PROLOGUE: AN INSTITUTIONALIST MONETARY THEORY?

Monetary theory is not exactly a haven for institutionalists. Yet an institutionalist perspective can help illuminate the penumbra of controversy that confounds the field. Monetary theorists continually join battle over Keynesian versus monetarist views regarding the structure of the economy. This paper proposes, first, that the distribution of income and political discordance influence the stability of monetary policy and, second, that the stability of monetary policy in turn influences the structure of the economy, Keynesian or monetarist, that will be observed and estimated. Therefore, the relationship between the polity and the economy, one of the elemental interests of institutionalism, is also of considerable relevance for contemporary monetary economics.

I am grateful to John Adams, Martin Bronfenbrenner, Ronald Rogowski, and Joseph Spengler for helpful comments. Some of the ideas developed in this paper were spawned in an inflation seminar that I led for Pieter Korteweg at Erasmus University in Rotterdam in 1977.
Positing a connection between the monetary and the political, this paper defends the case for monetary stability and explores appropriate strategies for advancing it in a milieu of unremitting pressures for politically expedient "easy money."

THE STABILITY OF STABILIZATION POLICY

Economists typically see stabilization policy as a constrained maximization problem. In the most naive form of this view the policymaker is assumed to maximize an assumed fixed and independent preference function subject to an assumed fixed and independent hypothetical structure of the economy.

For decades discussion of stabilization policy has been dominated by this simplistic vision. The image, conjured up for generations of students, has been one of hardheaded policymakers, their preferences molded by democratic mandate, nimbly adjusting the controls of an economic machine labeled Money Supply, Interest Rates, Autonomous Government Expenditures, and Tax Rates. Schooled in the mathematics of classical mechanics applied to the fancied workings of this economic machine, the learned have regaled their students with tales of the vast bounty of output and employment that could be "multiplied" and "accelerated" out of it by skillful policymakers. Economists' celebrations of this paradigm have reached such delirious proportions that alternative approaches to stabilization policy have virtually disappeared from the principles textbooks. Lost to most students, except for the few who went on to a painful unlearning in advanced courses, was any connection between this vision and the constrained choice and learning process of individuals and related efficiency criteria taught in courses in basic price theory.

Then, in its hour of greatest popularity and triumph, the vision began to fail. From the mid-1960s to the mid-1970s, the performance of the economy grew worse. Steadily increasing inflation was replaced by steadily increasing unemployment, which was followed, in turn, by steadily increasing inflation and unemployment. What went wrong? The stabilization policy paradigm allowed economists only two explanations: either the preferences of the policymakers had changed or part of the underlying economic structure had shifted; either the policymakers had wavered in their resolve to bestow low inflation and low unemployment on the nation or else something was seriously amiss inside the economic machine.

Certainly a cogent case could be made that changes took place in the preferences of the policymakers. For years critics of the Federal Reserve System had pointed out that it had never fully specified its own economic