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Economic Policy

A New Concept of Stabilization Policy

by Professor Manfred Willms, Kiel *

Inflation is the most important economic problem in Germany today. Although the economy is still in a process of slow recovery and there are still excess capacities, inflation continues. Consumer prices increase at an annual rate close to 6 p.c. and the GNP deflator is close to 8 p.c. Economists and politicians are looking for a new concept of stabilization policy.

Unsatisfactory results of stabilization policy practiced hitherto will especially be attributed to the use of inadequate indicators, to the insignificant consideration of monetary effects of fiscal policy, and to the insufficient control of the money supply in an open economy. The paper will show that a more efficient monetary and fiscal policy may essentially be realized by reorganizing the utilization of stabilization policy instruments. For this purpose fundamental legal changes will not be required.

Monetary Policy

At the center of business cycle policy lies monetary policy. It is of dominant importance for stabilizing business cycle fluctuations and for avoiding inflationary developments. The main task of monetary policy is to take care that there are no disturbances of economic processes originating from monetary influences.

Above all, monetary policy must be applied to the control of the level of aggregate demand. It can decisively contribute to the adjustment of changes of demand to the given real potential of aggregate supply. Only if monetary policy is consistently used for financing expansionary proc-

esses possible in real terms, a relatively stable development of the price level is guaranteed. Moreover, monetary policy can contribute to the support of price and wage flexibility obviously considerably reduced by organized group interests. Therefore monetary policy should not tolerate that changes of relative prices emerging in a growing economy due to technical innovations and varying consumer preferences lead to a permanent rise of the price level. Price increases in different industries characterized by increases of productivity below average should compensate price decreases in sectors with productivity developments above average. Monetary policy must prevent permanent increases of all prices, even if adjustment processes in the economy become more difficult due to distribution objectives and money illusion of economic decision-units.

Reduction of Cyclical Fluctuations

A monetary policy based on recent research can reduce cyclical fluctuations and can stabilize the rate of inflation at a lower level than is given today. Anti-inflationary monetary policy does not lead to an enlargement of unemployment. Inflation is not the price for full employment. However, in the short run the alignment of a high to a lower level of inflation will go along with an increasing rate of unemployment. The reason is that, assuming a reduction in the price rise, real

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wages are augmented to an extent incompatible with full employment. Nevertheless, the employment situation will promptly improve, as soon as trade unions and enterprises take account of the reduced rate of inflation in their decisions. A monetary policy geared to economic stability simultaneously prevents negative effects of inflation which are essentially represented by a redistribution of wealth in favor of high income people, an advancement of land speculation, a misallocation of scarce resources into realms of little social need, and a reduction in the volume of real public investment.

Having now indicated what monetary policy can achieve it shall subsequently be pointed out what it cannot achieve. Monetary policy cannot solve structural problems. This is valid for both the elimination of sectoral deficiencies and the improvement of regional imbalances. A regionally differentiated monetary policy leads to a growing deviation of regional rates of inflation than already given now. It hinders the allocation function of the price mechanism and handicaps long-term economic development of depressed regions because of inflationary pressure increasing fast in these areas.

Furthermore monetary policy is not in a position to guarantee a low level of interest in the long run. Expansionary monetary policy can only reduce the interest level within a short period of time. The national income expanded by expansionary monetary policy results again in an increase of the interest level. If a reduction in the value of money occurs, the interest level will additionally be raised according to the expected rate of inflation.

Monetary policy is also not in a position to stimulate economic growth in the long run. Looking at a long period of time, growth is determined by the proportion of population participating in the labor force relative to total population, level of education enjoyed by the work force, the given capital stock, as well as by labor productivity and technical progress. In the long run monetary policy being too expansionary in relation to average growth of real income only leads to inflation.

Reasons for Past Low Efficiency

Why could monetary policy practiced in Germany until now not stabilize business cycle fluctuations to a larger extent and why was the fight against inflation not more successful? One reason for the low efficiency of monetary policy is the application of inadequate monetary indicators by the German Bundesbank. Monetary indicators are variables which allow to classify the policy deci-

sions of the central bank as expansionary, restrictive, or neutral. In Germany the liquidity status of commercial banks plays a central role for monetary policy decisions. A reduction of bank liquidity is interpreted as restrictive monetary policy by the central bank, an increase of bank liquidity as an expansionary policy.

Typically, bank liquidity is reduced in a phase of economic expansion, since banks attempt to satisfy an increasing demand for credits. The central bank takes this reduction in bank liquidity as an effect of its restrictive monetary policy and abstains from further measures. However, the volume of money and credit is increasing at high growth rates and stimulating inflationary tendencies in the final phase of the boom.

Using bank liquidity as an indicator of monetary policy the central bank reacts too late in every phase of the business cycle. Thereby it reinforces the cyclical movements, instead of reducing them. The orientation of policy decisions to bank liquidity came out especially seriously in the year 1965/66. Since the end of 1965 bank liquidity permanently increased, while growth rates of money and national income substantially decreased. Instead of expanding the volume of money already at the end of 1965, the central bank only switched to an expansionary monetary policy a year later, that is at the end of 1966. The consequence of this postponement was the most severe recession in the economic history of Germany.

International Monetary Disturbances

The use of an indicator which does not give reliable information of the effects of monetary policy has certainly contributed to the amplification of cyclical fluctuations of economic activities. However, the use of such an indicator cannot explain why the rate of inflation in Germany has arrived with each business cycle at successively higher levels since 1951. An explanation for the reinforced inflationary tendency can only be found with respect to the permanently deteriorating control of international monetary influences on Germany. Due to the growth of productivity high by international standards and due to the comparatively low rates of inflation, Germany was relatively often pushed into a position of undervaluation for the German Mark. Repeated and finally senseless attempts of the Federal Government to prevent revaluations of the Mark forced the Bundesbank to buy billions of US dollars. Each dollar accepted not only increases the foreign reserves but also expands, in the magnitude of the counterpart value of foreign reserves, the volume of domestic high powered money. Assum-

ing a considerable influx of foreign currency, its impact on the money supply cannot be neutralized by the central bank, even if domestic components of high powered money are reduced or if legal reserve policy is employed. The new economic equilibrium will then emerge via an adjustment of the rate of domestic inflation to the level of foreign inflation.

These remarks will have indicated that every monetary policy oriented to economic stabilization is doomed to fail as long as international monetary disturbances affecting the domestic money supply are not eliminated. In a system of fixed exchange rates, which permanently prevents the adjustment of exchange rates to market equilibrium rates in due time, the target of monetary stability becomes a farce for a country such as Germany so heavily dependent on international trade, as long as other industrial nations do not attach too great importance to the objective of stabilizing their price levels. Germany can only protect itself against imported inflation through repeated revaluations. If politicians are not willing to adjust correspondingly the exchange rates, any anti-inflation policy does not make sense. For Germany there is only the alternative: realistic exchange rates and stable price level or undervalued exchanges rates of the German Mark and inflation.

Necessary Measures

What should monetary policy oriented to economic stability look like? The most important prerequisite for a successful anti-inflationary monetary policy in Germany is the control of domestic monetary disturbances originating from international finance and trade relationships. Another precondition is the abandonment of the liquidity concept, the use of money as an indicator and of high-powered money as a target variable of monetary policy. It cannot be the aim of the central bank to guarantee the liquidity of commercial banks; rather it should strive to provide the economy with money to such an extent that economic transactions may take place under the condition of a relatively stable price level.

The use of high-powered money as a target variable of the central bank only requires some changes in practicing monetary policy. In order to control more efficiently the money stock, rediscount policy must be reformulated in such a way that commercial banks cannot refinance themselves nearly unlimitedly at the central bank on occasion of an expanding demand for credit. The claim of commercial banks to refinance should be curtailed in the interest of monetary stability. Moreover, open market policy must be

reorganized. The existing impact of open market transaction on the money volume via the interest rate must make way to influencing the money supply by a direct quantitative policy. An open market policy using the quantity of government securities as policy parameter has the advantage that the central bank can immediately determine the quantitative effects of its policy, while, in the case of fixing the interest rate, the quantitative outcome of its policy operations depends on the decisions of the commercial banks. Since the money issue on the basis of government securities will play a greater role than given today in the case of a better protection against monetary disturbances originating from abroad, the proposed reformulation of open market policy will definitely be necessary. However, an extension of central bank policy to para-monetary institutions such as insurance companies or investment funds is not required.

Fiscal Policy

The tasks of fiscal policy are the reallocation of resources from the private to the public sector, the establishment of a better distribution of income and wealth, and the stabilization of business cycles. A fiscal policy geared to economic stability must guarantee that substantial fluctuations in the utilization of aggregate production potential are prevented. Within the framework of its possibilities, it must contribute to insuring full employment and to stabilizing the price level.

A fiscal policy practiced with respect to stabilizing business cycle fluctuations can stimulate aggregate demand in the case of unemployment and reduce the expansion of aggregate demand in inflationary periods. Since the inauguration of the Stability and Growth Law, fiscal policy in Germany has available a number of instruments to influence not only total demand, but also individual components of aggregate demand. In a phase of recession the existing demand gap can be closed by increasing government expenditures. If public demand should be substituted by private demand, the Stability and Growth Law provides the opportunities of influencing both investment and consumption. Private investment can be stimulated by a premium on investment and private consumption by a linear reduction of income taxes. Each of the mentioned components of demand may be varied individually or in any desired combination.

For the quantitative effect on national income it is not insignificant whether government expenditures are increased or taxes are reduced. Generally, a change of government expenditures generates a stronger impulse than a correspond-

ing change of tax revenues. The reason is that a certain part of additional income attributable to reduced taxes will be saved.

Quantitative Impact on National Income

The quantitative impact of an increase in government expenditures decisively depends on the type of financing. Additional expenditures may principally be covered by an increase of taxes, borrowing money from the economy's private sector or from the central bank. The effect on national income is small if the augmentation of government expenditures is financed by taxes. The same is valid for additional expenditures which are financed by capital market credits, if the volume of money remains constant. In this case only the level of interest is raised and public demand for credit displaces private demand for credit. Private investment is cut. The final outcome is that private demand is only substituted by government demand, without total demand being increased. Larger government expenditures will have a significant impact on national income only if financial means necessary are covered by

newly created central bank money. Then the stimulative effect of incremental government demand merges with the stimulative monetary effects. There is no neutralization through increasing taxes or narrowing the credit volume available for private investments.

This relationship illustrates the close interconnectivity of fiscal policy and monetary policy. It simultaneously demonstrates the limits of fiscal policy impacts. Government expenditure and tax policies are ineffective without a supporting quantitatively oriented monetary policy. For the United States empirical investigations of the Federal Reserve Bank of St. Louis show that economic growth followed the development of the monetary policy variable when fiscal policy (measured in terms of changing federal budget expenditures) and monetary policy (measured in terms of the money stock) moved in different directions. There is no reason for assuming that the German situation diverges from this pattern. Regarding fiscal policy, experiences in stabilization policy were encouraging in Germany, when fiscal policy actions went along with changes in the volume of

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money developing into the same direction, as given in the year 1967/68. Experiences were less satisfactory when fiscal policy has been used for restrictive purposes, as in the year 1970/71, and the substantial expansion of the money volume has simultaneously been continued.

Against this economic background we can neither theoretically justify nor empirically falsify the statement on stabilization policy which plays a great role in the present discussion on means of reducing inflation. This statement refers to the assertion that too considerable an expansion of government expenditures is responsible for high rates of inflation and that only an augmentation of government expenditures according to the growth rate of real national product is neutral with respect to inflation. Without restrictions, a progressive increase of government expenditures is compatible with a stable development of the price level. However, a precondition is that other components of total demand will correspondingly be reduced. Under the assumption of a balanced government budget this will automatically occur through a tax cut of private demand. Increasing government expenditures which surpass tax revenues do not aggravate inflationary tendencies as long as necessary credits can be procured from capital markets and monetary policy guarantees that the volume of money is consequently not expanded.

Deficiencies of Practical Fiscal Policy

How is practical fiscal policy organized in Germany? What are its fundamental deficiencies? Looking at the implementation of fiscal policy in Germany, an essential imperfection results from the insufficient observation of policy impacts on the volume of money. Another failure evolves from the attempt to neutralize changes in export demand by variations of government demand. An export demand progressively expanding due to the undervalued exchange rate of the German Mark can be compensated by a reduction of government demand only in the short run. Government expenditures cannot arbitrarily be restricted in order to give room for an unlimited export demand. The same is true for an adjustment of public demand to the development of demand of the domestic private sector. Without doubt, government demand may be expanded in a recession; however, it cannot indefinitely be reduced in favor of private demand during a boom period. For a balanced economic development government demand is too important to be solely employed as a dummy instrument occasionally filling demand gaps. Infrastructural investments of the Federal Government, the states, and local com-

munities must have priority ahead of private domestic and foreign demand, especially demand for consumption goods.

The adjustment of government expenditures to a given employment situation unevenly affects the various elements of this type of expenditures. A large part of government expenditures is given in a fixed form and cannot be varied in the short run. This particularly refers to labor costs and interest payments represented in the budgets of government entities. With reference to dampening business cycle fluctuations, the adjustment of government expenditures is therefore restricted to the manipulation of investment expenditures which are mainly construction expenditures. Firms and work-forces of the construction industry, especially those employed in sub-level construction, thus become scapegoats for a misguided business cycle policy. Consequently, an important sector of our economy, which, under long-term aspects, must be counted among the growth industries, is permanently forced into an expensive underutilization of its capacities in boom periods.

Fundamental Reorientation Necessary

As fiscal policy is practiced today, the volume of government demand is dominated by the development of private domestic and foreign demand. In view of the importance of public investments such a situation is highly unsatisfactory. It requires a fundamental reorientation of fiscal policy. This policy should be reformulated in such a way that it can effectively contribute to stabilizing economic growth. With least effort this aim may be realized by stabilizing government demand. Public expenditures should continuously expand independent of the given employment situation. The necessary adjustment of total demand could then be pursued by regulating private consumption and investment expenditures. A stability-oriented fiscal policy which does not assign a subordinate role to public demand must shift its policy emphasis, as far as the budget is concerned, from the side of the expenditures to the side of the revenues. Corresponding possibilities for Germany are given in the Stability and Growth Law.

The desirability of employing fiscal policy for stabilization purposes will significantly be reduced, if monetary policy will be reformulated according to the lines suggested above. The more the economic process is stabilized by a steady expansion of the volume of money and credit, the less necessary is the use of fiscal policy instruments. Then fiscal policy can be restricted to its intrinsic task, that is the redistribution of resources from the private to the public sector.