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*EFFECTIVENESS OF MONETARY, FISCAL, AND OTHER POLICY
TECHNIQUES: COMPETING MEANS*

What Can Stabilization Policy Achieve?

By ROBERT J. GORDON*

Skepticism about the role of discretionary or activist stabilization policy is not new, but within the past decade the balance of opinion in the economics profession has shifted sharply from widespread belief in the stabilizing potential of discretionary monetary and fiscal policy to a pandemic suspicion that such policy intervention may be incapable of yielding any net benefit. This paper briefly traces the intellectual and historical sources of this metamorphosis of opinion and attempts to reconstruct a qualified case for activism.

I. The Self-Assured Credulity of the Mid-1960's

At its zenith in early 1966, discretionary policy appeared to have achieved an unassailable victory over its critics. Few in the profession disagreed with Walter Heller's proclamation that "We now take for granted that the government must step in to provide the essential stability at high levels of employment and growth that the market mechanism, left alone, cannot deliver" (p. 9).

The theory of policy implicit in mid-1960's discussions called for maximization of an aggregate welfare function which depended 1) negatively on the absolute value of the "gap" between actual real *GNP* and the potential real *GNP* which could be produced at a 4.0 percent "full-employment" unemployment rate, 2) negatively on the inflation rate, and 3) positively on the growth rate of potential *GNP*. Maximization was to be performed subject to two

major constraints: that the inflation rate depended negatively on the algebraic size of the gap; and that the nation's balance of payments could not be allowed to be too large a negative number.

Since the use of changes in government expenditures for stabilization purposes interfered with allocative considerations, frequent changes in income tax rates became the central policy tool. Monetary policy was kept in the background, relegated to the maintenance of a low and stable level of long-term interest rates to achieve the goal of stimulating potential output growth. The main loophole interfering with preference for tax changes was thought to be the legislative lag, and activist advocates tried without success to win approval for standby presidential authority to make quick temporary tax changes.

II. Elements in the Erosion of Support for Activism

A. Forecasting and Lags

Milton Friedman (1961) previously argued that long and variable lags in the effect of monetary policy were likely to make countercyclical monetary policy actions destabilizing. A subsequent theoretical analysis by Stanley Fischer and J. Phillip Cooper found that mere length of lags called for a *more active* policy keyed to the rates of change of target variables, but that variability of lags was a stumbling block which could well allow a Constant Growth Rate Rule (*CGRR*) for the money supply to outperform a more activist policy.

In the Fischer-Cooper analysis, policy

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changes responded to variations in the actual values of a target variable and did not require any use of forecasts. Although the well-publicized failures of forecasters during the 1970's may appear to reinforce a skeptical disregard of forecast values, according to Stephen McNees, the record of four-quarter-ahead forecasts of real *GNP* during the 1970's actually was rather good, with the glaring exception of the special 1973-74 period dominated by unprecedented supply shocks. Further, both the length and variability of the lag in the effect of monetary policy may have been overstated. I have recently (1978) calculated that the average lag between the month of maximum monetary tightness and the subsequent onset of recession in four major post-Korean episodes was only 8.5 months, with a range between six and ten months.

B. *Uncertain Economic Structure and Policy Multipliers*

Present evidence provides no basis for confidence in the exact size of the impact of a policy change on target variables. In 1967 William Brainard showed that when policy multipliers are uncertain, the expected gap between actual and target *GNP* should be closed by only a fraction of the gap. Gary Fromm and Lawrence R. Klein, as well as Franco Modigliani and Albert Ando, exhibit widely varying estimates of both fiscal and monetary multipliers. Brainard's demonstration increases the danger that a policy stimulus introduced to close a *GNP* gap may lead to overshooting and an acceleration of inflation, or that policy restraint introduced to eliminate overheating will push the economy into a recession.

C. *The Natural Rate Hypothesis*

Milton Friedman's (1968) natural rate hypothesis (*NRH*) denied the ability of policymakers arbitrarily to select any

inflation-unemployment combination along a stable tradeoff curve. Instead below a critical natural rate of unemployment the inflation rate would continuously accelerate, adding new urgency to Brainard's warning against overshooting the policy target. Some writers have denied the validity of the *NRH*, because they find unrealistic or unconvincing the classical equilibrium context in which its theoretical validity was demonstrated by Milton Friedman and others, with all economic agents on voluntary supply curves along which employment and output varied only if deviations between actual and expected price movements caused agents to be "fooled." However, Robert Barro and Herschel Grossman have shown that the *NRH* emerges also in a disequilibrium framework in which prices and wages respond to the excess demand for or supply of labor.

D. *The St. Louis Equation*

Soon after Milton Friedman's theoretical demonstration that the full-employment target of the activists might be unsustainable, Leonall Andersen and Jerry Jordan struck another blow with empirical equations which widened the range of previous multiplier estimates and implied that fiscal policy had no impact at all on nominal spending over as short a period as a year. Although activist advocates eventually regrouped and presented convincing evidence of fatal statistical flaws in the St. Louis procedure (see Alan Blinder and Robert Solow; Modigliani and Ando), their disarray lasted long enough partially to discredit fiscal activism and to allow the adoption by the Fed of monetary growth targets. Ironically, the gradual evolution of the data has steadily raised estimates of the St. Louis-type fiscal policy multipliers until recently they arrived in the vicinity of more conventional estimates (see Benjamin Friedman, 1977a). In the end, the St. Louis results served to stimulate useful analyses

of the theoretical conditions under which fiscal policy might have a zero multiplier in the long run, and also to shorten the consensus estimate of the lag of monetary policy.

E. *The Permanent Income Hypothesis and Temporary Income Tax Changes*

Robert Eisner, using Milton Friedman's permanent income hypothesis of consumption, showed that a temporary income tax cut or surcharge would fail to alter permanent income and thus would have a low spending multiplier. The temporary tax changes favored by mid-1960's activists were thus discredited as inappropriate for stabilization purposes, since their impact on consumption would not be large or rapid. Further, the lag in the effect of fiscal policy might be long and variable, with the length of the lag depending on the public's assessment of the likelihood that a tax change would soon be reversed.

F. *Reinforcement in the Late 1960's Policy Debate*

These defects in the activist case might not have been so persuasive if they had not been accompanied by a remarkable coincidence of supporting events. Inflation accelerated between 1967 and 1969 far beyond the pre-1966 expectations of activist proponents. Further, inflation failed to slow down in the recession of 1970 and early 1971, as would have been expected along a fixed Phillips curve. The dramatic drop in the personal saving rate in late 1968 and the failure of spending growth to slow appreciably in response to the temporary tax surcharge was consistent both with the St. Louis claim that monetary multipliers had previously been underestimated and fiscal multipliers overestimated, as well as with the Eisner critique. Recent empirical work by William Springer and by Modigliani and Charles Steindel, reinforce the adverse verdict on the efficiency of temporary tax changes.

III. **Rational Expectations, Supply Shocks, and Other Challenges of the 1970's**

A. *Endogeneity of Structural Coefficients and Policy Multipliers*

Robert E. Lucas, Jr. added a new dimension to the Brainard analysis of policy multipliers by pointing out that both structural coefficients and policy multipliers were endogenous and would respond to the particular policies chosen, thus making the conduct of policy even more uncertain. For instance, workers have responded to the inflationary policies of the past decade by demanding much more complete indexation of wage contracts, thus altering the aggregate response of wage change to price change.

The insight that agents respond rationally to the policy environment has applied with special force to the recent behavior of financial markets. The short-run negative textbook correlation between the money supply and interest rates has been replaced by a positive correlation, as speculators observe the Fed's attempt to maintain monetary targets and bet that a high money supply outcome in a given week increases the probability that policy will be forced to shift toward restriction. But this new response pattern does not imply that an activist monetary policy is rendered impotent; market expectations are presently conditioned by knowledge that the Fed is attempting to pursue a particular target, and responses would change if the Fed were to alter that target to pursue a countercyclical activist policy stance.

B. *Application of Rational Expectations to Economic Policy*

Classical equilibrium versions of the *NRH* make changes in output depend on "surprises," that is, deviations between actual and expected prices. Thomas Sargent and Neil Wallace have argued that a monetary policy which reacts in a systematic way to past events, say a deriva-

tive control rule responding to past values of inflation and unemployment, cannot cause the required surprise, since rational agents will incorporate the systematic component of monetary behavior into their price expectations. Thus systematic countercyclical monetary changes can have no impact on real output, an apparently startling result.

Ironically, the Sargent-Wallace result, if true, would not only render policy impotent, but also make policy actions unnecessary. The price flexibility required to validate their result describes an economy with perfectly functioning self-correcting forces in which perceived shifts in aggregate demand alter prices but not output. In fact, in a Sargent-Wallace world the Fed could eliminate inflation simply by announcing that henceforth it would expand the money supply at a rate compatible with price stability. But today's world hardly appears consistent with the classical equilibrium interpretation of output fluctuations based on errors in forecasting prices. A large worldwide gap between actual and natural output has persisted in 1976-78 in the face of a relatively steady and well-predicted inflation rate.

C. *Supply Shocks and Legislated Inflation*

When a supply shock occurs, for example, the 1972-73 crop failures or the 1974 oil price increase, a *CGRR* policy condemns the economy to a simultaneous increase in both unemployment and inflation. The merits of an activist policy which increases the money supply to "pay for" the higher oil prices depends on the extent of wage indexation and the willingness of workers to accept a decline in the real wage (see the author, 1975). In retrospect, high unemployment in 1975-76 could have been substantially alleviated without an explosive inflation in the United States and Germany, but not in Italy and Britain, although the Lucas point requires this conclusion to be qualified for the possibility that American and German workers might

not have been so docile under a more accommodative policy regime.

Prospective increases in payroll taxes, energy taxes, and the minimum wage in the late 1970's and early 1980's amount to a series of "mini supply shocks." A monetary authority adhering to a *CGRR* policy would find that these cost increases would raise unemployment. An accommodative monetary policy would shift the burden of the legislation from unemployment to real income losses for those holding assets yielding nominal-fixed returns.

IV. *The Rehabilitation of Stabilization Policy*

A. *Limitations of a CGRR Monetary Policy*

The existence of a potent self-correcting mechanism of price flexibility has again been refuted in the 1975-77 interval. Far from declining steadily and rapidly, the rate of change in *U.S.* wages has become stuck at a relatively constant rate since early 1976. Under these circumstances, a constant growth rate for the money supply cannot be appropriate. Ignoring changes in velocity, if the constant money growth rate is chosen as the current rate of inflation plus the natural (constant unemployment) growth rate of output, then the unemployment rate cannot fall. Only if inflation gradually abates can real output grow fast enough to allow unemployment to decline, but then a *CGRR* implies a steady shift in the composition of fixed nominal income growth from inflation to output growth, leading to a steadily accelerating expansion and inevitable overshooting of the target unemployment level. To avoid this, the constancy of money growth must eventually be abandoned. But if the sanctity of *CGRR* is to be violated in one direction, why cannot the pace of monetary growth be temporarily quickened in the early stages of the expansion to reduce the duration and extent of wasted resources?

An activist policy which concentrates its stimulus in periods when the economy is operating far away from target output es-

capable most of the problems raised by Brainard and Milton Friedman. Even the most radical proposals for monetary stimulus by activist advocates in 1975 called for elimination of only a fraction of the output gap in the first year. The trajectory of a two to three-year recovery implied in activist recommendations allowed plenty of time for adjustments to be made if multiplier estimates proved to be inaccurate.

The main disadvantage of activist antirecession monetary policy is that a temporary acceleration must inevitably be followed by a deceleration as the economy approaches its target. Political objections to requisite increases in interest rates, perhaps exacerbated by the proximity of an election, may hinder the "soft landing" approach to the target and lead to overshooting. But even then, the natural rate target is not a knife edge separating hyperinflation from hyperdeflation. Just as long-term labor contracts limit wage deceleration in recessions, so the acceleration of wages in an overheated economy is not instantaneous.

Even when the economy has arrived at its target output level, a *CGRR* is not appropriate. Benjamin Friedman (1977b) has extended William Poole's earlier analysis of a *CGRR* monetary policy, showing that the adoption of short-run targets for the money supply is efficient and correct only if the demand for money by the nonbank public is completely stable in relation to income and totally insensitive to interest rates. When the money supply grows less rapidly than expected in relation to income as in 1976, or more rapidly as in mid-1977, policy is efficient when it utilizes this information that the demand for money has shifted and deviates from its previous growth rate target.

B. *The Role of Fiscal Stabilization*

While Eisner's criticism of temporary income tax changes is convincing, insufficient attention has been given to other fiscal tools. In contrast to the income tax, temporary changes in subsidies and

sales or payroll taxes are more effective than permanent ones by creating intertemporal displacement of spending. A reduction in a sales or payroll tax is exactly the opposite of a crop failure and allows policymakers to reduce unemployment and inflation simultaneously. Tax incentives for wage reductions also have this inflation-reducing beneficial impact. The main qualification is political; the necessity for congressional debate of such fiscal measures may lead not only to perverse spending effects in anticipation of future tax changes, but also to delay which causes tax changes to be made at the wrong stage of the business cycle.

The need to avoid political delay leads to renewed attention to automatic fiscal devices triggered by deviations of actual from target output. Exemplary applications abroad include the Swedish countercyclical investment fund, which allows corporations to escape tax on investment funds shifted from boom to recession periods, and the Japanese device of accelerating expenditures on public works in recessions (see the author, 1978, pp. 516-25).

The transition to flexible exchange rates in the 1970's has reinforced the case for using fiscal policy to stimulate the economy during recessions. While a monetary expansion boosts the supply of dollars and causes a *U.S.* exchange depreciation, fiscal policy raises the demand for money and appreciates the *U.S.* dollar. A stimulus which reduces the unemployment rate by a given amount will be accompanied by a stronger dollar, cheaper imports, and less inflation if it takes the form of fiscal rather than monetary ease.

V. Conclusion

Events in the late 1960's discredited the earlier brand of policy activism based on a permanent long-run inflation-unemployment tradeoff, and a hyperactive "fine tuning" technique.¹ But events in the 1970's

¹Although the tax rebate of 1975 indicates that actions of politicians lagged behind the skepticism of economists.

support a reconstructed case for activism. When output is well below target, rigid adherence to a *CGRR* monetary policy leads to permanent acceptance of high unemployment if there is no downward adjustment of prices, and to overshooting the target if prices do adjust. Deviations from any reasonable estimate of target output have been large enough to allow a sizeable temporary stimulus without need for excessive concern about multiplier uncertainty. The experience of adverse supply shocks has focused attention on the potential role of subsidies, cuts in sales or payroll taxes, and wage-tax schemes as methods to achieve a simultaneous reduction in inflation and unemployment through the active use of policy.

While the economic case for stabilization policy seems convincing, political obstacles cannot be ignored. A temporary monetary stimulus in a deep recession may be well timed and effective, but the unwinding of the stimulus will require a politically unpopular increase in interest rates which the central bank may be forced to resist. Reductions in sales and payroll taxes may be easy for economists to recommend, but in actuality politicians are presently engaged in a major shift in the composition of federal tax revenue from the personal income tax to price-increasing payroll and energy taxes. One can only hope that Lucas' idea of policy-responsive parameters can be extended to the political sphere, and that politicians will learn from the sorry aftermath of their own current behavior to be less obstreperous in the future.

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