

## Economic Stability

Economic booms and busts have always been a part of human history. In early modern times the first great Boom/Bust was the Tulip Bubble in 1636-1637 which was the result of a mania over the introduction of the tulip bulb from the Ottoman Empire to Europe and then the use of new financial instruments created to fund the mania on the various financial exchanges of the period in Europe. However it has only been in the last 150 years, through the development of modern economics and statistical methods, that it has been thought that government economic policy can be used to 'stabilize' the economy by slowing down economic booms and by lessening the negative impact of economy busts .

A general tendency in economics is that innovation leads to increased economic activity which then can result in economic booms and then economic busts. This innovation can be in the *real sector*, say through the improvement in production, transportation or information technology (such as the development of the internet and its use for commercial purposes, which lead to the boom of the 1990s and then the crash and recession of the early 2000s) or in the development of *new financial instruments* (the increased use of Fannie Mae and Freddie Mac mortgage-backed bonds and then the creation of various derivatives based on these bonds, which lead to the mid-2000s boom and then the corresponding bust in 2007).

Innovation leads to what Alan Greenspan termed "irrational exuberance" as investors believe that the innovation will be the new 'next best thing'. This exuberance creates a bubble as investment is attracted to fund the new innovation because it is expected that the innovation will lead to above-average returns on investment. This new investment is oftentimes unsustainable because the benefits of the innovation can be over-estimated and the expected returns to the investment are then not realized. This is what leads to a bust. Then, as the over-investment is worked-out of the economic system, this can lead to recession (short-term negative economic growth and increasing unemployment) or depression (long-term negative economic growth and/or long periods of high unemployment).

One of the great unresolved debates in economics is what should be done to, 1) prevent bubbles in the first place and, 2) what should be done about the bust which then occurs after the bubble is burst. This attempt to control the economy through government policy is known as "economic stabilization". It was thought that the development of central banks in the 1800s would lessen the Boom/Bust cycle (most major European countries had developed central banks by 1875 and the United States established a central bank in 1913). Many economists believe that monetary policy can be used by central banks to stabilize the economy through counter-cyclical monetary policy. Reducing the money supply and raising interest rates during a boom would slow down the investment during the boom and then increasing the money supply and raising interest rates would increase investment during the bust and reduce the negative impacts of unemployment as the economy got back on its feet again.

Even after the development of central banks and their use for counter-acting business cycles, economies still experienced periods of above-average positive and negative growth. The most notable period of negative economic growth and high unemployment was the Great Depression in the 1930s. The cause of the Great Depression is still today a matter of debate, although many economists agree with Milton Friedman and Anna Schwartz who found that monetary policy is what caused what is known as the Great Contraction of 1929-1933. The central bank of the

United States increased interest rates and reduced the money supply in 1928 to “pop” the stock market bubble of the 1920s. Then once the stock market crashed the central bank did not increase the money supply to allow the economy to recover. Because the United States was such a large part of the world’s economy, and because the world’s currencies were all tied together through the Gold Standard which fixed exchange rates between countries, the contractionary monetary policy of the United States negatively affected the rest of the world and helped to cause the recession in the countries who traded with the United States.

During the Great Depression it was seen that monetary policy alone could not stabilize the economy (although it was not known at the time that in fact it was bad monetary policy which held back economic recovery in the first place. In addition there were other economic policies which harmed economic recovery such as increased trade barriers worldwide). Governments then attempted to stabilize the economy through other measures because it was seen that monetary policy was not working. For example, both President Hoover and President Roosevelt attempted to keep prices high (remember prices were being held down because monetary policy was actually contractionary, keeping prices low through keeping the amount of money supply in the economy low) by asking that industry not reduce the prices of their products and not reduce the wages of their workers. It was thought that by keeping prices and wages high this would keep demand high and help in recovery. In addition the agriculture sector was asked to reduce output in order to keep agriculture prices high.

As the Great Depression continued it was seen that other measures of economic stabilization and recovery had to be tried. This led to what today is known as an active fiscal policy or Keynesian economics. It was thought that increased government spending and increased government debt could stimulate the economy into economic growth. This is what was recommended by the economist John Maynard Keynes, most prominently in his 1936 book *The General Theory of Employment, Interest and Money*. For example in 1935 President Roosevelt created the Works Progress Administration (WPA) which was the largest government program of its time and which was funded by Congress by an amount of almost 7% of the national income of the United States. During each year of the remainder of the Great Depression until the United States joined the Second World War in 1941, the WPA hired almost 6% of the workforce of the United States as relief workers. This was the only time in US history that the US Government hired such large numbers of people in an attempt at economic stabilization. Keynesian economics became firmly part of American economic policy in 1938 when Congress passed the Pump Priming Act. It is seen by some economists that the economy is like a water system and that an economic stimulus of increased government spending can be like increasing the flow of water through a water system, increasing the pressure on economic activity and stimulating economic growth. Economic stabilization through the use of both monetary policy and fiscal policy has been part of the economic policy of most countries in the world since the time of the Great Depression.

It should be noted that not all economists agree that government policy can, or should, attempt economic stabilization. Economists who agree with the Austrian School theory of the business cycle believe that a monetary policy which makes the interest rate too low (when central banks increase the money supply and lower the interest rate during economic downturns below a natural market rate of interest) increases investment more than is sustainable in the long-run. This artificially low interest rate then causes an over-investment in long-term investment,

investment which requires a low interest rate because the pay-back to the investment takes a long period of time to achieve. When the downward part of the business cycle hits, these long-term investments need to be worked-out of the system and this then prevents recovery and creates unemployment. This is what accounts for the over-building of commercial real-estate and large-scale manufacturing during boom cycles. Also, monetary economists believe that increasing the money supply does not affect the real economy at all and only raises prices and creates inflation in the long-term and therefore recommend that monetary policy be kept stable and not be used for counter-cyclical economic management.

Many economists believe that business cycles are a natural occurrence and are healthy for the economy because innovative booms create a more productive economy as innovations which are deemed good investments attract the necessary funding. Nobel prize-winning Edward C. Prescott supports this idea and states that economic fluctuations are “optimal responses to uncertainty in the rate of technical change”. Finally, many economists believe that it is simply not possible for the government to stabilize the economy because the economy is too complex to manage centrally. It is too difficult to know precisely when the economy has started a downturn and to implement a counter-cyclical monetary or fiscal policy in a timely-manner.

In addition to monetary and fiscal stabilization, modern economies are said to have ‘automatic stabilizers’. For example, unemployment insurance is used during economic downturns to lessen the negative effect of job losses on workers. Another example of an automatic stabilizer is inherent in corporate income tax policy. When companies make fewer profits they have to pay fewer taxes. The lowered tax burden then makes more funds available for investment and job-creation so the impact of a downturn is lessened as tax burdens are decreased.

See Also: Austrian School, Economic Stimulus Plan, Monetary Stability, Pre-20<sup>th</sup> Century Booms and Busts, Price Stability

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