Three views can be distinguished among economists. In this view, monetary policy, if well designed, may serve to stabilize the economy. To the extent that a Keynesian mechanism is at work, Keynesian policies will enhance welfare. But to the extent that fluctuations represent the economy’s efficient responses to changing real opportunities, successful stabilization will thwart these desirable responses. Just how aggressively policy should pursue stabilization will depend on which mechanism is most important in accounting for the business cycle. Lacking a clear answer, many economists believe that a cautiously countercyclical policy of some type may not be unwise.

Some Policy Considerations

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The financial crisis of 2007-2009, which led to the Great Recession, highlighted the importance of understanding the business cycle and its implications for economic policy. The crisis was triggered by a combination of factors, including subprime mortgage lending, unsustainable housing bubbles, and high levels of debt among households, businesses, and governments. As a result, policymakers faced difficult choices about how to respond to the crisis, and the effectiveness of various policy measures was debated extensively.

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The Keynesian economists attributed the Depression to insufficient overall demand. They held that wages and prices were too sticky in the short run to fall enough to eliminate excessive unemployment and other gaps between supply and demand. Instead, firms and workers would respond to rising or falling demand largely by increasing or decreasing output and employment in the short run. Consequently, government policies that stimulated spending would raise output as well as prices. At first, Keynesians argued that only direct

in equal proportion to the money increase. On the other hand, a rise in money demand due to rising output would, for a given money supply, tend to cause prices to fall as people tried to save money, so that the nominal supply would be adequate to carry out transactions. So long as prices adjusted fast enough, money growth and inflation would not appreciably disturb economic activity, and all resources would always be fully employed.

However, a strong positive relationship between inflation and overall activity was observed in the years prior to World War I. Economists began to suspect that markets do not clear rapidly enough for inflation to have no real effects. Finally, the severity of business cycles and the depth of the Great Depression made it appear that supply, particularly of labor, could exceed demand for commodities, and prices rose or fall (adjust) so that markets clear—that is, so that supply and demand are in balance. But the classical theory held that nominal prices or the overall price level did not influence supplies and demands of individual commodities. Instead, the prices that really matter to people are price ratios, or relative prices, which represent the terms of trade between different goods, and between leisure and consumption. If all nominal (or dollar) prices and wages are doubled, relative prices are unchanged, so that equilibrium quantities and outputs are also unchanged. It would seem to be a consequence that there is no effect of inflation—an overall increase in prices—on economic activity.

The overall price level, in turn, is determined by interaction of money supply and demand. For example, a rise in the supply of money would, given a stable money-wage ratio (velocity), translate into a higher volume of nominal spending on goods and services. This higher level of overall demand would not, however, be a reasonable approximation, affect any of the ultimate determinants of the economy’s output, so the classical view was that all prices would tend to be bid up

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government spending would have much effect. Monetary policy was thought ineffective because interest rates were always kept low. Hyperinflation, particularly in the Weimar Republic, helped to make people distrust Germany and depose the old ruling class. Depreciation, yet there were no unsatis-
ified creditworthy borrowers. In the context of the milder postwar recessions, however, they felt that monetary policy could stimulate spending by widening the money supply and lowering interest rates.

Monetarists had some technical dis-
agreements with Keynesians over the process linking monetary expansion to demand stimulation. Monetarists did not think it depended entirely on a fall in the interest rate. More importantly, they agreed with Keynesians that sticky prices and wages made for an interaction between nominal and real variables, they cautioned that the uncertain lags between policy actions and their effectiveness made it unlikely that active manipulation of the money supply would be helpful. They blamed economic fluctuations on instability in the money supply.

Problems of the Keynesian Model

Adjustment by firms and workers eventually would come to routinely raise prices rather than output. The idea that there is a certain level of economic activity that results when suppliers adjust to infla-
tion has been termed the natural-rate hypothesis. This hypothesis was so
nained because it held that, on average, the unemployment rate would equal a "natural rate" determined by real fac-
tors, such as labor force characteristics and the normal process of expansion and contraction of individual firms and industries. The unemployment rate could not be held down permanently by raising the rate of inflation. This hypothesis is no longer controversial.

Economists originally believed that the assumption that expectations adapted to past inflation, termed adap-
tive expectations, would make the mod-
el consistent with the natural-rate hypothesis. And although expectations are not explicitly represented in Keynesian models, they are consistent with the notion that a sustainable rate of inflation will have effects on economic activity only in the short run, until suppliers come to anticipate the infla-
tion. This improvement in the models made them a more plausible account of postwar data. (Indeed, in conjunction with the supply factors also incor-
posed, the models fit the historical data very well.) However, the notion of adaptive expectations was undermined in the 1970s by the seeming inability of accelerating inflation to bring about increased output and, more impor-
tantly, by a new recognition that this adaptive expectations notion is not consistent with the natural rate hypothesis after all. If expectations merely adapted to past experience, monetary policy could always keep accelerating inflation, thus keeping output above its natural level and unemployment artificially low.

The rational expectation hypothesis states that people could be consistently surprised by inflation. Although people do not have perfect foresight and may not use the knowledge they have, including knowledge of how monetary policy reacts to the business cycle. The remarkable conclusion was that, if the influence of money and inflation was due to the way it tricks suppliers and workers into increasing output and employment, then this influence cannot be systematic in any way. In particu-
lar, it cannot be systematically related to the state of the economy. If money growth is regularly increased during recessions, this will be expected and will only raise inflation. So monetary policy would be ineffective as a stabil-
ization tool. This would be true, even though unsystematic, hence, unex-
pected, changes in money growth and inflation would affect output.

The rational expectations hypothesis has proved too difficult to incorporate into the detailed statistical models. But its predictions have been am-
plicated and investment contracts in many ways, ranging from cost-of-living clauses and varying over time. In particular, different breaks and changing work rules and condi-
tions. Although some sticky-price or wage and pricing mechanisms are present, such as workers, suppliers, or firms making commitments at work in the business cycle, the earlier debates over rational expectations versus adaptive expectations have cul-
ted a healthy skepticism among economists regarding models that simply assume some plausible mechan-
ism rather than working out how individual people would rationally behave under different policies. A model or relationship that is not worked out in terms of the underlying incentives of individuals generally breaks down when policy, or any other aspect of the economic environment, changes. It would be very difficult to rationally relate variables, it would be very difficult to rationally relate rela-
tionships may not provide reliable guides for policy.