

IS THERE A RATIONALE FOR STABILIZATION POLICY?

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ABSTRACT

This paper argues that there is no consistent basis for hoping that stabilization policy can either prevent or cure unemployment. Unemployment is fundamentally explained by unavoidable uncertainty. It is the same uncertainty that makes it impossible for stabilization policy to effectively compensate for any incipient general disequilibrium.

The paper also explains why it is illogical to expect stabilization policy to introduce a higher degree of relative price flexibility in order to help cure unemployment. The explanation is found in an examination of price and wage formation in a future conscious, stabilization policy conscious world.

INTRODUCTION

The objectives of stabilization policy are usually defined as the satisfaction of internal and external stability. Internal stability is considered to be satisfied when "high" levels of employment of men and machines are combined with low rates of increase in prices. External stability is in turn satisfied by a "satisfactory" state of the balance of payments.

This conventional definition of the ends of stabilization policy is inclined to confuse ends and means. The present author believes that price stability is not to be preferred for its own sake but for the contribution it may make to economic growth. Exchange rate stability may be a necessary condition for general price stability.

In this discussion therefore the task of stabilization policy will be understood to be that of helping an economy realize its potential output. This view of stabilization policy is supported by D.E.W. Laidler's comment that "we want an economic system to solve for a set of quantities. Prices are of no intrinsic importance from this point of view."(1).

The task set for fiscal and monetary policy by the Keynesian analysis may be regarded as that of compensating for imbalances originating in the private sector of the economy. In practice the task of achieving full employment of resources together with other objectives of economic policy is recognised to be very complex. Nevertheless, despite the acknowledged difficulties of accurately forecasting economic activity and appropriately timing fiscal and monetary intervention, the theoretical justification for stabilization policy is widely accepted.

This article examines the fundamental basis for stabilization policy and finds two major grounds for scepticism about the rôle it has been accorded. In brief, the first argument is that if the failures of an economic system revealed in the form of general excess capacity and unemployment is caused by uncertainty and not necessarily by wage and price rigidities, then there can be no good reason for believing that the stabilization authorities are better able to compensate for such uncertainty than the producers and consumers of a market economy themselves. It will be argued that there may be no justification for believing that in principle stabilization policy can prevent unemployment.

The case for stabilization policy may alternatively be based on the argument that while the waste of unemployment is in principle unavoidable, prices and wages may be insufficiently flexible to make the necessary adjustments required of them. It will also be argued that if this view is valid then again there seems little prospect of stabilization policy being able to introduce the necessary flexibility. The problem here is that the impact of stabilization policy itself becomes anticipated and therefore part of the information upon which price and wage decisions are made. This paper will contend that there is no logically consistent basis for the view that stabilization policy can hope either to prevent or cure unemployment.

It is seldom made explicit in discussions of stabilization policy whether such policy is designed to prevent or to cure unemployment. The recognition that stabilization policy measures can at best influence the economy with a time lag would seem to imply that ideally, prevention is better than cure.

To pursue the issues raised above it has been thought necessary to consider briefly the nature of general equilibrium theory and the adaptations made of it for aggregate analysis.

GENERAL EQUILIBRIUM ANALYSIS

The general equilibrium analysis illuminates the interdependence of economic conduct through interdependent markets. As G.L.S. Shackle has put it, the general equilibrium solution represents the "... perfect and complete adjustment of everything in the economy to everything else, a general equilibrium attained after no matter how long a time..."²⁾ While the static general equilibrium analysis provides a revealing and important emphasis on the interdependence of economic conduct through interdependent markets, it cannot do justice to the time-consuming complexity of a real world, multi-market mechanism which Ludwig Lachmann has described as involving "a process of continuous change subject to both unexpected change as well as the inconsistency of human plans."³⁾ It is the inability to predict with certainty what will happen in the future that gives economic decisions their non-mechanical character. All production and consumption plans have to be realised over time on the basis of judgements about future market conditions. For the producing units of the economy, the firms, immediate decisions are taken in the attempt to maximise the

excess of sales revenue over associated costs of production. For the consuming units, the households, present decisions are taken to maximise present and future levels of consumption. Plans are thus made for future income and expenditure on the basis of an uncertain view of that future. Uncertainty and time are consequently of the essence of the economic process of production, consumption and the adjustment to inconsistent and incorrect planning. To quote Shackle again "... the problem of general unemployment has taught us that economic conduct is a response not only to scarcity but also to a circumstance at least as imperious namely uncertainty."⁴⁾

If all future prices and events were known with certainty there would be no need to postpone any dispositions of purchasing power or the sale of goods. Contracts would be established for all future deliveries and payments. Therefore, in such circumstances, there could be no possibility of general excess supplies or unemployment of factors of production. In an uncertain world contracts are made for forward delivery and payment but are a measure designed to reduce and spread uncertainty between buyers and sellers. In practice, future markets in commodities are confined to relatively short periods, to the near future, because of the hazards of taking a long view. Developed financial markets provide opportunities to borrow and lend for much longer periods. This is possibly because the demand for and supply of savings has been far more stable and hence interest rate fluctuations more limited than, for example, the demand for and supply of sugar or copper, the prices of which have been subject to much wider fluctuations.

In an uncertain, time-consuming world, money therefore is much more than merely one of the many goods in a multi-market economy. In a barter economy goods and services are traded for other goods and services. In a money economy, all goods and services are first exchanged for money. Money's function as medium of exchange and the nature of money itself result in the money market being uniquely well placed to receive the first impact of any change in general supply and demand conditions and, in particular, of any change in the mood and feelings about future economic developments.⁵⁾

It is this important distinction between money and other goods that is not relevant to the general equilibrium analysis. In that analysis goods are only exchanged at the eventually established equilibrium prices. The trading mechanism is presumed analogous to an auctioneering process and the process of gradually groping towards the set of equilibrium prices, Walras' tâtonnement, takes place during the auction attended by all buyers and sellers. There are no information costs and the trading process itself has no real impact of its own. The adjustment process is therefore analytically equivalent to an instantaneous and costless establishment of the correct set of equilibrium prices and output. In such circumstances the act of purchase and sale are contemporaneous and all goods are as liquid as money. The mechanism of exchange is in effect barter and there is no reason for holding money as a store of value or as an agent of production.

It is perhaps somewhat surprising that the standard framework used for the analysis of the effects of money on the general level of prices, output and interest rates is the aggregate general equilibrium model. Aggregated general equilibrium analysis of which Patinkin's⁶⁾ represents perhaps the most comprehensive and carefully worked out example has the limitations of the static analysis. It is not surprising therefore that Patinkin amongst others has been somewhat severely criticised for "disregarding the essential nature of money."⁷⁾

In brief the argument is that there can be no rational demand for money as a store of wealth in preference to other assets without uncertainty and there can be no general equilibrium with it. However, even in a relatively uncertain world a preferred aggregate demand for money would exist at every point in time. Such demands may be capricious and if so will have disturbing effects for the economy. Nevertheless this factor would not alter the voluntary nature of demands for money as for all other goods in uncertain circumstances. The future may be cloudy but some decisions about the disposition of resources, including money, to meet the future will have to be taken.

Considerable attention in the aggregate general equilibrium analysis has been directed at answering the question as to whether the static general equilibrium solution is a full employment one or not. Patinkin has established conclusively that, with price flexibility and real wealth effects the only logically consistent general equilibrium solution is a full employment one, provided that all the time necessary to effect complete adjustment is available. As Patinkin explains:

"... It follows that if the terms are understood in their usual, strict sense, the coexistence of involuntary unemployment and flexible money wages precludes the existence of equilibrium. For 'flexibility' means that the money wage rate tends to fall with excess supply, and 'equilibrium' means that nothing tends to change in the system..."⁸⁾

Patinkin however also recognised that involuntary unemployment is "a phenomenon of economic dynamics"⁹⁾ and argues that this has "freed ourselves from the necessity of static analysis to connect decreases in employment with increases in the real wage rate."¹⁰⁾

Theoretically, and this is a point that has been further elaborated by Clower¹¹⁾ and Leijonhufvud,¹²⁾ as long as the adjustment process to excess supply or demand is anything less than instantaneous the possibility exists of unemployment or over-employment or general excess demand or supply. The adjustment process, like the consumption and production process, inevitably takes time. During that period resources will not be fully utilized.

For Patinkin "the central question which divides classical and Keynesian economics is the efficacy of an automatically functioning market system with flexible money

wages in eliminating involuntary unemployment.¹³⁾ For him it is not a theoretical question of or whether this mechanism would tend to eliminate unemployment, a question involving the dynamic stability of the system, but rather an empirical issue of how long it would take to do so.

Patinkin therefore would seem to be concerned with the appropriateness of alternative cures for unemployment rather than the possibility of preventing it. The discussion will return to the question of stabilization policy as cure.

STABILIZATION POLICY AS PREVENTION

According to Leijonhufvud, Keynes saw the basic cause of general deflation in the inability of financial markets to communicate accurately the intentions of savers and investors.

"The circuits for the transmission of market signals presupposed by intertemporal general equilibrium theory are missing. They are missing for a good reason, moreover it does not pay to organise such markets because savers do not wish to place orders for the future deliveries of specific products..."¹⁴⁾

Here lies the rub of economic instability. The households do not wish to make up their minds about their future spending. They prefer to keep their options open in the uncertain world they know they live in. On the other hand, because the production process takes time firms are obliged to provide for the future. In doing so they may make mistakes but it is perhaps of more importance in explaining severe economic depressions that they may lack the confidence to commit themselves as hostages to an uncertain future. They may in general prefer to remain liquid.

The issue once more is what can be done about such a crisis of confidence? The Keynesian emphasis on interest rates and liquidity traps was surely misplaced. A depression is not perpetuated by the unwillingness of the households or more particularly the financial intermediaries to lend, but by the unwillingness of the potential investors to borrow. What can an interest rate policy do about such circumstances if the key to an investment decision is the investor's state of mind? In making up his mind the current and expected rates of interest are likely to brook small against all the other known and unknown factors that may influence the outcome of an investment. If stabilization policy is directed at the attainment of some "natural" rate of interest to balance the forces of supply and demand in financial markets then such policy would be in pursuit of a will-of-the-wisp. It would require variations in the target rate of interest that would attempt to compensate for each fluctuation in business sentiment.

Shackle describes Book IV of the General Theory with its thirty pages on expectations and eighty pages on the interest rate as "reversing even caricaturing" the relative impact of the two kinds of influence on investment decisions. Shackle finds Keynes's General Theory in two minds:

"... It turns instinctively towards stable functions, uninterrupted movements along curves, underemployment 'equilibrium', secular stagnation, step by step declension (for example of the level of interest rates). Yet the message spelled out by all this creaking semaphore is that intended (designed, ex-ante) investment is a law to itself, dependent (if at all) on too illusive and involved a skein of subtle influences, ... to be ever captured in any intelligible, let alone determinable equation."¹⁵⁾

It should perhaps be noted that in the modern mixed economy the unwillingness of the private sector to make up its mind and the inability to plan forward accurately may not be the only cause of instability. The same weakness may be characteristic of the government sector. Potentially of course a large government sector, less subject to risk aversion and loss avoidance, should be able to make independent long term plans and stick to them and therefore be a source of stability for the system as a whole. Unfortunately the reality is often very different not least because changes of government bring different conceptions as to the appropriate scope of government itself.

If prolonged general unemployment and excess capacity are not necessarily due to wage and price rigidities, but rather to the unpredictable states of mind of potential spenders, what can general stabilization policy hope to do about this.? It would seem to require that the authorities be able to read the minds of potential spenders. Is there, however, any reason for believing that they would be more capable of doing so than the entrepreneur? The success or failure of the firm in a market economy will depend ultimately on the capacity for knowing or guessing correctly what their own market or markets will be doing.

Shackle has reached a similar conclusion on this issue:

"... Keynes' search for an understanding of business led him to the conclusion that business is essentially, irreconcilably non rational, not through its defects of organisation or mistaken choice of ends or of methods, but in the nature of things at their most fundamental level, it is logically inconceivable for business to be rational. But if there is no consistently operating mechanism, how can any reliable levers exist for managing it..."¹⁶⁾

STABILIZATION POLICY AS CURE

A state of general excess supply or demand in the labour and commodity markets of the system must be attributed to mistakes made by decision-makers on a wide and important scale about the intentions of buyers and sellers. Curing a depression may be understood as "getting right" the relative values and volumes of prices, outputs, wages and employment. As has been suggested, if full market information were available about the intentions of buyers and sellers in all known future circumstances, as is implicitly assumed by the general equilibrium analysis, market

planners would be able to make fully informed, rational, decisions. With the availability of perfect knowledge the structure of relative prices would be consistent with the preferences of all parties for full employment and full capacity utilization. Since unemployment and excess capacity reveal by this definition an inappropriate structure of relative prices the question then remains as to what may be done about such regrettable circumstances.

Leijonhufvud suggests that Keynes rejected the notion that if an economy did not possess instant wage and price flexibility then the most desirable objective for economic policy would be help attain the highest possible degree of such flexibility by means of a balanced deflation. Leijonhufvud argues that:

"... It is well known that Keynes was adamant in attacking such a conclusion... The crux of Keynes' position is simply that balanced deflation will not do if relative values are wrong to begin with..."¹⁷⁾

It would seem to follow equally that if balanced deflation cannot re-establish the structure of real output and real prices consistent with the full employment of resources then balanced inflation cannot do so either.

The Keynesian remedy for unemployment may be regarded as the attempt to adapt aggregate demand to the planned level of aggregate output at the planned level of prices and wages. It may be called balanced inflation because no onus is put on prices and wages to adapt themselves in the downward direction to insufficient demand. Instead, the intention is to confirm planned wages and prices by the appropriate adaptation of aggregate demand through intervention by fiscal and monetary policy.

Yet, despite its inflationary bias, this policy has failed to guarantee full employment. Generally rising prices, which the static Keynesian analysis must assume to be the effect of excess demand, have come to be associated, seemingly paradoxically, with excess supplies and unemployment.

The paradox is resolved if price, output, wage and employment decisions are seen to be influenced by the all important factors of time, information costs and expectations. The discussion below will attempt to do this and after considering price and wage formation in an uncertain world will indicate the implications for stabilization policy when the impact of that policy comes to be anticipated.

THE ROLE OF TIME INFORMATION COSTS AND EXPECTATIONS

It has been emphasised that production and consumption plans are realised over time. In making investment plans for the long term and production and price plans for the shorter term, firms are obliged to predict their likely future sales revenues and costs and so select their estimated profit maximising output or price. If the

producer is a price taker, some view of likely prices will nevertheless be held and if the firm is a price fixer, again some view of likely demand at alternative prices will be taken. As long as the acts of production and sale are separated in time some decisions about future market conditions must be made. The same holds true of households. Saving and borrowing enable the household to separate the time patterns of income receipts and expenditure. Therefore the real consumption maximising household will also take a view about future income plans and consumption expenditure. Given their judgments about likely future market developments, firms and households will attempt to provide for the future at what seem the most favourable terms available at any point in time. They will contract forward in the widest sense of the term.

In all markets, expectations and therefore price, output, wage and employment plans will be revised in the light of newly released market information. There is, moreover, no necessary reason for this adjustment process to be very rapid. Expectations and new plans may only gradually be reconciled to realised magnitudes of quantities sold and employment offered and obtained. In addition, future plans will be based on what has happened in the recent past only to the extent that recent experiences influence what is expected to happen in the next period, for which prices or wages are being planned. Mistakes about future demand may in fact continue to be made though it may be presumed that something is learnt from mistakes, albeit slowly.

An inflationary ^{or} deflationary process is usually measured as a movement of prices over a period of time. It should be noted that the period over which price changes are measured is an arbitrary one. This period bears no necessary relationship to what may be called the trading period of price fixers. That is the period in which particular price and wage offers remain unaltered and during which information about current market developments is gathered.

The cost of gathering information, including the time involved, prevents prices from being continually revised. In the real world the planning or price fixing period of different firms and industries overlap and so imply a greater continuity of general price changes than is in fact true of many individual prices.

Furthermore market transactions and contracts are concluded at particular fixed prices at points in time. The general trend of prices is derived statistically from market developments over a period. Market traders are not fundamentally interested in the general trend of prices but in the future prices, wages and interest rates of the particular commodities, labour and financial securities they produce and utilise. This would be true even if the general trend of prices were expected to be constant. In a period of general price stability, an individual producer would still have to take some view of the future prices and costs that affect him in particular. In other words it is relative prices and expected relative prices that

are important in economic planning. Relative prices may of course change even if all prices are moving in the same direction. This factor makes any "cost of living" linked future contract a very arbitrary method of allowing for future developments in particular markets.

PRICE AND WAGE FORMATION IN AN UNCERTAIN WORLD

If prices are controlled by government authority on some pre-determined cost-plus basis and if demand for the commodity or service is price inelastic then no market forces inhibit the levels at which wages or other costs are settled. Prices are simply marked up accordingly. The timing of wage and price changes may be independent of general labour and commodity market conditions. Controlled price increases may well lag behind cost increases (i.e. prices and wages in general) and, if so, may well rise when general market conditions and expectations are not bouyant. Uncontrolled monopolies would not logically need to wait for costs to increase to discover that demand is inelastic and that prices may be raised.

In general, uncontrolled prices will not be determined on a cost-plus basis but on an expected profit maximising basis. Planned prices will only rise if future market conditions are expected to support such prices at profitable levels of output. Prices in perfectly competitive type markets will of course only rise with actual excess demand.

Those price fixing practices that may be responsible for short-term price rigidity cannot explain why prices do not fall over the longer term during which price offers may be revised. It may be assumed that firms generally would not voluntarily retain excess capacity over the longer term in the face of inadequate demand but would tend to reduce price offers to stimulate demand and attain a more profitable level of capacity utilization.

The same must hold true of the labour market and wage levels. High and rising wage levels can only be sustained if, despite higher wages, employment is maintained. In the short run wages may well be rigid in the downward direction and therefore be accompanied by unemployment but, in the longer term, such unemployment must, at least, other things being equal, restrain demands for further wage increases.

The expectation of price and wage increases and therefore planned increases in prices and wages are alone not sufficient to justify such increases. Whether planned general increases in prices and wages come to be supported by actual future market developments depends crucially on the realized state of demand. Price increases in themselves reduce excess demands and wage increases reduce demands for labour. Actual price and wage increases also directly affect the financial markets of the system. If prices and costs of production rise more funds are required to finance and support a given level of real output. This increased demand for funds

will tend to cause interest rates to rise and so have a further deflationary impact on the economy. There is, however, the possibility of increases in the velocity of circulation of money in response to actual and expected increases in interest rates. Another deflationary factor which may be of some significance is the real wealth effects of rising prices. Reductions in real wealth may call forth increases in real saving.

Demand and realized rates in the commodity markets and demand for labour and realized employment opportunities may in general prove less or more than anticipated at established prices. This could be true if the general trend of prices were downward in deflationary periods or upward in inflationary times. If so, the situation is clearly not one of equilibrium, where, at a certain combination of prices and wages at a point in time, no excess supply or demand would have appeared.

In a world of price and wage takers, prices or wages could only rise in general, in response to excess demand. In a world of price and wage makers, prices and wages are planned to anticipate demand. Therefore any resultant excess supply is not necessarily attributable to the fact that prices have risen over some period of time, but rather may indicate that prices have been increased by too much. In such circumstances the adjustment process to excess supply, other things equal, would require adjustments of interest rates, output, employment, prices and wages and possibly exchange rates. In an economy long accustomed to generally rising prices and wages dominated by price and wage fixers, the speed of adjustment to excess supply will also probably be made in the same order. Interest rates are likely to respond first and wages last. Prices and wages in general may continue to rise even after excess supplies make their appearance. It all depends, as has been suggested previously, not on what may have happened but on the future expectations of price and wage fixers about future demand. It may be presumed that, other things again equal, once excess supplies appear prices and wages would increase at a somewhat slower rate than would otherwise have been the case.

THE CONSEQUENCES OF AN ANTICIPATED STABILIZATION POLICY.

The authorities may wish to speed up the process of adjustment to excess supplies and the re-establishment of appropriate relative prices. Despite the fact that prices have already risen, further increases in aggregate demand could be engineered in the attempt to avoid disappointing the expectations of the price and wage fixers. The implication of such a policy is perpetual and presumably increasing rates of inflation without any necessarily favourable impact on employment.

Stabilization policy does not necessarily stimulate employment because the impact of such intervention will already have been anticipated. The expected impact of stabilization policy is implicit in the planned level of prices and wages, output and employment. Sooner or later the economic actors must come to recognise the influence of stabilization policy on the aggregate level of demand and act

accordingly. Indeed, perhaps the major task of professional economists employed by the business and financial sector is that of predicting the state of the economy. The likely influence of stabilization policy is of course always one of the key assumptions of any such forecasting exercise. It therefore follows that the extra spending stimulated by stabilization policy does not simply induce an increase in the real level of output or employment. The impact may be largely on higher prices or wages or imports.

It is of course now widely accepted that prices, wages, interest rates, output, employment and the demand for and supply of credit do not simply respond to actual market conditions but are established in anticipation of them. The impact of information costs and expectations and the manner in which expectations are formed are the important themes of the 'new' micro foundations of macroeconomics,¹⁸⁾ the theory of the natural level of unemployment¹⁹⁾ and the theory of rational expectations.²⁰⁾ The general influence of this work will be apparent in the interpretation of price and wage formation provided above.

CONCLUSION

Monetary or fiscal stimulation or deflation of an economy can only influence the general level of demand. Such policies cannot determine the real level of wages or prices. Nor can such policies eliminate uncertainty about the future. The market mechanism in a market type economy will establish real prices with and without intervention. It may be conveniently assumed that any monetary or fiscal intervention will affect the commodity and financial markets of the economic system before the labour markets. If so, prices and/or output would increase/decrease before money wages and so the fall/rise in real wages would tend to increase/decrease the demand for labour. However, the impact of expansionary or contractionary stabilization policy on real wages is likely to be at best very temporary. It is not realistic to expect one side of a market always to suffer from money illusion and increases in wages are unlikely to continue to lag behind increases in prices. Fiscal and monetary policy will be able to reduce or increase the natural level of real wages and so employment only if the impact of policy is incorrectly anticipated. There can further be no comfortable guarantee that expectations of aggregate demand will be under-rather than over-estimates.

General unemployment and excess capacity are clearly possible given the nature of the market economy. Economic history of course provides ample confirmation of such potential instability. Economic history does not, however, give any reason to believe that a market economy has any inevitable bias towards deflation and that a continuous policy of balanced inflation is necessary to offset this tendency.

It is not at all clear either in principle or in practice whether a stabilization authority is able to effectively compensate for the inherent instability of a market system. Pump-priming an economy out of a major depression is an obvious remedy, but the task set stabilization policy is much more ambitiously to prevent rather than

merely cure major depressions. (Indeed the confident anticipation of such pump-priming would itself prevent major depressions). The policy of what has been called balanced inflation widely applied in the post-war period to this end must be counted a failure. Not only has inflation reached something of epidemic proportions but it has also failed to guarantee full employment. Since inflation once anticipated does not stimulate, but adds to the costs of a market economy, the major problem for stabilization policy to-day is how to stop the inflationary process without severely dislocating the system. To-day, more than ever before, the major objective of policy must surely be the attainment of the highest possible degree of wage and price flexibility.

The case against discretionary stabilization policy becomes, of course, the case for a monetary rule. A monetary rule still represents an interference with the market mechanism. For without the rule there would be no reason to expect the money supply to grow at that recommended rate. Automatic rules therefore also imply intervention with the market but are made on very different assumptions about the predictability of economic behaviour. The case for a monetary rule is made on grounds that if the growth of the money supply can be made subject to a monetary rule then one potential source of instability for the system, the unpredictable behaviour of the monetary aggregates, and monetary policy, will have been removed.