The case against active stabilization policy

Some economists argue that the government should avoid active use of monetary and fiscal policy to try to stabilize the economy. They claim that these policy instruments should be set to achieve long-run goals, such as rapid economic growth and low inflation, and that the economy should be left to deal with short-run fluctuations on its own. Although these economists may admit that monetary and fiscal policy can stabilize the economy in theory, they doubt whether it can do so in practice.

The primary argument against active monetary and fiscal policy is that these policies affect the economy with a substantial lag. As we know, monetary policy works by changing interest rates, which in turn influence investment spending. But many firms make investment plans far in advance. Thus, most economists believe that it takes at least six months for changes in monetary policy to have much effect on output and employment. Moreover, once these effects occur, they can last for several years. Critics of stabilization policy argue that because of this lag, the Federal should not try to fine-tune the economy.

They claim that the Fed often reacts too late to changing economic conditions and, as a result, ends up being a cause of rather than a cure for economic fluctuations. These critics advocate a passive monetary policy, such as slow and steady growth in the money supply. Fiscal policy also works with a lag, but unlike the lag in monetary policy, the lag in fiscal policy is largely attributable to the political process. In the United States, most changes in government spending and taxes must go through congressional committees in both the House and the Senate, be passed by both legislative bodies, and then be signed by the president.

Completing this process can take months and, in some cases, years. By the time the change in fiscal policy is passed and ready to implement, the condition of the economy may well have changed. These lags in monetary and fiscal policy are a problem in part because economic forecasting is so imprecise. If forecasters could accurately predict the condition of the economy a year in advance, then monetary and fiscal policymakers could look ahead when making policy decisions. In this case, policymakers could stabilize the economy, despite the lags they face. In practice, however, major recessions and epressions arrive without much advance warning. The best policymakers can do at any time is to respond to economic changes as they occur. In periods of short stabilization it is agreed by all economists (both the advocates and the critics) that the delay in implementation makes the policy a less useful tool. They policymakers have found a way to avoid some of these delays and stabilize the economy. Automatic stabilizers are changes in fiscal policy that stimulate aggregate demand when the economy goes into a recession without policymakers having to take any deliberate action.