Part 5 - MACROECONOMIC POLICY DEBATES

Ch14 - Stabilization Policy?

- Should monetary and fiscal policy take an active role in trying to stabilize the economy, or should remain passive?
- Should policymakers be free to use their discretion, or should they be committed to following a fixed policy rule?
- Below we consider some problems with policy making

Argument 1: The Cause of Crisis

- It depends the cause of crisis, on which Economists are usually disagree

Argument 2: Lags in the Implementation and Effects of Policies

- The inside lag is the time between a shock to the economy and the policy action responding to that shock
- The outside lag is the time between a policy action and its influence on the economy
  - A long inside lag is a central problem with using fiscal

policy. Because changes in spending or taxes require the approval of higher authorities

- Monetary policy has a substantial outside lag. This is because monetary policy works by changing the interest rates, which in turn influence investment. But many firms make investment plans far in advance

- Automatic stabilizers stimulate or depress the economy when necessary without any deliberate policy change

  - Income taxes, the unemployment-insurance and welfare systems

Argument 3: The Difficult Job of Economic Forecasting

- Economic developments are often unpredictable

Argument 4: The Lucas Critique

- Lucas has emphasized that optimal decision rules of economic agents vary systematically over time
- Hence, it is naive to try to predict the effects of a change in economic policy entirely on the basis of relationships observed in aggregated historical data
- Economists evaluating alternative policies need to consider how policy affects agents' expectations

Should Policy Be Conducted by Rule or by Discretion?

- Policy is conducted by *rule* if policymakers announce in advance how policy will respond to various situations and commit themselves to those rules
- Policy is conducted by *discretion* if policymakers are free to choose whatever policy seems appropriate at the time of events
  - The debate over rules versus discretion is distinct from the debate over passive versus active policy (Policy can be conducted by rule and yet be either passive or active)

- Why commitment could be a better alternative to discretion?

...Distrust of Policymakers and the Political Process

- If politicians are incompetent or opportunistic, then we may not want to give them the discretion to use the powerful tools of monetary and fiscal policy
  - Politicians often do not have sufficient knowledge to make informed judgments, which allows them to propose incorrect but superficially appealing solutions to complex problems

  - Manipulation of the economy for electoral gain, called the political business cycle

...The Time Inconsistency of Discretionary Policy

- In some situations policymakers may want to announce in advance the policy they will follow in order to influence the expectations of private decisionmakers. But later, after the private decisionmakers have acted on the basis of their expectations, these policymakers may be tempted to renege on their announcement. Hence, to make their announcements credible, policymakers may want to make a commitment to a fixed policy rule.

- Ex: Negotiating with terrorists over the release of hostages
- Ex: Consider the dilemma of a CB that cares about both inflation an unemployment. According to the Phillips curve, the trade-off between inflation and unemployment depends on expected inflation. To reduce expected inflation, the CB might announce that low inflation is the paramount goal of monetary policy but does not fulfill it promise then. As a result, CB loses credibility, which leaves the economy with higher inflation rates in the longer run

Rules for Monetary Policy

- CB were to commit to a rule for monetary policy, what rule should it choose?
- Some economists believe that fluctuations in the money supply are responsible for most large fluctuations in the economy
  - They advocate that the CB keep the money supply growing at a steady rate (stabilizes aggregate demand only if the velocity of money is stable)
  - A second policy rule that economists widely advocate is that CB announces a planned path for nominal GDP.

If nominal GDP rises above the target, the CB reduces money growth to dampen aggregate demand

– A third policy rule that is often advocated is inflation targeting. Like nominal GDP targeting, inflation targeting insulates the economy from changes in the velocity of money. In addition, it is easy to explain to the public

- Notice that all these rules are expressed in terms of some nominal variable: the money supply, nominal GDP, or the price level. One can also imagine policy rules expressed in terms of real variables, such as real GDP growth rate or the unemployment rate, but this is not a common approach

Ch15 - Government Debt

Problems in Measurement

- The government budget deficit equals the amount of new debt (or printing money) the government needs to issue to finance its operations

$$P_t(G_t - T_t) + B_{t-1}i_{t-1} + B^{yp}_{t-1}i^{yp}_{t-1} = B_t i_t + B^{yp}_t i^{yp}_t (+PM_t)$$

- There is a discussion that the budget deficit does not accurately gauge either the impact of fiscal policy on today' s economy or the burden being placed on future generations of taxpayers

...Measurement Problem 1: Inflation and Real GDP Growth

- Nominal government debt may rise at the same time with decline in real government debt
- Real government debt may rise at the a rate lower than the real GDP growth

...Measurement Problem 2: Capital Assets

- When a person borrows to buy a house, we do not say that he is running a budget deficit
  - A budget procedure that accounts for assets as well as liabilities is called capital budgeting

  - The major difficulty with capital budgeting is that it is hard to decide which government expenditures should count as capital expenditures

...Measurement Problem 3: Uncounted Liabilities

- Some economists argue that the measured budget deficit is misleading because it excludes some important government liabilities

- For example, consider the pensions of government workers. These workers provide labor services to the government today, but part of their compensation is deferred to the future

...Measurement Problem 4: The Business Cycle

- Many changes in the government's budget deficit occur automatically in response to a fluctuating economy

- For example, when the economy goes into a recession, incomes fall, so people and firm pay less taxes. Moreover, more people become eligible for government assistance, so government spending rises

- So, the deficit can rise or fall either because the economy has changed direction. To solve this problem, the government calculates a cyclically adjusted budget deficit (sometimes called the full-employment budget deficit). It is the estimate of what government spending and tax revenue

would be if the economy were operating at its natural rate of output and employment

The Traditional View of Government Debt

Exchange of letters between a politician and an economist

- (An Economist) Dear Sir: *A tax cut financed by government borrowing* would have many effects on the economy. The immediate impact of the tax cut would be to stimulate consumer spending
- In the short run, higher consumer spending would raise the demand for goods and services and thus raise output and

employment. Interest rates would also rise, as investors competed for a smaller flow of saving. Higher interest rates would discourage investment and would encourage capital to flow in from abroad. The dollar would rise in value against foreign currencies, and U.S. firms would become less competitive in world markets

- In the long run, the smaller national saving caused by the tax cut would mean a smaller capital stock and a greater foreign debt. Therefore, the output of the nation would be smaller, and a greater share of that output would be owed to foreigners

- Overall, current generations would benefit from higher con-

sumption and higher employment, although inflation would likely be higher as well. Future generations would bear much of the burden of today' s budget deficits: they would be born into a nation with a smaller capital stock and a larger foreign debt

- (The Politician) Thank you for your letter. It made sense to me. But yesterday my committee heard testimony from a prominent economist who called herself a "Ricardian" an who reached quite a different conclusion. She said that a tax cut by itself would no stimulate consumer spending; hence, it would therefore not have all the effects you listed. What' s going on here?

The Ricardian View of Government Debt

- According to the Ricardian view, consumers are forward-looking and, therefore, base their spending not only on their current income but also on their expected future income
- A tax cut financed by government debt means rescheduling current taxes to the future taxes
- Hence, a tax cut financed by government debt does not reduce the tax burden; therefore should not encourage the consumer to spend more

...Consumers and Future Taxes: Some arguments

- Myopia: It may be that consumers are not forward-looking but shortsighted
- Future Generations: A debt-financed tax cut gives the current generation the opportunity to consume at the expense of the next generation
  - The fact that many people leave minimal bequests to their children is consistent with this hypothesis

Fiscal Effects on Monetary Policy

- A high level of debt might also encourage the government to create inflation
- The ends of hyperinflations almost always coincide with fiscal reforms that include large cuts in government spending

...International Dimensions

- The higher the level of the government debt, the greater the temptation of default. Thus, as government debt increases, international investors may come to fear default and curtail their lending. If this loss of confidence occurs suddenly, the result could be the classic symptoms of capital flight: a collapse in the value of the currency and an increase in interest rates