

ECONOMICS U\$A
21st Century Edition
PROGRAM #26

STABILIZATION POLICY: ARE WE STILL IN CONTROL?

AIRSCRIPT

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Final Transcript

Annenberg Learner (Logo and Music)

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DAVID SCHOUUMACHER: In 1981, the Federal Reserve set out to quell inflation once and for all. A year later, 12 million workers were unemployed. Why was it so hard to break the back of inflation? In 1985, the leaders of the industrial world gathered in Bonn to wrestle with the question, "Why was a growing international trade making it harder to solve domestic economic problems?" In 2008, why would Treasury Secretary Paulson and Fed Chairman Bernanke ask Congress for a \$700 billion bailout for a banking system that had failed the American people?

The activists' theories of fiscal and monetary policy have dominated modern economics since the Great Depression. But by 2011 we were having some doubts. Stabilization Policy: Are We Still in Control? That's the story we'll investigate, with the help of Economic Analysts Nariman Behravesh and Richard Gill, on this 21st Century Edition of Economics U\$A. I'm David Schouumacher.

(MUSIC PLAYS - OPENING TITLES)

PART I

DAVID SCHOUMACHER: For many years after the Great Depression, the basic goal of national economic policy was to minimize unemployment. But the winter of 1982 saw 12 million men and women unemployed, and many complained bitterly that they were the victims of a needlessly cruel government policy. This time public enemy number one was inflation and the jobless workers were the casualties in the war. The severity of the battle cast new doubt on the ability of the government to effectively manage the economy...or the wisdom of even trying. Why was it so hard to break the back of inflation?

RICHARD M. NIXON: “The time has come for decisive action...action that will break the vicious circle of spiraling prices and costs.”

GERALD FORD: “Inflation is domestic enemy number one...”

JIMMY CARTER: “Present high inflation threatens the economic security of our nation.”

DAVID SCHOUMACHER: From Richard Nixon through Jimmy Carter, president after president set out to fight inflation. But when that fight threatened to increase unemployment, president after president reversed course, opting for stimulative policies to keep the economy growing and unemployment low.

GERALD FORD: “We must shift our emphasis from inflation to recession.”

DAVID SCHOUMACHER: For more than a decade the economy grew a little and prices grew a lot. America ended 1979 with significantly higher inflation than we had in 1970. By the end of the decade most Americans expected inflation to be with them forever...and they conducted themselves accordingly. Fred Schultz was Vice Chairman of the Federal Reserve in 1979...

FRED SCHULTZ: "When you have inflation, money becomes worth less and the financial assets of bonds and stocks don't respond as well...and the thing you need to do is to go out and buy things. You need to buy art and stamps and gold and land and houses...and... So people got in the habit of going out and borrowing all they could borrow and spending all they could spend. And it takes a long time to change the way people carry out their activities. In the 1970s, people were convinced we were going to get inflation under control, and only in the latter part of the 1970s...in '78 and '79...did they become convinced that we weren't going to get it under control. And so, then, that's when inflation really began to heat up very rapidly."

DAVID SCHOUUMACHER: In the closing months of 1979, Federal Reserve Chairman Paul Volcker, announced a new tight money policy to counter inflation. He was forced to abandon this policy in the recession of 1980...But 1981 brought a new president and a renewed determination to clamp down on inflation. But the Reagan administration wanted it all...both lower inflation and higher growth. The Fed sent out warning signals.

FRED SCHULTZ: "We kept saying, all through the early part of 1981, that if there's too big a tax cut...or if it is not matched by expenditure cuts...that's going to make the monetary policy more difficult, because, if you're putting fiscal thrust into the economic system, and you are trying to restrain it with monetary policy, that means that interest rates are going to be higher than they otherwise would have been. And we made speech after speech...We had meeting after meeting in which we said, 'If this tax cut's too big or if their expenditure cuts are not big enough, interest rates are going to go very high'...and they did."

DAVID SCHOUUMACHER: When the Federal Reserve began once again to tighten the money supply, workers and businessmen alike refused to believe that the government was serious about ending inflation. Wages and prices continued upwards, growing faster than the money supply. The economy was out of balance...It was bound to topple...and it did. Late in 1981, the economy headed into a recession and millions of Americans

headed for the unemployment line. But even as the unemployment line grew, workers continued to ask for increases to pay for the inflation that had become part of their lives. The Fed stuck to its guns...By the spring of 1982 things were bad throughout America...By the summer, they were worse. Fred Schultz was given the lonely job of explaining why the Fed was causing so much pain.

FRED SCHULTZ: "But I'll never forget...That...I...The worst thing that happened to me the whole time I was on the Fed Board was...I made a speech and tried to explain...and this was to a group of automobile dealers...and one of them stood up and said, 'I understand what you're trying to do, Mr. Vice Chairman, but I want you to know I've tried for more than 30 years to build up a successful automobile dealership and next week I'm going to close my doors'...And I'll tell you, that kind of thing stays with you for a long time. It was very hard on us, you know, to try to be in that kind of a position where you know you're causing individual pain...It's not something that's just theoretical... You know you're hurting people out there...and to know it's something you have to do is tough when you're doing it, but I think the results have shown now that it was successful. The country is back on a much sounder path."

DAVID SCHOUUMACHER: As the summer wore on, and unemployment passed 10 percent, the inflation rate began to drop. In August, Volcker announced that the time had come to ease monetary policy. Wall Street was the first to respond. But the bitter memories of the recession lingered on...and faith in counter-cyclical policy was one of the casualties. Many people blamed the misery on the failures of stabilization policies in the 1970s. Others, like Congressman Henry Reuss, blamed the unnecessarily harsh policies of the 1980s.

HENRY REUSS: "Now I'm all for curing inflation...but, in my view, it could have been done without stepping on the brake so hard that the economy was thrown through the windshield."

DAVID SCHOUUMACHER: By Christmas, the economy was growing again. Workers began returning to their jobs and inflation held at four percent throughout 1983. By 1985, after two years of recovery, inflation remained at four percent...but the economy still bore the scars of the recession. Millions of manufacturing jobs were gone for good...and unemployment remained stuck at seven percent. Fifteen years of entrenched inflationary expectations had been sharply reduced, but only after the government had finally proven its willingness to pay the price necessary to wring inflation out of the economic system. We asked economic analyst Richard Gill why a tight monetary policy had caused such hardship.

(MUSIC PLAYS - COMMENT AND ANALYSIS I)

(ECONOMICS U\$A LOGO appears on screen)

RICHARD GILL: If one takes a benign view, one could argue that the difficult times of the early 1980s were really a reflection of the success of our past policies. Keynesian economics was directed mainly at stabilizing the growth of real national income and, if you compare recent decades with the decades before World War II, you find that the American economy did pretty well. Here is the way the growth of our real GNP fluctuated before World War II. And this is what happened from the 1950s to 1980. In real terms, the economy was much more stable in the recent period. The very success of these policies, however, undoubtedly contributed to the recent inflationary tendencies of the economy and, perhaps more significantly, to the expectation of future inflation. By 1980, they had created a general sense that the government would back down in the inflation fight as soon as it began to create serious costs in terms of recession and unemployment. People, in short, began betting on continued inflation. And this made the government's task infinitely more difficult. The government had to act strongly enough to break the back of these well-entrenched inflationary expectations. It not only had to fight inflation, but to fight a general belief that it would not fight inflation that hard. Expectations are important in economics. They made the task of monetary policy much harder in the early 1980s. Some economists, indeed, have come to the conclusion that they make stabilization policy virtually useless in general. According to this new

school...the so-called “rational expectationists”...only unexpected government policies are likely to have any effect on the economy, and these unexpected policies will more than likely be harmful. So far have we come from the happy days of the Keynesian revolution!

PART II

DAVID SCHOUMACHER: In 1983, America came bouncing out of the recession with a boisterous recovery. But a funny thing happened on the way to prosperity. Out of all those billions of dollars of consumer spending, too much seemed to be pouring overseas. At the same time, foreigners had a high percentage of our national debt. By 1985, economists both here and abroad were asking, “Is our domestic economy the hostage of international forces?” Those international forces had been building throughout the 1970s. During that decade, the percentage of our economy devoted to foreign trade doubled, passing 10 percent by 1981. What problems would this create for the conduct of economic policy? We asked economist Robert Gordon...

ROBERT GORDON: “The problems that that creates would be no problem at all if it were not for the flexible variable exchange rate of the dollar...Which means that conducting policy in Washington now has side effects that didn’t used to exist...Namely, if we decide to fight inflation with tight money and loose or easy fiscal policy...the policies of the 1980s...then we’re going to find that part of our economy is harmed while another part benefits. And we are really taking from Peter to pay Paul.”

DAVID SCHOUMACHER: 1983 was a year of vigorous growth for America. As the economic recovery surged ahead it soon became obvious that many Americans were being left behind. While millions of jobs were being created in the service industries, millions more in manufacturing appeared gone for good...lost to overseas competition.

RAY CALORE: “Well, there’s no question about it. We’re in deep trouble...and specifically...right here in Tarrytown where about 2,000 people will be laid off...they’re

in deep trouble. I don't know any place in the state of New York where there's anybody gonna hire 2,000 people."

DAVID SCHOUMACHER: In the '60s and '70s, expansive economic policies had created jobs for American workers. Now these same policies were creating jobs overseas while Americans remained unemployed. The situation was causing severe problems for American policymakers, as Federal Reserve Governor Henry Wallich explains...

HENRY WALLICH: "You may want to expand the economy...let us say by budget deficit or easier money...but some of this demand goes abroad. People buy Japanese cars and so you get expansion in Japan but not in Detroit. For instance, we've got a 200-odd billion dollar budget deficit, but half of the money is going abroad and so we're getting stimulation only from half. Fiscal policy is losing much of its power."

DAVID SCHOUMACHER: No one in the Reagan administration had foreseen this effect in 1981 when the administration first embarked on its expansive course...But as our trade deficit shot past the \$100 billion mark, economists and politicians alike began to search for a solution. Most economists agreed that the trade deficit was caused by the overly strong American dollar, which was in turn caused by the runaway budget deficit. But many politicians began to argue for trade barriers to keep out the flood of imports. The Reagan administration resisted this approach.

BERYL SPRINKEL: "All economists...I'd say 99.9 percent of economists...believe that we all gain from free trade. This administration believes we gain from free trade...And therefore, we are not going to lead the world down a protectionist road which will reduce our standard of living and reduce standards of living abroad."

DAVID SCHOUMACHER: In May of 1985, the heads of state of the leading industrial nations of the free world met in an economic summit conference in Bonn, West Germany, to try to resolve differences in economic policy. The Europeans and the Japanese urged the U.S. to get its budget deficit under control. We urged them to expand

their economies to create new markets for American goods. No firm decisions were made, but international cooperation remains a promising approach to economic problems. Beryl Sprinkel speaks for the Reagan administration...

BERYL SPRINKEL: "When governments recognize a particular set of policies are in their interest, they are very likely to move in that direction. The great difficulty is trying to get them to do something which they perceive is against their interest. And they won't do it. They shouldn't do it. And we won't do it either. But I think that working together you can make some progress on the economic front and, in fact, I think we have done so over the past give years."

DAVID SCHOUUMACHER: Five months after the Bonn summit, the U.S., Japan, France, Britain and Germany announced a coordinated effort to reduce the value of the U.S. dollar. The move was a promising effort to ease the U.S. international trade dilemma and possibly create more jobs for American workers. But major problems remained.

By 1985, the United States was running \$200 billion budget deficits. But half the economic stimulus, the amount of the U.S. trade deficit, was going overseas and any effort to contain this deficit or to promote continued growth would have a major impact around the world. We asked economist Richard Gill why the international aspect was much more important in U.S. policy.

(MUSIC PLAYS - COMMENT AND ANALYSIS II)

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RICHARD GILL: The main reason the international aspect is so important today is that the numbers have gotten so big. We had our first post-war merchandise deficit in 1971: A little over two billion dollars. By 1984, our merchandise deficit was over 105 billion dollars. And what these numbers mean is that we can't separate our domestic stabilization policies from our international trade policies. To take a simple example: It

has been argued that our trade deficit in 1984 was mainly due to an overvalued dollar. This made our exports too expensive and foreign imports too cheap. Well, the value of the dollar is determined by supply and demand. Thus, the high value of the dollar must have been due to a great demand for dollars...largely for investment in the U.S....in relation to supply. Simple solution: Increase the supply of dollars. Have the Fed start printing money and buying back those billions of dollars of U.S. Treasury securities held by foreigners. But wait a second! Hadn't we just gone through a very painful period of monetary restraint to break the back of our inflation? If the Fed began printing up money like that, what would happen to those dread "inflationary expectations" we had been at such pains to destroy? The simple fact is that, in an interdependent world economy, we have many more variables to take into account. And this creates still another difficulty for our already rather shaky efforts at economic stabilization.

PART III

DAVID SCHOUMACHER: In the prosperous 1990s the Fed's fine tuning of the economy seemed to work. But the collapse of the housing market in 2007 revealed a major flaw in our financial system and in our regulatory agencies as well. Once again, the government was forced to intervene. Would its actions stabilize the economy?

Early in 2007, the housing bubble began to burst. Cheap mortgages, low down payments, and confidence that purchasing a home was a solid investment led Americans to buy expensive properties...properties well beyond their means. Banks loaned and resold loans to investors in the market. It seemed so easy. Everyone was making money. It seemed too good to last. And it didn't. The housing market collapsed, leaving the banks holding the bag. One by one the big banks, investment houses, and insurance companies began to fail and with them went the open door to credit, the lifeblood of the economy.

In September of 2008, with the banking industry on the verge of collapse, Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke nervously came before Congress to tell them the sky was falling.

BENJAMIN BERNANKE: “I believe if the credit markets are not functioning, that jobs will be lost, the unemployment rate will rise, more houses will be foreclosed upon, GDP will contract...that the economy will just not be able to recover in a normal, healthy way no matter what other policies are taken.”

DAVID SCHOUUMACHER: They had an unorthodox plan. Bernanke and Paulson were asking for Congress to release taxpayer money so that that they could then infuse that money into a faltering financial industry.

HENRY PAULSON: “This Troubled Asset Purchase program, on its own, is the single most effective thing we can do to help homeowners, the American people, and to stimulate the economy.”

DOUGLAS ELLIOT: “The government was at a point where it had to do something, and so it came up with a program that came to be called the Troubled Asset Relief Program, the TARP. It’s kind of a misnomer, because the way it was really used in the end was as a way of injecting capital into banks, basically investing in the banks and some insurance companies so that they had enough equity that people knew that they could make it through the crisis. So the government became a partner with the banks and the insurance companies. It was hugely important, it was absolutely necessary. But the public to this day hates it and thinks that it was a mistake.”

WOMAN: “My resentment is towards the fat cats on Wall Street who are probably going to ride off into the sunset with millions in their saddle bags while the rest of us are worried about our 401K s.”

MAN: “That’s my concern, is that I’m going to shoulder responsibility for a lot of problems that I didn’t create.”

DAVID SCHOUMACHER: Even before TARP could be enacted and capital could flow into the financial system, it was labeled a bailout by both political opponents and a majority of the public. Americans were looking to point the blame. And along with the so-called “fat cats on Wall Street,” people began questioning the institution that should have been minding the store--the Federal Reserve.

KAREN PETROU: “The Fed, as the Senior Regulator for the biggest financial institutions, failed miserably. You can see that into the fall of 2008, where in October, November, at the Fed, and the OCC, which is the big regulator, the regulator of big national banks, thought Citibank was so sound that it could have taken over one of the weakest banks. Only they had no idea that Citi had \$300 plus billion of off balance sheet liabilities on its books.”

DIMITRI PAPADIMITRIOU: “The Fed has said that it’s very difficult to know when there is an asset bubble. Unfortunately, you only know when the bubble bursts. However, the conditions were actually very obvious. You have seen that an inflationary housing market cannot continue forever...and therefore there were steps the Fed could have taken.”

DAVID SCHOUMACHER: Since the Fed did not take the lead and raise interest rates, it allowed risky lending practices to continue at a feverish pace.

DONALD KOHN: “We were tightening in 2005, 2006, but should we have tightened more in order to take the steam out of the housing market and to prevent the subsequent disaster? My view is that we kept our eyes on the right thing, that if you give monetary policy too many jobs--employment prices and asset prices--then you don’t get any of them quite right.”

DAVID SCHOUMACHER: With TARP, however, many economists believe the government could redeem itself by thinking outside the box.

GEORGE W. BUSH: "America's economy is facing unprecedented challenges and we are responding with unprecedented action."

DAVID SCHOUUMACHER: If Congress would pass TARP, then the government, rather than acting as lender of last resort, would become an investor.

BENJAMIN BERNANKE: "Going forward, the ability of the Treasury to use the TARP to inject capital into financial institutions, and to take other steps to stabilize the financial system, including any actions that might be needed to prevent the disorderly failure of a systemically important financial institution, will be critical to restoring confidence and promoting the return of credit markets to more normal functioning."

DAVID SCHOUUMACHER: On October 3, 2008 TARP was signed into law.

DOUGLAS ELLIOT: "This was a good program. I've described it as the best large federal program ever to be despised by the public. If you ask the person on the street they will tell you, if they follow this at all, that the tax payers spent \$700 billion, got back almost nothing, and that most of it went into the pockets of the bankers. All of those statements are false. The government did not invest \$700 billion; in fact, it was significantly less than that in the end. The investments will actually have made tax payers money."

DAVID SCHOUUMACHER: TARP was successful at ending the threat of a complete banking catastrophe. By 2010, most of the banks had paid back the money, and the cost of the program was far less than expected.

DAVID SCHOUUMACHER: But confidence did not return and the economy did not stabilize as many hoped it would. Markets continued to drop, jobs continued to vanish, and banks, though they had billions in taxpayer dollars, were reluctant to begin lending again, and the doors of credit barely remained open. As a result, though TARP saved the financial industry from collapse, the benefits of the program failed to reach those it was

truly intended to help--the American people. So why didn't the government go one step further and mandate the conditions on how those TARP funds were to be used? We asked that question of economic analyst Nariman Behravesh.

(MUSIC PLAYS - COMMENT AND ANALYSIS III)

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NARIMAN BEHRAVESH: To some people TARP -- the Troubled Asset Relief Program, was and still is a four-letter word. To these people it represented all that is wrong with our financial system—especially the part about taxpayer money being used to bailout Wall Street “fat cats.”

There are several myths about the TARP. One is that the program cost U.S. taxpayers \$700 billion. In fact, it cost a tiny fraction of that amount, since the recipients of the funds paid most of it back—and the government may have actually made a profit on the program. Another myth is that the “fat cats” got the money. They did not. The funds were disbursed as temporary loans, almost all of which were returned.

In the end, the TARP was an emergency program that along with the unorthodox and massive monetary stimulus provided by the Fed—prevented the implosion of the U.S. financial system and economy. Without it, chances are good that things would have been a lot worse for the economy and the American people.

DAVID SCHOUMACHER: Can we control the economy? Well, for many years we were convinced that we could. However, economists are no longer so certain. The problems of runaway deficits, the effective expectations on people's behavior, and the increasing interdependence of the world's economies have forced economists and policymakers to face increasingly difficult and complex decisions. Fortunately the huge engine of the American economy continues to be a powerful force throughout the world...and prudence demands that we provide this engine with some form of guidance.

But how...continues to be the topic of lively debate. For this 21st-Century edition of Economics U\$A, I'm David Schoumacher.

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