The book’s central theme is that a policymaker’s role is to enhance the public’s ability to coordinate its price information, price expectations, and economic activities. The role is fulfilled when policymakers maintain inflation stability. Inflation persists less when an implicit or explicit inflation target is met. Granato and Wong argue that inflation persistence is reduced when the public substitutes the prespecified inflation target for past inflation. A byproduct of this coordination process is greater economic stability. In particular, inflation stability contributes to greater economic output stability, including the potential for the simultaneous reduction of both inflation and output variability – inflation-output costabilization (IOCS). Granato and Wong use historical, formal, and applied statistical analysis of business cycle performance in the United States for the 1960–2000 period. They find, for example, that during periods when policymakers emphasize inflation stability, inflation uncertainty and persistence were reduced.

JIM GRANATO is Adjunct Associate Professor in the Department of Government at the University of Texas at Austin. Prior to his current position, he was Visiting Scientist and Political Science Program Director in the Political Science Program of the National Science Foundation (NSF). He is the author or co-author of numerous publications in academic journals such as American Journal of Political Science, Economics and Politics, Journal of Theoretical Politics, Political Analysis, Political Research Quarterly, Public Choice, and the Southern Economic Journal.

M. C. SUNNY WONG is Assistant Professor of Economics at the University of Southern Mississippi. His primary research has focused on adaptive learning dynamics in monetary policy, and he is also interested in the areas of foreign direct investment (FDI) and economic growth. Professor Wong has published research articles in such journals as the Journal of Macroeconomics, Political Research Quarterly, and the Southern Economic Journal.
The Role of Policymakers in Business Cycle Fluctuations

Jim Granato
University of Texas at Austin

M. C. Sunny Wong
University of Southern Mississippi
For our parents,

* Dolores Mistro Granato, James Lawrence Granato,
  
  Sing Luen Tam, Chi Kong Wong

And our wives,

* Helen Au Yeung, Mary Bange
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7.4 ARCH Model Results with Structural Breaks
If business cycles were simply efficient responses of quantities and prices to unpredictable shifts in technology and preferences, there would be no need for distinct stabilization or demand management policies. If, on the other hand, rigidities of some kind prevent the economy from reacting efficiently to nominal or real shocks, or both, there is a need to design suitable policies and to assess their performance. In my opinion, this is the case: I think the stability of monetary aggregates and nominal spending in the postwar United States is a major reason for the stability of aggregate production and consumption during these years, relative to the experience of the interwar period and the contemporary experience of other economies.


The theory of economic policy occupies a central place in academia and government. This book addresses concerns in both communities. For academics, this book examines the ongoing scientific endeavor to determine the most accurate
Preface

representation of the business cycle and what the optimal role for policymakers is in stabilizing it.\(^1\) Scientific controversies center on such issues as the relation between inflation and real outcomes and how these disagreements influence the supposed effectiveness of policy.\(^2\) In more technical language, a particular scientific controversy of interest to us is the evolution in thinking about the slope of the Phillips curve and how this has influenced policy and outcomes (see Akerlof et al. 2000).

\(^1\) There are numerous definitions of the business cycle. The U.S. Congressional Budget Office (CBO) uses but also credits the National Bureau of Economic Research (NBER) with the following definition (see http://www.cbo.gov/showdoc.cfm?index=3280&sequence=0):

Fluctuations in overall business activity accompanied by swings in the unemployment rate, interest rates, and corporate profits. Over a business cycle, real activity rises to a peak (its highest level during the cycle), then falls until it reaches a trough (its lowest level following the peak), whereupon it starts to rise again, defining a new cycle. Business cycles are irregular, varying in frequency, magnitude, and duration (NBER).

Classic work in the study of business cycles can be found in Burns and Mitchell (1946) and Mitchell (1913, 1951). More technical and modern treatments of business cycles can be found in Diebold and Rudebusch (1999), Sargent (1987), and Zarnowitz (1996).

\(^2\) Because inflation is primarily a monetary phenomenon, we focus on monetary policy.
On the other hand, policymakers – a term that includes policy advisors to the executive administration and members of the monetary authority (who can be either research scientists or decision makers, or both) – are focused on, for example, taking the right policy action at the right time. Yet, there is no doubt that policymaker discretion has been influenced by changing scientific conceptions of the Phillips curve. Policy goals or targets, long a concern of policymakers, receive more or less weight based not only on current economic conditions but also on what science says is the optimal course of action. To be more specific, policy trade-offs between inflation (inflation variability) and real economic factors (and their variability) are dictated in part by the academic consensus on the slope of the Phillips curve. This scientific debate includes whether and when these trade-offs even exist. An issue for policymakers, then, is the degree to which they rely on such research as opposed to just using common sense.  

Although the academic and policymaking communities have different ways of looking at the world, we contend that it would be a mistake to treat these two groups separately. Academics analyze the effects of actual policy, whereas

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policymakers use the analysis of scholars when implementing policy. In a real sense, this book is an argument for blurring the distinction between academics and policymakers. The integration of practical policy concerns – with a thorough social scientific examination of the process of how policy influences business cycle outcomes – is one aim of this book.

Furthermore, in matters of policy, academics and policymakers each need the expertise of the other to avoid policy errors. In the United States, during the 1930s, policymakers failed to engage in stimulative monetary policy when economic theory dictated that course of action (Friedman and Schwartz 1963; Meltzer 2003). The Great Depression was the result. At the other extreme, the stagflation of the 1970s occurred because the academic consensus supported the idea of a structural Phillips curve that policymakers could control, but policymaker “experience” suggested otherwise (see also Lucas 1980; Sargent 1999).4

4 Examples of the interplay between scientific research and policymaker experience are found in Meyer (2004). For example, on the relation among productivity, wages, and inflation he states, “Economic theory tells us that a leap in productivity will raise wages in the long run. But experience tells us that wages are not initially much affected. As a result, in the short term, an increase in productivity
The issue of when to take the right course of action, then, is not just a matter of luck. The fusion of scientific research with practical day-to-day policy activity cannot totally eliminate harmful policy choices, given the uncertainties of certain scientific relations and the pressure of making real-time decisions, but greater collaboration cannot hurt either.\(^5\) Alan Greenspan (2004) suggests that peaceful coexistence is possible in the conduct of policy:

In designing strategies to meet our policy objectives, we have drawn on the work of analysts. . . . A critical result has been the identification of a relatively small set of key relationships that, taken together, provide a useful approximation of the economy’s dynamics. . . . However, . . . our knowledge about many of the important linkages is far from complete and, in all likelihood, will always remain so. . . . For such judgment, policymakers have needed to reach beyond models to broader – though less mathematically precise – hypotheses about how the world works. (pp. 5, 7)

Against this background, we consider the role of policymakers in business cycle fluctuations. We argue that the
tends to lower the cost per unit of output. This, in turn, will generally push prices down\(^5\) (p. 126).

\(^5\) Söderström and Vredein (2000) refer to this fusion as a complete re-orientation of monetary policy where “politicians and central bankers learned from experience (and from economic theory)” (p. 8).
overriding role of policymakers is to harness both scientific and practical acumen to assist in coordinating economic (that is, price) information so that the marketplace functions efficiently. The specific way to fulfill this role is to ensure inflation stability. Although inflation stability can coincide with other macroeconomic goals, we view inflation instability as a preventable cause of economic affliction. Inflation stability does not guarantee economic prosperity, but its absence presages harmful economic consequences. We also argue that achieving inflation stability can coincide with further stability in aggregate output.

This book is a mix of narrative, formal modeling, and econometrics. It is geared toward the academic and policy audience. The people most comfortable with this material will be graduate students, fellow academics, professionals, and policymakers with a working knowledge of the issues and the technical approach. We also think that there is sufficient nontechnical material to enable upper-level undergraduates to grasp the main arguments. This book would be useful for courses in macropolitical economy, macroeconomic policy, and monetary policy; courses that examine learning dynamics; and methodological courses that need examples that merge formal and empirical analysis.
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