PERSONALLY SPEAKING

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MUDDLING THROUGH THE CURRENT ECONOMIC MESS

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Why are we getting so much conflicting advice from economists at a time when we face the most severe economic crisis in 75 years? The reason is simple enough. Economists have been deeply divided over macroeconomic theory for the last 30 years.

Many, perhaps most, economists recommend letting markets sort through the problem, in effect separating the wheat from the chaff. They are known as neo-classical economists. Their confidence in unfettered markets is based in part on (a) the assumption that markets continuously eliminate surpluses and shortages and thereby restore macroeconomic equilibrium and (b) the hypothesis that rational, fully knowledgeable economic agents anticipate how the government is likely to intervene in economic affairs and modify their behavior in order to protect their self-interest. Thus under assumption (a) government intervention is unnecessary and under hypothesis (b) it is futile. Contrary to (a), financial markets did not clear last fall. Instead they froze up cutting off the credit needed to fuel the day-to-day operations of the economy. Contrary to (b), economic agents have not been able to modify their behavior in any rational way because the government has been managing this crisis by the seat of its pants – purchase toxic assets, shore up failing banks, bailout automakers, rescue insurance companies, restructure mortgages in default.

Other economists argue for boosting consumer demand through tax cuts, rebates, handouts, and public infrastructure projects to stimulate the economy from the demand side. They are called Keynesians. Their numbers have dwindled over the years due mainly to the inability of Keynesian economics to address the stagflation problem of the late 1960s and early 1970s.

A third school argues for cutting marginal tax rates on business and capital gains taxes in order to stimulate the economy from the supply side. They call themselves supply-siders. They were roundly condemned from the outset by their professional colleagues for proposing "voodoo economics" but gained wide support during the Reagan presidency. Their critics hold them responsible for the huge increases in the public debt in the 1980s.

Whatever their differences, Keynesians and supply-siders share one thing in common. Both are convinced that the remedy lies in fiscal policy and therefore rests in the hands of Congress.

A fourth school of thought argues that the best way to intervene in economic affairs and to restore and maintain a robust economy is through control of the money supply. They are called monetarists. This school of thought spearheaded by Nobel Laureate Milton Friedman dominated economic affairs in the late 1970s and early 1980s until unemployment climbed above 10 percent and the prime rate of interest soared above 20

percent. Monetarists agree with Keynesians and supply-siders in supporting some type of government intervention when the market economy dysfunctions. Only neo-classical economists argue for nonintervention.

Four comments follow. First, the federal government will intervene massively in the current crisis on grounds that it alone is powerful enough to address the dysfunctionality in the system. It matters not whether the government can indeed turn the economy around. The non-interventionist neo-classical school lost its credibility when financial markets froze last fall instead of clearing.

Second, the intervention will be fiscal in nature because the Federal Reserve already has spent its arsenal of weapons to fight the crisis: reducing interest rates to near zero to encourage borrowing and spending and flooding the banking system with the reserves necessary to increase the ability of banks to extend credit and make loans. To a large extent credit markets still remain frozen.

The new president will push intervention through Congress quickly arguing that any delay in putting together a stimulus package will only worsen the crisis. Mayo Research Institute would like to see Congress hold extended hearings, but frankly to what purpose? For every interventionist faction in Congress, there are economists who can be called to testify and support whatever remedy that faction wants included in the stimulus package. So it will be trial and error, seat of the pants intervention with federal monies being thrown all around in the hope that some will stick. For lack of a better term, this interventionist strategy gets down to simply muddling through.

Third, the massive intervention will add very substantially to the deficit in the current federal budget, the budget for the next fiscal year, and perhaps beyond that. Those deficits will force the Treasury to borrow huge amounts thereby piling up more public debt.

Fourth, and last, taxes will be raised to pay interest on the debt, at least $300 billion per year, well into the future such that our children and grandchildren will be paying for the excesses in lending and investing that produced the current crisis. Conceivably, a federal ad valorem tax will be proposed because, unlike a sales tax, it is folded into the price of item being sold. It is in effect hidden from view. Thus it lacks the transparency that the new president insists will be part of his administration. But in Washington promises made are not always promises kept.

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