Is Postwar Stability Spurious?\footnote{Some readers may ask why we examine out-
put variability when the growth trend itself is correct, the recent volatility in
our economy is minor when compared to what happened between 1900 and
the start of World War II. Between 1900 and 1940, the growth rate
of real GNP swung wildly. (See chart 1.) It varied between a high of
10.6 percent in 1909, to a low of -14.8 percent in 1932.

The period since the end of World War II, in contrast, has been relatively
stable. Between 1947 and 1984, the maximum and minimum growth rates of
real GNP were 9.6 percent in 1950 and 2.1 percent in 1982. Not
only were the extremes reduced in the postwar period, but the standard deviation in the
growth rate since 1950 was also reduced to about 50 percent—excluding the years 1917 to
1921, which were influenced by World War I and its aftermath.\footnote{This greater stability in economic output is also reflected in the unem-
ployment rate (chart 2), which generally has been more stable in the post-
war period.}

Even the rate of inflation has become more stable. The standard deviation of the GNP implicit
price deflator decreased by about 30
percent in the postwar period.\footnote{The dramatic changes in the sta-
bility of inflation, GNP, and unem-
ployment before and after the Second
World War are of keen interest to
economists. An effort to explain these
differences is at the heart of the cur-
taneous period.}

Romer’s estimates understandably have not been widely accepted by other economists. Although she pre-
sents a persuasive argument, there is no evidence that points to greater stability in the postwar period. For
example, estimates of the duration of business cycles computed by the Na-
tional Bureau of Economic Research, which are based on a wider data set
than that used by Romer, suggest greater stability. Compared with the
period from 1854 to 1940, the average duration of recessions in the postwar
period is shorter by about 10 months,
while that of expansions is longer by about 16 months.

Conclusion

The debate about the causes of greater economic stability after the
Second World War may be premature and esoteric. However, the outcome
is important because it will influence government policy decisions that will
affect just about every aspect of our
economy in the future.

The growing governmental share
of GNP, as well as some automatic sta-
tabilizers, such as deposit insurance,
remain the least controversial factors con-
tributing to postwar stability and thus
must be used to argue for a continued
(continued)
rent debate in economics about the effectiveness of the government’s fiscal and monetary stabilization policies. Some economists believe, by using its taxing and spending powers, and the Federal Reserve System, by using its ability to alter the supply of bank reserves, can control the business cycle enough to prevent the kind of instability that took place before the Second World War.

Economists have a number of widely differing viewpoints. Some, for example, such as Baily (1978) and DeLong and Summers (1984) use inflation as the criterion to argue that institutional and structural changes in the economy, as well as deliberate stabilization policies, have been responsible for the improved postwar performance. Others, such as Herbert Stein of the American Enterprise Institute and Professor Christina Romer of Princeton University, argue that the effects of these changes are not so clear. Romer, in fact, argues that the difference in the economy’s behavior before and after World War II is simply a quirk in the smaller number of business cycles pre-World War II GNP show much less volatility in the economy—only slightly greater than that observed in the last 50 years. In this Economic Commentary, we survey the major arguments used to explain postwar economic stability and discuss why the data may be faulty.

Competitive Factors

Most economists believe that the amount of competition in product and labor markets has an effect on price fluctuations and, consequently, on the stability of the economy, with supply fixed in the short run, imbalances in supply and demand for goods and labor are quite small with changes in prices and wages. As markets become less competitive, prices rise and fall quickly in response to changes in demand, as for example oil supply shocks

that affect the balance between supply and demand. Thus, a less competitive economy experiences more rapid short-run price changes. Some economists believe that the trend toward less competition since the end of the Second World War explains the increase in relative prices in prices during the last 40 years.

This argument centers on both the goods and labor markets. Labor markets, for example, became much less competitive after 1945. Labor unions gained membership, status, and, hence, market power. Instead of bargains with individuals who either had little or no power to bargain, unions had to bargain with unions that could very effectively threaten the employer with a strike and the loss of customers and profits if wage demands were not met. In goods markets, industry concentration increased after the war. For example, the value added by the largest 200 corporations increased from 23 percent of total value added in 1947 to 33 percent in 1970. The larger size and smaller number of firms in industry reduced the competitiveness of markets for the goods they sold, as well as for the factors of production they bought.

Implicit Contracts

The use of implicit contracts in the postwar period is another institutional change that some economists (Azariadis 1975, Baily 1978, and Okun 1983) believe has promoted employment and consumer stability. The implicit contract theory states that because firms and workers are averse to risk and want to have stable incomes, they are willing to forgo larger increases in some other factor, such as large income losses. Under this theory, workers will not leave a job when business is good and firms will not fire employees when business is bad. Workers thus avoid large income losses by avoiding job loss during recessions, and large increases in income and larger and more attractive training programs. Without long-term expansions by maintaining a skilled and available labor force. Wages and employment are thus stabilized by this mutually beneficial relationship. Okun extends the implicit contract theory to product markets. Instead of raising prices and increasing profits at peak capacity, firms increase back orders and ration available supplies among preferred customers. Thus, they profit from having to wait longer the longer run by not reacting to every increase in demand with a price hike. In other words, “the kings of tight markets,” says Okun, “the sellers build a clientele and establish a reputation that helps to retain customers.” Prices and real incomes are therefore higher in tight markets.

Compositional Explanations

Some economists have looked at the components of GNP to see whether or not the growth of GNP has declined rather mechanistically because of the relatively more volatile components, such as farm output and consumer durables. Instead of aggregating income, sales, and prices, etc., take up a smaller share of GNP than they did before the end of World War II. Unfortunately, the data contradict this hypothesis. Agricultural output has declined dramatically as a fraction of GNP, but the notion that it is a volatile sector is unfounded. The standard deviation in the growth of agricultural output is less than the standard deviation in GNP both during the pre- and after World War II. Thus, a decline in the agricultural share of the economy should, all else remaining equal, lead to a smaller increase in the volatility of GNP. The share of consumer durable purchases in GNP actually has risen during the last 50 years, so the relative volatility of this segment of the economy is irrelevant to decreased swings in overall GNP.

Some economists believe that the postwar economy has shown increased stability because it has become more service-oriented. Service workers maintain close communications, private education, etc., take up a larger share of GNP, and are seen as a stabilizing influence because they are less volatile than other sectors, such as consumer durables. This argument, however, is difficult to evaluate because demand for services is cyclical, and the cyclical swings are not limited to the cyclical swings of the larger average size of firms and the smaller number of firms in industry reduced the competitiveness of markets for the goods they sold, as well as for the factors of production they bought.

References


Policy Tools

The effect of discretionary policy tools is far more controversial than the effect of automatic stabilizers. Generally, these policy tools are changes in federal government spending and taxes, the supply of bank reserves that are made at the discretion of policymakers in order to counteract undesired income and price changes. Although most economists believe that the use of these tools can affect prices and real output at least in the short run, many believe that such effects are offset by the automatic stabilizers effectively.

Critics charge that policymakers do not always consider the stabilizing effect of the current state of the economy, that their understanding of the economy is imprecise, that there are delays that distort the policymaking process, and that political concerns often override efficient economic considerations. The record of the effective use of discretionary policy is considered mixed. (See Perry 1976).

Other Explanations

DeLong and Summers do not attempt to explain the greater stability of post World War II GNP, but they do show that decreased price variance (for whatever reason) lessens output fluctuations. Volatile prices make estimating future inflations difficult. Under a system in which the rate of change in wages and the rate of change in prices are not predictable, it is generally assumed that a high rate of inflation makes the economy by spending demand for goods and services. In a recession, as personal income falls, the tax burden is reduced, which again increases the demand for goods and services. Another important automatic stabilizer is social insurance. The government is deposit insurance (the FDIC and FSLIC, respectively). Many economists argue that the effect of deposit insurance has helped limit the number of bank runs and financial panics that were so common before the end of World War II. Firms maintain confidence that the government will cover any deposit losses due to bank failure, they have no incentive to panic and withdraw funds from suspect banks.


rent debate in economics about the effectiveness of the government’s fiscal and monetary stabilization policies. For example, the government, by using its taxing and spending powers, and the Federal Reserve System, by using its ability to alter the supply of bank reserves, can try to keep the business cycle as smooth as possible. Economists debate the effectiveness of these policies by trying to identify the trend behavior and cyclical deviations of various economic variables. In most cases, the effects of lag in the system and problems of measurement complicate interpretation of the data. Research by many economists and the Federal Reserve System indicates that the business cycle is quite volatile compared to the underlying economic processes. A few other important views were discussed in the preceding section.

The output of a government’s economic policies is contingent on many factors, including the nature of the demand for goods and services, the level of government spending, the pricing behavior of businesses, and external shocks such as oil price shocks.

3. Although this argument strictly deals with relatively few factors, others believe that the relative prices contribute to more variable absolute prices. (See Stockton 1985.)

Competitive Factors

Most economists believe that the amount of competition in product and labor markets has an effect on price fluctuations. If the government increases the competitiveness of its economy, with supply fixed in the short run, imbalances in supply and demand for goods and labor are quickly reduced with changes in prices and wages.

As markets become less competitive, prices rise and fall quickly in response to short-term economic events (such as oil price shocks) that affect the balance between supply and demand. Thus, a less competitive economic experience smaller short-run price changes. Some economists believe that the trend toward less competition since the end of the Second World War explains the increase in the variability of prices during the past 40 years.

This argument centers on both the goods and labor markets. Labor markets, for example, became much less competitive after 1945. Labor unions gained much more power, and hence, market power. Instead of bargaining with individual employers, each of whom had little market power, firms had to bargain with unions that could very effectively threaten the employer with a strike and the loss of customers and profits if wage demands were not met.

Compositional Explanations

Some economists have looked at the components of GNP to see whether or not they support this hypothesis. Agricultural output is less than the share that GNP from 1947 to 1970. The larger size and the larger number of factors industry reduced the competitiveness of markets for the goods they sold, as well as for the factors of production they bought.

Implicit Contracts

The use of implicit contracts in the postwar period is another institutional change that many economists (Azariadis 1975, Baily 1979, and Okun 1984) believe have promoted employment and customer stability. The implicit contract theory states that because firms and workers are averse to risk and want to have stable incomes, they are willing to forgo large gains to achieve a more certain income. Under this theory, workers will not leave a job when business is good and firms will not fire employees when business is bad. Workers thus avoid large income losses by avoiding job loss during recessions, and firms avoid large losses in income and labor costs and training during expansions by maintaining a skilled and available labor force. Wages and employment are thus stabilized by this mutually beneficial relationship.

Okun extends the implicit contract theory to product markets. Instead of raising prices and increasing profits at peak capacity, firms increase back orders and ration available supplies among preferred customers. Thus, demand for labor and for output are reduced over the long run by not reacting to every increase in demand with a price hike. This is what Okun means by “tight markets,” says Okun, “the sellers build a clientele and establish a reputation that helps to retain customers when markets ease.” Prices and output are thus stabilized.

Government’s Stabilizing Effect

A few economists believe that government’s explanation for the decreased variation in real GNP is the growth in the government sector. From under 1 percent in 1900, total government outlays now amount to roughly 25 percent of GNP. Government outlays help stabilize GNP because a large proportion of postwar growth has not occurred in the private sector. As long as the government sector is growing, and as long as its output is government services, the government can increase demand for goods and services. In recession, as personal income falls, the tax burden is reduced, which alleviates the pressure on the economy by slowing demand for goods and services.

Another important stabilizing effect of government is its deposit insurance (the FDIC and FSLIC, respectively). Many economists believe that the existence of deposit insurance has helped limit the number of bank runs and financial panics that were so common before World War II. The government maintains confidence that the government will cover any deposit losses due to bank failure, they have no response to prudently withdraw funds from suspect banks.

Other Explanations

DeLong and Summers do not attempt to explain the larger stability of postwar output (as measured by relative price variance) for the reasons that follow (see Perry 1976).

REFERENCES


Is Postwar Stability Spurious? Intuitively, one would expect the different variabilities of the two periods to be understated because it would seem that the pre-war data contain relatively more smooth approximations for missing data. However, in a recent paper, Christina Romer (1985) argues that these smooth approximations are swamped by a key assumption that impacts volatility. In the pre-war period, government policy decisions that will affect just about every aspect of our economy in the future.

The growing governmental share of GNP, as well as some automatic stabilizers, such as deposit insurance, remain the least controversial factors contributing to postwar stability and thus can be used to argue for a continued governmental role in such matters.

However, the effect of discretionary governmental policies on the business cycle is not clear: more research definitively is warranted. If it is found to be true that the greater stability of the postwar period is simply a statistical mirage, then arguments for reducing the role of government in the economy would be strengthened.

Romer’s estimates understandably have not been widely accepted by other economists. Although she presents a persuasive argument, there is other evidence that points to greater stability in the postwar period. For example, estimates of the duration of business cycles compiled by the National Bureau of Economic Research, which are based on a wider data set than that used by Romer, suggest greater stability. Compared with the period from 1854 to 1940, the average duration of recessions in the postwar period is shorter by about 10 months, while that of expansions is longer by about 16 months.

Conclusion
The debate about the causes of greater economic stability after World War II may well prove to be more esoteric. However, the outcome is important because it will influence government policy decisions that will affect just about every aspect of our economy in the future.

The growing governmental share of GNP, as well as some automatic stabilizers, such as deposit insurance, remain the least controversial factors contributing to postwar stability and thus can be used to argue for a continued governmental role in such matters.

However, the effect of discretionary governmental policies on the business cycle is not clear: more research definitively is warranted. If it is found to be true that the greater stability of the postwar period is simply a statistical mirage, then arguments for reducing the role of government in the economy would be strengthened.

Since 1981, business activity has been cycling through high and low points so often that the casual observer might get the impression that the economy has become unstable.

Between 1981 and 1982, for example, inflation-adjusted (real) gross national product (GNP) fell 0.2 percent in 1981 and 1.2 percent in 1982. This was followed by a recovery in 1983 and 1984, with real GNP growing in both years. The timing of these changes was influenced by both domestic and international factors.

The debate about the causes of greater economic stability after World War II may well prove to be more esoteric. However, the outcome is important because it will influence government policy decisions that will affect just about every aspect of our economy in the future.

The growing governmental share of GNP, as well as some automatic stabilizers, such as deposit insurance, remain the least controversial factors contributing to postwar stability and thus can be used to argue for a continued governmental role in such matters.

However, the effect of discretionary governmental policies on the business cycle is not clear: more research definitively is warranted. If it is found to be true that the greater stability of the postwar period is simply a statistical mirage, then arguments for reducing the role of government in the economy would be strengthened.

Since 1981, business activity has been cycling through high and low points so often that the casual observer might get the impression that the economy has become unstable.

Between 1981 and 1982, for example, inflation-adjusted (real) gross national product (GNP) fell 0.2 percent in 1981 and 1.2 percent in 1982. This was followed by a recovery in 1983 and 1984, with real GNP growing in both years. The timing of these changes was influenced by both domestic and international factors.

The debate about the causes of greater economic stability after World War II may well prove to be more esoteric. However, the outcome is important because it will influence government policy decisions that will affect just about every aspect of our economy in the future.

The growing governmental share of GNP, as well as some automatic stabilizers, such as deposit insurance, remain the least controversial factors contributing to postwar stability and thus can be used to argue for a continued governmental role in such matters.

However, the effect of discretionary governmental policies on the business cycle is not clear: more research definitively is warranted. If it is found to be true that the greater stability of the postwar period is simply a statistical mirage, then arguments for reducing the role of government in the economy would be strengthened.