ECON 3510 - Intermediate Macroeconomic Theory

Fall 2015

Mankiw, *Macroeconomics, 8th ed.*, Chapter 18

Chapter 18: Stabilization Policy

Key points:

- Understand the debate over passive vs. active policy
- Know the arguments on both sides of the "rules vs. discretion" debate

Should policy be active?:

- That is, should monetary and fiscal policy respond to economic conditions?
- Pros:
  - Able to increase output, employment, etc.
  - Why not?
- Cons:
  1. Lags are long and variable - the economic event may be over before we can react
     - inside lag - time between economic event and policy action (e.g. Sept 15, 2008 to Oct 3, 2008 - time between Lehman bankruptcy and passage of TARP)
     - outside lag - time between policy action and effects (e.g. Oct 3, 2008 to ??? Sometime when banks started lending again. Talk about "shovel-ready" projects)
     - Automatic stabilizers - can reduce this problem of lags because they respond as conditions changes
       * Taxes as a % of income, so amount of taxes paid go down if economy is doing poorly, unemp benefits increase when economy doing poorly
  2. Forecasting is difficult
     - SHOW figure 18-1
     - SHOW forecasts of Great Recession
  3. Expectations matter
     - When change policy, people's expectations of future policy change
       * e.g. When bailed out Bear Stearns in March 2008, people may have thought gov't would bail out Lehman (and, for example, some MMFs increased their holdings of Lehman debt in summer 2008, despite poor signs from Lehman)
  4. It's too complicated
     - Even the brightest economists don't really know what all is going on
  5. Poor incentives
     - e.g., Short time horizon of elected officials, lobbying efforts (e.g. TARP funds disproportionately to firms with more lobbying efforts)

Historical record: has an active policy been better?:

- Not clear
- e.g. The Great Depression
  - Some say needed more active monetary and fiscal policy because of shock to spending
  - Others: the GD would had been avoided if the Fed followed a passive policy of increasing the money supply
- e.g. Christina Romer (former Obama advisor) work on historical stabilization policy
  - Finds that poor data made pre- WWI period (where more passive policies because no Fed, no income tax, smaller Federal Gov't) look worse than was

<u>What do rules look like?</u>:

- Common examples:
  - Inflation targeting
    * Central bank's sole focus is to keep inflation at some pre-determined level (e.g. 2%)
    * Policy at ECB, BoE, BoNZ and many others (but not US)
  - Taylor rule
    * Target a Fed funds rate that is a function of GDP and inflation
    * So raise rate ($\downarrow M$) when worried about inflation and lower rate ($\uparrow M$) when economy doing poorly (GDP low)
    * e.g. Fed Funds Rate = inflation + 2 + 0.5*(inflation - 2) - 0.5*(Actual GDP - Potential GDP)
    * Potential GDP = $\bar{Y}$ = "natural level" of output (think LRAS)
    * SHOW figure 15-1 about Taylor rule vs actual policy
- Note that rules may be active or passive
  - passive rule: increase M at 3% per year
  - active rule: e.g. Increase M at 3% per year, plus another 1% for each 0.5% GDP is below trend

<u>Should policy be conducted by rules or discretion?</u>:

- Discretion Pros:
  - Flexible - can respond to specific situation
  - Why not?
- Discretion Cons:
  1. Political economy
     - Politicians have poor incentives
     - Consider research on political business cycles - show's that economy performs better in election years (though this is less true in more developed countries)
     - SHOW figure 18-2 on central bank independence
  2. Inept policy makers
  3. Time inconsistency
     - Policy makers can't help themselves from tinkering with the economy
     - e.g., Fed and GDP

- Fed wants to increase GDP so increases M
- But over time, prices increase and go back to $\bar{Y}$
- So increase M again to stay at higher level of output
- and keep on doing this...
- Problem: If people expect the Fed to do this, the policy has no effect
- Prices adjust in anticipation of action and you just get higher inflation and no output growth
- DRAW LRAS curve and AD curves and show shifts in AD that increase output....
- Would have been better off to never do policy (same output, less inflation), but can't help from trying...