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Will More Dollars Save the World?

by William H. Peterson*

"Stingy" is the word critics hurl at President Bush's initial foreign aid offer of $100 million to Poland and $25 million to Hungary. Some critics go further and invoke the idea of a new Marshall Plan — this time including the support of Japan and the West generally — for Eastern Europe and, perhaps, another for the Third World as well. The idea brings to mind a variation on an old question: Will hard-currency transfers save the world?

The old question: "Will Dollars Save the World?" That was the title of a 1947 Foundation for Economic Education study, later condensed in *Reader's Digest*, by *Newsweek* economic columnist Henry Hazlitt. Hazlitt questioned the premises of foreign aid in responding to a speech on June 5, 1947, at Harvard University by Secretary of State George Marshall. Marshall had called for vast, coordinated dollar transfers to stagnating war-torn Europe (which was already receiving substantial U.S. war relief). Declared Secretary Marshall:

"The truth of the matter is that Europe's requirements, for the next three or four years, of foreign food and other essential products — principally from America — are so much greater than her present ability to pay that she must have substantial additional help, or face economic, social and political deterioration of a very grave character."

Hazlitt wondered about Marshall's "ability to pay" perspective on Europe. He took note of the Keynesian pattern of postwar European protectionism, inflation, rationing, exchange rate controls, huge public spending, deficit financing, heavy taxation, and wage and price controls. He wondered if dollar aid would hence but temporize the thick jungle of interventionism and not get at the root causes of postwar European stagnation.

Hazlitt contended, long before the advent of the supply-siders, that purchasing power grows out of production, that production is frustrated by government controls, that it thrives on free markets and stable currencies, that the great producing nations are perforce the great consuming nations, that, in essence, *supply creates demand.*

This basic economic truth, the perception of 19th-century French economist Jean-Baptiste Say, had been challenged, at first rather successfully, by John Maynard Keynes. In his *The General Theory of Employment, Interest and Money* (1936), Keynes promoted his own idea of demand management, mainly through government spending, to achieve "full employment." The 1940s (and, indeed, the 1950s and 1960s) were the heyday of Keynesianism, it should be noted, and Marshall's speech and the ensuing era of foreign aid had this going for it.

In any event, after the enactment of the Marshall Plan, the Hazlitt contention was soon put to the test. In 1948, on a June Sunday, without the knowledge or approval of the Allied military occupation authorities (who were of course away from their offices), West German Economics Minister Ludwig Erhard unilaterally and bravely issued a decree wiping out rationing and wage-price controls and introducing a new hard currency, the Deutsche-mark. The decree was effective immediately. Said Erhard to the stunned German people: "Now your only ration coupon is the mark."

The American, British, and French authorities, who had appointed Erhard to his post, were aghast. Some charged that he had exceeded his defined powers, that he should be removed. But the deed was done. Said U.S. Commanding General Lucius Clay: "Herr Erhard, my advisers tell me you're making a terrible mistake." "Don't listen to them, General," Erhard replied, "my advisers tell me the same thing."

The advisers were wrong. The German people rolled up their sleeves as never before, and the decontrol action brought about what has since been called "the German Economic Miracle." The moribund, ravaged West German economy snapped back to life, a phoenix soon becoming, ironically, the most prosperous in Europe.

Erhard, who had earned a doctorate in economics from the University of Frankfurt in 1924, who had witnessed the catastrophe of the German super-inflation of the early 1920s, and who followed Adenauer as West Germany's chancellor in 1963, conceded that Marshall Plan dollars helped the German recovery but held that the greater factor by far was the introduction of sound money and the deregulation of the economy.

As he wrote in his *Prosperity Through Competition* (1958), a book describing West Germany's rather radical system of *Soziale Marktwirtschaft* (Responsible Free Market Economy): "What has taken place in Germany...is anything but a miracle. It is the result of the honest efforts of a whole people who, in keeping with the principles of liberty, were given the opportunity of using personal initiative and human energy."

With the further successful examples of Japan and the "four tigers" of Singapore, Hong Kong, Taiwan, and South Korea, are not other economic miracles in Eastern Europe and the Third World awaiting non-dependency on foreign aid and a return to freedom and free enterprise?

In this light, does foreign aid really aid? Can it be that U.S. bilateral economic and military support (see accompanying table), along with U.S. multilateral support of international agencies like the World Bank and the International Monetary Fund, act as a net drag on a goodly number of recipient countries — some of which lack even a basic system of private property rights let alone a capital market?

Such support often does a disservice both to the donor and to recipient countries as the interventionist status quo is preserved and precious time and financial resources are

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COUNTRIES GETTING 10 BIGGEST SHARES OF U.S. BILATERAL ECONOMIC AND MILITARY AID
(Estimates in millions of dollars in fiscal 1989.)

1.	Israel	$3,000
2.	Egypt	2,400
3.	Pakistan	627
4.	Turkey	624
5.	El Salvador	389
6.	Greece	351
7.	Philippines	270
8.	Honduras	209
9.	Portugal	163
10.	Guatemala	146

Source: Congressional Research Service, House Foreign Affairs Committee.

wasted. National examples of that waste on all five continents are legion, as Peter Bauer has long demonstrated.

Even politicians occasionally spot the waste. As Secretary of State James Baker observed at a press conference in Warsaw last June: "In the 1970s, we and our allies and Polish people made a mistake. We shoveled a lot of money into this country with no requirement for economic reform."

So notwithstanding more than four decades since its first enunciation, the Hazlitt question is still relevant: *Will dollars save the world?*

An answer may lie in a further quotation from the Erhard book: "If the German example has any value beyond the frontiers of this country, it can only be that of proving to the world at large the blessings of both personal and economic freedom."

ANOTHER LOOK AT RESIDENTIAL CONSTRUCTION

Residential construction activity has been more or less "flat" during recent months, but, having decreased sharply since 1986, it remains depressed. The recent decrease in interest rates bodes well for the industry, but other factors suggest the industry is unlikely to lead the economy into a period of renewed expansion in the months ahead. Housing prices remain high, and while mortgage rates and prices have decreased in recent months, any increase in demand may be met largely with existing stock. The Federal Government's plan to sell off the assets of insolvent thrifts will add to the existing stock of properties for sale, further diminishing demand for new construction.

Residential construction activity remains far below the peak levels of 1985-86. Building permits for new privately owned housing units, a leading indicator, were issued at an annual rate of 1,333,000 in November, which is 30 percent below the 1,916,000 issued in September 1985 (seasonally adjusted). Housing starts, another leading indicator, were 1,361,000 in November, which also is 30 percent below the peak rate of 1,972,000 reached in January 1986. New housing units under construction and new units completed have been similarly depressed compared to the levels reached 3 and 4 years ago. These trends can be seen in the panels of the accompanying chart, which illustrates the major phases of the residential construction process.

As the chart shows, much of the slowdown is attributable to a steady decline in multifamily housing activity. Changes in the tax laws since 1986 and the loss of baby-boom renters to the buyer's market are among the reasons for the sharp decline. By comparison, the decrease in single family residential construction activity has been less steep.

More so than with other goods, the supply, demand, and price of housing depend upon its location, and the national averages mask widely different experiences across regional, state, and local housing markets. Over the past 3 years activity in the Northeast actually has increased and in the West has remained strong. Much of the slowdown has been concentrated in the South, where the supply of housing has exceeded the demand.

Price trends also have varied widely from region to region, but nationally the decrease in new construction activity has been accompanied by continued increases in the purchase prices and financing costs of new and existing homes, as shown below:

Newly Built Homes

National Average	*Nov. 1986*	*Nov. 1989*	*Percent Increase*
Purchase price	$124,200	$152,800	23
Down payment	31,700	42,400	34
Loan amount	92,500	110,400	19
Monthly mortgage payment	819	994	21

Previously Occupied Homes

National Average	*Nov. 1986*	*Nov. 1989*	*Percent Increase*
Purchase price	$110,700	$140,600	27
Down payment	31,200	38,500	23
Loan amount	79,500	102,100	28
Monthly mortgage payment	708	919	30

These rates of price appreciation are high relative to the increases in many households' incomes, but they are below the rates seen in the late 1970's and early 1980's. More recently, price trends have been more favorable for buyers. The national average purchase price of a new single family home was $5,500 less in November than the average price in the first half of 1989, and $2,500 less than a year ago. And while the average purchase price of previously occupied single family homes continues to increase, the rate of increase has slowed markedly since July. In addition, mortgage rates have decreased since July.

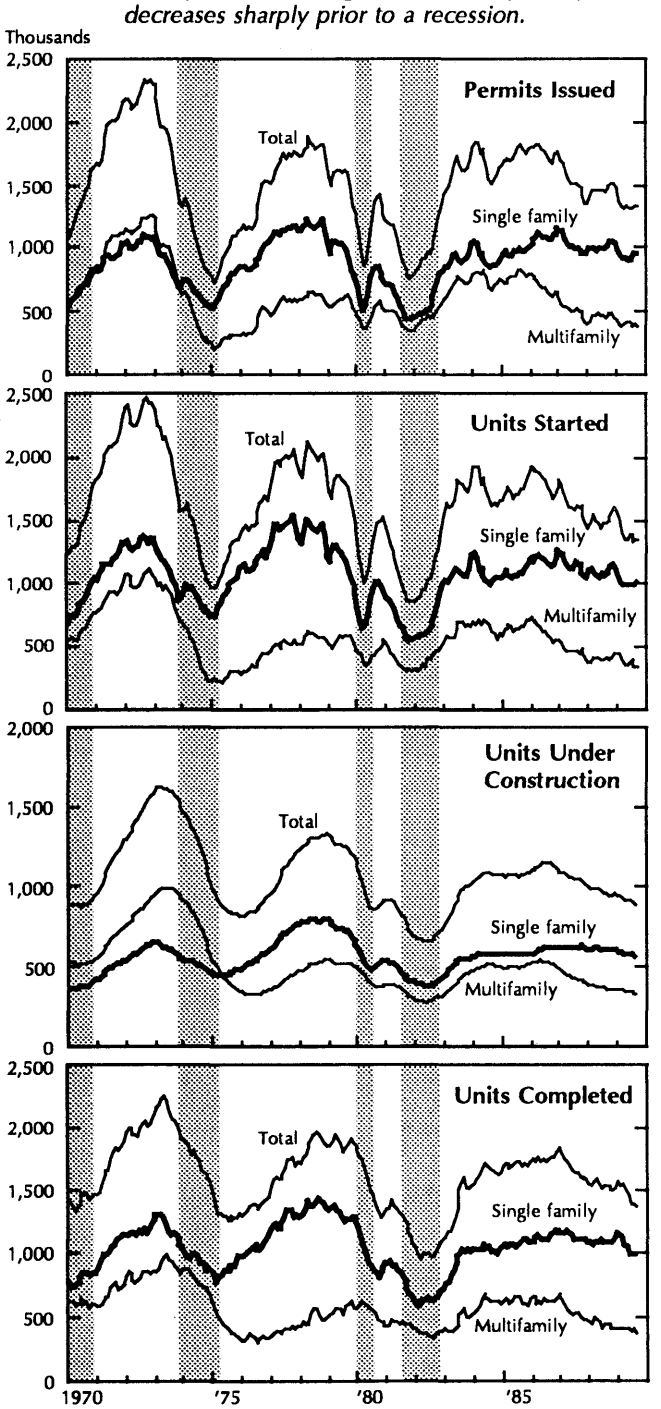
The Outlook

One factor that will influence the supply, and thus the price of housing in future months (and probably years) is the Federal Government's plan to sell off the assets of insolvent thrifts under its control. Only a fraction of these assets are in real estate, and not all of the real estate is residential. The total value of all these assets, however, has been estimated to be over $100 billion, and officials at the Resolution Trust Corp., the Federal agency charged with selling them, have stated their intention to sell them as quickly as possible. This month the agency published a 3,000 page listing of the real estate it has inventoried so far. Included in the list were 12,000 single family homes, 2,500 commercial properties, and 800 parcels of land.

How overall real estate values will be affected by the introduction of these properties into the market is unclear. Many of the properties are located in the South and the West, and the impact on, say, the Midwest may be minimal. Reportedly some of the properties are shoddily constructed or badly located, but some are plush, well-maintained and highly marketable. To the extent that Government officials slash prices on these assets to speed their sale, their actions may help create a buyer's market in some local markets. Whether or not they have a significant impact on real estate values, their addition to the existing stock of available housing will reduce, to some degree, the demand for new residential construction.

NEW HOUSING UNITS

Since decreasing sharply in 1988 and early 1989, residential construction activity has leveled off, partly in response to decreasing mortgage rates since June. Activity remains well below the peak level of 1985-86, however, particularly in the multifamily housing sector. Activity in that sector is unlikely to improve much in future months, since rental vacancy rates in existing units remain high. Overall, the slight improvement in total activity in recent months bodes well for the economy, since housing construction typically decreases sharply prior to a recession.



Note: All series are 3-month averages of seasonally adjusted monthly data at annual rates. Latest base data: for permits and starts, November 1989; for units under construction and completed, October 1989.

BUSINESS-CYCLE CONDITIONS

The AIER leading index continues to warn that a recession is likely in 1990. Also, our experimental "cyclical score," which until this month has signaled that continued expansion was probable, now is indicating that a recession is imminent. Already the current slowdown has been characterized by one leading economist as a "growth cycle" downturn. Whether it deteriorates into a recession will be largely influenced by the monetary policy of the Federal Reserve over future months.

Among the primary leading indicators of business conditions, demand for manufactured goods, particularly durable goods, remained relatively weak through November, as indicated by the decrease in the moving average of *new orders for consumer goods and materials*. Monthly fluctuations in this series have masked any underlying trend and it remains appraised as cyclically indeterminate. (This and all other dollar-denominated series are in constant dollars.) The base data for the *ratio of manufacturing and trade sales to inventories* also decreased, due to a sharp drop in sales and a moderate increase in inventories, and this series is clearly contracting. The moving average of *contracts and orders for plant and equipment* hit a new low, as the previously reported increase in the base data in October was revised to show a decrease. This series has weakened steadily since reaching a peak 4 months ago, and now is cyclically indeterminate.

Faced with uncertain demand for their goods and increased inventories, producers have been cutting production and reducing their own demand for inputs. The base data for the 3-month rate of *change in sensitive materials prices*, a measure of demand for raw and unfinished materials, decreased sharply in November. The moving average increased, however, and the series remains appraised as only probably contracting. New lows in the *average workweek in manufacturing* and *initial claims for unemployment insurance* (inverted) are evidence of continued weakening in demand for labor.

The poor performance of many of the leading series partly reflects the disproportionately large weight we give to the cyclically sensitive manufacturing sector in our leading index. The recent slowdown has not been limited to this sector, however. The residential construction industry, as measured by the *index of new housing permits*, continues to show little vigor. This series has been more or less flat since last March, and it remains cyclically indeterminate. This is an improvement, however, from the second half of 1988, when the series decreased sharply. The current flatness is encouraging, since typically this series contracts sharply just prior to a recession. (For more on the housing sector, see the preceding article.) The outlook for the financial sector, as measured by the *index of common stocks prices*, is somewhat less favorable than a few months ago. Since reaching a post-crash peak in August this series has hit consecutive new lows, and is appraised as only probably expanding.

The *M1 money supply* now is 5 months from its most recent trough, despite a decrease in November. Previously indeterminate, the series now appears to be probably expanding. The *M2 money supply* is 6 months from its most recent trough and clearly expanding. The increases in these series reflect actions taken by Federal Reserve officials to ease credit terms. Over the second half of 1989 the nominal M2 money supply increased at an annual rate of 8.4 percent, compared to an increase over the previous 6 months of only 1.1 percent. The announcement by major banks on January 8th of a reduction in the prime rate from 10.5 to 10 percent is further evidence of easier credit. This may improve the outlook for the 3-month *rate of change in consumer installment debt*. A slight increase in the monthly data did not offset earlier decreases, and the series is clearly contracting.

Among the primary roughly coincident indicators, *non-*

THE STATISTICAL INDICATORS

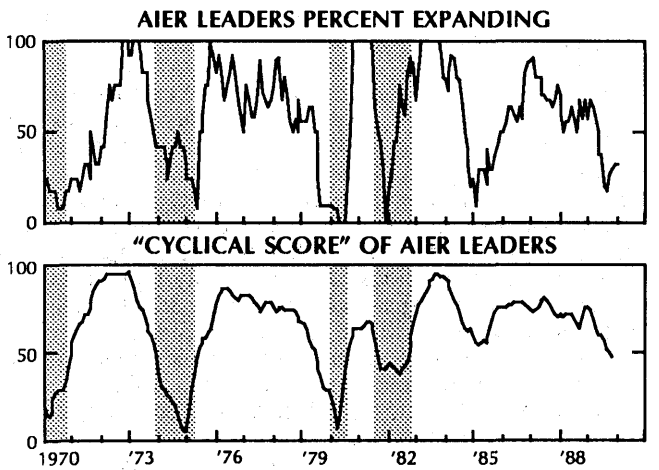
	Direction of Change in Base Data				Cyclical Status		
Primary Leading	*Sept.*	*Oct.*	*Nov.*	*Dec.*	*11/89*	*12/89*	*1/90*
M1 money supply†	+	+	–		?	?	+?
M2 money supply†	+	+	+		+	+	+
Chg. in sensitive mat. prices	+	+	–		–?	–?	–?
New orders, cons. goods†	–	–	+		?	?	?
Contracts & orders, p. & e.†	–	–′	+		+	+?	?
Housing permits	–	+	–		–?	?	?
Mfg. & trade sales/inv.†	–	–			–	–	–
Vendor performance	–	–	–		–	–	–
Stock prices†	–	–	–		+	+?	+?
Average workweek, mfg.	nc	–	–	nc	–?	–	–
Initial claims, unempl. ins.*	–	–	+		–	–	–
Chg. in cons. instal. debt	–	+	+		–	–	–
Percent expanding cyclically					**30**	**33**	**33**
Primary Roughly Coincident							
Nonagr. employment	+	+	+	+	+	+	+
Industrial production	–′	–	+		+	+	+?
Personal income, mfg.†	–	+	–		?	?	?
Mfg. & trade sales†	–	–			+?	+	+?
Nonagr. employment ratio	–	+	+	–	?	?	?
Gross National Product†q	+				+	+	+
Percent expanding cyclically					**100**	**100**	**100**
Primary Lagging							
Avg. duration of unempl.*	–	–	+′	+	+	+?	+?
Mfg. & trade inventories†	–	+			+	+	+
Com'l. & industrial loans†	–	–	+		+	+?	+?
Cons. instal. debt/pers. inc.	nc′	–	–		–	–	–
Chg. in labor cost/output	–	+	–		+	+	+
Short-term interest rates	+	–	–	–	–	–	–
Percent expanding cyclically					**67**	**67**	**67**

† In constant dollars. * Inverted. q Quarterly. nc No change. ′Revised.

Under "Direction of Change," plus and minus signs indicate, respectively, increases or decreases in monthly or quarterly data from the previous month or quarter, blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign or indeterminate status when standing alone.

agricultural employment reached a new high and the estimate of the third quarter increase in *Gross National Product* was revised upward to 3 percent from 2.7 percent. A sharp drop in *manufacturing and trade sales* and a downward revision in the base data for the *index of industrial production* raised new doubts about these series' statuses, and they now are appraised as only probably expanding. The recent decreases in 3 of the 6 coinciders are another indication that a recession may be in the offing. If a recession had already begun, however, we would expect to see a decrease in the percentage of coinciders expanding. This month, the percentage expanding remains unchanged at 100.

Among the primary lagging indicators the 12-month *change in unit labor costs* posted another sharp increase. The *average duration of unemployment* (inverted), *commercial and industrial loans*, and *manufacturing and trade inventories* also increased, and all three series appear to be expanding. The *composite of short-term interest rates* decreased and is clearly contracting. The "mixed signals" offered by the laggers is encouraging, inasmuch as these series typically expand prior to recessions. Only 67 percent (4 out of 6) of the laggers appear to be expanding, unchanged from last month and down from 100 in August.



The Cyclical Score Signals Recession

For the past 8 months the percentage of leaders expanding has been below 50, indicating that a recession is more probable than continued expansion. We have hesitated to conclude that a recession is imminent, however, because other economic data suggested otherwise, including our experimental "cyclical score."

The cyclical score, which is shown along with the percentage of leaders in the accompanying chart, is based on the same 12 series included in the AIER leaders. However, it is a purely arithmetical calculation that does not reflect the judgments of AIER's staff. And unlike the percentage of AIER leaders expanding, the "score" is subject to revision as the data for the indicators are revised. As with the AIER leading index, a "score" below 50 indicates a recession is imminent. As can be seen in the chart, the cyclical score has provided fewer false signals in the past than the percentage of AIER leaders expanding.

The cyclical score has decreased steadily since last January, but it remained above 50 until this month. This month it decreased from 50 to 47. Barring an upward revision in the score next month, then, both the AIER leading index and the cyclical score now are below 50. Based on this evidence, we expect a recession will occur in 1990.

The current slowdown has been tentatively identified by Geoffrey Moore, a leading analyst of business cycles, as a "growth cycle" downturn that began in February 1989. That is, the economy still is expanding, but at a rate less than its long-term trend. Similar "soft landings" occurred in 1951-52, 1962-64, 1966-67, and 1984-87. Currently, Moore's long-leading economic index is increasing at a rate that, he asserts, indicates the slowdown will not turn into a recession.

How severe the current growth cycle downturn will be, and whether it deteriorates into recession, will be greatly influenced by the actions of Federal Reserve officials. Fed chairman Alan Greenspan thus far has maintained publicly that he would prefer a (mild) recession to accelerated price inflation. In recent months, however, and more so in recent weeks, Fed officials have eased credit in hopes of averting further slowdown. If policymakers at the Fed now have decided that their primary goal is to avert a recession, the outlook for continued expansion could improve markedly in the next few months. The long-term outlook for price inflation, however, would worsen.

PRICE OF GOLD

	1989	*1990*	
	Jan. 12	*Jan. 4*	*Jan. 11*
Final fixing in London	$404.15	$396.50	$412.25

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