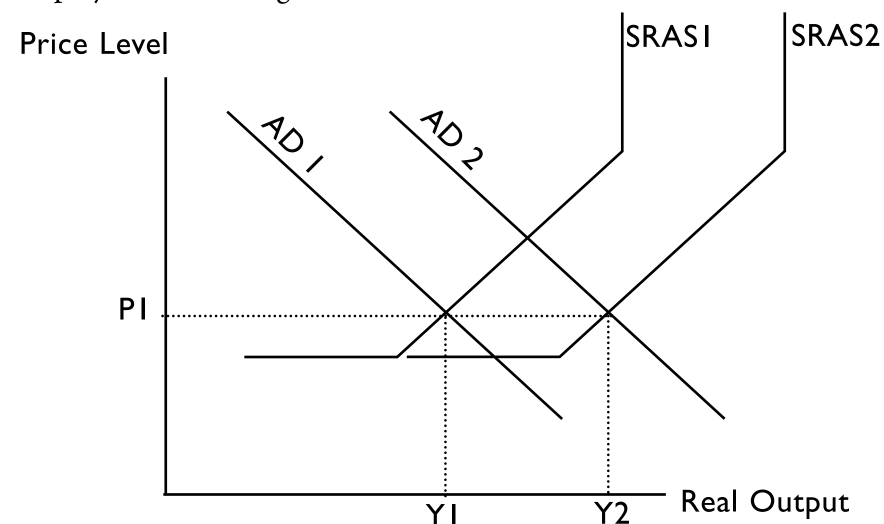
Lesson 57 The Policy Balance (a historical view)

Faced with the economic objectives of full employment, price stability, counter-cyclical stability, equity, economic growth and efficiency and international competitiveness, how have governments employed demand management and supply-side policies effectively in the past? What can we learn about when best to employ the various tools available?

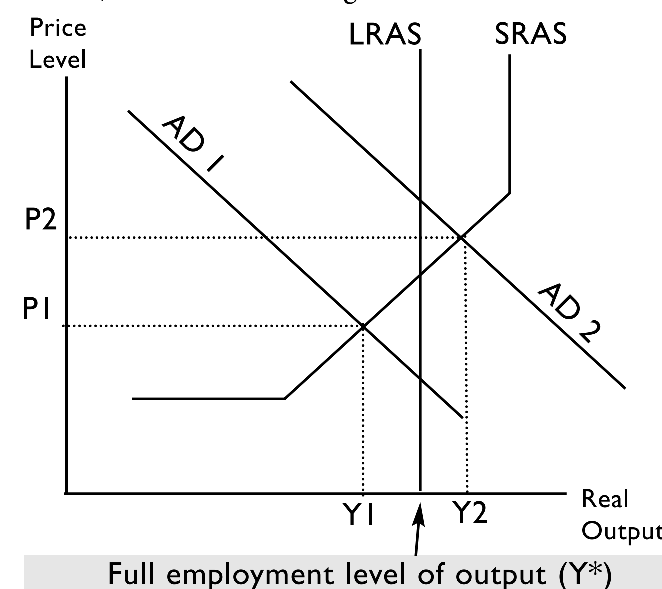
From the late 1940s through to the early 1970s, the global economy flourished. Many thought this due to a reliance on Keynesian demand management alone, but in truth supply-side improvements were also important. Investments in infrastructure and in higher education, along with low-cost energy and rapid technological change combined with a Keynesian focus on keeping unemployment low to produce 25 years of steadily improving living standards, low inflation and low unemployment. As a diagram:



To take Canada as an example, the building of infrastructure like the St. Lawrence Seaway system, the massive expansion of the university system begun in the 1960s, the electrification of rural areas, and the improvements in and spread of technology pushed short-run aggregate supply out from SRAS1 to SRAS2. Simultaneously, government demand-management policies designed to provide full employment pushed aggregate demand out from AD1 to AD2. The net impact was a massive increase in real output, and hence living standards, from Y1 to Y2, with the price level showing only modest change (in this diagram, no change at all) at P1.

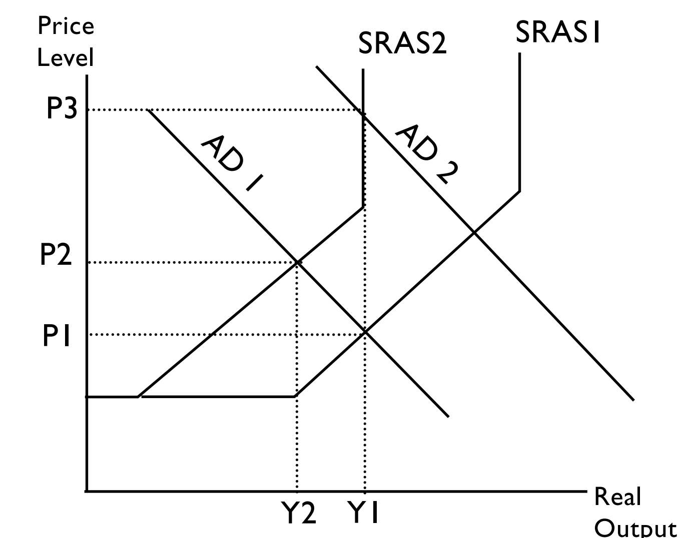
In fact, while straightforward means of increasing aggregate supply were available, demand management policies designed to provide full employment themselves motivated firms to engage in supply-side improvements in training and technology. If the economy is near full employment, workers are relatively scarce and can therefore demand and receive wage increases. The only way that their employers can afford to pay the higher wages is to improve worker productivity. Thus, employers had an incentive to improve the skills and training of their workers or invest in more efficient machinery, which would have had a positive impact on potential output and aggregate supply.

By the 1970s, most easy methods of increasing productivity had been exploited. However, governments were still pursuing full-employment demand management policies. The result was inflation. To look at the Canada again, starting in the mid-1960s, the federal government grew enormously as it established the modern welfare state, including old age pensions and Medicare. These policies led to large increases in government spending and borrowing, and pushed aggregate demand out far faster than aggregate supply improvements could keep up. The economy began to overheat, and while real output was growing, inflation began to rise as well, as shown in the diagram below.



The increase in aggregate demand from AD1 to AD2 has pushed real output (Y2) beyond the full employment level of output (Y*). As was discussed in the exercises for lesson 51, this results in shortages and hence inflation, as is shown by the increase in the price level from P1 to P2.

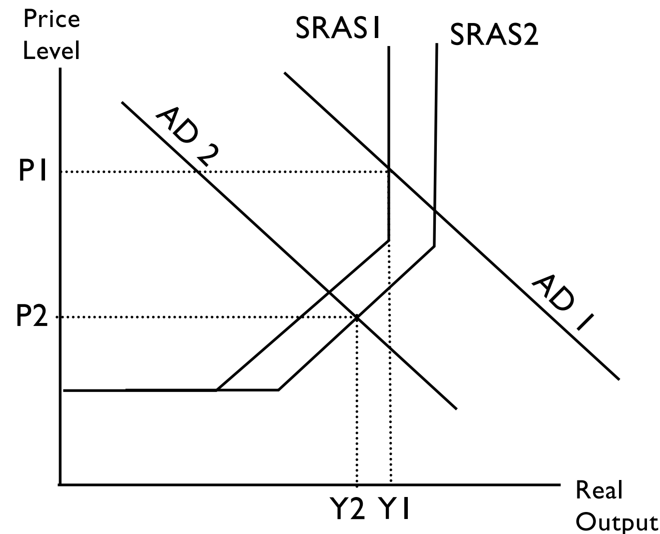
Sadly, the troubles did not stop there. In 1973, Syrian and Egyptian forces attacked Israel and were initially winning. The Israelis asked for more supplies and the Americans agreed to send them under cover of darkness, so as not to upset the Arabs. However, the resupply planes left Europe later than planned with the result that the American transport planes were seen landing in Israel in broad daylight, for all the world to see on television. The Arab oil producers had sensed since the mid-1960s that they had more power than the major oil companies when it came to negotiating production agreements. In 1973 they finally used their 'oil weapon', and refused to sell oil to the West. The price of crude oil roughly tripled in a very short time, which further exacerbated the economic situation. Government demand-side measures intended to reduce the unemployment caused by this supply-side shock just made inflation worse, and did little if anything to reduce unemployment. **Stagflation** (stagnant or negative growth coupled with rising inflation) had arrived.



The Arab oil embargo had the effect of raising the price of oil and hence, as oil is involved in the production and transportation of many goods, of raising costs of production throughout the economy, moving SRAS to the left from SRAS1 to SRAS2. This caused both a reduction in real output and an increase in the price level (Y2 and P2). Governments focused on unemployment responded by cutting taxes and increasing government spending (fiscal policy) and reducing interest rates (monetary policy), which moved aggregate demand to the right, from AD1 to AD2. At the end of the day, output was no higher than before (around Y1), but the price level had jumped enormously, from P1 to P3. This jump was noticed by workers and firms, who adjusted their expectations of future inflation, setting many countries on the path of accelerating inflation (lesson 49 - the wage/price spiral).

By the late 1970s, inflation was recognized as the serious policy problem facing governments. Initially, governments tried to implement **wage and price controls** (in Canada, the famous "6 and 5" program which encouraged workers to limit their wage demands to a 6% increase in the first year and a 5% increase in the second) to control inflation, but these just created shortages and led to the formation of black markets. Monetarist economists meanwhile proposed that inflation would fall if the money supply could be reduced. So, starting in 1979, central banks began to take money out of the economy and raise interest rates. Eventually, interest rates rose to 20% or more. This had predictable effects. Farmers and businessmen could not pay the interest on their loans, households could not pay the interest on their mortgages, and so many businesses and households went bankrupt. Borrowing and spending ground to a halt, and unemployment rose massively. The serious recession of 1981-82 did however reduce inflation, and more importantly, people's expectations of future inflation.

At the same time governments were making some supply-side changes as well, mainly to do with deregulation. Many industries had been **nationalized**, or brought under state control (ie aircraft production (Canadair), railroads (CN), and oil production (Petro-Canada), or were heavily regulated (long distance trucking and air travel) in the period following WWII. Economists recognized that nationalized industries did not have many incentives to cut costs and lower prices as they were usually monopolies, and that the regulated industries were similarly often protected from competing against new rivals, again keeping prices high. So, starting in the UK under Margaret Thatcher, nationalized industries began to be sold off (or '**privatized**') while in the USA, **deregulation** started to free up entrepreneurial energies in the transportation and other sectors. Canada followed the lead of the UK and the US and in all three cases, the results were clear - more was provided, at cheaper prices, as shown above:



The hike in interest rates to 20% pushed aggregate demand from AD1 to AD2, while deregulation and privatization moved aggregate supply from SRAS1 to SRAS2. The net result was a small fall in output (ie unemployment became permanently higher) from Y1 to Y2, but a fall in the price level from P1 to P2.

In the 1980s the challenges of a globalizing world economy were taken seriously by the Conservative government of Brian Mulroney. In recognition of the fact that Canada's relatively small and protected manufacturing industries needed to become more efficient if Canadian products were to be internationally competitive, in 1988 Canada signed a free trade agreement with the United States which was amended to include Mexico in the North American Free Trade Agreement (NAFTA) in 1994.

The dislocation caused by Canada's joining NAFTA was considerable. Many businesses shut down or moved their operations elsewhere while others expanded. To help ease the pain of this structural change, during the 1990s and into the 2000s the government allowed the Canadian dollar to fall steadily from almost 90 cents US in 1991 to just over 60 cents US in 2002. This fall in the value of the Canadian dollar helped to make Canadian exports competitive on world markets and bought Canadian firms time in which to adopt better technology and management practices to stay in business.

NAFTA did, though, lead to a fundamental change in the Canadian economy. Up until NAFTA, protected manufacturers in Ontario and Quebec sold their (relatively pricey) goods to the other provinces in exchange for commodities, to the general benefit of central Canada. After NAFTA, though, Canadian manufacturers faced tough competition from American, Mexican and other producers while oil, timber and mineral producers found many more foreign markets for their goods. As such, it can be argued that NAFTA has led Canada away from being an industrial nation and back towards being a commodity-based economy, and has led to a weakening of central Canada's economic position relative to the resource-rich provinces in the west and the east. However, the manufacturing industry that has survived in Canada is strong and overall most economists would agree that NAFTA has had a positive impact on Canadian competitiveness, growth, inflation and unemployment. Tellingly, though, the Conservative party which had negotiated and campaigned on free trade was reduced from 151 to 2 seats in Parliament in the election of 1993.

Looking at the sweep of history, what lessons can we learn? Overall, the biggest advantage of demand management (using both fiscal and monetary policy tools) is its speed. When a crisis erupts, governments can quickly increase spending, cut taxes and lower interest rates to keep the crisis from getting worse. However, clearly the government cannot continue on indefinitely in this way, or it will accumulate more and more debt and inflation (including asset price inflation) will become a problem. The challenge for policymakers is to figure out when it is safe for them to start raising interest rates and taxes and lowering government spending without putting the economy back into recession. Generally they will pursue expansionary demand management policies until they perceive that inflation, and in particular inflationary expectations, are beginning to become a problem. Meanwhile, the advantage of supply-side policy prescriptions is that they lead to long-term improvements in productivity, output and living standards. However, governments will almost never choose to enact supply-side regulatory changes until all other options have been tried as the political price they have to pay in terms of riots, strikes and political opposition (or, as the Conservatives learned, annihilation) is invariably quite high.

Exercise 57

1. What is the risk of depending too much on demand management policy to ensure full employment? What economic problem can arise as a result?

2. How did joining NAFTA initially affect Canadian output/GDP? How did the managed fall in the value of the Canadian dollar in the years that followed help reverse this situation?

3. In each of the following situations, tell what policies the government should pursue in both the short term, and if necessary, the long term. Choose from (but you need not limit yourself to just one) fiscal, monetary and supply-side policies. Be sure to specify your precise policy prescriptions. Draw an AS/AD diagram to show both the problem and your solution.

a) Singapore imports most of its food. For various reasons, food prices have risen quickly and this is causing cost-push inflation. However, it is not anticipated that this rise in food prices will last more than a year. What should the Singaporean government do?

b) Chinese exports are a major component of its GDP. A global recession has drastically reduced the demand for Chinese goods in foreign markets, leading to growing unemployment in its export industries. Policymakers in China know that they cannot continue to rely indefinitely on exports to fuel economic growth. What should the Chinese government do?

c) Economic growth is accelerating and with it inflation is starting to become a problem as labour productivity improvements cannot keep pace with wage increases.

4. In the wake of the financial crisis in 2008, governments around the world cut taxes, increased government spending and reduced interest rates. Now, with their economies still weak, many of these same governments (Greece, Italy) are facing pressure from financial markets to cut government spending and reduce their budget deficits. What would you recommend they do?