Chapter 18: Alternative Perspectives on Stabilization Policy

- "The Federal Reserve's job is to take away the punch bowl just as the party gets going"
- "What we need is not a skilled monetary driver of the economic vehicle continuously turning the steering wheel to adjust to the unexpected irregularities of the route, but some means of keeping the monetary passenger who is in the back seat as ballast from occasionally leaning over and giving the steering wheel a jerk that threatens to send the car off the road" M. Friedman
- These two quotations display the diversity of opinion as to how policymakers should respond to the business cycle; is the economy inherently stable or unstable?
- We ask two questions in this chapter:
  - Should monetary/fiscal policy take an active role in stabilizing the economy or should it remain passive?
  - Should policymakers be free to use their discretion in responding to changing conditions, or should they be committed to fixed policy rules?

18.1 Should Policy be Active or Passive?

- Analysis of macroeconomic policy is the regular job of many government agencies
- When thinking about a policy, the big question is: how will it affect inflation and unemployment; does AD need to be stimulated or constrained?
- This is a relatively new responsibility of the government, coming into play after the Great Depression, most notably with the Employment Act of 1946
  - "It is the continuing policy and responsibility of the Federal Government to…promote full employment and production"
- Many economists believe shocks can be mitigated with monetary/fiscal policies, so it seems wasteful not to use them
- Other believe governments should take a hands-off approach to macroeconomic policy; some of their arguments include:
- Lags in the Implementation and Effects of Policies
  - Macroeconomic policy is much like steering a large ship
  - There are long and variable (with indeterminate lengths) lags with conducting monetary and fiscal policy
  - There are two important lags:
    - Inside Lag - time between a shock to the economy and the policy action being implemented
    - Outside Lag - time between policy action and its influence on the economy
  - Long inside lags are a big problem for fiscal policy - long debates, legislative process is complicated, need approval from both houses of Congress and the President; better in Parliamentary systems, but still
- Monetary policy has much shorter inside lags (policy changes within a day) but much larger outside lags
  - Money supply and interest rates take a long time to change investment plans, because investors usually plan far into the future
- Advocates of passive policy point out that by the time they are applied, economic situations may have changed and the policies no longer appropriate
- But, the policies should not be completely passive and are necessary in times of severe shocks such as the financial crisis recently
- Another possible solution to these lags are automatic stabilizers - they stimulate or depress the economy without explicit policy changes
  - Examples: income taxes, unemployment insurance, welfare systems
  - Basically fiscal policy without inside lags
- The Difficult Job of Economic Forecasting
  - Because of these time lags, policymakers need to be able to predict where the economy will be in, say, six months
  - Unfortunately, this is difficult, since economic developments can be quite unpredictable
  - One way to deal with the problem is with leading indicators (see Ch. 10)
  - Another way is with macro-econometric models which try to predict the developments in inflation, output, unemployment, etc.
    - However, these models are only as good as the model and the forecasters' assumptions about the exogenous variables!
- Case Study: Mistakes in Forecasting
  - Economic shocks such as the Great Depression, recession of 1982, and the Great Recession show that most dramatic economic events are unpredictable
- Ignorance, Expectations, and the Lucas Critique
  - R. Lucas: "As an advice-giving profession we are in way over our heads"
  - Lucas emphasized the need to pay attention to how people form expectations about the future, because this is crucial for future behavior
    - One factor he said is very important to forming expectations is government policies; he argues this is not usually adequately dealt with
    - This critique of traditional policy evaluation is called the Lucas Critique
  - Analysis of disinflation is an example of this criticism; because estimates of the sacrifice ratio are based on assumption of adaptive expectations, they do not take into account policymakers making a credible change and consumers responding
    - The Lucas Critique argues that reducing inflation could be much less painful than predicted by traditional estimates of the sacrifice ratio
- The Historical Record
  - The view of stabilization policy should be influenced by whether policy has historically been stabilizing or destabilizing
  - Disagreements still arise because sources of fluctuations are not always clear
The Great Depression is a good example of this dispute - economists still cannot agree what exactly caused the depression and what were the correct ways to have dealt with it.

Case Study: Is the Stabilization of the Economy a Figment of the Data?
- Economist Christina Romer argues that the evident stabilization after the Keynesian revolution in the 1930s and introduction of more macroeconomic policies compared to pre-WWI was not the result of decreased volatility but of better data after WWII.
- This remains controversial, but economists now believe that the economy after Keynesian revolution was only slightly more stable than before.

18.2 Should Policy Be Conducted by Rule or by Discretion?
- Policy by Rule - policymakers announce how they will act and commit themselves to their announcement.
- Policy by Discretion - policymakers free to choose whatever policy they consider appropriate at the time.
- This is different from the debate between *active* and *passive* policy.
- We now discuss why policy might be improved by committing to a policy rule.
- Distrust of Policymakers and the Political Process
  - Monetary/Fiscal Policy too important to be at policymakers' discretion.
  - Political process could be erratic; politicians not having sufficient knowledge.
  - Opportunism in economic policy to further electoral ends.
  - Political Business Cycle - manipulation of the economy for electoral gain.
  - As a result, some economists advocated rules or constitutional amendments that would tie the hands of incompetent or opportunistic legislators.

- The Time Inconsistency of Discretionary Policy
  - But, if policymakers are intelligent and benevolent, why deny them the flexibility of discretionary policy.
  - Time Inconsistency of Policy is another case for rules of discretion.
  - Policymakers need to prove that their commitments credible; if they may be inclined to renege on promises, private decision makers will not trust them → need of fixed policy rule is apparent.
  - A simple example to illustrate this is public policy about negotiation with terrorists.
    - Governments say they will not negotiate in order to deter terrorists in the first place, since there would be nothing to gain.
    - But if this commitment is not credible…incentives for terrorists ↑.
  - The same problem arises with monetary policy - the Fed, caring only about inflation and unemployment, announces that the paramount goal of monetary policy is low inflation.
But, this is not credible, since the Fed has the incentive to renege and pursue expansionary monetary policy to ↓ unemployment after inflation expectations are made - so nobody trusts the Fed.

The outcome is policymakers can sometimes better achieve their goals by having their discretion taken away.

Rational agents understand the incentive for policymakers to renege and this expectation affects their behavior.

Case Study: Alexander Hamilton Versus Time Inconsistency

Hamilton opposed the time-inconsistent policy of repudiating the debt → proposed that the nation make a commitment to the policy rule of honoring its debt.

Rules for Monetary Policy

If the Fed were to commit to a rule what would it be?

Here are three policy rules that various economists advocate:

- **Monetarists →** Fed should keep the money supply growing at a steady rate
  - Milton Friedman
  - However, this does not account for changes in velocity, and so would be incomplete

- **Nominal GDP Targeting →** Fed announces a planned path for nominal GDP and adjusts money supply to maintain that path; allows for adjustments when velocity changes

- **Inflation Targeting →** Fed announces an inflation rate target (usually a low one) and adjusts money supply accordingly; insulates against changes in velocity; easy to explain to the public

Notice that all three rules deal with nominal variables; real variables, such as unemployment, are rarely used for targets because it is difficult to say what the natural rate of unemployment is.

Case Study: Inflation Targeting - Rule or Constrained Discretion?

Although inflation targeting does not tie the hands of the central bank, it does increase transparency of monetary policy and make central bankers more accountable.

Case Study: Central-Bank Independence

- Assuming monetary policy is made by discretion rather than by rule, who should exercise that discretion?
- Studies show that more independent central banks are more strongly associated with lower and more stable inflation
- No relationship between independence and real economic activity

18.3 Conclusion: Making Policy in an Uncertain World

No clear answer to the passive/active and rule/discretion debate.

One must weigh the various arguments and decide for himself what kind of role the government should play in stabilizing the economy.