『経済科学』第69巻第３号（2021年12月発行）
THE ECONOMIC SCIENCE, Vol.69, No.3, December 2021
DOI:10. 18999/ecos. 69. 3. 21

〔SUMMARY〕

How Stabilization Policy Has Come of Age

LANDMANN Oliver*

* University of Freiburg i.Br.

Early in the 21st Century, the world economy was shaken twice by massive macroeconomic crises, sparked by a global financial crisis and a pandemic, respectively. In both cases, policymakers, supported by a broad consensus on the necessity of a decisive government intervention, responded with strong monetary and fiscal stimulus in order to prevent an out-of-control implosion of the economy. This near-unanimous resolve to engage governments in the macroeconomic stabilization of their economies is remarkable and certainly not a matter of course. In fact, the theory and practice of stabilization policy has evolved with many twists and turns over the past century, oscillating between high hopes and deep skepticism regarding the capacity - and desirability - of macroeconomic stabilization policy.

Throughout the history of stabilization policy, attitudes towards the scope for an active role of government hinged on what Keynes had identified as the key difference between his opponents and himself in the midst of the Great Depression: the question of whether or not "the economic system has an inherent tendency toward self-adjustment if it is not interfered with." Then as now, different policy doctrines and regimes reflected, more than anything else, different judgments on this question. Experience, theory and ideology have shaped these judgments to varying degrees.

Over a time span of some 150 years, the history of the theory and practice of stabilization policy, from the Gold Standard to the present time, can be divided into seven distinct stages:

I. The Era of the Gold Standard (19th century – 1931)

Under the Gold Standard, monetary policy was completely subordinated to the task of maintaining the gold parity of the currency, which left no room for stabilizing the price level, the inflation rate or economic activity. The resulting tension between the primacy of the gold parity and the stability of the domestic economy did not go unnoticed, but it was not until the depths of the Great Depression that this conflict led to the definitive abandonment of the Gold Standard.

II. The Great Depression and the Keynesian Revolution (1930s)

For John Maynard Keynes, the experience of the Great Depression decisively refuted the notion of the self-adjusting market economy. His diagnosis was that the economy was trapped in a low-level equilibrium from which it could be extracted only by expansionary demand policy. This diagnosis ran counter to the gist of mainstream economic thinking which misled policymakers into pulling all the wrong levers, thus exacerbating the depression. In response, Keynes wrote the 'General Theory of Employment, Interest and Money' with the explicit intent of revolutionizing economic thought. He thereby established macroeconomics as a branch of economics in its own right.

III. The Neoclassical Synthesis and the Promise of Full Employment (post-WWII period)

The theoretical legacy of Keynes was recast by his disciples into a recipe book for a policy of full employment, with fiscal policy as the dominant instrument of demand management. The schism between Keynesian macroeconomics and the traditional microeconomic theory of prices and markets was bridged by Paul Samuelson's "Neoclassical Synthesis" which proclaimed that Keynesian policies were needed to maintain full employment, but that once full employment was ensured, prices and markets would allocate resources efficiently along the lines of classical microeconomics. A long period of rapid economic growth after World War II, uninterrupted by major setbacks, fostered a general sense of confidence in the ability of governments to fine-tune the economy and to maintain permanent full employment. The business cycle was widely believed to be tamed – a premature belief, as it soon turned out.

Ⅳ. The Monetarist Counter-Revolution and the Case for Rule-Based Policy (1960s and 1970s)

The most consistent and influential challenge against the Keynesian mainstream of the post-war period was the monetarist counter-revolution launched by Milton Friedman, mainly in the 1960s. He questioned the central tenets of the prevailing Keynesian consensus. In particular, he rejected the discretionary use of fiscal policy and proposed a constant-money-growth rule instead. He thereby also rejected the pursuit of a full employment objective. Rather, the growth rate of the money supply should be chosen so as to achieve price stability while output and employment could be counted on to converge to their natural equilibrium values. Friedman's theory of the natural unemployment rate implied, contrary to Keynesian thinking, a strong capacity of markets for self-adjustment. It led to a thorough reappraisal of stabilization policy. The collapse of the Bretton-Woods regime of fixed exchange rates in the early 1970s and the concomitant surge of inflation led to the adoption of the monetarist policy approach by central banks around the world.

Ⅴ. Rational Expectations and the Return of Classical Equilibrium Theory (1970s and 1980s)

An even more fundamental departure from the Keynesian consensus of the Neoclassical Synthesis was initiated by Robert Lucas, another graduate from Chicago, who started a highly influential research agenda devoted to anchoring macroeconomics in the framework of standard classical, or rather neoclassical, competitive general equilibrium theory. This agenda promised to reunite microeconomics and macroeconomics and held considerable empirical promise in view of the stagflationary turmoil of the early 1970s which appeared hard to square with the ruling Keynesian orthodoxy. Within this "New Classical framework," the "Real Business Cycle" model, first proposed by Finn Kydland and Edward Prescott in 1982, attracted particular attention. It implied that observed fluctuations of economic activity were unrelated to monetary factors and did not constitute departures from potential output, but should rather be regarded as movements of potential output itself, reflecting the best possible response of a competitive market system to unavoidable exogenous disturbances. In the world of this model, the market economy was assumed to be perfectly self-adjusting, thus leaving no scope for any useful stabilizing role of public policy. Empirically, the explanatory power of this theory has been found wanting, however. To central bankers, at least, the proposition that monetary policy had no predictable impact on output variations appeared suspect, to put it mildly. In a somewhat ironic coincidence, Real Business Cycle theory was riding highest in academia precisely when major advanced economies suffered from extended recessions in the wake of the tough anti-inflationary stance adopted by their central banks in the 1980s.

Ⅵ. The 'Great Moderation' and the New Neoclassical Synthesis (1990s – 2008)

The specific models proposed by the New Classicals and their nihilistic implications for stabilization policy may not have fared well in the face of mounting evidence. But their basic methodological innovations, such as rational expectations and dynamic stochastic general equilibrium (DSGE), proved to be a gold mine for the research community and had a lasting influence on macroeconomics. The combination of these new modeling tools with the Keynesian feature of incomplete price flexibility created a theoretical framework which was soon dubbed the "New Neoclassical Synthesis," The resulting models mostly accept Friedman's natural-rate hypothesis and thus do not display the pathological instability of early Keynesian models, but they provide a clear rationale for central banks to foster macroeconomic stability actively.

After the stagflationary turmoil of the 1970s

and the disruptions associated with the tough anti-inflationary stance taken by central banks in the early 1980s, the advanced economies enjoyed an extended period of macroeconomic stability, the so-called 'Great Moderation,' lasting from the late 1980s until the eve of the Global Financial Crisis of 2008. As this benign state of affairs persisted, both academics and practitioners of monetary policy grew increasingly confident that the painful lessons of the 1970s had been learned and that central banks had the means to maintain macroeconomic stability. As Robert Lucas famously put it in his Presidential Address to the American Economic Association: "[The] central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades." This level of confidence was reminiscent of that prevailing in the heydays of the old Neoclassical Synthesis 40 years earlier. It had been premature then, and it proved to be premature again.

Ⅶ. Two Severe Global Crises in the 21st Century: 2009 and 2020

The global financial crisis which ended the 'Great Moderation' came as a shock, but authorities were quick to react. Central banks slashed interest rates as the rulebooks said they should. But once they had hit the zero lower bound on policy rates, the state-of-the-art macroeconomic models were of limited use on what to do next. In particular when governments jumped in with fiscal stimulus, they had to rely on more dated theory as the more recent DSGE brand had been concerned almost exclusively with monetary policy. This led to a fair amount of soul-searching in macroeconomics which led different observers to different judgments on the ruling DSGE paradigm. In contrast to the 1930s or the 1970s, however, when an existing paradigm was struggling to deal with a major macroeconomic upheaval, no revolution was in the cards for macroeconomic theory this time.

When the Covid-19 Pandemic hit the world in 2020, this was a public health crisis first and foremost. However, there was also a macroeconomic policy dimension to it. Just as the virus was contagious among humans, the shutdown of contact-intensive economic sectors was bound to spill over to other, epidemiologically less hazardous sectors. Thus, income support to agents immediately affected by a shutdown was not just a matter of social equity or of protecting viable production capacity, but also served to prevent these spillovers from spreading the damage across the economy. Once again, there was a robust welfare case for macroeconomic stabilization.

Ⅷ. Conclusion

Stabilization policy has come of age on its long journey through time, marked by crises, periods of relative calm, paradigms, paradigm wars, and attempted syntheses between conflicting paradigms. An intense interaction between events, ideas and policies was the driving force of this journey. Over time, the answers to Keynes's initial question about the capacity of the market economy for "self-adjustment" kept changing. Under the impression of the Great Depression, early Keynesians predicted a secular tendency toward stagnation. When the quarter-century after World War II brought anything but stagnation, initial pessimism gave way to a general sense of confidence that the business cycle had been tamed. Although this confidence soon proved to be misplaced, it was brought back again by the extended 'Great Moderation' of the 1990s and the 2000s – only to be disappointed again when the global financial crisis struck in 2008. The common denominator to these two episodes was complacency. Be it complacency about the threat of inflation in the 1960s or complacency about the risks to financial stability in the 2000s: Time and again, stability bred complacency and complacency bred new instability. Notwithstanding all the progress in the technical analysis of stabilization policy, it is not yet well understood how to break this meta-cycle.