Symposium Introduction: Monetary and Fiscal Policy in Theory and Practice

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At the 1997 Annual Meeting of the American Economic Association five eminent but diverse economists participated in a symposium on whether there is a core of practical macroeconomics that could be confidently used, especially to underpin macroeconomic policy. The papers were published as Blanchard (1997), Blinder (1997), Eichenbaum (1997), Solow (1997) and Taylor (1997). Given the diversity of the five there is a remarkable degree of agreement. All five agree that in the long run there is no trade off between unemployment and inflation and that trend movements in real variables such as output, employment and unemployment are determined by the supply side. Aggregate demand has little place in long run analysis. As Solow put it, "the appropriate vehicle for analysing the trend motion is some sort of growth model, preferably mine" (1997, p. 230).

There is also agreement that in the short run, due to wage and price rigidities and perhaps expectation factors, monetary policy can and does affect the levels of output, employment and unemployment. Moreover, there is a short run trade off between unemployment and inflation. Views on how to balance the costs of unemployment against the cost of inflation can be expected to vary among economists, but since monetary policy is in the hands of central bankers, generally a conservative group of people, most weight is given to keeping the inflation rate low. In a number of countries this goal is explicitly made the major responsibility of the central bank. In Australia the Government has given in writing the Reserve Bank a target for inflation but no other explicit targets, although unemployment

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is ranked equally with price stability as goals in the legislation establishing the Reserve Bank.

The five economists also agree that in the short run fiscal policy as well as monetary policy can influence output, employment and unemployment, though their theoretical reasons for this differ. Eichenbaum argues that discretionary fiscal policy is "neither desirable nor politically feasible" (1997, p. 236), since long lags in implementation (in the United States, at least)[1] may make the use of fiscal policy counterproductive. Also there are worries about the use of expansionary fiscal policy when the level of public debt is high. In Australia neither of these objections carry much weight. Fiscal policy measures can be, and have been, introduced whenever thought desirable and not just in the annual budget. Moreover, expansionary fiscal policy measures usually are approved without delay by both Houses of Parliament. Eichenbaum's statement about the undesirability of fiscal policy may reflect a widespread concern about the use of expansionary fiscal policy when there is a high level of public debt. In Australia the public debt is so small as to be virtually non-existent.

This core of macroeconomics has become known as the new consensus or the new neoclassical synthesis. It is described in more detail in the articles in this symposium by Hart and by Kriesler and Lavoie. Hart goes further and sets out in detail the theoretical structure on which the new consensus is based. Both articles are highly critical of this new consensus. The discussion may sound like a doctrinal discussion among economic theorists. But it does affect policy making in the real world. As Blinder points out, this sort of discussion "potentially affects the well-being of hundreds of millions of people around the globe" (1997, p.243).

The article by Kriesler and Lavoie is a critique of this new consensus, or new neoclassical synthesis, that draws particularly on the work of Post Keynesian economists.[2] Kriesler and Lavoie reject the conclusions of the new consensus about the relationship between unemployment and inflation in both the short run and the long run. They argue that, over a large range of unemployment rates, changes in the rate of unemployment have no effect on the rate of inflation. Moreover, the level of economic activity is often such that unemployment is in this range. Kriesler and Lavoie also reject the new consensus notion of a supply-determined natural growth and the associated doctrine that in the long run, monetary policy only affects the rate of inflation and not real variables such as unemployment. These different conclusions result not so much from the correction of logical flaws in the theory underlying the new consensus, but in replacing the assumptions about how economic actors act with others which many would find more realistic. Perhaps the two most important departures from the

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new consensus are the Post Keynesian assumption that mark-up pricing is prevalent and a belief in the necessity of a detailed theory of the links between the short run and the long run. As Solow says of his own version of the new consensus, “one major weakness in the core of macroeconomics as I have represented it is the lack of real coupling between the short run picture and the long run picture” (1997, pp. 231-232). Kriesler and Lavoie’s critique of the new consensus also leads to the conclusion that fiscal policy, not monetary policy, is the better policy instrument for stabilization purposes, especially in a recession, though both should be used.

When it comes to fiscal policy, the gap between the new consensus theory and actual policy is great. It is not just the five economists in the American Economic Association Symposium who accept that fiscal policy can affect output, employment and unemployment in the short run. Even that conservative institution, the IMF, has stated that

> Most economists argue that in the right circumstances, fiscal expansion can be an effective tool to stimulate aggregate demand and revive a stagnant economy. But expansionary fiscal policy may not have its intended salutary effects where there are high or unsustainable levels of public debt. (Gupta and Clements, 2005, p.10)

On the other hand as Blinder (1997) puts it, “Nowadays the opposite presumption [to the IMF view] seems to have taken hold in policy circles, ... Deficit reduction, we are told promotes economic growth in the short run” (p. 242). It is true that there is one case, Clinton’s deficit reducing budget plan of 1993, when a reduction in the deficit was associated with an increase in the rate of growth of economic activity. But this increase could have been due to many factors. It is hard to find any systematic theory that links contractionary fiscal policy with a short run stimulation of economic activity.

In Australia, despite some comments by politicians and journalists, the Australian Treasury goes no further than casting doubt that any effect of fiscal policy on economic activity will be significant. In section 2 of his article Hart shows how the Treasury position can be derived from the type of economic theory still enshrined in many textbooks and taught in many undergraduate courses. But, as Hart points out, this theory assumes that the volume of money is exogenous and fixed by the Reserve Bank of Australia. This certainly has not been the case for at least 20 years.[3] While the Treasury cannot escape the responsibility for using out of date theory, the shame should probably be shared with text book writers.

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In section 3 of his article Hart sets out a new consensus type model in which the money supply is endogenous and the central bank targets the interest rate. The implications of this model, discussed in section 4, are somewhat surprising. In the short run, fiscal policy is a more reliable instrument to influence economic activity than is monetary policy. The basic model is ambiguous about the long run as alternative assumptions about the causes of wage and price stickiness have different long run implications. Section 5 looks at the so-called budget constraint and finds that it vanishes when the assumption of an exogenous constant money supply is dropped. This section finishes with a caution that the equilibrium models discussed in the paper may not, by their very nature, be appropriate for discussing the effects of policy changes. Dynamic models, not comparative statistics, are what is needed. Overall, Hart's paper suggests that the Australian Treasury position on fiscal policy is dangerously misleading.

The third paper in the symposium turns to the problems of evaluating actual macroeconomic policies in specific economies and in particular Australia. Junankar seeks to discover whether the Labor Party or the Coalition has performed better at economic management since the Labor Government came to power in 1983. This is not an easy question to answer for many reasons. One could compare the average values of the various indicators that measure macroeconomic health over the periods 1983-1996 and 1996 to the present, but in 1983 the economy was in worse shape than in 1996. Labor had a lot of ground to make up so it is not surprising that the Coalition appears to be the better manager. Similarly, because Labor had a poorly performing economy as a starting point, it is to be expected that comparing changes over the term of office would make Labor's performance much better, and this is the case. However, an even bigger problem in assessing the relative success of the two governments is that the Australian economy is heavily influenced by economic conditions in the rest of the world. These were quite different between the periods in which Labor and the Coalition were in power. Junankar takes the performance of the United States' economy to represent what is happening in the rest of the world. He then looks at the changes in the difference between the indicators of economic health in the two countries. If Australia does better (or worse) than the rest of the world as represented by the United States, this could be assumed to be due to Australian economic management. Again, there are differences whether one looks at averages over the periods or the changes from the beginning to the end of each period. The surprising result is that looking at the change in the difference between Australia and the United States from the beginning to the end of

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the period Labor does better as far as the rate of inflation and the real interest rate is concerned and the Coalition does better as far as unemployment is concerned. However, the major conclusion is that it is impossible to obtain a clear cut answer to the question which government has proved to be the better economic managers.

Notes

[1] The division of powers between the President and the Congress make the use of timely fiscal policy difficult in the United States.

[2] Post Keynesian economics maintains the essential message of Keynes' *General Theory*, namely that, in both the short run and the long run, in capitalist economies output and employment may be constrained by aggregate demand below the level that eliminates involuntary unemployment. In contrast New Keynesian economists hold that this may be true in the short run due to wage and price rigidities but there is a reliable mechanism that moves an economy to full employment in the long run.

[3] See e.g., Macfarlane and Stevens (1989), p. 5.

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