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THE KORTEWEG AND LUCAS REVIEWS OF THE McCRACKEN REPORT

Comments

Stanley Fischer*
Massachusetts Institute of Technology

Korteweg and Lucas deserve thanks for providing interesting and provocative reviews of a report that is not exciting reading. My discussion of their reviews is in five sections. The first section asks whether there is anything to be said for the McCracken Report. Then in the next two sections, I discuss specific points arising from the Korteweg and Lucas reviews respectively. In the fourth section, I speculate on how Korteweg and Lucas might have written the report if they'd been assigned the task. And finally I venture a few words on the role of the economist as policy advisor.

The terms of reference of the Committee are set out in the letter of transmittal, at the front of the Report. They were:

> ...to identify and consider the main policy issues involved in the pursuit, by Member countries, of non-inflationary economic growth and high employment levels in the light of the structural changes which have taken place in the recent past; and to make suggestions on the alternative strategies and instruments that Member countries could adopt, both at national and international levels, in order to deal successfully with those issues.

Now what can be said about the report? Basically, the Report is not as bad as one might think from reading the two reviews, and not as bad as it might have been. There is no question that it is boring. And there is no question that it is severely hedged.But it would be remarkable if a report written by eight people were not hedged; instead, it is the degree of agreement that is surprising. The Committee met at a time when reputable economists, at least in the United States, were urging 15 percent growth in $M1$, and at a time when others were urging that money supply growth go immediately to 4 percent, and stay there. The Report recommended neither. The Report could have come out strongly for wage and price controls but did not; it could have come out for protectionism, but did not.

*I am grateful to Robert Solow for his comments.

One may complain about particular economists agreeing to serve on a committee of this sort–I shall return to this issue in the final section–but given that there was a committee, the Report is neither a disaster nor very useful.[1] It is not very useful because it is so hedged; nevertheless, it does come out for middle-of-the-road policies, with details presumably to be filled in by the national policymaking bodies. Whether this Report, or reports like it, have much effect on policy is not an issue about which I know anything or want to speculate.

Korteweg's discussion is quite restrained. He makes some good criticisms of the Report.

(i) The potential output path is both too high and too steep: The Report fails to recognize that the increase in the relative price of oil reduced the level of potential output, and that the trend rate of productivity increase is lower than it was in the sixties. Both these criticisms are valid, though the emphasis by Korteweg on the role of government interference in reducing trend productivity growth is not supported by analysis. Distortions reduce the level of potential output, but it is not obvious that, except in a transitional period, they affect the growth rate of potential output, unless they interfere with research and development, or reduce the rate of investment.

(ii) Korteweg calls the Locomotive/Convoy Approach unconvincing. He argues, using LINK estimates, that the growth rates required in the strong countries to do much for the weak countries would be greater than apparent growth rates of potential output in those countries. The use of LINK is amusing, since it is subject to the criticisms Korteweg later makes of other econometric models; however, there is no reason not to use the best evidence that can be found.

While growth in the strong countries would not be sufficient to save the weak, the Locomotive Approach was surely right in arguing that more rapid growth in the stronger countries would make recovery easier for the weaker countries.

(iii) Korteweg also complains that the Report fails to provide hard numbers for the policymakers to follow. I suppose he means that the Report should have announced a 5 percent monetary growth rate for one country and an 8 percent rate for another, and so on. I don't believe the Report could or should have gone to this level of detail; indeed, if the Report is to be criticized in this general area, it should be for implying that some single growth target (4%) was right for all countries.

(iv) Korteweg makes a general rational expectations criticism of the Report, to which I shall return below.

Lucas's comments relate to both the style and the substance of the Report. One of the major problems I have in reading Lucas's popular pieces is that he is himself a very good stylist: On a first reading, it was impossible to see how anyone could disagree with his criticisms of "undisciplined eclecticism" and "opportunism posing as pragmatism." Lucas might usefully have distinguished, as Korteweg does, between the macro and micro aspects of the Report. It is in discussing microeconomics that the Report gives the air of having something to say about everything. In fact, it seems to me, the Report says much the same thing about a number of microeconomic issues; by and large, it argues, there should be less regulation. What Lucas detects to be resignation about the market, I diagnose as defensiveness before potential complaints about its "naive" faith in the market.

Lucas objects in particular to the Report's appearance of presenting a professional consensus, buttressed by notes and references prepared by the secretariat of the OECD, which are included as an annex to the Report. I did not think that the Report explicitly or implicitly made any such claim until I read Lucas's review; his review makes it clear that the Report does not represent any such consensus, since there is none. I doubt there was ever a professional consensus–certainly not even in the heyday of Keynesianism in the United States in the early sixties.

Lucas remarks that Keynesianism served a great rationalizing role in the sixties, arguing as it did that there was no need to handle problems of unemployment at the micro level by interfering in particular markets. In principle it might have done so, but a reading of the Economic Reports of the President for the sixties suggests no reduction in discussion of, and proposed policies for, particular markets. When Don Patinkin turns his microscope to this text of Lucas's, I suspect he'll conclude that there is no evidence that government showed any less desire to intervene in particular markets in the sixties than in the fifties.[2]

Incidentally, it is something of a surprise–and certainly a relief–to know that "Keynesian" means "consistent with the behavior of time series." Until now, I'd thought it meant "ad hoc" or "sloppy."

Lucas argues that simple-minded multiplier analysis suffered a fatal set-back in the late sixties, and that since then the profession has been adrift. In particular, I suppose, the 1968 tax surcharge was the Keynesian failure. By a similar standard, simple-minded monetarism suffered a serious set-back when the inflation rate stayed up stubbornly through 1971, despite the monetary policy engineered recession of 1969-70.[3] The so-called failures of Keynesianism and monetarism have certainly led us to revise our models, and have indeed left most macroeconomists far less confident of their policy prescriptions than they used to be. But there is little better to do than the best we can, which is to continue trying to improve macroeconometric models, adapting them to take account of misspecifications, such as those pointed out by Friedman (1968) and Phelps, (1967) when they discovered the role of expectations in the Phillips curve, and by Lucas (1976) in his Econometric Policy Evaluation paper.

What sort of report might a two-man committee of Korteweg and Lucas have written? We have part of Korteweg's draft:

> What is needed is coordinated and coherent action, national and international, on two counts.
>
> First, steady and moderate monetary and fiscal policies aimed at a gradual return to stable, preannounced and potential growth-oriented growth targets for the monetary and fiscal aggregates should be implemented. Such policies, if adopted and implemented internationally, would reduce inflation, tax pressure, uncertainty, and the unpredictability of the economic environment and would stabilize exchange rates, thereby restoring both investment incentives and investment resources.
>
> Second, these macroeconomic policies should be supported by microeconomic measures and structural reform designed to make product and factor markets more flexible and competitive.

This is quite admirable, and quite like the McCracken Report. It illustrates primarily the difficulty of giving general rather than specific policy advice. On what does Korteweg base his advice? He is quite explicit in using a standard simple rational expectations cum neutral money and flexible prices model of the Lucas persuasion.[4]

But that model has severe defects as the basis for policy advice.

(i) It presents no reason for thinking that the rate of inflation matters.

(ii) It has no theory of unemployment–output varies only through movements up and down a supply curve of labor.

(iii) It does not say what the fundamental time period is. It could be a day, or it could be five years. If it is a day, then it is impossible to believe that preannounced policies have no real effects. If it is five years, then it is impossible to believe that policymakers cannot systematically produce unanticipated policy effects.[5]

(iv) The empirical evidence for such models, only now beginning to come in, does not provide much support for the aggregate supply curve, which is the key equation in the model.

As far as I can tell, the Lucas model provides no reason for thinking that constant growth rate rules are optimal. It argues that any monetary rule is as good as any other from the viewpoint of the behavior of output. If it is desired to stabilize prices, then, provided there is serial correlation of disturbance terms in any of the equations, an activist rule would be better than a constant growth rate rule. Lucas argues that for a Keynesian, instrument instability is of no consequence, since only stability of goal variables matters. Exactly the same is true in the Lucas model. The only stability that matters–in the sense of predictability– is that of prices. If policy variables could be manipulated to improve the predictability of prices, then that would be an improvement.

In brief, I believe that the Lucas model is being used to advocate policy positions on which it has, at best, very little to say. Rather a host of subsidiary considerations are implicitly being invoked by those who argue for constant growth rate rules and nonactivism in general as optimal policies. These considerations are the same arguments that Friedman advanced in 1948 for nonactivism namely, that our ignorance is great–and they may well be convincing arguments. But it would be reasonable to conduct the argument on these grounds rather than the grounds Korteweg chooses.

In order to sharpen discussion, I would like to pose three questions, without any great confidence that they will be answered:

(i) Should the Fed tomorrow implement a policy of 4-percent growth in the money supply, having announced its intentions tonight? If not, why not?

(ii) If, after the Fed adopted a 4-percent rule, the inflation rate was 10 percent over the course of a year, what would you advise?

(iii) If the Fed adopted a 4-percent rule, and the unemployment rate rose to 8 percent, what would you advise?

The intent behind the first question is to pin down the issues of the length of period that is referred to in the typical rational expectations model. I expect very few people would want the growth rate of money to drop overnight. In explaining why not, they might say something about expectations being falsified. In practice, the falsification of those expectations is relfected in capital and labor contracts. The second and third questions are directed to the issue of shifts in the demand for money; these have occurred in the past, and can in principle be offset by the Fed. Under the extreme circumstances specified, the necessary policies would be sufficiently obvious that most arguments about their undesireability would not be persuasive.

There is finally the issue of the role of the economist as policy advisor. Our ignorance is indeed stupendous, and it is for that reason easy to exaggerate. Talking to noneconomists about economics is the best treatment of the error of assuming that we know nothing about the economy.

Does our ignorance suggest that economists should stay away from the giving of policy advice? That would be clear if not giving advice somehow resulted in better policies being followed. But economic advice will in any event be solicited by and given to policymakers. The real issue is whether better advice will be given by engineers, sociologists, or lawyers rather than by economists.

Of course, trained economists will give better advice on average than noneconomists. Whether such advice will be followed is another matter. But it is hard to see how policy could be systematically better if based on poor advice. Accordingly, economists should (and in any event will) give policy advice, and members of the profession should not be discouraged from serving in official policy advisory roles. Whoever takes an official job will find it necessary to agree to and support what he views as second-best policy,[6] but that is the nature of the policymaking process. It is precisely compromises of that sort that members of the McCracken Committee made in writing their Report; it is difficult to criticize them severely for trying to find policy formulations on which they could all agree, even if in the end they could not. Needless to say, no individual member of the profession need or will feel compelled to accept any particular job–we are probably all better off for having Milton Friedman and Bob Lucas remain free to state their views without having to engage in any polite compromises.

Notes

1. During the discussion at the Carnegie-Rochester Conference, David Laidler raised the question of how this Report compared with other committee reports, arguing that it was of a significantly lower standard than, for instance, the reports of the Commission on Money and Credit, or the Radcliffe Committee, and certainly the Bullion Commission. He speculated that this might have been a result of its failure to commission research or invite witnesses and/or the absence of a single strong intellectual leader of the group. The comparison is somewhat unfair since the present Report did have a much wider set of issues and countries to discuss than its distinguished predecessors.

2. Robert Solow suggests that this comment should distinguish between distortion-creating and distortion-removing interventions.

3. See Milton Friedman, *An Economist's Protest*, Thomas Horton, 1972, particularly pp. 6-14.

4. Incidentally, while fiscal policy has no predictable effects on output in the model that Korteweg uses, the mechanism underlying the aggregate supply curve in that model--intertemporal substitution of labor--would suggest a potent role for income taxes in affecting cyclical behavior.

5. I have explored this further in a paper prepared for the Bald Peak, New Hampshire Conference on Rational Expectations and Economic Policy, held in October 1978. See Fisher (1979).

6. There will doubtless be issues of principle over which resignations should occur.

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