to find solutions to present day problems by
reducing the number of viable alternatives in the areas in which we can
search for alternatives.

For most of the past forty years, we have accepted solutions to social
and economic problems that transfer control and power from individuals to
public agencies. The current effect of this transfer is to increase the
instability of society and the effort that must be made to find new
solutions. The most important means of restoring economic and social
health to our society is to reduce the monopoly powers of governments and
agencies by reversing the former process and widening the area of choice.
I hope my examples have indicated some of the areas in which improvements
are long overdue.