Theory and Practice Part II

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

Why Things Don't Always Work

- There are four obstacles to policy success.
  - goal conflicts
  - measurement problems
  - design problems
  - implementation problems

Goal Conflicts

Most often goal conflicts originate in the short-run trade-off between unemployment and inflation.

Goal Conflicts

- The goal conflict is often institutionalized in the decision making process.
  - The Fed is traditionally viewed as the guardian of price stability.
  - The President and Congress worry more about people's jobs and government programs.

Goal Conflicts

- Distributional goals may conflict with macro objectives.
  - Anti-inflationary policies may require cutbacks in programs for the poor, the elderly or needy students.
  - These cutbacks may be politically impossible.

Measurement Problems

- The processes of data collection, assembly and presentation take time, even in this age of high-speed computers.
- At best, we know what was happening in the economy last month or last week.

Measurement Problems

The average recession lasts about 11 months, but official data generally do not even confirm the existence of a recession until 8 months after a downturn starts.

Forecasts

In designing policy, policymakers must depend on economic forecasts, that is, informed guesses about what the economy will look like in future periods.

Macro Models

Those guesses are often based on econometric **macro models** which are mathematical summaries of the economy's past performance.

Leading Indicators

- Many people prefer to use leading indicators to divine the future.
  - **Leading indicators** are things we can observe today that are logically linked to future events.

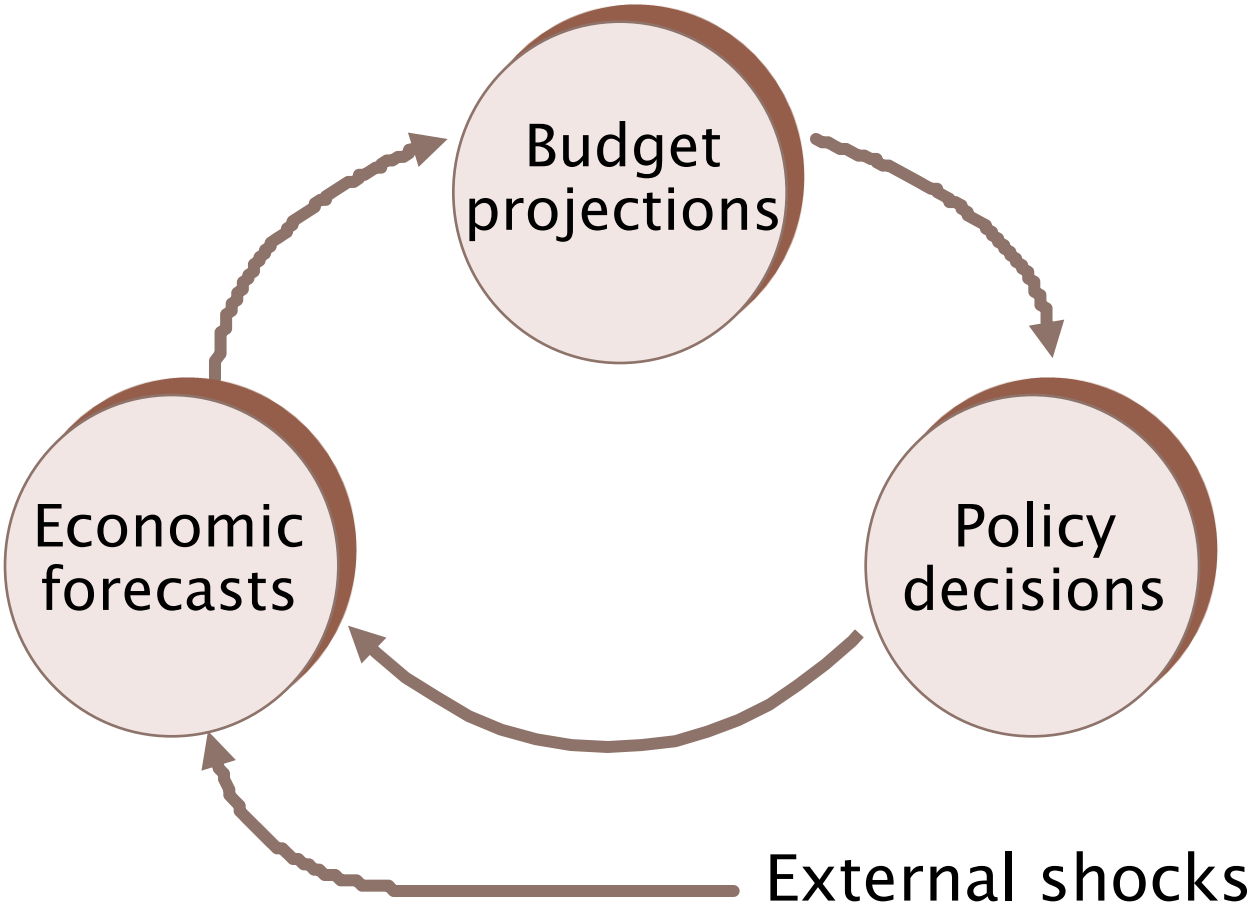
Crystal Balls

Many people disregard economists' forecasts and rely on their own personal systems or ideas.

Policy and Forecasts

The task of forecasting the economic future is made still more complex by the interdependency of forecasts, policy decisions and economic outcomes.

Policy and Forecasts



External Shocks

An external shock can disrupt the economy and ruin economic forecasts.

Design Problems

- We need to chart our course -- to design an economic plan.
- It is difficult to predict how market participants will respond to any specific economic policy action.

Implementation Problems

- A good idea has little value unless someone puts it to use.
- It is often difficult to implement even a well-designed policy.

Congressional Deliberations

- Once the President decides on a policy, he must ask Congress to enact legislation to implement it.
- There is no guarantee that Congress will do so.

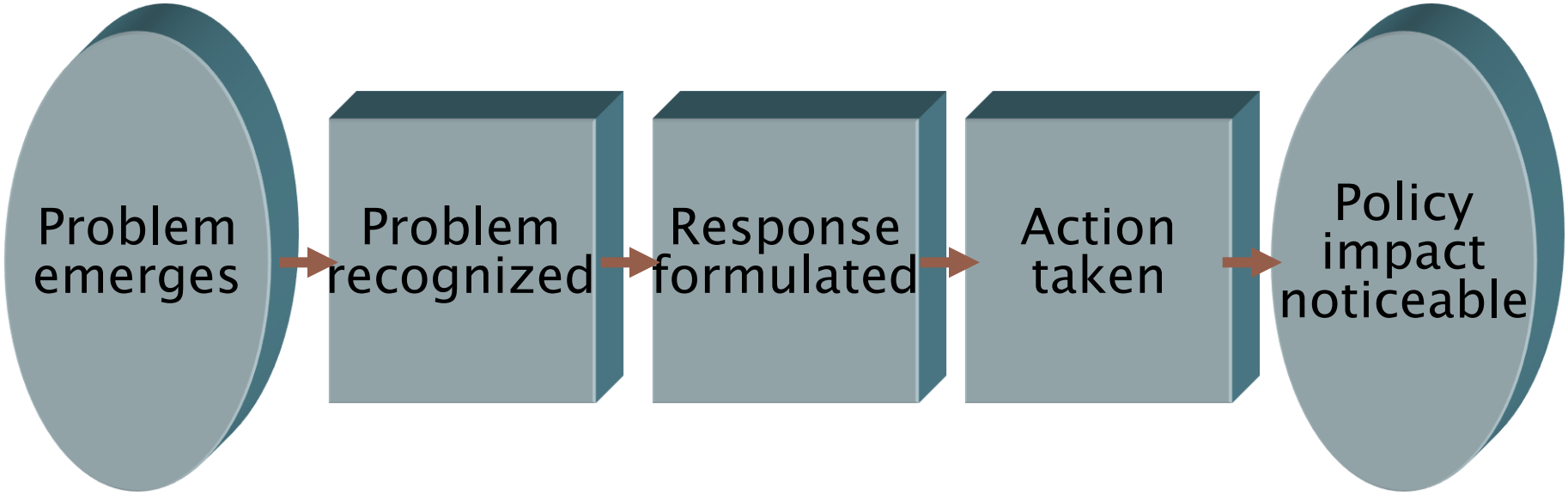
Time Lags

- Even if the right policy is formulated to solve an emerging economic problem, there is no assurance it will be implemented.
- Even if it is implemented, there is no assurance that it will take effect at the right time.

Time Lags

In fact, there is a danger that the policy will be enacted well after the problem it was created to fix is gone.

Time Lags


Problem emerges
Problem recognized
Response formulated
Action taken
Policy impact noticeable

Politics vs. Economics

A particular policy may be correct in view of the economy but might never be enacted due to political pressures.

Politics vs. Economics

- Congress tends to hold fiscal policy hostage to electoral concerns.
- This has created a kind of policy-induced business cycle — a pattern of short-run stops and starts.

Politics vs. Economics

Rather than political risks, Congress and the President often rely on the Fed to take the unpopular actions necessary to fight inflation.

Hands On or Hands Off?

We can conclude that consistent fine-tuning of the economy is not compatible with either our design capabilities or our decision-making procedures.

Hands Off

- Everyone agrees that discretionary policies could result in better economic performance.
- Some argue that the practical requirements of monetary and fiscal management are too demanding and thus prone to failure.

New Classical Economics

According to the *New Classical Economists*, it is best for the government to provide a stable environment and then stay out of the way.

New Classical Economics

- This laissez-faire conclusion is based on the notion of rational expectations.
  - **Rational expectations** is the hypothesis that people's spending decisions are based on all available information, including the anticipated effects of government intervention.

New Classical Economics

- Acting on rational expectations, consumers anticipate the results of government policies and adapt immediately.
- That adaptation renders the policy ineffective.

New Classical Economics

Under rational expectations, the only policy that works is one that surprises people.

Hands On

- Proponents of a hands-on policy admit the possibility of occasional blunders.
- They emphasize the greater risks of doing nothing when the economy is faltering.

Hands On

Historically, the economy has been much more stable during times of discretionary policy (as opposed to earlier times).

Hands On

- It is difficult to determine if stability comes from discretionary policies or other changes or both.
- The clamor for fixed policy rules is more a rebuke of past policy than a viable policy alternative.

Modest Expectations

We really have no choice but to pursue discretionary policies.

Modest Expectations

If public policy can create a few more jobs, a better mix of output, a little more growth and price stability, or an improved distribution of income, those initiatives are worthwhile.

The End