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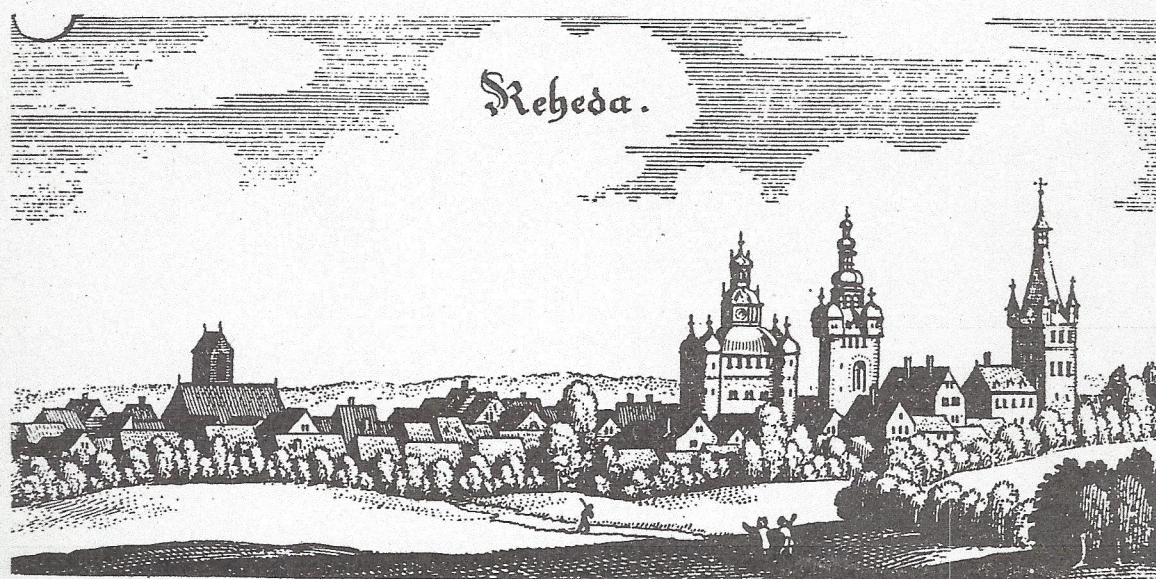
**Working Papers
Institute of Mathematical Economics**

**Arbeiten aus dem
Institut für Mathematische Wirtschaftsforschung**

Nr. 19

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zation Policy

June 1974



Anno 1600 nach Merian

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Political Limits of Traditional Stabilization Policy

The disappointment of the public with traditional monetarist, Keynesian and post-keynesian policy proposals to stabilize the price level and employment is almost a world wide phenomenon. Academic economists in their large majority still adhere to one of the different traditional schools of thought and so do the experts in the Government and central bank bureaucracies as well as in economic journalism who in their youth have been trained by those economist. What is the reason for this great contrast of opinion between the economists and the rest of the world? I do not claim to have a complete answer to this question. But the conflict of opinion between politicians and economists - apart from the weaknesses on the political side - may partly be due to certain preferences and aversions of economic model builders who thereby may get a biased view of the economic and political process.

To support my view of the economists' bias I should like to quote two British economists whose fame rests very much on unorthodox views. One of them is Keynes who made the famous remark: "in the long run we are all dead." I don't know of any other insight of economists into the true nature of things which has a better chance to be appreciated by those who have the responsibility to make decisions now, that is the politicians. But economists appear to have a special preference for the long run. The other British economist whose criticism of orthodoxy I want to mention is Professor Kaldor.

In his lecture on "The Irrelevance of Equilibrium Economics" [] he criticizes the orthodox tradition for their insufficient understanding and analysis of the Smithian principle of division of labour. I do not agree with the consequences drawn by Kaldor but I do agree with his criticism. Have we really sufficiently well understood the consequences of the division of labour?

Let me point out some obvious consequences of the division of labour which are perhaps of relevance for the problem of stability. The division of labour means that people and firms specialize in the services and commodities they sell but they do not specialize in the commodities they buy and consume. For many markets this implies: there are many more buyers than sellers in any given market. This has consequences for the structure of market transactions: The seller benefits from economies of scale in performing certain functions related to the transaction such as storage, informational activities (e.g. advertising, know how). In particular, every seller meets many buyers who have different need for the commodity in question. It follows that it is mainly the buyer whose wishes are relevant for the quantity to be transacted. It is then a time saving device if the seller standardises the bargaining process in such a way that he offers to sell any quantity of the commodity - within certain limits - for a price fixed by the seller and equal for all buyers. This description is adequate for the transaction of consumption goods. Markets for intermediate products may deviate from it and labour

markets function in a markedly different way. From the macro-economic point of view it is important to draw the following conclusion. A change in aggregate demand will have its immediate impact on quantities transacted. Only later will price revisions take place.

If I had more time I would elaborate on the following thought experiment: what would be the consequences of specialization not in production but in consumption? By analogy to the description of specialization in production we should conclude that here prices are set by purchasers and quantities by sellers. As a sideline of my main argument I should like to make the following observation on the theoretical foundations of modern and traditional monetarism. If there is producer specialization, a rise in the quantity of money will raise the propensity of purchasers to spend, thereby raise the volume of transactions until at last this volume has adapted to the higher quantity of money. If there were consumer specialization a rise in the quantity of money will reduce the propensity to sell (and thereby acquire liquidity). Transactions will then decline, the disequilibrium between the quantity of money and the volume of transactions becomes larger. The process seems to be less stable. This suggests that the theoretical foundations of monetary theory should contain explicit reference to the division of labour, as was already suggested by Adam Smith. I should also like to mention that Leijonhuvud's [] interpretation of Keynes' work could be related to what we have discussed here. Leijonhuvud considers the theory of Keynes to be a theory of economic systems in which quantities react faster than prices

on changing market conditions. Producer specialization may provide the reason for such market behaviour.

A further implication of the division of labour lies in the structure of coalitions and interest groups. The high cost of forming, maintaining and controlling coalitions puts a heavy premium on such coalitions from which its members can expect high returns. But then specialization of production and diffuseness of consumption imply the prevalence of producer coalitions rather than consumer coalitions. Thus the important problems of political economy are those of relative income shares of producers rather than relative prices of consumer goods. If pressure of producer coalitions prevails, inflation may for a while be an expedient device to make inconsistent demands consistent. In an analogous way we would expect that deflation is the problem of a society with consumer specialisation.

Let me now approach the problem of the long run. Economists are specialists for the analysis of the interaction of many elements in a complex system. Thus their comparative advantage lies in the prediction of the final outcome of a complicated process of interaction and this means their comparative advantage is the long run. The general public on the other hand has difficulties in distinguishing between long run and short run effects of policy measures. This means that the electorate imputes present day economic conditions to the ability and willingness of the present government to solve the economic problems. Hence governments which want to stay in power are forced to have a very high rate of time preference with respect to benefits

and costs of policy measures. This time preference may vary depending on the amount of time available until the next general election takes place. But on the whole, it is rather high. If we combine the high rate of time preference of governments with the observation that quantities tend to react faster on changed market conditions than prices do, we conclude that politicians have a strong bias towards expansionary measures of economic policy. Monetary and fiscal restraint, if they endanger full employment and full utilization of capacities, will be used with much greater care than measures designed to stimulate demand. Expansionary policies first harvest the benefits of higher employment and production and only later pay the cost of higher rates of inflation. Restrictive measures first pay the cost of reduced production and employment and only later result in more stable prices.

The long run result of this high time preference of government is what has become to be called stagflation: high rates of inflation and high rates of unemployment at the same time. I skip the detailed description leading to this result in order to have enough time for a discussion of possible remedies in this situation.

In recent years many governments have tried to solve their problems by using the instrument of price and wage controls. By and large one can say that these experiments have failed. Economists have a good explanation for this. Using the analytical framework developed so far in this lecture we may formulate the reason as follows: if price rigidity is the cause of the policy bias leading towards inflation and stagflation then price

controls will only aggravate this bias. They are an additional artificial element of price rigidity and thus are apt to be used mainly to postpone the detrimental effects of expansionary monetary and fiscal policies.

If it is true that the problem of economic stabilization is mainly a political one, due to the electorate's false imputation of the causes of the general economic condition, then the solution, if there is any solution, must be one which takes the behaviour of politicians and their high rate of time preference into account. The proposal which I want to make is specifically designed for that purpose. For expository simplicity let me adopt the monetarist doctrine which says that in the long run there exists proportionality between the quantity of money in the economy and the nominal value of national product. An additional assumption is that in the long run the volume of real national product is not greatly influenced by the quantity of money available. From this follows the conclusion that in the long run the price level will be proportional to the supply of money. My proposal is to transform the long run effects of changes in the money supply into short run effects by means of price controls. This can be done as follows.

The government imposes by decree a certain price level on the economy. This price level cannot be chosen arbitrarily by the government, rather it must change in proportion to the money supply available in the economy. This restriction by law in the choice of the price level is the important point of the proposal. It implies an immediate effect of a change in mone-

tary policy on the rate of inflation and thus enables politicians to pursue a policy of price stabilization with immediate effects. The essence of the proposal is to use price controls for the purpose of reducing price rigidity or enhancing price flexibility. At the moment I should say price level flexibility, but I shall argue later that it really is price flexibility. For those of us who like formulas I write down the formula which ties the percentage rate of change of the price level (π) to the percentage rate of change of money supply (μ). Let ξ be the trend rate of growth of real national product. We then propose

$$\pi_t = \mu_{t-1} - \xi_{t-1}$$

where the index t refers to, say, quarters. The time lag of monetary policy on the price level thus would be approximately a quarter of a year. I shall modify this formula later, after having discussed additional details of the proposal.

What we here are interested in is the price level in the economy as a whole, not so much any particular price. It is therefore not necessary to fix all prices in the economy. It is only necessary to fix the average of all prices. How can we fix the rate of change of the average of all prices without having to fix the rate of change of each individual price? The answer is obvious to the trained economist. This can be done by introducing a system of transferable licences for price changes. Each firm receives these licences in proportion to its value added from the government. But it can trade them freely with other firms. Each firm is allowed

to pass on price changes of its inputs unless these inputs contribute to value added. In this way the administrative intervention in the process of price formation reduces its degrees of freedom only by one. Market forces are restricted in their functioning much less than under a complete system of price controls.

Is such a system viable and reasonable? There are two interrelated main aspects of this question. One is the black market problem, the other is the problem of distortions of incentives in the economic process. Let me say only a few words about the black market aspect. Of course, the higher the distortions the greater is the danger of black markets, just as tax evasion and smuggling are problems growing with the square of the tax rates or the tariff rates. Similarly here: the black market problem is only important if the free market price for licences to change prices is considerable. The technical aspects of the control are not too severe: of course in principle every price has to be under some kind of control. But firms selling different commodities can be allowed to use a price index. Sales between firms are not such a problem if the buying firm is interested to have the price rise recorded in order to pass it on to its customers without having to have a licence. Black markets are mainly a problem if the seller has no interest to sell his commodity at the official price. If the buyer knows that the seller rather wants to sell his commodity at the official price than not sell it at all, it is difficult for the seller to sell the good at a higher black market price. Now, in a largely oligopolistic world this is the situation as long as

the official price is not completely unrealistic. At the consumer level consumer information services may also perform this function of checking on the actual prices paid.

Let us now approach the problem of distortion. The degree of distortion can as a first approximation be measured by the price of the licence to change prices. Thus we can concentrate on the question what this price will be. For this purpose I have to make something explicit which I so far have not mentioned. The scheme proposed works much better if the decree of the government does not only allow but also obliges the firms to change their prices by so and so much. Thus the word licence is not quite adequate. It is a licence as well as an obligation to change the price by one percent per, say, £ 1000 quarterly value added. This means that this "licence" can have a positive as well as a negative market price. There may be situations in which firms do not really want to raise their prices but an expansion of the supply of money forces them to do it by the rule proposed here. Then they will pay to get rid of the obligation to raise their prices.

Let us now remember that under our monetarist assumptions the price level change imposed by the government is the total or long run result of the change in money supply. Given that these monetarist assumptions are correct, the average price of the licences will be zero. There will be about as many situations in which past expansionary monetary measures have not had their full price effect as situations in which contractionary monetary measures have not yet worked themselves out fully. After a period of relative monetary contraction the price of the li-

cences will be positive, after a period of monetary expansion the licences are obligatious to raise prices and they have a negative price.

Let us now introduce speculation and forward markets for these licences. The business cycle as well as the period until most of the price effect of a change in money supply has become reality is a period of about three to five years. Thus the cycle of the price for licences will have about the same length. A firm can therefore expect that within a period of one or at most two years the price of the licence will change signs. But this will be an effective check on too high market prices for the licences. The basic reason for this optimism concerning the size of distortions implied by the scheme is clear: the scheme does not work against market forces, it only removes a certain inertia of the price system.

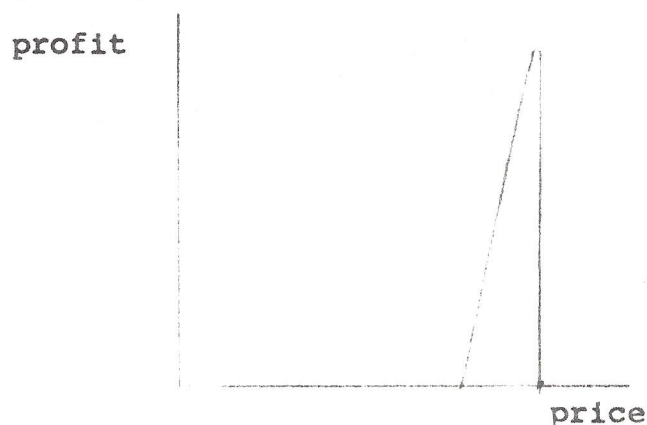
There is of course the problem that the income velocity of money does not remain constant in the long run or that indeed it may be influenced by the effects of the proposed scheme. Also it will not be easy to find the correct initial price level to be decreed, as we are not completely sure about future effects of past monetary and fiscal policies at the start of the scheme. There is therefore no guarantee that the average price of these licences will really be zero. But this problem can be solved by making our formula slightly more sophisticated. Let λ_t be the price of the licence in period t , let $\hat{\lambda}_t$ be an exponentially weighted average of licence prices in the periods preceeding t , let α be a positive constant. We then impose the

the following rate of change of the price level.

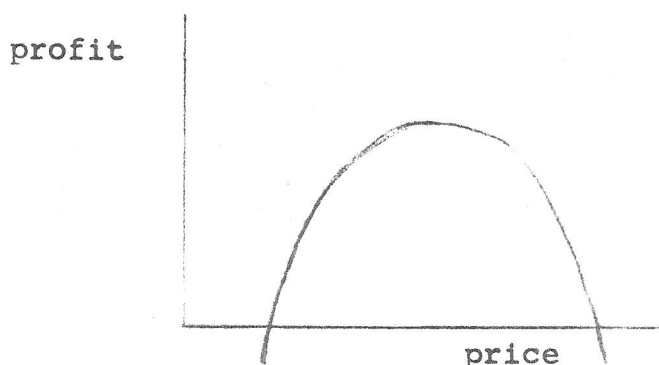
$$\pi_t = \xi_{t-1} + \mu_{t-1} + \alpha \hat{\lambda}_{t-1}$$

The correction term $\alpha \hat{\lambda}_{t-1}$ operates like a safety valve so as to avoid too large distortions caused by the system. If prices for licences in the past have had a bias to the positive side then more price rises are allowed in the present. This will have a depressing effect on the price of licences. The appropriate choice of the weighting system in the construction of $\hat{\lambda}_t$ is a matter of further investigation. The system must have a sufficiently long memory to avoid its instability, on the other hand, too long a memory implies inefficiencies in the adaptation process. Similarly there exists a problem in the choice of α . If α is chosen too high the safety valve is too big: no pressure whatsoever can be accumulated and the system has no effect. If α is chosen too small the system may explode, the prices of the licences may deviate too much from zero to keep the system viable.

Let me, before concluding, try to explain the philosophy of the proposed system in a different way. I draw a diagram in which the price of the product of a firm is on the horizontal axis and its profits are on the vertical axis. Take first the firm close to a situation of pure competition, say, a farmer growing wheat. His price profit curve looks like this



Now take the oligopolist or monopolist. His price profit curve looks like this



It can easily be established that the Kalecki degree of monopoly is inversely proportional to the second derivative of the price profit curve at its peak. The higher the "degree of monopoly" the flatter the price profit curve. What does this mean? It means that a firm in a pure competition situation knows which price to ask and it immediately changes the price, as demand or cost conditions change. On the other hand it will be difficult and expensive to induce it to choose a price different from the one at which the profit curve obtains its maximum. This is the basis of economists' aversion against price controls and their argument that black markets will ensue. The oligopolist is much less certain about his optimal price. When demand conditions change he first will wait and see before he changes his price. The flat profit curve on the other hand will make it easier to induce firms to deviate from their profit maximum.

I believe that oligopolistic market structure is typical for our economies. This appears to be particularly true for markets close to the consumer. Thus the consumer price index is the slowest to react on changes in monetary policy. It appears that

in our economies the conditions are fulfilled which make our proposed scheme a reasonable one.