Lecture 14: Policy Debate
(chapter 14)

1) Why stabilization policy potentially might be a bad idea

We have developed a theory that explains where recessions come from, and we have seen there are stabilization policies government can use to combat them. But there is a debate whether it is a good idea for governments actually to try to do this. There are several reasons one might give for why the government should be passive:

a) Lags

It takes time for a policy to begin to have an effect on the economy.

Fiscal policy: takes time for tax or spending bills to be approved by legislature. Example of an inside lag.

Monetary policy: takes 6 months to a year before the fall in the interest rate begins to affect investment projects. Example of an outside lag.

As a result, stabilization policies taken today must be aimed at the needs of the economy 6 months to a year in the future. So it is necessary for policy makers to have a way to forecast the future of the economy.

Greenspan try to predict inflation 6 months to a year ahead of time.

There are some variables which are useful for predicting the economy’s future: leading economic indicators like: orders for new plant and equipment to be built, new building permits...

Economists also use mathematical forecasting models. Sets of equations, usually based on the equations studied here, but more of them. Describe relationship between variables in the macroeconomy. Especially link between current variables and future ones.

b) Lucas Critique – critique of forecasting models

It is especially hard to predict the effect of a policy based on past experience, because the policy itself may affect people’s expectations, so it affects the model one uses to forecast the economy.

This problem is called the Lucas Critique: to estimate the effect of a policy, you must take into consideration the impact on people’s expectations. IS-LM does not do this - it takes expectations as exogenous.

For example, consider what happens if the Fed raises the money. The IS-LM model tells us output will go up. But this assumed people were not expecting the money supply to go up. If expectations are rational, then expectations shift with the policy, and the only effect is to raise the price level without any effect on output.
c) Incompetence

Policy makers do not always have an adequate understanding of the macroeconomy.

It is Unclear if policy has made things better or worse.

Looks from Great Depression that fiscal and monetary policies both made depressions worse than otherwise would have been.

Some say business cycles have been smaller since WWII and policy makers learned from Keynesian economics the use of stabilization policy.

Others argue just looks that way. Data collection was more erratic then, so the wider fluctuations are in the quality of the data not in the actual levels of output and employment.

d) Opportunism: Policy makers may not choose to make the best decision for the public

To further electoral ends, may stimulate economy before an election. Lead to political business cycle.

Example of Nixon in 1972: running surplus prior, run deficit in 71 and 72.

e) Time inconsistency

Giving policy makers the freedom to choose may inevitably lead to worse outcomes.

Suppose Fed wants low inflation and low unemployment both. Phillips curve says has to accept more of one to get less of the other. But the lower inflation expectations are, then it is possible to have less of each.

So Fed announce inflation will be very low in order to lower inflation expectations.

But if wants low unemployment and inflation, then it will have incentive to renege on its announcement and increase money supply some to lower unemployment. Hope to get inflation and unemployment lower than otherwise possible.

But if people have rational expectations, they know this incentive exists, so they will expect the Fed to renege. So their expectations will be for the higher inflation that the fed would actually create.

So inflationary expectations can be worse than if Fed did nothing, and tradeoff can be even less favorable.
Math example of Time Inconsistency: (optional material)

Suppose Phillips curve: $\pi = \pi^e - 0.5(u - u^n)$
Fed announce inflation will equal zero:

**Case 1:** If Fed follows through on promise and people know this:
- $\pi = 0$, and
- $0 = 0 - 0.5(u - u^n)$
- $0 = 0 - 0.5(u - u^n)$, so $u = u^n$
- So end up inflation = 0 and unemployment is natural rate.

**Case 2:** Temptation: Fed may be tempted to try to get lower unemployment. Despite its promise to aim at zero inflation, it may try to aim at a somewhat higher inflation rate as a way to lower unemployment.

Suppose Fed dislikes both unemployment and inflation:
- $L(u, \pi) = u + 10\pi^2$: Loss function
Loss function tells how Fed would be willing to trade inflation for lower unemployment; Phillips curve tells what tradeoffs are possible.

Combine the two:
- rewrite Phillips curve: $u = u^n - 2(\pi - \pi^e)$
- put in loss function:
  - $L(u, \pi) = u + 10\pi^2 = u^n - 2(\pi - \pi^e) + 10\pi^2$

- $dL/d\pi = -2 + 20\pi = 0$
- So choose: $\pi = 0.10$
- Will choose 10% inflation rate if given the choice.

But if agents are rational and well informed, know how Fed behaves and what its incentive are. Know actual inflation will by 10% not 0%. So $\pi^e = 0.10$

So actual unemployment is:
- $u = u^n - 2(\pi - \pi^e) = u^n - 2(0.10 - 0.10) = u^n$

**Compare results:**
- Fed chooses: $u = u^n, \pi = 0.10$
- So end result: unemployment no better, just inflation worse than if had kept promise.
- Problem is people won’t ever expect Fed to keep its promise as long as the incentive is there to break the promise.
How we can deal with these incentive problems:

a) Policy rules

If not trust policy makers to make the right choice in the circumstances, pass a law that assigns a policy rule to tell policy makers how to act.

For example several countries have rules that require the central bankers to only worry about inflation, and requires them to keep inflation below 3 percent. If fail, they might lose their jobs.

This could solve the time inconsistency problem above. Everyone knows Fed must keep its promise to aim for low inflation. It is perhaps surprising that you can achieve a better result by tying your hands ahead of time.

Examples of rules for monetary policy:
1) Money aggregate growth rule: but not able to respond to changes in money demand.
2) Nominal GDP targeting
3) P-level targeting

b) Central Bank independence:

Another way to appoint central banker who dislikes inflation more than unemployment, then insulate his decisions from political pressures to lower unemployment. This way people will more likely believe him when he promises to keep inflation low.

Example: Fed governors have 14 year terms, and President can’t recall them.
Problem: this makes economic policy making less democratic, because these important decisions are not being made by our elected representatives.