

LAGS IN MONETARY AND FISCAL POLICY*

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Current debate about a tax increase reflects a fundamental problem in the timing of changes in monetary and fiscal policy. In essence, the short-run objective of these policies is to moderate swings in the economy, stimulating when the economy is slack and restraining when it is taut. But a change in policy may not affect economic conditions immediately. In this case, policy-makers must anticipate economic changes and take action on the basis of expected future conditions. Effective policymaking requires knowledge of the causes and lengths of the lags of monetary and fiscal policy.

WHY POLICY EFFECTS LAG

Lags of monetary and fiscal policy can be traced to several causes, as shown in Figure 1.

Recognition lag. It takes time to recognize that the economy has changed in such a way as to require a change in policy. Assume, for example, that a business decline should be offset by an easing of policy. Although such a decline actually begins at point t_0 in Figure 1, it will be some time before reports evidencing the decline will be received by various Government agencies. More time will pass while these reports are aggregated and analyzed. Most analysts will not be content with one piece of information; they will want supporting evidence from several economic series over some period of time before they will be ready to conclude that they are confronting a general decline in business rather than simply a transient fluctuation in one statistic. Time elapsing between the start of the decline (t_0) and when this decline is recognized (t_1) has been dubbed by economists as the recognition lag.

Action lag. Once the need for a policy change is recognized, it takes decision-makers time to alter policy. This lag is shown in Figure 1 as the period between points t_1 and t_2 . Action lags can be caused by several things. First, not all those with policy responsibilities may be convinced of the need for change; this may delay action. Second, it may take time to work out details of the change and to go through the administrative exercises necessary to implement them. Finally, there might be political or other economic objectives which lead to policymakers to put off any policy change. For example, a change in monetary policy might be delayed if such action would hamper a current or prospective Treasury financing operation. Or, an easing of policy to stimulate business might be put off because it would conflict with a desire to protect the balance of payments.

Responsiveness to more than one objective need not always extend the length of the action lag, however. It could cause policymakers to change policy before they recognized a general movement in business, thus producing a *negative* action lag. This could happen, for example, if a decline in the money supply or an increase in unemployment led to an easing in monetary policy even though a downturn in general business conditions was not yet evident.

Inside lag. The sum of the recognition and action lags, called the inside lag, does not, therefore, depend solely on the ability of policymakers to recognize and respond to some economic change. Its length depends also upon what is used as a base for measurement and how this base relates to changes in other conditions that also influence policy decisions. The inside lags are influenced by policy trade-offs and priorities as well as speed of data collection and analysis, administrative procedures, and other commonly recognized factors.

Outside lags. After policy is changed, it takes time for the effects of the change to work their way through the economy and alter spending. This outside lag is shown as the space between points t_2 and t_3 in Figure 1.

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