Postwar policies fueled prosperity decades later

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Economists call it the Great Moderation: the long stretch of low inflation and steady growth in the United States and seven other developed nations from the mid-1980s until the recession hit in 2007.

These nations actually experienced greater eras of economic stability during the 1920s and after World War II, according to a new study by an economist at The University of Texas at Dallas. The research challenges accepted notions about the 1950s postwar economy and argues that policies from that era laid a foundation that continues to protect the economy from volatility in inflation and gross domestic product.

"Economists tend to reserve the qualifier 'great' only for the most important events—events that seem unprecedented in their magnitude or overall societal effect," said Dr. Victor Valcarcel, associate professor of economics in the School of Economic, Political and Policy Sciences. "But we found that, while the 1980s Great Moderation was indeed impressive in terms of stability gains, it pales in comparison to greater moderations in inflation in the 1920s, and in both inflation and output growth in the 1950s and 1960s."

The study, "What's so great about the Great Moderation?" is published in an upcoming edition of the Journal of Macroeconomics. Valcarcel and co-author Dr. John Keating of the University of Kansas coined the terms "Postwar Moderation" and "Roaring '20s Inflation Moderation" to describe those eras.

The research puts the Great Moderation in a broader historical context by analyzing data from 1869 to 2012. Few studies have examined macroeconomic volatility in the United States and other developed nations before World War II, Valcarcel said. The other nations in the study included Australia, Canada, Denmark, Finland, Italy, Sweden and the United Kingdom.

The study disputes the idea that the period of economic stability after World War II was simply a return to normalcy after war. Valcarcel argues that policy changes during that time fueled a postwar moderation and likely had a compounding effect on the gains made during the Great Moderation.

Important policy shifts included fixed exchange rates; the Employment Act of 1946, which charged the government with the responsibility of economic stability and high employment; and the Federal Reserve Accord of 1951, which gave the Federal Reserve independence from the U.S. Department of Treasury.

The study makes the case that these policies prevented conditions from being even worse during the recession that began in 2007.

"This is important information for policymakers because it shows that forward-thinking economic policies that take the long view may yield more lasting benefits than policy measures targeted to address short-term concerns," Valcarcel said.

The protective effect of the postwar policies highlighted in the study gives reason for optimism about the future economy, he said.

"There was an understanding when the Great Moderation was underway in the 1990s that we had a 'new normal,' that we'd never get the uncertainty of the 1970s back. That certainly went to pieces in the 2007

recession," Valcarcel said. "After the recession, there has been concern about whether the stability gains of the Great Moderation are over.

"Whether this last major disturbance in the global economy represents a temporary interruption or the death of stability gains associated with the Great Moderation, the stability gains achieved with the Postwar Moderation are still having a positive impact on the global economy," Valcarcel said.

More information: John W. Keating et al. What's so great about the Great Moderation?, *Journal of Macroeconomics* (2017). DOI: 10.1016/j.jmacro.2016.11.006

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