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Introduction

1.1 Economic policy as policy action

This book has been designed to give a novel and rather unconventional account of the evolution and changes in macroeconomic stabilization policies and institutions in the world's economies since World War II. It is unconventional because it presents the analysis of the policies and underlying theories in an informal way, so that the reader can easily grasp the main story line, implications, and reasoning behind policies, eschewing formal solution techniques that can be found elsewhere.

The understanding of macroeconomic policy and institutions designed to achieve desirable economic, political, or social goals has greatly changed over time, oscillating between state intervention and a free-market approach. We focus on the tension between these two positions, which is driven by conflicts between the desired goals of economic policy and what is feasible or manageable according to our understanding of the economic system.

Macroeconomics and macroeconomic policies began with J. M. Keynes in the 1930s – although the terms appeared in scientific journals only later, in the 1940s.[1] Before Keynes, the main typical state interventions involved the use of taxes (including tariffs), provision of essential public goods, and money regulation. In some cases, as with antitrust laws, it aimed only at avoiding the limits to competition introduced by firms with excess market power.

After Keynes, policy action started to include interventions of a more traditional macroeconomic type, targeted at aggregate variables such as employment, national income, inflation, and growth. The Great Depression that began in 1929 can be considered as a watershed in the evolution of state intervention in general, and particularly so from the standpoint of macroeconomic policy. The main issue of the 1930s was unemployment. Policies enacted just before and just after

[1] As stressed by Blanchard (2000), the period before 1940 was "a period of exploration, where macroeconomics was not macroeconomics yet, but monetary theory on one side and business cycle theory on the other."

World War II targeted that problem directly. Further policies designed to deal with other macroeconomic problems followed in the postwar period: policies for balanced trade, investment flows, productivity, income distribution, inflation, exchange rate movements, and financial policy.

The climax of Keynesian macroeconomic policy action was reached at the end of the 1970s. After the second oil crisis of 1979–1980, and to some extent after the first crisis in 1973–1974, the focus shifted from unemployment to inflation. Policies had then to react to the emergence of inflation on a scale that had never before been experienced collectively by developed economies.

At the same time, since the rise in oil prices implied a considerable increase in production costs (a supply-side shock), policymakers had also to contend with a sharp reduction in economic activity. This new phenomenon became known as "stagflation," a deadly combination of stagnation and inflation in which costs, wages, and unemployment went up while prices were rising in a way normally associated with excess demand.

The eventual policy response to stagflation was a combination of tight monetary policies and high interest rates to control prices, neutral fiscal policies (in as far as was possible, given the automatic stabilizers in the economy), and supply-side policies and structural reforms to reduce costs and increase efficiency at the market and firm level.

These were market-oriented policies aimed at improving competitiveness, business conditions, and incentives, and lowering relative costs and the cost of doing business. In many cases, they were paired with retraining schemes or reforms to increase opportunities and incentives in the labor market or in the use of capital.

In other words, gone were the old demand-management policies of the early postwar period and the attempts to fine-tune interventions around the cycle by changes in public spending or taxation. Instead, the *new* approach was extensive market liberalization, emphasizing unregulated markets, interventions to free up the supply side, market flexibility, but careful control of the credit markets and inflation.

Since that time, there has been a period characterized by limited government intervention and cautious attitudes of public action vis-à-vis the market. Government interventions have been directed at institution framing more than countercyclical discretionary action.

The recent financial and economic crisis has shown up that tendency strongly, most obviously in financial regulation and in fiscal oversight and controls, while at the same time rebalancing conventional economic policy toward discretionary action in a number of other fields. Moreover, after the 1970s, the issues faced by both developed and developing economies have become more international because of the globalization process. As a result, both domestic (inter-institution) and international (inter-country) coordination have become relevant.

These cycles in styles of policy action require some explanation. Why do they change? Under the influence of what factors and circumstances do they occur? In our view, the economic policy stance mainly changes because the economy changes and new problems emerge. Policies implemented, and their relative priorities in each historical period, respond to specific circumstances.

The economic policies actually undertaken also draw inspiration from the stock of economic ideas accumulated through time. In earlier times, macroeconomic intervention was possible only by exploiting Keynesian thought, which had been developed in the 1930s. In later times policy actions followed the classical monetarist analysis and prescriptions, and since then those of New Classical macroeconomists. In a number of cases, which we explore later in the book, old ideas and policy suggestions are revived, sometimes modified and extended to fit the new circumstances of the time.

Suffice it to recall a couple of examples: first, the suggestion by Keynes (1919) to substitute forgiveness for punishment as a general approach to war reparations. This was resurrected after some decades, in the Marshall Plan (1953) for the benefit of German reconstruction, with smaller programs for other countries such as Italy and Greece. Keynes (1919) also suggested the institution of a "Free Trade Union" under the auspices of the League of Nations, an idea that was finally realized almost 30 years later – first through the General Agreement on Tariffs and Trade (GATT) and then the World Trade Organization in the 1990s.

From this point of view, a review of the policies implemented in the last 70 years – and the theories supporting them – can be useful not only as a historical reconstruction but also as a way of assembling and recording the toolkit of an economist that may be useful for the purposes of both theoretical and applied analysis.

Our view therefore differs from Blanchard (2000), who looks instead at macroeconomic theory as a natural evolution from exploration, through theorizing and then on to testing and a consolidation of our understanding of the economic system. But economics is not a hard science: the economic system changes, problems change, people and their priorities and behavior change, and theories often come back, usually in a modified and more sophisticated form, as our understanding of how the economy works develops and improves. Moreover, neither theories nor policies are ever fully independent from ideology in practice. Reaganomics and Thatcherism, for example, were a mix of ideologies and economic political theories or practicalities.

We, however, agree with Blanchard that the tools used by macroeconomists evolved a great deal over time and will no doubt continue to evolve in the future.[2] The battlefield between state intervention and free-market theorists has thus become more complex, but the disagreements do exist and are unlikely to vanish.

Finally, the purely political aspect of economic policy cannot be ignored. Policy action reflects the preferences of policymakers, which in turn reflect those of their constituencies or, according to a more pessimistic view, those of interest groups that could influence them.

After the war, many governments adopted a social democratic approach, or "left-of-centre" preferences, to their policymaking, whereas those elected at the end of the 1970s in the United Kingdom, the United States, and some parts of Europe adopted a more aggressive free-market approach in their policies.

Differences in orientation are obviously linked also to the changing nature of the problems of the time. However, for the purposes of this book, we take the different attitudes and preferences in policymaking as given and then examine the implications and consequences for the policy settings and frameworks that emerge. We are not directly concerned with the origin and sources of those different attitudes themselves, as interesting as those questions may be.

The aim of the book is therefore to look at the evolution of macroeconomic policies and economic thought in the light of the developments of the world economy and social preferences. We will thus proceed by connecting the developments of economic needs and demands of the time, the policymakers' choices and economic ideas, while stressing the links and complementarities among them.

1.2 The discipline of economic policy[3]

The term "economic policy" can be generally understood as public action to steer the economy toward some agreed or desirable goals. The term, however, can also be intended to mean a discipline, designed to guide how one should determine those interventions.

Specifically, we can define economic policy as the discipline that studies public economic action at three levels: (a) the identification of social preferences or objectives; (b) the optimal choice of institutions (i.e., the definition of society's economic constitution); (c) the optimality of the policy choices of the government.

The term "institution" also requires some qualification, as it has been given a variety of meanings in social sciences. These can be reduced essentially to the following two.

[2] For instance, the introduction of strategic interactions and time consistency problems, the evolution of econometric techniques, the consideration of externalities and international spillovers that cannot now be ignored.
[3] This section draws on Acocella (2014b).

First, the term may indicate a set of rules that regulate, in a lasting manner, the relationships within or between groups of agents; for example, marriage, private property, and the market are all institutions.

A second meaning extends the definition to include the agents involved in implementing the rules and the resources necessary to do so. In this second sense, the government, the family, and enterprises are all institutions.

We will use the term in both senses. In addition, when we refer to the "market," we obviously include private enterprises and the behavior of private agents. The term "government" or "state" instead covers all kinds of public institutions.

It is also necessary to specify a definition of economic policy and the meaning of the term "institution" in order to understand some of the debates and issues in which economic policy as a discipline was first involved. In fact, the very birth of economic analysis as a discipline separate from moral sciences dates back to discussions about the comparative merits of different institutions such as the market and the state.

Such discussions began with Adam Smith's statement of the virtues of free markets (Smith, 1776).[4] Before him, specific cases of state intervention were advocated and Smith himself proposed a few for particular ends, often not economic such as defense, with little evaluation of the outcomes that might be derived from alternative institutions.

Obviously, economic policy as a discipline could not have emerged in the absence of these diffuse positions taken up by economists asserting the existence of market failures and in favor of state intervention to correct those failures or to create substitute markets.

After Smith, a stiffer line of reasoning had indeed developed asserting the reasons for a "night-watchman" state. Over the years, this position became an exception as most classical and neoclassical economists (such as Henry Sidgwick, Alfred Marshall, Arthur C. Pigou) tended to state specific or general cases where markets fail and where microeconomic government intervention is in order.

All the same, until the 1930s, there was no set of general principles for policy intervention in a market economy, and no logic was offered for economic policy. Economic policy as a discipline was little more than a collection of what Walras called "examples of empirical policy," rather than systematic and rational policies.

[4] We are conscious that attributing to Smith the naive idea of a fully pro-market position – in particular the prevailing interpretation of the meaning of the invisible hand – is unfounded in Smith's works and has been criticized by a number of authors. However, we must distinguish two different issues here. The first is whether it is appropriate to refer to this term with respect to either the letter of Smith's works (in particular in *The Wealth of Nations*), or the context in which it appears. The second is the separate issue of whether it is representative of Smith's thought to argue in favor of the virtues of a free market – and in particular to favor the division of labor. In this book, we hold that to be the case. Be that as it may, we use the term invisible hand as a metaphor for the Smithian position as well as of later theories of a similar orientation vis-à-vis the market.

In the 1930s and the following decades, further essential ingredients were added. A debate involving the leading economists of the day began on the logic for government intervention in market economies. The discussion involved the principles of government intervention, the role of distributive considerations vis-à-vis those of efficiency, the need for effective or potential compensation, and the possibility of taking both efficiency and distributional aspects into consideration in order to maximize a society's economic welfare starting from individual preferences.

Most importantly for the viewpoint of this book, the concept of macroeconomic market failures emerged, in addition to the microeconomic failures, as an effect of Keynesian thought. Finally, the possibility of testing theoretical propositions empirically after the birth of econometrics permits us to take into account the multiple interrelations existing in an economic system in order to coordinate government interventions directed at achieving a set of different but interrelated targets.

These advances made it possible for an autonomous discipline dealing with the logic of government intervention and its consistent design (what has been called the "Theory of Economic Policy") to appear in the Scandinavian countries and the Netherlands in the 1950s.

The geographical location of the founders of this discipline was the product of circumstances: not only the political trends and the social substrata prevailing in these countries, but also their full participation in a wave of theoretical innovations that had produced the slow but steady development of the essential components of the discipline.

In particular, these economists were enormously active in developing theoretical models and the tools to use them for normative purposes and in taking these models to the data by using the increasing availability of data and the development of econometric methods (Hughes Hallett, 1989).

A discipline however cannot survive and spread if some pre-conditions for its existence are not satisfied: we need the existence of a consistent basis of reasoning that is proof against practical and, especially, theoretical objections. The flow of continuous innovations can attack some of these bases. Minor objections can be incorporated into the theory. Unaddressed critiques or objections to its core can be fatal for its existence and lead to a slow or fast decay.

For a discipline such as economic policy, the decline might be accelerated by a simultaneous and interacting political wave counter to it, as can be the case in particular for other social disciplines.

Economic policy in Scandinavia and the Netherlands was built up as a discipline by collecting various innovations introduced in different fields of economics, mathematics, and statistics (which underpin the theory of economic policy), in addition to aspects of political philosophy and political science from which we construct welfare economics and social choice as the foundation for economic policy.

The discipline was composed of the logic and theory of economic policy, complemented by practical applications of both microeconomic and macroeconomic issues, both highly dependent on institutional factors. Various parts of its core were the object of both minor and vital critiques concerning existence of government failures.

Most minor critiques are of a "political economy" kind and refer to the existence of agency problems in the relationship between politicians and their constituencies. They have been incorporated into the discipline with no major problem. We deal with them in the next section, and in a more extensive way in the rest of the book.

Major critiques have instead left the logic of economic policy untouched in so far as the existence of market failures is concerned, thus setting the stage for government intervention to cure such failures, with the proviso that this should also take government failures into account.

Objections have also been directed at the impossibility of taking people's preferences as a reference point for public action, as stated by Arrow (1951), and at the ineffectiveness of public action of the kind raised by Lucas (1976) in his famous critique. These critiques undermined the very possibility that government action could heal market failures. That appeared to make the foundations of economic policy shaky.

A number of possible solutions for escaping from the impossibility theorem stated by Arrow have been suggested. We cannot deal with them here as this issue is only peripherally relevant for the purposes of this book. However, they can be considered as being solid and rich enough to preserve the core of economic policy.

Being concerned with macroeconomic policies, we have to refer briefly to the critiques that concern the effectiveness of policy action under forward-looking expectations – in particular, rational expectations.

Such critiques tend to negate the effectiveness of policy action even in the absence of agency issues. In their weakest form, they have constrained public policy into a Nessus shirt by prescribing policy action only under a rather rigid set of rules. Stronger versions of this kind of criticism appear to negate any active role for public policy as a means of influencing the conduct of private agents.

Clearly, these critics had a decisive influence on the realm of application of the discipline as it had been designed in the Scandinavian countries and the Netherlands. Critiques on policy effectiveness became strong and acquired a status of a (negative) milestone for discussions on governmental actions.

This was an unaddressed problem for a long time. More recently, the core theory of economic policy has not only been shown to be exempt from the critique if policy actions are designed in their proper strategic context, but also to be able to produce new interesting results in so far as existence, uniqueness, or multiplicity of equilibria are concerned (Acocella et al., 2013).

1.3 The ingredients of economic policy

The main ingredients of economic policy as a discipline are based on four elements: (1) an assessment of the relative performance of alternative institutions (the optimum regime); (2) an indication of the targets that policymakers pursue (or should pursue) and the relative priorities to be assigned to each; (3) a specification of the model illustrating the relationships between targets and instruments available to policymakers; and (4) an assessment of the external factors that can be expected to have an impact on the outcomes of policy and, if possible, some assessment of the main uncertainties that would affect those outcomes. The four ingredients are discussed below in more detail.

The first one draws on economic and political analysis. It should give an indication about the relative performance of economic systems depending on the working of different types of markets, different types of governments, and other institutions, including the non-profit sector. Much of economic analysis has been concerned with the performance of markets and the cases and reasons for market failures. However, the only part of that debate which is of interest, in this book, is the part that deals with the so-called "macroeconomic failures."

Stiglitz (1986: chapter 4) formally recognized unemployment as a case of market failure and perhaps the most evident one.[5] We can label it as a "macroeconomic failure" in the sense that it affects the performance of the economy at an aggregate level.[6] Other macroeconomic failures can then be added in, such as inflation, low (or excessive, unsustainable) growth, external imbalances, and debt or financial instability.

In the last decades, and almost in parallel with the increasing role taken by government in managing the economy, a large part of economic and political analysis has also pointed out reasons for government failures. These have to do with different ways of organizing public or collective action – including the role of the personal interests pursued by the policymakers – and the capacity of policy instruments to affect the economic targets to which they are directed.

[5] Before him the concept of market failures was referred only to what are now known in the literature as "microeconomic failures" (Bator, 1958) – later extended by also considering the role of asymmetric information (Akerlof, 1970).
[6] That is not to say that these failures are of macroeconomic origin, or a consequence of microeconomic failures and distortions.

Failures in organizing collective action are properly part of the political economy literature, which draws inputs from both the political and economic sciences. Collective choices are then portrayed as a collection of self-interested decisions (Buchanan and Tullock, 1962) made by policymakers, or to attempt to maximize the length of their office (Downs, 1957), or to win elections (Nordhaus, 1975), or have partisan inclinations (Hibbs, 1977; Wittman, 1977), or represent particular interest groups (Olson, 1965).

Some of the above factors – in particular pressure by political constituency, or partisan parties and interest groups – explain why policymakers might target a level of employment higher than the natural one, thus causing inflation, or the tendency to run persistent budget deficits, accumulate public debt, or behave in other distortionary ways.

Government failures can also derive from the inadequate capacity of specific policy instruments to affect the economic targets in the way they were intended to. We deal with these failures extensively in the rest of the book.

Institutions which work as an alternative to both markets and the state have instead received less attention, apart from the studies dedicated to certain private organizations that are systematically important to us: trade unions, for example. As we will see, the outcomes deriving from different ways of organizing their actions (in particular, the degree to which their decisions are centralized) can affect the performance of the whole economy.

The definition of the targets pursued by policymakers is the second ingredient of economic policy. Targets are derived mostly from history and politics. It is historical evolution, conditioned by the effect of exogenous shocks or the development of each country (or the world economy), that influences the preferences of the constituencies, elected governments, and hence policymakers.

In developed countries, the emphasis of macroeconomic policy in the 1930s and subsequent three decades was on unemployment and, to some extent, growth. The balance of payments was not a problem for the United States, chiefly because of its hegemonic position in the international monetary system devised at Bretton Woods at the end of World War II. By contrast, it was the dominant issue, together with growth, for the United Kingdom in the 1960s and 1970s.

In the 1960s, inflation appeared among the list of policy targets for the first time and became the overriding objective in the 1970s because of the price and cost pressures created by the two oil crises. The simultaneous presence of high rates of inflation and unemployment (stagflation) raised a dilemma for economic policy, since actions designed to lower inflation were associated with the risk of exacerbating unemployment, and vice versa.

Starting in the mid 1980s, after disinflation, a period of Great Moderation followed in the United States and elsewhere, characterized by a reduction in the volatility of business cycle fluctuations. Some economies, notably the United States, observed relatively high rates of growth and rather low unemployment, but without the inflationary pressures that had always appeared in previous expansionary periods – and which would have been predicted by Phillips curve theory. Some other countries, notably Europe and Japan, suffered a marked reduction in their previous growth rates.

The Great Moderation ended in 2007, giving way to the Great Recession. A new target had then to be added – that of financial stability – which the deregulated financial markets had not been able to achieve. Moreover, employment and growth became again important targets to pursue almost everywhere in developed countries, with the objective of price stability clearly becoming irrelevant in the deep and prolonged crisis that followed.

Economic policy as a discipline cannot always keep account of the targets pursued by policymakers. Sometimes they do not pursue certain targets with the best instruments, or they think that their targets cannot be realized. The discipline must also be able to indicate what additional targets could be added or what alternative ways could be used to pursue them. To that end, we need to rely on economic analysis in the first instance, even if significant insights can come from other human and social sciences.[7]

For example, Keynesian analysis using an innovative theoretical framework first made the proposition that market failures may cause less than full employment and suggested new instruments that might be brought to bear on the problem.

Other economists have dealt with the roots of inflation and ways to cope with inflationary pressures (notably Milton Friedman and the monetarists), similarly for growth models (both in their exogenous version, beginning with Roy Harrod, Evsey Domar, and Robert Solow, and in the more recent endogenous variant from Kenneth Arrow and Paul Romer), and explanations of the balance of payments (James Meade).

Financial instability had long been studied in the past, but in recent times it has been the object of analyses and policy suggestions going back again to John Maynard Keynes, Irving Fisher, and Hyman Minsky.

Economic policy naturally indicates new targets as a result of the current economic needs. However, it sometimes does so simply or mainly because of a process internal to the dynamics of economic analysis or because the internal dynamics offers new analytical insights or instruments to deal with old or ongoing issues.

[7] This is also the case in philosophy as far as the principles of justice applied to judging the relative performance of institutions and setting targets are concerned. Such principles are less important for the macroeconomic purposes of this book; thus, we will not pursue this issue further in this book.