
- Welcome once again as MIT professor Paul Samuelson discusses the current economic scene. This series is produced by Instructional Dynamics Incorporated. Professor Samuelson a lot has been said and a lot has been written about the fears that the federal deficit will crowd out private capital from the market, what are your views on this?

- We have the interesting spectacle of a Secretary of Treasury who instead of going around the country trying to talk up the market for government bonds has been giving dire warnings that the deficit may well be too large, and that this will be very difficult to finance and that government bonds may therefore be falling in price. This is not the first time, many of us will remember that George Humphrey who, during the Eisenhower years was Secretary of Treasury and being a forceful, retired business man from Ohio he often carried the ball in the budget briefings even though it's ordinarily not the Secretary of Treasury's function to do that. And we then had the spectacle of George Humphrey often undercutting the Presidential, that is the Eisenhower decisions and the cabinet decisions on the size of the expenditure budget and the deficit. He once spoke about deficits that would curl your hair, well Secretary of Treasury Simon seems to be engaged in somewhat the same type of behavior. Why is this? Well it could be that we live in a pluralistic administration and the Secretary Simon has different views from other members of the administration and he's just exercising his civil liberties. A more cynical interpretation is that Secretary Simon is going to return to the New York community and he wishes to return with his reputation intact and that he therefore is saying the things that he's doing. I think the more realistic interpretation is the third one namely, that he keeps saying these things in order to put pressure on congress and not to spend more money than the President has recommended. That of course is not feasible they already have voted to spend more money that the President has recommended but Secretary Simon would like to hold down the excess. And so we have always kept alive the question of crowding out effects of the federal deficit. I believe I've had occasion to remark on this problem. Where shall one begin? Shall one begin at the most naive level of sophistication? Namely is the deficit too large so that the government bonds just won't sell? I think it would have to be a very large deficit indeed for that to be the case, that the government bonds could not sell at any price. Some economists might argue that that's really impossible to happen, we could rephrase it, the government bonds won't sell at any feasible price that does not boggle the mind. I don't think that is the problem certainly not for the deficits that we're talking about, I think that there's some reason to think that the next fiscal year deficit, that's the fiscal year coming up from the middle of 1975 to the middle of 1976 will be in the neighborhood of 70 billion dollars but let's suppose that it's in the neighborhood of eight billion which is 6% of the GNP, or even 100 billion, the inability of the Federal Treasury to sell those bonds I don't think is a realistic apprehension at that level of deficit spending. The second degree of sophistication rewords the problem. In order to sell the bonds will the Federal Reserve have to buy them? Will the Federal Reserve have to create and undo expansion of the money supply in order to support the government bond market when there are deficits of this size? Now of course the Federal Reserve doesn't have to do anything if we have answered the first question that the government can't sell the bonds one way or another even though it means some increase in the interest rates and if the Federal Reserve thought that that were the desirable thing to happen to interest rates then it could refuse to finance the bonds. I don't wish to deny that there are certain political pressures from the administration possibly and certainly from the congress, but, many people would think that the more likely scenario is that the Federal Reserve will be motivated to expand the money supply to help finance the deficit or an even larger deficit than we're talking about at interest rates lower than the natural, spontaneous market would create them. Now it's not clear why this expansion of the money supply should crowd anything out, the argument at this point often branches off into saying well that would be inflationary because there is supposed to be some special connection in one run or another, let me for the moment talk about the short run, between the increase in the money supply and the price level. Now I don't think that there is in the short run, a special connection between an increase in the money supply and the price level. Which is different from an increase in total spending of equivalent amount however brought about other than by a Federal Reserve operation of increasing the money supply. An increase in aggregate demand and aggregate spending is likely in the short run to be distributed between both an expansion of real output and some expansion of the rate of price increase over what the rate of price increase would otherwise have been. And when we're operating in an economy with a good winter wheat crop coming up with many industries operating now at about 70% of capacity when the unemployment rate is 8.9% going on lets say, 9 and a third percent before we're finished and with some deceleration already going on in the rate of inflation then I think one would be rash to expect the partition of an increase in nominal or money GNP between real output increase and price increase to be very much in the price direction. Now it could be that when we come to discuss the intermediate run and the long run we'll have to make some modification in that judgment, but let's stick with how things are likely to be for the next fiscal year. Remember the steady state deficit is not as large as the 70 or 80 billion dollars of the fiscal year or not to play games with the actual months of the next fiscal year let's just take from the present moment, talking in May of course to May of next year we're getting rebates on last years taxes perhaps some of my listeners have gotten their $100 if you have $200 you probably don't have enough money to spend on this subscription series, that is a one shot operation and it's not going to run into long run deficits of the same magnitude although Mr Simon may fear that having gone to the pump and found it so satisfactory this year there will be a move in congress to have another tax rebate next year. Well the issue has shifted you see from a crowding out effect to an inflation effect now to the degree that an inflation effect is a too much money spending, chasing too little expansible supply of goods that might, I guess be legitimately deemed to be be one aspect of a crowding out effect. To return though to the crowding out effect as such, it's usually what's crowded out is private capital formation so it is argued. Now to the degree that the Federal Reserve is doing its job, an increase in the deficit other things being equal, should be met by the Federal Reserve with some increase in the money supply probably, but it should not increase the money supply so much if it was already doing its job about right that there will be no increase in the rate of interest. There will therefore be some crowding out of the availability of credit to private investment spenders. This by the way is what would happen from any expansion of the economy brought about for example by an increase in consumption spending as I understand it and as I monitor the statements that come out of administration economists to say nothing of non-governmental economists, people like Mr Alan Greenspan want consumption spending to increase, they look with hope towards a rebound in automobile expenditures, for that matter, they look with hope for a rebound on housing expenditures. These are what are called spontaneous expansions they are not engineered by wicked deficit financers, by fine tuners, but they certainly have the effect other things being equal, of increasing interest rates and therefore making it more difficult for a private investor to get the credit to build a new machine tool which he otherwise would not have built. I picked machine tool because to the vulgar mind that's the kind of capital formation which constitutes the only really legitimate, genuine kind of capital formation. If you stockpile inventories that's kind of unnecessary or speculation to the vulgar mind. As a matter of fact to many vulgar minds housing is just kind of a regretful expenditure, housing construction expenditure and is not legitimate capital formation it doesn't, they say enable us to compete with the enterprising west Germans and the Japanese only machines tools are really productive, now I wouldn't want to give my blessing to such interpretation. But the point is, and this is where I think one should focus. The only legitimate way to describe the crowding out effect is to ask yourself whether you think as a result of the deficit there is too much consumption spending. If there is so much consumption spending that it takes us to full employment and you have even more consumption spending than that obviously it must come at the expense of private investment. If If one puts the matter incorrectly one says something like the following I couldn't even begin to sort out the number of fallacies that are involved in an argument like this but let me try to state it, if you run too big a deficit that will make the problem of financing the federal debt so unmanageable and so difficult that that will increase interest rates and that will abort the boom. Well, if it is the expansion of the economy which is creating the transaction demand for money which pushes up the interest rates, then all you really have to do is to have an even bigger deficit. And then the boom will not be aborted although if the logic of the proposition I stated the first time had been correct I suppose by the same logic or illogic the more you expand the economy the less you expand the economy. So all you really have to ask yourself I think is whether you think that the fiscal stimulus is creating too much consumption spending. We are very near, the experts think, to the trough of the business cycle. We are as people say very near to the end of the recession. It's a very bad terminology one must say, that we've all fallen into because the word recession as defined by the national bureau is used to describe the decline in the real GNP. When you get to the end of the decline you come to the end of the recession. That's the language which is used. The person who is not a tactical economist could be forgiven for breathing a sigh of relief and saying thank God the recession is over. Well what it is that's over is the period of active sliding. The moment just before the dawn is the darkest moment of the night. The moment just after the dawn is still very, very dark indeed, according to the principle of continuity. Now if you don't like a moment make it a micro moment. When we are at the end of the recession we are at the trough at the very nature of prosperity indeed with respect to the amount of unemployment if you use that as a measure of the amount of suffering, or if you use as a measure of the amount of cost of the business cycle, the shortfall from what it is we could be producing our high employment real income production potential then it is sometime after the recession ends that the situation is still worsening. You're not at the end of the problem, you're not at the beginning of the end of the problem to use the expression of Churchill and Roosevelt during the dark days of World War II, when the first ray of dawn was our successful invasion of North Africa, I believe that Churchill and Roosevelt said this is not the beginning of the end it's the end of the beginning. Well the end of the recession, when it comes, is only the end of the beginning of our troubles. So we should not now in the economic winter of our discontent, which is still to be with us, as I have explained it even if the optimistic consensus forecasters are correct we should not be losing our sense of balance between what is too much stimulus and what is too little stimulus. Any increase in the interest rates which causes there to be too little rate of expansion of overall real demand can be countered and offset by greater deficit spending and or greater increase in the rate of growth of the money supply. Well those are the terms in which the crowding out effect should be analyzed. We're still left of course, with a problem that few people seriously discuss and that is whether we have a special scarcity of capital goods and capital formation at this time. That issue is always begged, it is taken for granted that for a variety of reasons the rapid capital formation abroad the pollution demands upon the system, the ravages of inflation as it is put, that America is especially capital short now. What exactly is being said there? Surely not that, if we had more capital we would be somewhat better off, that is always true. The only time that wouldn't be true would be if the stationary economy had brought the rate of interest down to zero, and then any further deepening of capital any extension of the degree of roundaboutness of production would no longer pay. It's a nice academic debate, whether one could get to that state. You can get philosophers to argue on both sides of the proposition, and neither one can convince the others because it's an argument about asymptotes and about the horizon and just beyond the horizon. But there is nobody that I know, who thinks that we are already at that point where the American economy could not use more capital. But what else is new? What are you saying when you just say that well if you just had more capital then the productivity of labor would be a little bit higher, real wages would be a little bit higher also I may add that other things being equal the rate of profit would be a little bit lower if you had more capital. What is being argued by Secretary Simon for one by many trade association groups, in fact a whole chorus of administration economists is that there is some identifiable sense in which we are especially short of capital formation and of stock of capital. Now, I've reviewed this problem I suppose like Halley's Comet not at intervals of 75 years on these tapes but at intervals of maybe every six months and I want to assure you that if you do a very careful analysis, double entry bookkeeping on the one hand all the factors which can be discerned in the situation which suggests that capital is in some sense especially short, and you jot those down well, for example the five fold increase in the price of oil, much of it coming from the Persian Gulf obviously makes for great profit opportunities in the exploitation of new energy sources in North America. The Alaska Slope is just an example offshore drilling reactivation of coal mines and strip mining these are needs for capital formation. But a notice, every survey that we have, this is the other side of the balance sheet shows a diminution of the intended real capital formation plans of business. And this is something that I should have mentioned when I was talking about the crowding out effect, the, everything which expands consumption does it is true, tend to raise interest rates other things being equal, but that same expansion of consumption also increases the motivation for investment. It increases the degree of fullness of capacity operations the profitability at the margin of new capital and the SOE's economists have known, well since the time of Malthus and Ricardo but more particularly I recall in 1938 a famous article by Oscar Lange in which he showed that there is an optimal configuration of investment which involves not too much consumption spending as at full employment and on the other hand not too little as when there is practically no final consumption spending and that's undermining the demand for capital formation, this is not to deny that something which he overlooked, should not be overlooked namely that you can have new capital which is being built for the purpose of building new capital. People say a Ponzi game like that cannot continue indefinitely, well all of life is kind of a Ponzi game and there is no necessary limit to that process the overwhelming bulk of the evidence if you do this double entry bookkeeping is extremely mixed. I've quoted again and again studies like that of William Nordhaus of Yale that appeared in The Brookings Papers oh six months ago or nine months ago, showing that if you correct properly, profit figures, for under reporting of profits and for over reporting of profits you correct for example, for the fact that if the firm is not using a LIFO, the time of inflation, the tax upon so called reportable money earnings is really a depleting of capital kind of tax, and also that even if you allow fast appreciation in a time of inflation if you can only take into appreciation your historical cost which falls uniformly short of reproduction cost then there is an overstatement of reported profits. Well after somebody like Nordhaus or George Terborgh for the Machine Tool Trade Association make these computations you find that the share of profits, incorporate value added in particularly in manufacturing and mining, leave out the banks but there's no reason to leave them out. Has been a falling fractional share, some of the increase of course has been to government but there still is a discernible increase in the relative share of labor in the corporate value added. An even better measure of how valuable capital is, is to take its marginal yield which is the rate of interest or the rate of profit before or after taxes and whichever way you compute it Professor Nordhaus finds it to have fallen rather steadily these last ten, these last 20 years, moreover this is a world wide phenomenon it's a phenomenon that has been going on at a rapid pace even more rapid pace in the UK and in Italy, it's a phenomenon that's been going on In western Germany, it's a phenomenon that has been going on in Japan. People blame it on inflation but that's just one, new example of money illusion because to the degree that the inflation is unanticipated it's not likely to be prejudicial to profits to the degree I suppose I have to modify that to the degree that the inflation is due to wage push, it might be prejudicial profits but we haven't had an inflation primarily due to wage push, and in any case how do the workers successfully make their push without causing their employment to fall off? And so that it's unlikely that the situation with respect to the rate of profit would be very much different. I'm speaking of course of corrected profits, if there had been no inflation but a steady price level it is in the last analysis a question of how much capital there is around the world competing with capital around the world in conjunction with and against the background the amount of labor and the skills that work with it. And so I have to remain an agnostic on the need for capital, I won't go over to the other side and say that there is absolutely a capital glut because it could be that there has been a capital glut in the recent past, I mean the last decade but we're just moving into a epoch where the yields on capital are actually in process of rising. But it's when they rise and through their rising that we will know that pollution demands and other demands have caused capital to be short.

- If you have any comments or questions for Professor Samuelson address them to Instructional Dynamics Incorporated 450 East Ohio street, Chicago Illinois 60611.