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Have Fiscal and/or Monetary Policies Failed?

By ARTHUR M. OKUN*

The provocative, loaded question addressed to this panel asks for an evaluation of the capabilities of fiscal and monetary tools and the performance of the policymakers. Any evaluation of anything is, of course, a relative matter. Successes or failures emerge only by comparison to some set of standards or by virtue of some competition.

In the case at hand, many possible standards of comparison emerge; and they point toward different verdicts:

1. Measured against the standards that prevailed at the time of passage of the Employment Act in 1946, fiscal-monetary policy has been a resounding success throughout the postwar period.
2. Judged by its contribution to generating social welfare or to solving the big social problems, fiscal-monetary policy can be regarded as trivial and perhaps somewhat obsolete.
3. By the standard of the hopes and aspirations that prevailed in the mid-sixties, the performance of recent fiscal and monetary policies must be deemed a great disappointment.
4. Measured against what can and should be accomplished in the future, the past record of fiscal-monetary policy is a promising start.

The Perspective of a Generation

It is against the perspective of the attitudes and expectations of a generation ago that fiscal-monetary policy looks best. At that time, even ardent Keynesians accepted the business cycle as a fact of economic life. They hoped that countercyclical stabilization policy would reduce the sharpness of business cycle peaks and fill in the abysses, but even their promised land was marked by a terrain of hills and valleys. Paul Douglas spelled out his prescription: urging stimulative fiscal policy whenever the unemployment rate exceeded 8 percent, but warning against the use of deficit financing in order to drive unemployment down below 6 percent. In retrospect, the emphasis in the early postwar years was on the avoidance of catastrophe—like the Great Depression—rather than the attainment of perfection.

By that yardstick, the profession and the policymakers have clearly delivered more than was expected. The median annual unemployment rate for the last twenty-five years has been 4.5 percent. The worst yearly unemployment record of the postwar era was $6\frac{3}{4}$ percent in both 1958 and 1961; 1949 and 1971 follow with about 6 percent. Annual real *GNP* has declined only three times—1954, 1958, and 1970. Recessions have been milder, shorter, and less frequent than in the prewar annals. And their inevitability has been subjected to question with the record of 105 months of economic expansion during the sixties—a phenomenon that would have qualified as a 400 to 1 longshot on the basis of the business cycle chonology prior to 1960. In a generation, we have moved, conservatively estimated, half the distance from our previous performance to perfection.

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The Contribution to Social Welfare

The easiest way to deprecate the accomplishments of stabilization policy in the postwar era is to judge its contribution in terms of the ultimate goals and the big problems of our society. That kind of appraisal, of course, ignores the purposes and the limited scope of these policies; it would condemn polio vaccine as a failure because it hasn't cured cancer. Fiscal and monetary policies can contribute to social welfare only by regulating the level and growth of aggregate demand. In the 1930's, the inadequacy of aggregate demand was the cancer of our society, destroying social tissue at a rate previously experienced only during the Civil War. Since a depressed economy created such an unhappy society, prosperity was, naively though understandably, expected to produce a happy society. Precisely because prosperity has typically prevailed during the postwar era, it has been demonstrated that the nation does not live by economic growth alone. The achievement of "maximum employment" does not necessarily provide jobs that are rewarding in ways that go beyond the pay check. The achievement of "maximum purchasing power" cannot guarantee that consumers get satisfaction from the goods available in the private market place or that they get a sufficient quantity and quality of public services that are not offered in the market. And no amount of prosperity closes the enormous gap between our lofty principles of equality of opportunity and our lowly performance in tolerating huge inequities that persist over generations.

Although prosperity is a small component of any broad social appraisal, it is an essential vitamin for the body politic, and is sorely missed in its absence. The deficiency of prosperity of the past two years shows up everywhere: productivity is depressed; the number of people in poverty has risen for the first time in a decade; advances of the disadvantaged up the job ladder have been set into slow motion; state and local budgets are squeezed; the contrast of urgent needs with idle resources taints the whole picture of the efficiency of our institutions. The scarcity of jobs produces a search for scapegoats: some blame those cheap foreign goods, while observers on the left and the right, in a curious agreement, identify military cutbacks as the key source of joblessness. Despite these misconceptions, there is enough recognition of the truth to make prosperity the number one political issue when we don't have it.

There is another important limitation to the significance of fiscal-monetary policy, reflecting the fact that effective regulation of aggregate demand cannot eliminate the problem of the unemployment-inflation tradeoff. At best, fiscal-monetary policy can pick the desired point on the tradeoff.

The nature of the tradeoff is a matter of extreme social concern today. In my judgment, there is much greater hope and greater need for a breakthrough in professional understanding of the nature of the tradeoff and of policy measures to improve it than in our knowledge of fiscal-monetary tools. Macroeconomists are responding and will increasingly respond to that challenge by investigating the nature of the inflationary biases in our society, the characteristics of the process of wage and price determination, the key elements of job turnover and job search, and the way these are and could be influenced by a variety of techniques of public policy, ranging from manpower programs to incomes policies. This effort is bound to push research on fiscal and monetary policies off the center of the professional stage. But that trend is emerging, not because demand-management has failed, but because it has had a measure of success. When the economy fluctuated violently, it did not stay close to full employment long enough

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to pose serious worries about the conflict of price stability and high employment. The tradeoff problem is a noxious weed in the garden of a prosperous economy. But the weeds bother us only because we can grow flowers in the garden.

The Perspective of the Recent Record

A third relevant standard for the appraisal of fiscal-monetary policy is the disappointing record of the last half dozen years. Indeed, the loaded question we are being asked today undoubtedly reflects that record.

Herbert Stein has dated the high point of prestige of macroeconomic policymaking to the moment early in 1966 when *Time Magazine* put John Maynard Keynes on its cover. The prescription Walter Heller and his "new economist" colleagues had written for the economy had finally been administered and the patient had recovered brilliantly. The enthusiasm of the press was unrestrained; with friends like that, the "new economists" needed no enemies. And they knew it. At these professional meetings just six years ago, Gardner Ackley presented a model of temperance in a moment of triumph. He warned that the success scored in achieving high level employment could not be extrapolated into the future:

> We would all like the economy to tread the narrow path of a balanced, parallel growth of demand and capacity —at as high a level of capacity utilization as is consistent with reasonable price stability. . . . But the macroeconomics of a high employment economy is insufficiently known to allow us to map that path with a high degree of reliability. . . . It is easy to prescribe expansionary policies in a period of slack. Managing high level prosperity is a vastly more difficult business and requires vastly superior knowledge. [pp. 174 and 176]

But the record of the past half dozen years has been disappointing even to a temperate man. Only someone cursed with neurotic pessimism—or blessed with omniscience—could have believed at that time that the next six years would witness an average growth of real output of barely 3 percent and an average inflation rate over 4 percent. We can profit from the lessons of that period if we read them properly. Viewed in light of some unique events like the Vietnam war and some typical phenomena like the imperfect capability of economic forecasting and the persistent gap between economic analysis and political feasibility, the record of 1966–71 provides no basis for revising significantly downward—or upward—the estimates of the capability of stabilization policies that a temperate man should have held a half dozen years ago.

The Role of Vietnam

The Vietnam buildup was a unique destabilizing force that fortunately should not be and need not be extrapolated into any peacetime experience. Of course, the stimulus of an anticipated upsurge in military outlays can be neutralized *in principle* by any of various stabilizing devices: an increase in taxes, reduction in civilian public expenditures, or a tightening of monetary policy. And this principle applies equally to crusading wars and senseless ones; to victorious wars, stalemates, and defeats. In practice, however, the unpredictability of military outlays adds to economic instability in every period of hostilities.

In the particular event of Vietnam, the national unwillingness to face up to the issue of guns versus butter—to recognize the resource costs of the war—vastly complicated the problem of stabilization. In the Korean war, when our military posture won the support of a reasonably broad social consensus, the political feasibility of restrictive tax and monetary policy was far greater. Because it did not command that

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kind of broad public support, Vietnam created a major problem of economic instability, as well as many other—and, in perspective, far more important—social and political problems.

No one can produce a valid hypothetical history of the last six years on the assumption that the Vietnam war had never happened. But history provides some clues, both favorable and unfavorable, on the performance of economists in diagnosing and prescribing. The unfavorable clues confirm Ackley's concern that economists don't yet know enough to offer policy makers very good prescriptions for managing high-level prosperity. Indeed, events that had taken place prior to his talk make that clear in retrospect. The amount of fiscal-monetary stimulus supplied to the economy had probably gone a little too far by the middle of 1965. However, fiscal policy was scheduled to move toward restraint after the third quarter of 1965 and would have worked to slow down the pace of aggregate demand if the war had not intervened. Some gradual turn toward restraint in monetary policy would also have been required. These turns would not have been made on an ideal schedule and the economy would have strayed into inflationary territory. But it strayed as far as it did only because fiscal policy became paralyzed by the uncertainties and the politics of war.

The Side Effects of Tight Money

When the fiscal paralysis became evident, monetary policy was used in 1966 to apply a massive dose of restraint that offset the huge fiscal stimulus. Judged by its success in halting the boom and curbing inflation, the Federal Reserve strategy must be scored a remarkable success. The cost of living, which had been rising at a 4 percent rate during much of 1966, slowed down to an annual rate of $2\frac{1}{2}$ percent in the first half of 1967. And unemployment never rose significantly above 4 percent; the pause of 1967 was as different from the five postwar recessions—including 1969–70—as a cold is different from pneumonia. That experience demonstrated that aggregate demand can be restrained (or stimulated) as much as required by the use of monetary policy (or fiscal policy) alone. But it also demonstrated the multiplicity of objectives of macroeconomic performance, which can be pursued jointly only through a carefully coordinated use of fiscal and monetary tools. For the same good reasons that the public dislikes losses in income and instability in the prices of goods and services, it also dislikes losses in wealth and instability in the price of credit. The adverse side effects of tight money in 1966 were enormous—a huge jump in interest rates, distortions of asset values, consternation in financial markets, and a depression in homebuilding.

In light of that experience, the Federal Reserve made a conscious and deliberate decision early in 1967 *not* to make a further effort to offset fiscal stimulus with monetary restraint. At that time, both the Fed and the Administration saw a new boom coming, as is evident from their remarkably accurate forecast of the year. They also knew that monetary policy could be used to stop that boom, just as it had been in 1966, but they decided—rightly or wrongly—that the disease of inflation was a lesser evil than the cure offered by tight money. The consequent decision to provide a reemerging boom with the liquidity it demanded may or may not have been a wrong decision, but it was not based on a wrong forecast or a wrong assessment of the potency of monetary policy.

The 1968–69 Disappointment

When the Revenue and Expenditure Control Act of 1968 was finally enacted at midyear, fiscal policy came back into line with the recommendations of government

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economic officials for the first time in nearly three years. It was a particularly distressing experience that, when we were able to call the policy tune once again, the economy did not dance to it. The economic forecast used within the government at that time was the most inaccurate short-term prediction for which I have ever shared responsibility. Because I and my colleagues did not recognize how feverish the economy was, we wrote some inappropriate prescriptions, particularly for an unduly easy monetary policy in the second half of 1968. I cannot explain why my forecast was particularly unsuccessful at that time any better than I can explain why it was unusually accurate at the start of 1967 and 1971.

"You can't win them all" is not a satisfactory explanation of anything, but it is a more accurate and less harmful lesson of the 1968 experience than others that have been advanced. One particularly wrong and harmful alleged lesson is the claim that temporary changes in personal income taxes don't work. (See Robert Eisner.) Several cross-section studies of consumer behavior, conducted and published prior to the surcharge experience, provide compelling empirical evidence that households do not treat small windfalls (positive or negative) differently from permanent income in their consumption-saving decisions.[1] Nor does the time-series evidence following the imposition of the surcharge suggest that consumer outlays on services and nondurable goods were higher than would have been predicted by econometric consumption models that treated the drain of income resulting from the tax surcharge as equivalent to any other loss of disposable income.[2] Although the permanent income hypothesis illuminates many aspects of consumer behavior, it sheds no light on the strength of the economy from mid-1968 to mid-1969. The myth about the ineffectiveness of small temporary changes in income taxes threatens to rob fiscal policy of its most legislatively feasible and socially acceptable tool for combatting economic fluctuations. The U.S. Senate came within one vote this autumn of adopting a $50 credit per family on personal income taxes as a temporary measure for 1972; "expert opinion" may have helped to swing this regrettable adverse verdict.

The surprises of late 1968 and early 1969 occurred in the strength of demands for automobiles, for business plant and equipment, and for new homes. As information from that episode is incorporated into statistical studies of the determinants of investment, it strengthens the estimated link between investment outlays and various financial factors. In that sense, it marks up the estimated potency of monetary policy to influence aggregate demand. But it reaffirms the conclusion that money is only one of the major determinants of aggregate demand and that a monetary growth rate of 7 percent or higher would be constructive under some economic conditions.

In general, the 1968–69 experience reminds us that forecasts that turn out to be wrong lead to errors in policy. But it also demonstrates that, when policies are flexible, errors are not irretrievable. Monetary policy deviated from an appropriate track for six or perhaps eight months; more adversity has been blamed by some observers on that deviation than on any other event in human history since Eve's encounter with the serpent.

The 1969–71 Game Plan

Perhaps the most serious consequence of the 1968–69 disappointment is that it

[1] See references on pp. 177–8 of my article in *Brookings Papers on Economic Activity*. In particular, Michael Landsberger's contribution deserves attention.

[2] *Ibid*. See also Eisner's criticisms, pp. 207 ff.

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made many macroeconomists lose their nerve. They became receptive to formulas for economic instruments and formulations of economic theory that claimed to offer salvation from the perils of assessing and forecasting the economic outlook and appraising the impact of policy actions.

Concluding that the fiscal and monetary policy errors of 1965–68 had reflected excessive tampering and excessive dependence on economic forecasting, the Nixon Administration committed itself to a "game-plan" economic policy featuring a steady course: a maintained posture of the full-employment budget, stable growth of the money supply, and consistent nonintervention in the wage-price process. The strategy was followed with remarkable consistency: the full-employment surplus was barely nudged downward despite the recession and inadequate subsequent recovery; although it fluctuated over short periods of time, the money supply was kept at a growth rate that averaged close to the game-plan rate of 6 percent for any substantial period; price-wage jawboning was not practiced.

With the nation's unemployment rate still at 6 percent and the deceleration of inflation visible only in a microscope, the President of the United States pronounced the practical verdict on this test of "steady-course" economic policy on August 15. It is no coincidence that the administration most committed to a steady course made the biggest reversal in the course of economic policy in forty years. Because it had made such a virtue of unvarying instrument settings and had therefore waited so long before making any adjustments, the administration felt obliged to make a 180-degree turn when it did decide to change course. The enormous shift from the old game plan to the "new economic policy" should be particularly instructive to those economists who are most concerned about disruptive changes in economic policy. It is far more disruptive than the small, flexible, and frequent adjustments made under a discretionary policy that keeps trying to stay close to a track of sustainable balanced economic growth. This lesson is like the one economists have been trying to teach international bankers: small continuous fluctuations in exchange rates are less disruptive than the major, though infrequent, crises and revaluations that marked the traditional fixed-rate system. Like the fixed-rate system for currencies, steady-course economics obtains stability in the small by courting instability in the large.

In light of recent experience, the profession can no longer shirk its responsibility to make the best possible diagnoses and the best possible forecasts, in full recognition that they can be wrong, and to recommend economic policy measures that seem likely to promote the nation's economic goals, recognizing that they may impede them. Fortunately, the record of 1971 may help economists to screw up their courage and restore their nerve. This has been a good year for most macroeconomists, although not for the economy. Private economists who forecast *GNP* on an eclectic Keynesian basis were generally accurate a year ago in predicting that real economic growth in 1971 would be only 3 percent. They saw correctly that the economy was stuck in the mud and unlikely to get rolling without a fiscal-monetary push. And they correctly judged at midyear that the rapid growth of money during the first half of 1971 was not the harbinger of an imminent boom. To be sure, the future will bring disappointments like 1968, as well as successes like 1967 and 1971. Still we are likely to be right more than half the time in recommending prompt and flexible adjustments of fiscal-monetary policy. And we can fairly conclude that the only realistic alternative to such a strategy of sensible-steering economics is an oscilla-

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tion between game-plan economics and crisis economics.

More effective regulation of aggregate demand remains one of the important tasks of the profession and the policy-makers; that task can be pursued through better analysis, more timely diagnosis, more appropriate prescription, and more effective conversion of prescription into public policy. The mistakes of the last six years can serve us well to improve the record over the next generation. In 1996, the fiftieth anniversary of the Employment Act, perhaps the American Economic Association can schedule a session entitled "Have Fiscal and Monetary Policies Triumphed?"

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