

## FOREWORD

On October 29 and 30, 1979, the Federal Reserve Bank of St. Louis and the Center for the Study of American Business at Washington University co-sponsored their fourth annual conference. This volume presents the papers and comments delivered at the conference, entitled "Stabilization Policies: Lessons from the '70s and Implications for the '80s."

The conference was divided into three sessions. The first of these considered recent developments in the theory of stabilization policy and empirical evidence on the effects of stabilization policies. The second session focused on evaluations of the monetary and fiscal policies pursued in the 1970s. The third and final session discussed international aspects of stabilization policies. This foreword presents summaries of the three sessions.

### Stabilization Policies: Theoretical and Empirical Issues

In his paper "Recent Developments in the Theory of Stabilization Policy," John Taylor focuses on current theoretical work on the response of output and employment to changes in aggregate demand. He distinguishes between two approaches: information-based theories in which uncertainties about economy-wide disturbances are emphasized, and contract-based theories in which temporary rigidities in wages and prices are emphasized. The former set of theories, combined with rational expectations, are the foundation of the "new classical microeconomics." In these models only unanticipated disturbances affect real variables, and systematic policy has no effect on real variables. The contract models, on the other hand, allow for temporary

rigidities in wages and prices and therefore yield more traditional conclusions about the short-run response of output and employment to demand disturbances and policy actions.

Taylor contrasts the implications of these two approaches for two important issues of stabilization policy: the possibility of improving economic performance of output and employment through systematic variation in policy instruments, and the cumulative output loss associated with anti-inflationary monetary restraint. The information-based models suggest an absence of any gains associated with policy activism and an ability to decelerate inflation without a prolonged or serious rise in unemployment. The contract-based models suggest that there may be gains to policy activism and that there may be sizable costs in terms of foregone output associated with policies aimed at reducing inflation.

In his comments on the Taylor paper, Hyman P. Minsky rejects both the new classical microeconomics and other theories based on "neo-classical" economics as meaningful frameworks for understanding the role and effects of stabilization policies. Minsky believes that these models: (1) lack the potential for economic instability that makes policy actions potentially useful; (2) ignore important developments, beginning in the mid-60s, that radically changed the environment in which stabilization policy must operate; (3) abstract from essential aspects of economic institutions, particularly the evolution of the financial system and of financial practices which have made the economy increasingly susceptible to financial instability with the accompanying threat of a serious debt-deflation process.

The second paper in the first session, "Empirical Evidence on the Effects of Stabilization Policies" by Laurence H. Meyer and Robert H. Rasche, begins with a survey of monetary and fiscal multipliers. These are examined both across various large scale macroeconomic models and simple reduced-forms, and over time, to assess the degree of consensus and the nature of the evolution in policy multipliers as the various macroeconomic models have been refined. The authors give special attention to the difference in estimated fiscal policy multipliers between the large scale income-expenditure econometric models, on the one hand, and the St. Louis reduced-form equation on the other hand.

Meyer and Rasche then develop the implications of both the large-scale income-expenditure models and smaller monetarist models for the two issues highlighted in Taylor's presentation: the cumulative output loss associated with anti-inflation policies and the gains from policy activism. They contrast the large cumulative output losses implicit in both conventional estimated Phillips curve equations and monetarist models with the implications of rational expectation macro models. Meyer and Rasche note, however, the importance of balancing the gains from reducing inflation against the transitional costs associated with reducing inflation. They conclude with a survey of empirical evidence on the gains to policy activism, based on model simulations which compare the simulated performance of the economy under fixed rules, ad hoc rules with feedback, and optimal control.

In his comments on the Meyer and Rasche paper, Neil Wallace rejects as useless any results based on the current generation of large-scale econometric models and reduced forms. According to Wallace,

these models are not "coherent" in the sense that their conclusions are not derived from a mutually consistent and defensible set of assumptions. However, he admits that the same criticism can also be applied to almost all the recent rational expectation macro models. The important contribution of these models, according to Wallace, is not so much the policy ineffectiveness conclusion which has attracted so much attention, but the demonstration that the assumptions made about how economic agents forecast future values of variables have great influence on the response of real variables to macroeconomic policies.

#### Stabilization Policies: Critique of the '70s and Preview of the '80s

The second session focused on evaluations of the monetary and fiscal policies pursued in the '70s. In "The Case for Gradualism in Policies to Reduce Inflation," Allan H. Meltzer rejects as myth the view that the current inflation has its roots in the Vietnam War era deficits. Instead, Meltzer states that the proximate source of the current inflation is the monetary policy of the early 1960s, and that inflation persists because monetary policy continues to sustain anticipations of future inflation.

Meltzer then develops the rationale for a policy of "gradualism"--pre-announced, gradual, sustained declines in the rate of growth of money. Meltzer emphasizes the importance of conducting monetary policy in a way that permits individuals to quickly recognize permanent shifts in the rate of monetary growth. If monetary growth is volatile, individuals have difficulty in inferring from observed money supply figures what direction the Federal Reserve is likely to take in the future. This situation results in a slow adjustment of expectations about

future monetary growth and inflation to a permanent decline in the rate of monetary growth -- and, as a consequence, a serious cumulative output loss. By announcing its target and reducing the variance of actual monetary growth around its target, the Fed promotes more rapid revision in inflation expectations and minimizes the cumulative output loss associated with anti-inflation policy.

In "Federal Budget Policies of the 1970s: Some Lessons for the 1980s," Michael E. Levy is critical of monetarist explanations of the persistent inflation of the last decade and a half. While recognizing the important role of monetary change in the inflation process, Levy argues that monetarist explanations, such as that provided in the previous papers by Allan Meltzer, fail to take the analysis far enough. Although they identify the Federal Reserve as the ultimate source of inflation, monetarists do not give the Fed's inflationary behavior adequate explanation.

The fundamental source of the inflation of the last decade and a half, according to Levy, lies in the drastic changes in social attitudes and in economic policies that got underway in the mid-60s and persisted throughout the '70s. This new social activism resulted in large and rapidly growing federal programs designed to transfer real after-tax income from the productive sectors to nonproducers, a dramatic increase in both the size and scope of civilian programs, increased reliance on deficit spending, and a new wave of socially-oriented regulation. The dominant forces behind the persistent inflation were the following: the increased expansionary thrust of the budget; the acceleration in monetary growth in order to accommodate the deficit financing; the acceleration in wage demands as workers attempted to reverse the

decline in after-tax real income associated with tax-transfer programs; the increased reliance on "inflationary" social security taxes; the increased business costs associated with regulation; and the slowdown in productivity and real growth resulting from disincentives, both to work and invest.

In his comments on the Levy paper, William Poole suggests that the slowdown in productivity could have raised the inflation rate associated with a given rate of monetary growth by only one or two percentage points. The remainder of the rise would have to be associated with increases in monetary growth to accommodate the inflation initiated by the other factors cited by Levy. Poole states, however, that Levy does not provide any evidence that the factors he cited were quantitatively important sources of inflation pressure. Moreover, Albert Burger, in his discussion paper, notes that Levy gives relatively little attention to the behavior of the Fed and hence leaves unanswered the question that motivates Levy's objection to the monetarist explanation of inflation: "Why did the Fed accommodate these inflationary forces?"

In his luncheon address, Lawrence K. Roos, president of the Federal Reserve Bank of St. Louis, described what he termed the "shortcomings" of the past monetary policy actions and announced his enthusiastic support for the Fed's recently announced change in the method by which future monetary policy will be conducted. Although the new policy approach, which places primary emphasis on the growth of reserves and monetary aggregates, holds the promise of avoiding the policy errors of the past, Mr. Roos cautioned that there are several steps which must be taken if the policy change is to fully achieve its

desired results. Among the necessary steps are increased focus on the growth in the monetary base, the avoidance of monetary policy surprises, and a commitment to a long-run policy viewpoint so that neither political pressures nor false expectations force abandonment of the new policy. He emphasized that the new policy must be given at least a year to prove its value and should not be expected to dissipate inflation in a matter of months.

### Stabilization Policies: International Aspects

Jacob Frenkel began the third session of the conference with a thorough analysis of the experience with flexible exchange rates in the 1970s. His paper, "Flexible Exchange Rates in the 1970s," sets forth the way in which the asset market or monetary approach to exchange rate determination helps to explain this experience, particularly the observed volatility in exchange rates and the relation between exchange rates and both domestic and foreign interest rates and price levels.

Within this framework Dr. Frenkel highlights the central role of expectations, particularly expectations about future inflation, in determining exchange rates. An explanation of the volatility of exchange rates is aided by the view that these rates are a financial variable whose value is sensitive to expectations about future developments and is capable of quickly incorporating new information about these developments. The central role of inflation expectations suggests, according to Frenkel, an "intimate connection between monetary policy and exchange rate policy" and imposes a "unique responsibility on the monetary authorities in affecting the rate of exchange."

H. Robert Heller outlines in his paper, "International Stabilization Policy Under Flexible Exchange Rates" the adverse effects that the move to flexible exchange rates has had on international trade, international capital movements, and foreign investment. Heller takes the position that the increased uncertainty about exchange rate fluctuations has resulted in a significant increase in costs to the business sector and that the adverse effect of this uncertainty has been particularly evident in the decreased willingness of investors to undertake direct investment and long-term construction activity abroad. He also suggests that speculative capital flows may have accentuated rather than reduced the fluctuation in exchange rates. These increased costs, moreover, were not offset by any benefits associated with flexible exchange rates, such as greater freedom for domestic stabilization policies.

Heller notes that it will be impossible to return to fixed exchange rates as long as national inflation rates differ so widely. He concludes his paper with a series of recommendations for improving the functioning of the international monetary system under flexible exchange rates. To preserve the dollar standard, the United States must act to maintain the real purchasing power of the dollar. This, in turn, will require better control of monetary aggregates and will be facilitated by adoption of longer-term monetary aggregate targets.

In his comments on the Frenkel and Heller papers, David Laidler emphasized the implications of flexible exchange rates for the response of inflation and output to deceleration in monetary growth by a single country. Flexible exchange rates, according to Laidler, impart an added degree of price flexibility; hence they permit both a more rapid

deceleration in inflation and a reduction in the cumulative output loss associated with anti-inflationary policies. This fact suggests that empirical approaches which do not explicitly allow for the effect of an open economy under flexible exchange rates may seriously overestimate the cumulative output loss.

In his comments on the Heller paper, Geoffrey Wood remarks upon the lack of evidence to support Heller's contention that flexible exchange rates have had a harmful effect on international trade. Wood also objects to Heller's contention that destabilization of capital movements has been an important source of volatility of exchange rates. In Wood's view, the volatility of exchange rates simply reflects the underlying volatility of national monetary policies.

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