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Why 'shock therapy' won't work

Richard Freeman outlines the omissions and self-contradictions in Stanley Fischer's argument for all-out deflation.

"This paper examines the consequence of pursuit of a sharply deflationary policy, with primary emphasis on the United States. The policy will be referred to as a shock or cold-turkey policy. . . . The fear is that bankruptcies and large-scale unemployment, worse than any experienced in the postwar period, would follow implementation of a deflationary policy."

After citing this fear, Stanley Fischer, Massachusetts Institute of Technology economist and author of these lines, then dismisses it. Shock therapy will not trigger a chain reaction of bankruptcies within the U. S. economy, but rather merely cause some discomfort. Therefore, it is permissible to apply this policy to the United States. Fischer, makes this same point repeatedly and obsessively, in different formulations, throughout his paper.

Fischer's thesis is not for private circulation, but appeared in a paper entitled, "The Economics of Deflation," which, along with three other papers on the same subject, were the main documents at a three-day Group of 30 symposium on the subject of "shock therapy versus gradualism" in the realm of monetary affairs. Founded in 1978, the body is an unofficial adjunct to the International Monetary Fund, whose previous chairman Johannes Witteveen, now chairs the Group. Other prominent members include the chairman of Royal Dutch Shell, Dirk de Bruyne; the chairman of the executive committee of Morgan Guaranty Trust, Dennis Weatherstone; a partner in Brown Brothers Harriman and longtime government policymaker, Robert V. Roosa; Alexandre Lamfalussy of the Bank for International Settlement, and the former editor of the London monthly journal, *The Banker*, Robert Pringle, who is the Group's executive director.

The striking thing about the meeting is the refusal of most of the participants interviewed after the meeting to dissent from Fischer's assertion that a sharp contraction *will not plunge* the U.S. economy into a depression, nor blow out the dollar, despite an overwhelming mass of evidence that it will do just that. In short, the meeting can be viewed as a war cabinet meeting of monetarists mapping out a strategy to bring the experiment of Britain's Thatcher government to the United States. Most of the meeting's participants viewed the Thatcher experiment as "gradualism" and saw "shock therapy" as something more extreme than the Thatcher model.

Fischer's thesis

Fischer made it clear in a phone interview last week that he does not see shock therapy weakening the value of the dollar. "The dollar will appreciate after shock therapy," he said. "Even though interest rates would fall, investors would find the idea reassuring that inflation will be eliminated in the United States, and we would see capital flight into the dollar. In any event, if I'm wrong," he added, "there will still be foreign capital coming into the U.S. to take advantage of cheap American assets."

A transplanted Rhodesian, Fischer privately asserts that "I'm sure glad the Thatcher experiment is occurring in Britain and not here." Nonetheless, his public paper, "The Economics of Deflation," provides a rationale for concluding that there is not cause for concern when it is applied here. The Fischer thesis displays a problem in thinking that is rampant not only in universities—as Fischer and his paper suggest—but of a loss of wits within the Anglo-American policymaking establishment.

Consider for a moment how one would react, if in

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predicting the OPEC price for oil next year someone simply produced a supply-demand curve for oil use and availability. Well, this is what Fischer does for the U.S. economy.

For example, Fischer argues that the housing market will not collapse. Fischer argues that interest rates will fall, making mortgate lending easier, and inflation will fall, making homes cheaper and easier to buy. Fischer posits at the same time an offsetting tendency for the value of housing assets to rise, thus preserving the net worth of the housing market.

To compensate for any problems, Fischer notes that household debt has risen since World War II to a ratio of 30 percent of disposable income, making people less liquid during a monetary contraction— but household tangible assets, including $1.79 trillion in housing stock and $0.82 trillion in consumer durables, are larger than the financial liabilities of households of $1.33 trillion. The obvious implication is that families can sell off their homes and furniture, if need be, to pay off their debt.

In the corporate sphere, Fischer's all-purpose supply-demand formula is applied to produce the claim that although interest costs have skyrocketed as a percentage of pretax profits, from 4 percent in 1948 to 35 percent in 1979, they are "manageable" under shock therapy.

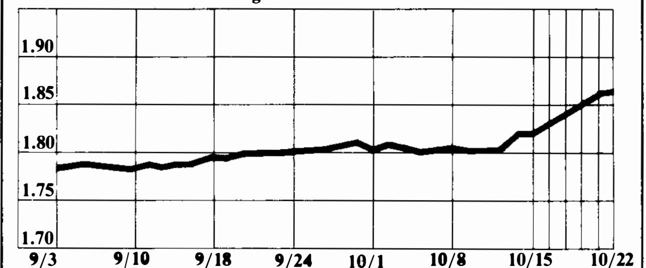
Yet, as both history and common sense show, a shock-therapy regime would decimate companies that have piled up short-term for debt rollover, inventory financing, and so forth; a blow-out in any key corporate sector, such as auto (see Domestic Credit), will devastate the commercial paper market, along with several highly leveraged money center banks—beginning with some in New York. Industry does not conform to neat supply-demand curves, but unravels at an accelerating pace, taking major banks and major chunks of the economy with it.

Fischer himself is intelligent enough to have doubts about his formula, doubts that sprinkle his paper with inconsistencies. At one point, he reassures himself that "The worst potential effects of a debt deflation have already been neutralized by deposit insurance." In the next sentence, he blurts out. "Further adverse effects can be minimized by the Fed's acting decisively as lender of last resort, as it did in the Penn Central and Franklin National cases, to prevent financial collapse." Further on, Fischer repeats: "In the event of a collapse of the housing market, mortgage purchases by the federally sponsored agencies, and quick use of fiscal policy, would make it possible to limit the contractionary effects on aggregate demand and output." In plain English: a massive federal government rescue operation—and an open admission of the "free market" failure of his proposed policy. What he does not admit is that the policy is a oneway ticket to hyperinflation of the present Thatcher variety.

Currency Rates

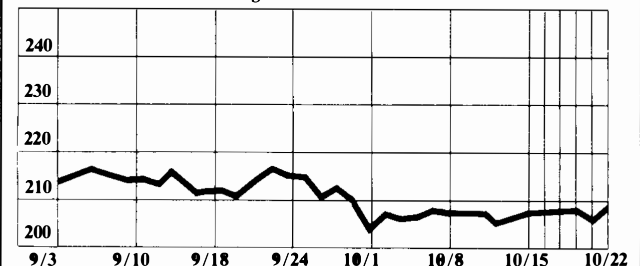
The dollar in deutschemarks

New York late afternoon fixing



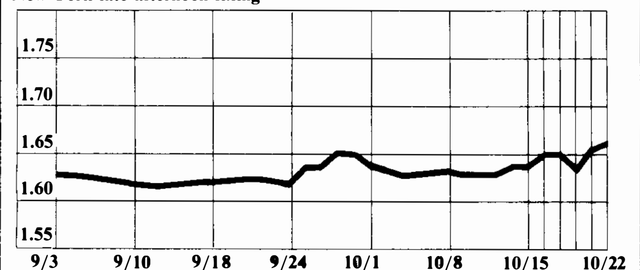
The dollar in yen

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing