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STABILIZATION POLICY: MACROECONOMIC DIMENSIONS

СТАБІЛІЗАЦІЙНА ПОЛІТИКА: МАКРОЕКОНОМІЧНІ ВИМІРИ

СТАБИЛИЗАЦИОННАЯ ПОЛИТИКА: МАКРОЭКОНОМИЧЕСКИЕ ИЗМЕРЕНИЯ

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Abstract. *The article studies models and conceptions of stabilization policy that aims to reduce the severity of economic fluctuations in the short term. According to the economic science, production and employment fluctuate around their natural levels in the long run. The paper reveals, that stabilization policies are designed to defuse the business cycle phases, bringing production and employment to its natural level. It uncovers, that the main function of stabilization policy is to limit short-term deviations in the system of long-term market equilibrium. This is done in the form of aggregate supply – aggregate demand by establishing relationships between potential output and prices of production, on the one hand, and the relationship between aggregate demand and industrial production prices – on the other. The government's instruments are fiscal and monetary policy, which maintains high and stable levels of economic activity.*

The article outlines, that the best option for stabilization policy is to stimulate aggregate supply and use only certain aspects of aggregate demand in the absence of real prerequisites for its improvement under current economic conditions. Therefore, neoclassical paradigm and monetary concept should be taken for the basis of stabilization.

Key words: *stabilization policy, Ukraine, macroeconomic policy, economic growth, foreign equilibrium, full employment.*

Анотація. *Розглянуто моделі і концепції стабілізаційної політики, яка спрямована на зменшення гостроти економічних коливань у короткостроковому періоді. У довго-*

строковому періоді, як встановлено економічною наукою, обсяг виробництва і зайнятість коливаються навколо своїх природних рівнів. Тому стабілізаційна політика покликана згладжувати фази ділового циклу, наближаючи обсяг виробництва і зайнятість до свого природного рівня. Виявлено, що головна функція стабілізаційної політики полягає в обмеженні короткострокового відхилення в системі довгострокової ринкової рівноваги. Це здійснюється у форматі сукупної пропозиції – сукупного попиту шляхом встановлення співвідношень між потенційним випуском та цінами виробництва, з одного боку, та співвідношень між сукупним виробничим попитом та цінами виробництва – з іншого. Уряд використовує при цьому інструменти бюджетної (фіскальної) та грошово-кредитної (монетарної) політики з метою підтримання високого і стабільного рівня економічної активності.

Виявлено, що у сучасних економічних умовах України оптимальним варіантом стабілізаційної політики є стимулювання сукупної пропозиції та використання лише окремих аспектів сукупного попиту у зв'язку з відсутністю реальних передумов для його підвищення. Тобто за основу стабілізаційної політики слід взяти неокласичну парадигму, монетаристську концепцію.

Ключові слова: *стабілізаційна політика, Україна, макроекономічна політика, економічне зростання, зовнішня рівновага, повна зайнятість.*

Аннотация. *Рассмотрены модели и концепции стабилизационной политики, направленной на сглаживание остроты экономических колебаний в краткосрочном периоде. В долгосрочном периоде, как установлено экономической наукой, объемы производства и занятости колеблются вокруг своих природных уровней. Обнаружено, что главная функция стабилизационной политики состоит в том, чтобы ограничить краткосрочные отклонения в системе долгосрочного рыночного равновесия. Это осуществляется в формате совокупного предложения – совокупного спроса путем установления соотношений между потенциальным выпуском и ценами производства, с одной стороны, и соотношений между совокупным производственным спросом и ценами производства – с другой. Правительство использует при этом инструменты бюджетной (фискальной) и кредитно-денежной (монетарной) политики с целью поддержания высокого уровня экономической активности.*

Установлено, что в современных экономических условиях Украины оптимальным вариантом стабилизационной политики является стимулирование совокупного предложения и использование только отдельных аспектов совокупного спроса в связи с отсутствием реальных предпосылок его повышения. То есть в основу стабилизационной политики следует положить неоклассическую парадигму, монетаристскую концепцию.

Ключевые слова: *стабилизационная политика, Украина, макроэкономическая политика, экономический рост, внешнее равновесие, полная занятость.*

Current problems. Dictionary of Economics defines stabilization policy as government action aimed at reducing in national income. During the long-term period production and employment fluctuate around their natural levels. Therefore, stabilization policies are designed to smooth out the business cycle phase, bringing production and employment to their natural level. The main function of stabilization policy is to limit short-term deviations in the system of long-term market equilibrium. This is accomplished in the form of aggregate supply – aggregate demand by establishing relationships between potential output and prices of production, on the one hand, and the relationships between aggregate demand and industrial production prices, on the other hand. The government uses instruments of the budget (fiscal) and monetary policy in order to maintain high and stable levels of economic activity. The issues of stabilization policy

have been discussed by Modigliani [*Modigliani*, 2011], Mundell [*Mundell*, 1968], Scarth [*Scarth*, 2014], Taylor [*Taylor*, 1995], Tinbergen [*Tinbergen*, 1967], etc.

The aim of the article is to analyze the main macroeconomic dimensions of stabilization policy. In particular, attention is paid to the so called magic polygon, which contains full employment, fair distribution of income, the prices stability, economic growth, foreign equilibrium, and environmental protection.

Important research results. Stabilization policy is equated to the level of aggregate demand management in order to mitigate or eliminate fluctuations in economic activity related to the business cycle. The main goal of demand management is 'fine tuning' of aggregate demand, which involves two main tasks. On the one hand, we must ensure its sufficient level of potential GDP, preventing the loss of production and services, and rising unemployment. On the other hand, demand management is aimed at avoiding its excess, which can cause inflation. Aggregate demand is stimulated when the economy is in a state of depression. During the "overheating" of the economy the government reduces demand through appropriate instruments. The best way is a demand management when an increase in aggregate demand is consistent with the GDP growth. The achievement of this ratio encounters two problems. Firstly, it is about establishing the precise moment when we must carry out extraction of resources from the economy, or otherwise provide them additional income to smooth cyclical fluctuations. Secondly, we have to determine the amount of resources that should be removed from or poured into the economy at extreme phases of the business cycle (boom, depression). Inaccuracies in these calculations are determined by institutional, behavioral factors and a lack of reliable knowledge about these economic processes.

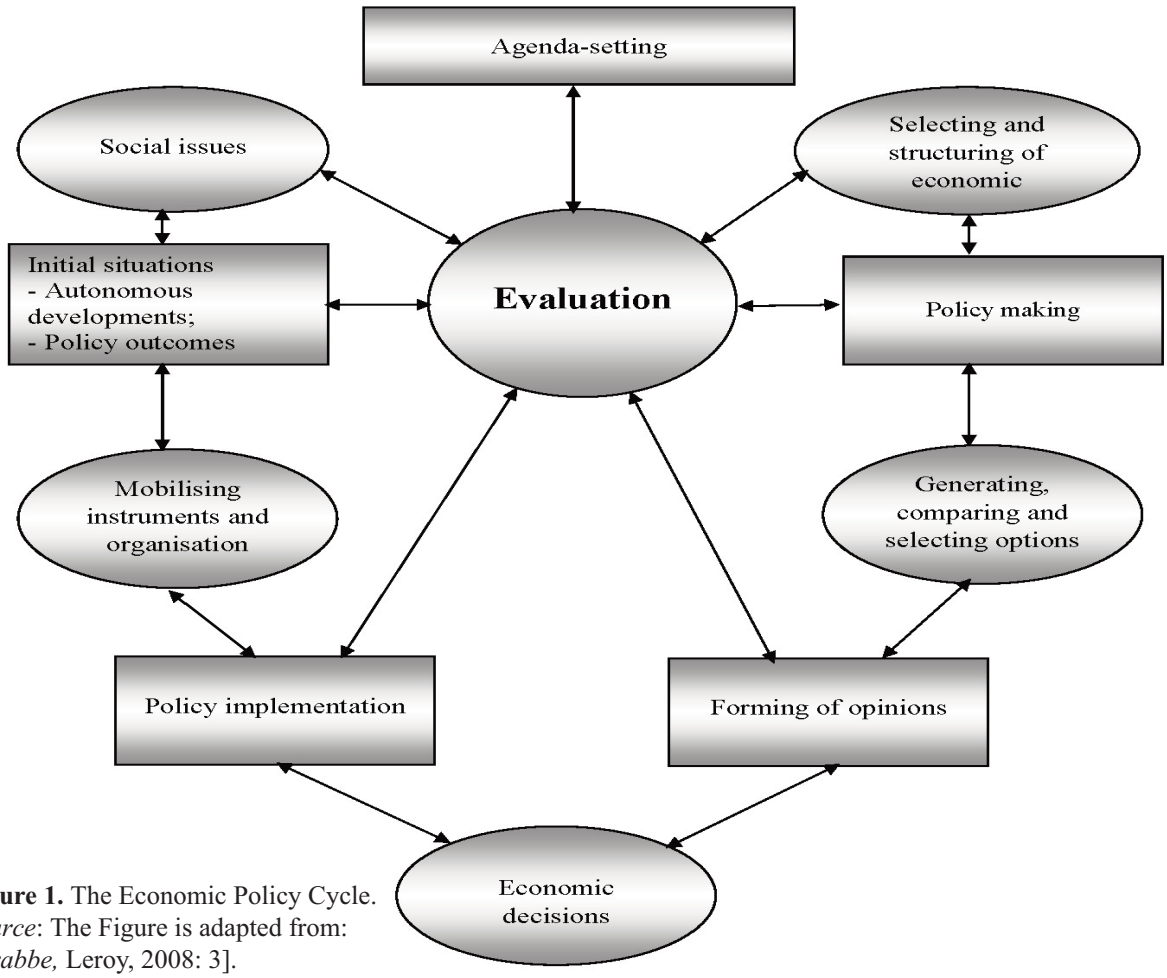

Figure 1. The Economic Policy Cycle.
Source: The Figure is adapted from: [*Grabbe,* Leroy, 2008: 3].

Theoretical background. Economists have different views in the stabilization policy. Some economists argue that the government should use monetary and fiscal policy only to achieve long-term goals, such as economic growth and low inflation, and to allow a national economy cope with short-term fluctuations itself. Thus, they doubt deeply in the practical value of the government regulation [*Scarth*, 2014: 150-151].

The main argument against active monetary and fiscal policy is an inevitable delay of ongoing activities or the so-called time lag. Measures of monetary policy led to a change in interest rates, which, in turn, has an impact on investment expenditures. However, most of the investment plans of firms are designed far ahead. Therefore, in order to achieve any effect on production and employment (involving adjustments to the plans of economic agents) a minimum period of six months (sometimes even a few years) is required.

Critics of stabilization policy argue that due to the time lag the Central Bank should stop trying 'fine tuning' of the economy. They argue that the Central bank is doomed to constant delays, and, ultimately, its action is rather the cause of economic fluctuations rather than a cure for them. Critics advocate the need for a passive monetary policy, such as high and stable growth of money supply.

Fiscal policy is also lagging, but, unlike monetary policy, its backlog to a large extent can be ascribed to the political process [*Mankiw*, 2000: 228-229].

The problem of time lags in the monetary and fiscal policy is partly linked to the level of accuracy of economic forecasts. If economists had an ability to accurately predict future economic growth for at least a year in advance, the use of instruments of monetary and fiscal policy would not cause an objection, even taking into account the time lags. However, recession and depression occur without any prior notice. To our mind, the only true policy is the solution of economic problems as they arise.

In a situation of crisis, in the state of economic recession, the primary objective is to restore the macroeconomic equilibrium and create prerequisites for economic growth by way of utilizing stabilization policy tools. Macroeconomic stabilization is aimed at eliminating exogenous shocks that disrupt the inner balance of economy (it is defined as full employment along with price stability). Stabilization policy presupposes bringing economy to a state of equilibrium within the meaning of Keynesian theory, as well as restoring the trajectory of real business cycle (RBC) in line with the neoclassical concept, predominantly through the use of monetary and budget policy levers.

Stabilization and growth. Stabilization model is determined by the current state of Ukraine's economy, which requires macroeconomic stability, external balance, entering the trajectory of economic growth, solving urgent social problems (Figure 2). The main parameters of stabilization policies are calculated using econometric macroeconomic models of general equilibrium.

At the first sight, it may seem that growth and stabilization pursue similar objectives. The difference between them lies precisely in the distinction between the increase of production volume in the long term and the short-term fluctuations around the trend. The allocation policy (allocation of resources) is oriented towards the increase of the maximum production level without generating inflation, which has come to be designated as potential growth, while the goal of stabilization policy is to minimize the discrepancies between actual and potential output, which is known as output gap (Figure 3).

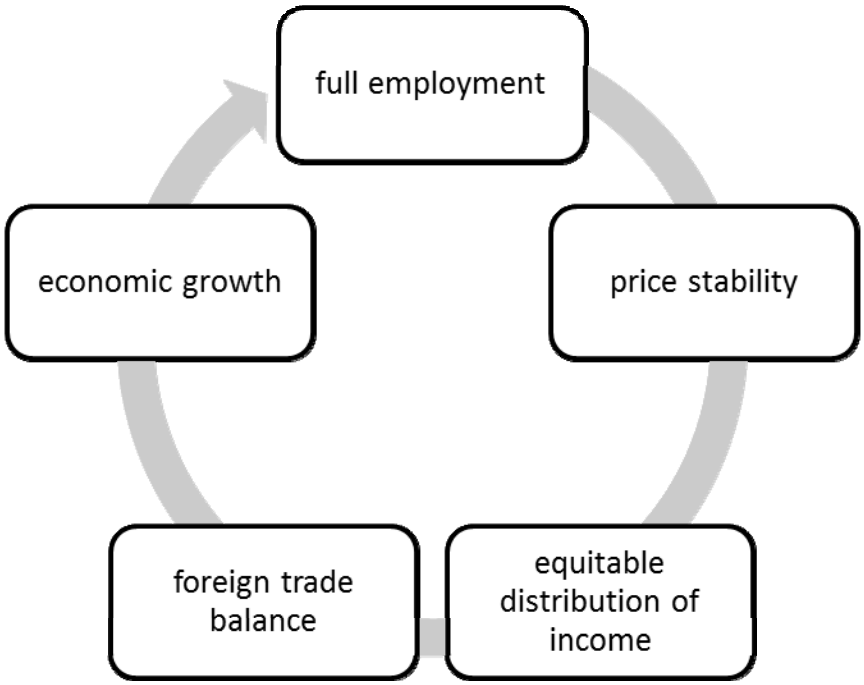

Figure 2. Magic Pentagon of Economic Growth

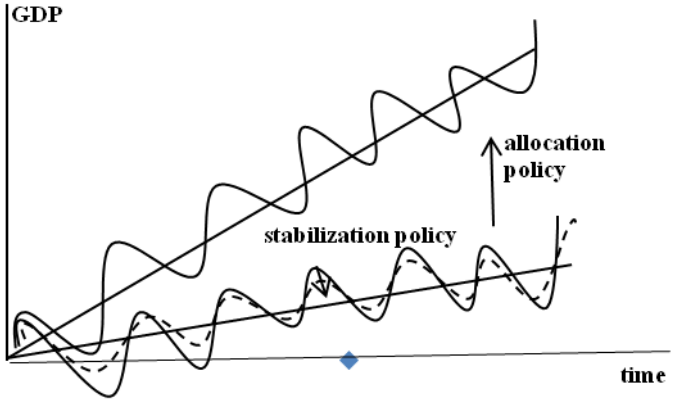

Figure 3. Magic Pentagon of Economic Growth.
Source: [*Benassy-Quere et. al*, 2010: 21].

Output gap (OG) may be defined as the difference between the demand-determined output Y_t and supply-determined potential output $\bar{Y}_t$. As a rule, it is measured as a percentage of the potential output, i. e.:

$$OG = \frac{Y_t}{\bar{Y}_t} - 1$$

There exist a few stabilization policy concepts, in particular, post-Keynesian, neoclassical, and Schumpeterian ones [*Welfens*, 2008: 302-303].

Post-Keynesian approach. Post-Keynesian methodology of stabilization policy is oriented towards the stimulation of aggregate demand due to the decrease of tax level, the increase of state consumption, investment activities stimulation through the reduction of Central Bank discount rate, the reduction of the depreciation period and respective increase of investment return [*Jespersen*, 2009: 39-40]. The main objective of the post-Keynesian stabilization policy is securing

full employment with price stabilization playing a secondary role. In the short term, the excess of the budget deficit norm is permissible. State intervention is performed as counter-cyclical regulation by the means of fiscal policy aimed at aggregate demand stimulation.

Keynes gave two reasons for such intervention. The first one is what he called 'animal spirit', the instability of private behavior under the influence of spontaneous expectations leading to excessive optimism followed by excesses of pessimism. Second, Keynes argued that nominal rigidities of wages and prices prevent the self-correcting market mechanisms from operating and moving the economy back to equilibrium. In the eyes of Keynes, the combination of private instability and ineffective self-correcting mechanisms provided a justification for relying on counter-cyclical monetary and fiscal policies to smooth out economic fluctuations and prevent economic depressions.

A shock can be described as positive if it increases aggregate output relative to the money supply. Clearly in monetarist terminology a positive demand shock is one that has the effect of increasing the velocity of circulation at the initial output level.

A demand shock is an exogenous modification in the relationship between product demand and the product price. This can be, for example, a drop in the level of household consumption resulting from a reduction of household wealth [*Benassy-Quere et.al,* 2010: 32].

How will the system respond to a demand shock? The answer depends on the response of wages and prices to positive or negative excess demand. If prices and wages are fully flexible, demand shocks will not affect output and employment, except for a short time, as the change in wages and prices will produce the change in real money supply necessary to make it consistent with full-employment output and the new velocity. With the occurrence of significant demand shocks and velocity changes, there is, in principle, a clear need for stabilization policies – monetary or fiscal – even when wages and prices are quite responsive to positive as well as negative excess demand [*Modigliani*, 2011: 8-9].

Neoclassical approach. Neoclassical concept is focused on supply stimulation. Its primary objective is securing price stability as a prerequisite for the functioning of the market mechanism and the revival of economic growth. The constituents of the concept are investment-facilitating policy, while implementing the reduction of income tax and corporate tax levels, and a more flexible wages policy; stimulating the development of new forms of entrepreneurship, deregulation, trading openness, and establishment of regional cluster unions. A supply shocks an exogenous modification in the relationship between potential output and the product price [*Wolff and Resnick*, 2012: 37-38]. For example, at any given level of the wage and the product price an oil shock (a rise in the price of oil) reduces the level of potential output because it increases prices and reduces the profitability of production.

During a decline period, expansionist monetary policy is implemented. Fiscal policy is directed towards securing a sufficient level of public goods production.

The neoclassical concept of stabilization is based upon three central hypotheses:

- the private sector immanent stability hypothesis;
- the fundamental theoretical foundations of the supply-side economy;
- and monetary policy dominance [*Mussel / Pätzold*, 2012: 11].

Austrian school. Schumpeterian stabilization policy is mainly employed in the context of mid-term and long-term economic growth on the basis of state facilitation of innovation processes, particularly, by way of expanding the norm of capital accumulation in GDP. Chief focus is on information and communication branches (ICT) with quick return of capital, which, to a large extent, become the engine of modern economic development [*Heise,* 2005:27].

Certain authors also single out Austrian-Keynesian stabilization policy, characteristic of which are both classical Keynesian tenets (aggregate demand stimulation, full employment pri-

ority etc.) and rigid monetary policy of fixed exchange rate, stabilization income policy, expansive fiscal policy, etc.

Mechanism of stabilization policy. The major tools of stabilization policy are fiscal and monetary ones, which are used in different combinations depending on the economic condition in a country, as well as short-term and long-term goals of economic policy. Fiscal policy encompasses three main directions: the use of the so-called discretionary approaches, i.e. such economic policy tools that do not conform to strict rules formulated by economic science and developed through practical experience. Such measures are used, as a rule, under the extraordinary circumstances (economic, political, financial crises, military actions, natural disasters, etc.). Another direction, which is opposite to the first one in a way, is the use of automated stabilizers as the primary toolkit of stabilization policy (Figure 4). The said direction prevails in monetarist concepts of stabilization policy. The third component of stabilization policy is based on the "harsh rules" policy, which to a greater extent means implementing a stability policy, and is becoming less significant in stabilization policy [*Kronberger/Hofer*, 2012: 348-349].

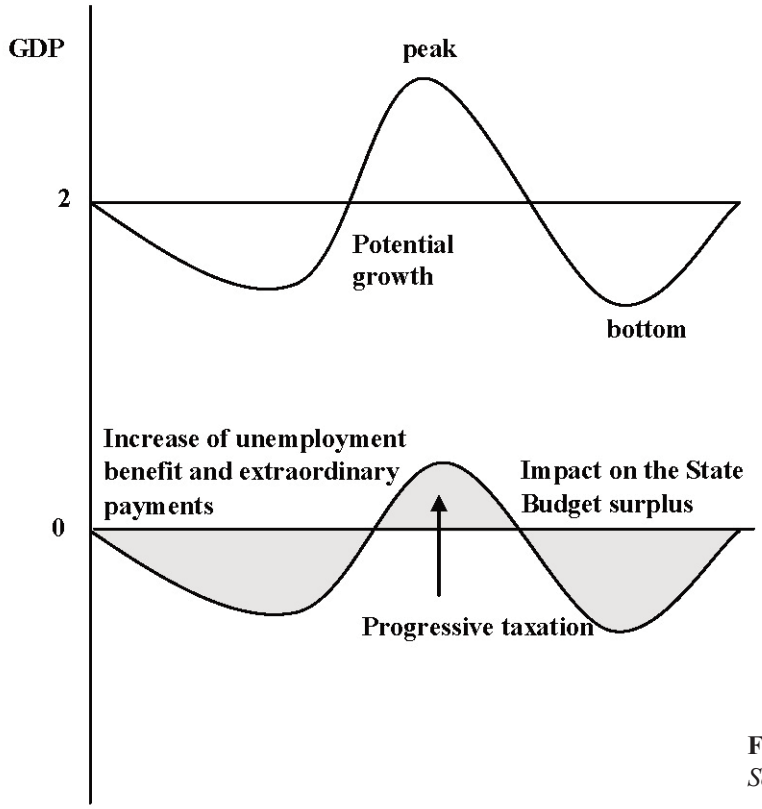

Figure 4. Automatic Stabilizers.
Source: [*Kronberger/Hofer,* 2012: 349].

Under the conditions of production volume reduction and stagnation, which is observed in Ukraine, counter-cyclical tools of fiscal policy gain significance. At the low phase of economic situation, consumption (expenditures) is stimulated, including by way of using public funds to support the unemployed. At the high phase of economic situation, value added tax is raised in order to avoid economy overheating. Progressive increase of tax rate facilitates the increase of budget incomes, the improvement of economic condition, and the transfer of tax payers to other categories. In low-level conditions, expenses increase automatically and, consequently, state budget surplus worsens [*Bird,* 2007: 113-116]. Revitalization of economic activity allows increase income and build up budget receipts. The advantage of the said fiscal tools lies in the absence of any special political decisions made with regard to the economic condition in the country.

Basic hypotheses. In the general sense, the basic hypotheses of stabilization concepts of the neoclassical and supply-side schools are combined within six directions:

- the decrease of marginal tax rate;
- intensifying the facilitation of scientific research;
- raising competition level in infrastructure sectors;
- promoting the establishment of new enterprises;
- market deregulation and the reduction of bureaucratization;
- implementation of measures aimed at promoting e-economy [*Etchemendy,* 2011: 9-10].

Stabilization policy in Ukraine. Under the present-day economic conditions in Ukraine, an optimal option of stabilization policy is the stimulation of aggregate supply and the use of separate aspects of aggregate demand due to the absence of real prerequisites for its increase [*Carlin and Soskice,* 2015: 42-43]. That is, taken up as the basis of stabilization policy should be neoclassical paradigm, monetarist concept, which the IMF also employs in its guidelines and stabilization models (Figure 5). Emphasis ought to be placed again on the counter-cyclical character of stabilization policy, which will prevail prior to the breaking point in the recession cycle, after which it will become possible to discuss the use of pro-cyclical stabilization policy aimed at the consolidation of positive trends in economic dynamics and securing sustainable economic growth.

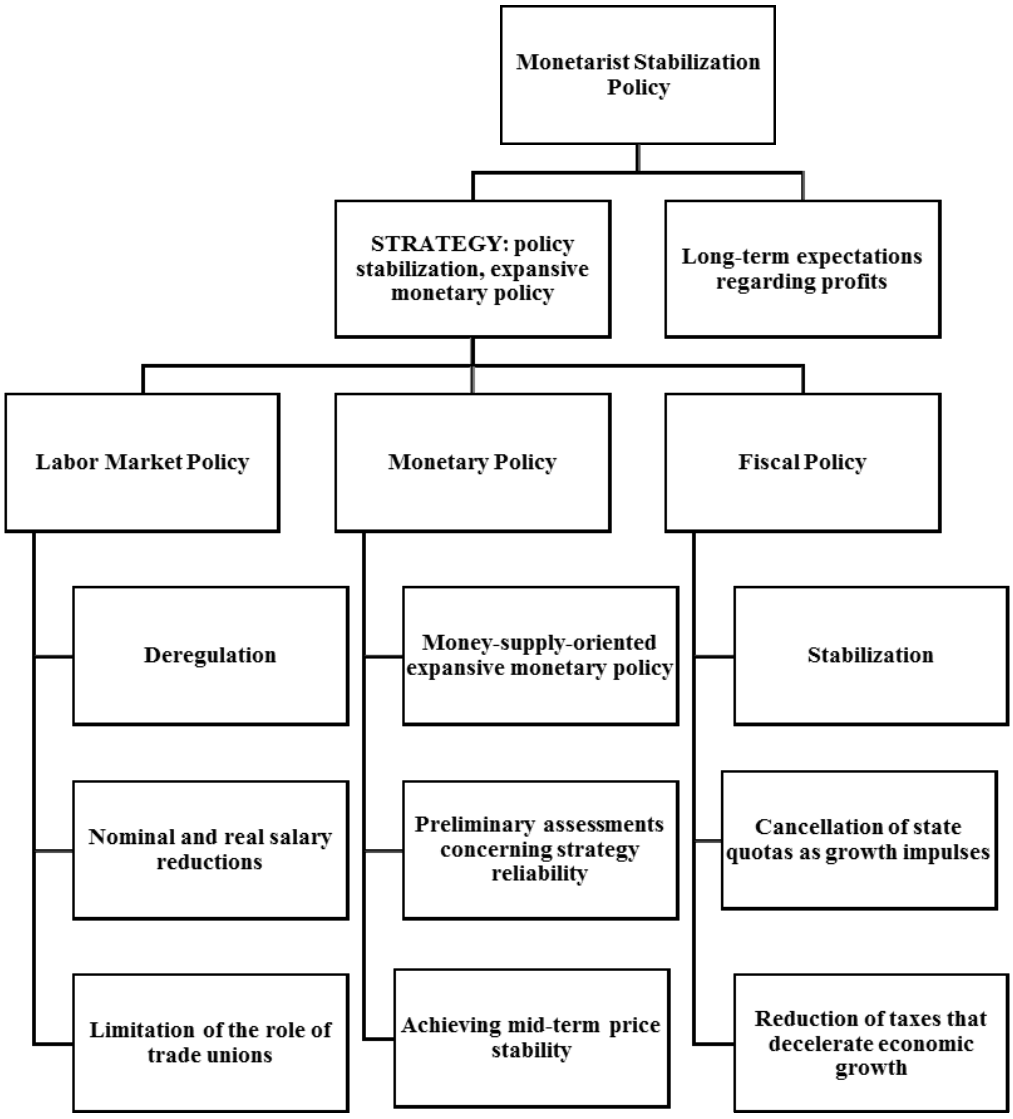

Figure 5. Monetarist Stabilization Policy.

The present recession in Ukraine's economy is caused by the triple shock – the aggregate demand shock due to the reduction of consumption on the part of population and the curtailment of investment demand for goods and production services; and the aggregate supply shock brought about by the loss of production capacities in Crimea and in the East Donbas of the country and productivity shock. It can be a priori ascertained that supply shocks played the main negative role in the present crisis situation; hence, stabilization policy must be primarily oriented towards the stimulation of supply. The proponents of the RBC theory give the greatest significance to shocks connected with the production function or the productivity shock. Such approach considerably expands the scope of stabilization policy, but, at the same time, complicates the selection of a set of tools for its implementation. Thus, productivity shocks include the creation of new goods or production methods, introduction of new management methods, changes in the quality of capital and labour, changes in the accessibility of raw materials and energy, climatic changes, changes in state regulation pertaining to production, as well as other factors impacting productivity [*Abel, Bernanke,* 2008: 459-460]. Ukraine's economy is in the state of stagflation, i.e. the combination of high-level stagnation and inflation (the economic situation in the USA in 1973-1975), which essentially complicates the search of optimal toolkit for supply-oriented stabilization policy.

The world-wide experience in stabilization policy implementation performed both independently of the IMF (in 1967 in Germany; in 1970 in the USA) and putting to use direct guidelines of this international financial institution (Argentina, Brazil, Israel, South Korea, Malaysia, Pakistan, and others), may be taken on board in present-day Ukraine, taking into account the specific features of internal, geo-regional and geo-economic situation.

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