Theory and Practice Part I

In a normal time, I don't think economic policy makes a large difference one way or another. But in times of crisis it makes all the difference in the world.

Mark Zandi

Policy Levers

The macroeconomic tools available to policymakers are summarized below.

Type of Policy	Policy Instruments
Fiscal	Tax cuts and increases Changes in government spending
Monetary	Open market operations Reserve requirements Discount rates
Supply-side	Tax incentives for investment and saving Deregulation Human-capital investment Infrastructure development Free trade Immigration

Fiscal Policy

- The basic tools of fiscal policy are contained in the federal budget.
  - **Fiscal policy** is the use of government taxes and spending to alter macroeconomic outcomes.

Who Makes Fiscal Policy?

Changes in taxes and government spending originate both in economic events and in explicit policy decisions.

Who Makes Fiscal Policy?

- Automatic stabilizers are a basic countercyclical feature of the federal budget.
  - **Automatic stabilizers** are federal expenditure or revenue items that automatically respond countercyclically to changes in national income.

Who Makes Fiscal Policy?

- Fiscal policy refers to deliberate changes in tax or spending legislation.
- Fiscal policy expands or shrinks the structural deficit to give the economy a shot of fiscal stimulus or fiscal restraint.

Who Makes Fiscal Policy?

The **structural deficit** is federal revenues at full employment minus expenditures at full employment under prevailing fiscal policy.

Who Makes Fiscal Policy?

- **Fiscal stimulus** – tax cuts or spending hikes intended to increase (shift) aggregate demand
- **Fiscal restraint** – tax hikes or spending cuts intended to reduce (shift) aggregate demand

Monetary Policy

- **Monetary Policy** – the use of money and credit controls to influence macroeconomic activity
- Monetary policy tools include open-market operations, discount-rate changes and reserve requirements.

Monetary Policy

- Keynesians believe that *interest rates* are the critical policy lever.
- Monetarists believe the *money supply* is the critical variable.

Monetary Policy

- Monetarist believe the money supply should be expanded at a steady, predictable rate to ensure price stability and a natural rate of unemployment.
  - Natural rate of unemployment – long-term rate of unemployment determined by structural forces in labor and product markets

Monetary Policy

Expansionary Monetary Policy

CAUSE-EFFECT CHAIN

Problem: Unemployment and Recession

↓

Fed Buys Bonds, Lowers the Reserve Ratio or Lowers the Discount Rate

↓

Excess Reserves Increase

↓

Federal Funds Rate Falls

↓

Money Supply Rises

↓

Interest Rate Falls

↓

Investment Spending Increases

↓

Aggregate Demand Increases

↓

Real GDP Rises

Monetary Policy

Restrictive Monetary Policy

Problem: Inflation

CAUSE-EFFECT CHAIN

Fed Sells Bonds, Increases Reserve Ratio or Increases the Discount Rate

↓

Excess Reserves Decrease

↓

Federal Funds Rate Rises

↓

Money Supply Falls

↓

Interest Rate Rises

↓

Investment Spending Decreases

↓

Aggregate Demand Decreases

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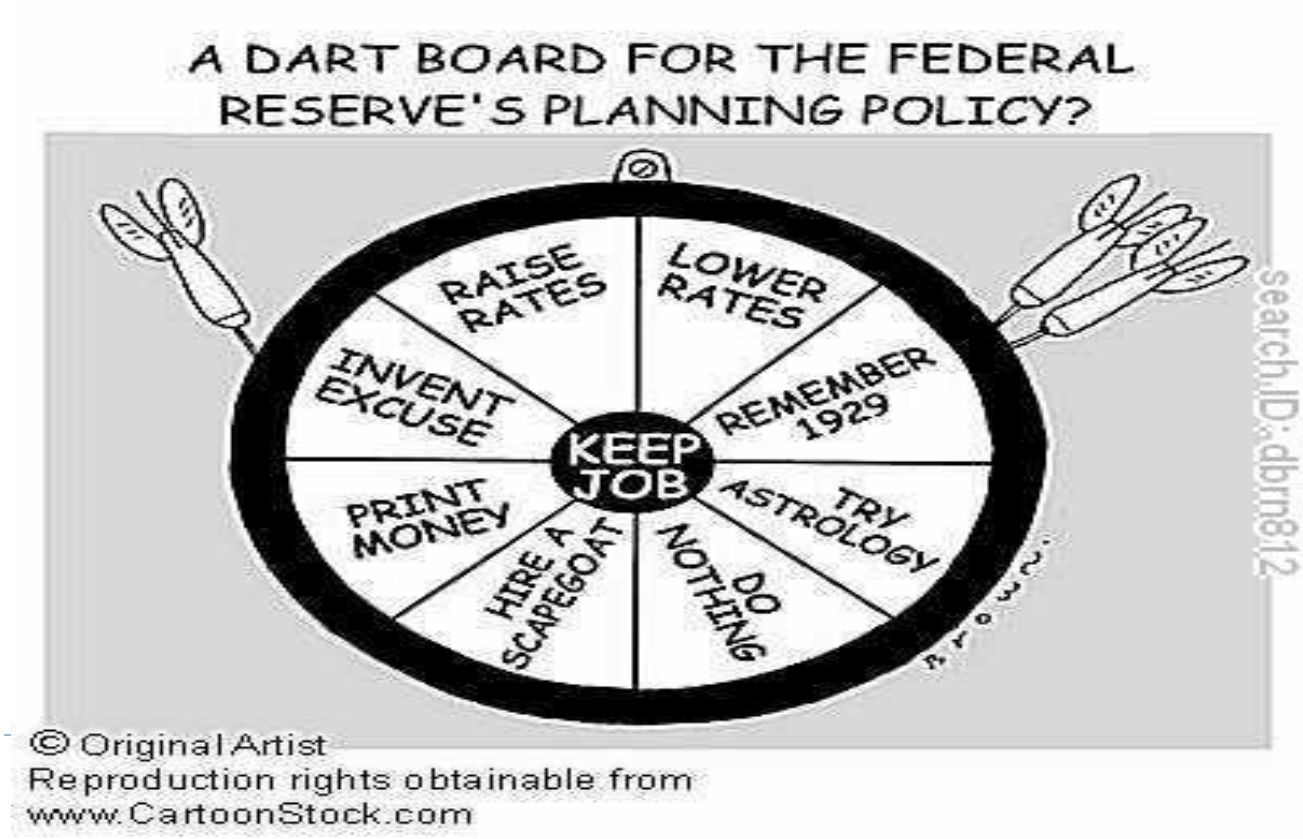
Inflation Declines

Who Makes Monetary Policy?

- Monetary policy is made by the Federal Reserves Board of Governors.
- The Federal Open Market Committee decides which monetary-policy levers to pull.



Supply-Side Policy

- **Supply-Side Policy** – the use of tax rates, (de)regulation and other mechanisms to increase the ability and willingness to produce goods and services
  - Supply-side policy focuses on incentives to work, invest and produce.

Who Makes Supply-Side Policy?

- Fiscal and supply-side policies are often intertwined.
  - Deciding whether to increase spending is a fiscal-policy decision.
  - Deciding how to spend may entail supply-side policy.

Idealized Uses

Fiscal, monetary and supply-side tools are potentially powerful levers for controlling the economy.

Case 1: Recession

- Output and employment levels are far short of the economy's full-employment potential.
- The recessionary GDP gap must be closed.
  - **Recessionary GDP gap** – the amount by which equilibrium GDP falls short of full-employment GDP

Case 1: Recession

- *Keynesians* emphasize the need to increase aggregate demand by cutting taxes or boosting government spending.
- *Modern Keynesians* acknowledge that monetary policy might also help.

Case 1: Recession

- In the *Monetarists* view, the appropriate response to a recession is patience.
- So long as the velocity of money (V) is constant, fiscal policy doesn't matter.
  - **Velocity of money (V)** – the number of times per year, on average, that a dollar is used to purchase final goods and services ... PQ ÷ M

Case 1: Recession

- *Supply-siders* would
  - cut marginal tax rates on investment and labor.
  - reduce government regulation.
  - focus any government spending on long-run capacity expansion.

Case 2: Inflation

- *Keynesians* would close the inflationary GDP gap by raising taxes and lowering government spending.
- Keynesians would also increase interest rates to curb investment spending.
  - **Inflationary GDP gap** — the amount by which equilibrium GDP exceeds full-employment GDP

Case 2: Inflation

- *Monetarists* would simply cut the money supply.
- *Supply-siders* would look at the supply side of the market for ways to expand productive capacity.

Case 3: Stagflation

- Stagflation is much more of a gray area than recession or inflation individually.
  - **Stagflation** – the simultaneous occurrence of substantial unemployment and inflation
- Attempting to address one of the two problems will make the other problem worse.

Case 3: Stagflation

If prices are rising before full employment is reached, there is likely to be some degree of structural unemployment.

Case 3: Stagflation

- High tax rates or costly regulations might contribute to stagflation.
- Stagflation can begin with an “external shock” like an earthquake or embargo.

Fine-Tuning

- At one time, it was widely believed that it was possible to fine-tune the economy to assure prosperity.
  - **Fine-tuning** refers to adjustments in economic policy designed to counteract small changes in economic outcomes; continuous responses to changing economic conditions.

The Economic Record

- The economy's track record does not live up to the high expectations of fine-tuning.
- Over the postwar period, the record includes nine years of outright recession and another nineteen years of growth recession.

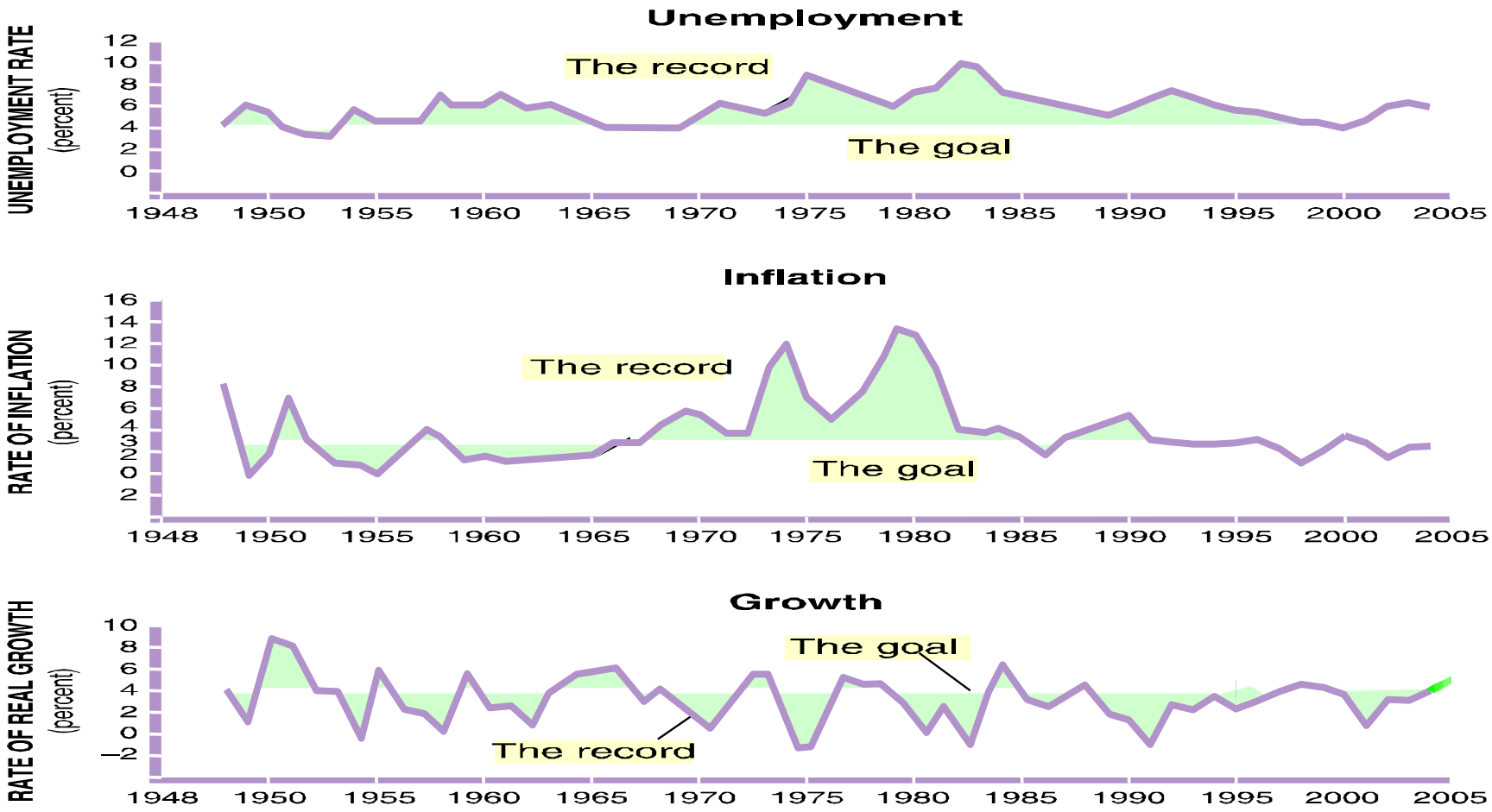
The Economic Record

A **growth recession** is a period during which real GDP grows, but at a rate below the long-term trend of 3%.

The Economic Record

- The economic performance of the United States in the 1990s was better than other Western nations.
- Some countries did a better job of restraining prices or reducing unemployment.

The Economic Record



Continued in Theory and Practice Part II