

macro

Topic 12:
Stabilization Policy
(chapter 14)

macroeconomics
fifth edition

N. Gregory Mankiw

PowerPoint® Slides
by Ron Cronovich

© 2002 Worth Publishers, all rights reserved

Question 1:

Should policy be _____ or _____?

CHAPTER 14 Stabilization Policy slide 1

Arguments for active policy

- Recessions cause economic hardship for millions of people.
- The Employment Act of 1946: "it is the continuing policy and responsibility of the Federal Government to...promote full employment and production."
- The model of aggregate demand and supply (Chapters 9-13) shows how fiscal and monetary policy can respond to shocks and stabilize the economy.

CHAPTER 14 Stabilization Policy slide 2

Arguments against active policy

1. _____:
the time between the shock and the policy response
- takes time to recognize shock
 - takes time to implement policy, especially fiscal policy
- _____:
the time it takes for policy to affect economy

If conditions change before policy's impact is felt, then policy may end up destabilizing the economy.

CHAPTER 14 Stabilization Policy

slide 3

Automatic stabilizers

- definition:

_____.
- They are designed to reduce the lags associated with stabilization policy.
- Examples:
 - income tax
 - unemployment insurance
 - welfare

CHAPTER 14 Stabilization Policy

slide 4

Forecasting the macroeconomy

Because policies act with lags, _____
_____.

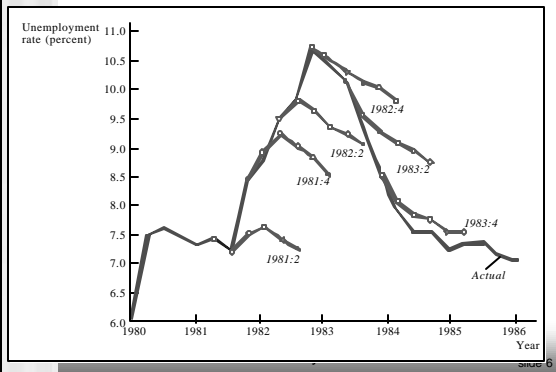
Ways to generate forecasts:

- _____:
data series that fluctuate in advance of the economy
- Macroeconometric _____:
Large-scale models with estimated parameters that can be used to forecast the response of endogenous variables to shocks and policies

CHAPTER 14 Stabilization Policy

slide 5

Mistakes Forecasting the Recession of 1982



Forecasting the macroeconomy

Because policies act with lags, policymakers must predict future conditions.

The preceding slides show that the forecasts are often wrong.
This is one reason why some economists oppose policy activism.

The Lucas Critique

- Due to Robert Lucas won Nobel Prize in 1995 for "rational expectations"
- Forecasting the effects of policy changes has often been done using models estimated with historical data.
- Lucas pointed out that such predictions would not be valid if the policy change _____

_____.

An example of the Lucas Critique

- Prediction (based on past experience): an increase in the money growth rate will reduce unemployment
- The Lucas Critique points out that increasing the money growth rate may raise expected inflation, _____
_____.

The Jury's Out...

Looking at recent history does not clearly answer Question 1:

- It's hard to identify shocks in the data,
- and it's hard to tell how things would have been different had actual policies not been used.

Question 2:

Should policy be conducted by _____ or _____?

Rules and Discretion: basic concepts

- **Policy conducted by rule :**
Policymakers announce in advance how policy will respond in various situations, and commit themselves to following through.
- **Policy conducted by discretion:**
As events occur and circumstances change, policymakers use their judgment and apply whatever policies seem appropriate at the time.

CHAPTER 14 Stabilization Policy

slide 12

Arguments for Rules

1. _____

 - misinformed politicians
 - politicians' interests sometimes not the same as the interests of society

CHAPTER 14 Stabilization Policy

slide 13

Arguments for Rules

2. The **Time Inconsistency of Discretionary Policy**
 - def: _____

_____.
 - Destroys policymakers' credibility, thereby reducing effectiveness of their policies.

CHAPTER 14 Stabilization Policy

slide 14

Examples of Time-Inconsistent Policies

To encourage investment, government announces it won't tax income from capital.

But once the factories are built, the govt reneges in order to raise more tax revenue.

CHAPTER 14 Stabilization Policy

slide 15

Monetary Policy Rules

- a.
- b.
- c.
- d.

Target Federal Funds rate based on

- inflation rate
- gap between actual & full-employment GDP

CHAPTER 14 Stabilization Policy

slide 16

The Taylor Rule

$$i_{ff} = p + 2 + 0.5(p - 2) - 0.5(\text{GDP Gap})$$

where:

i_{ff} = nominal federal funds rate

$$\text{GDP Gap} = 100 \times \frac{\bar{Y} - Y}{\bar{Y}}$$

= the percent by which real GDP is below its natural rate

CHAPTER 14 Stabilization Policy

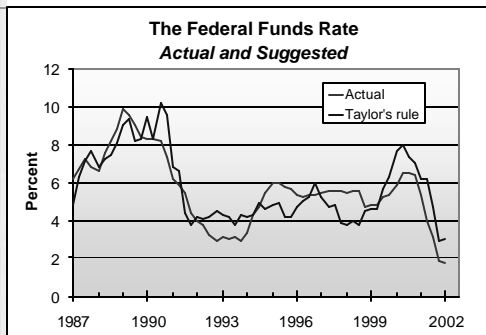
slide 17

The Taylor Rule

$$i_{ff} = p + 2 + 0.5(p - 2) - 0.5(\text{GDP Gap})$$

- If $\pi = 2$ and output is at its natural rate, then monetary policy targets the nominal Funds rate at 4%.
- For each one-point increase in π , mon. policy is automatically tightened to _____.
- For each one percentage point that GDP falls below its natural rate, mon. policy automatically _____.

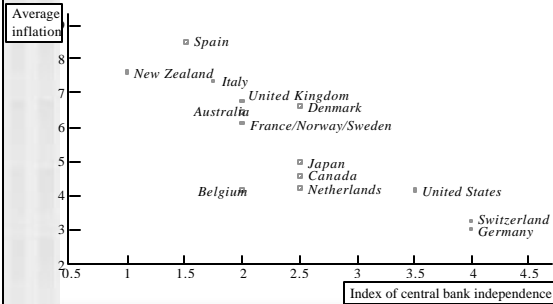
Does Greenspan follow the Taylor Rule?



Central Bank Independence

- A policy rule announced by Central Bank will work only if _____.
- Credibility depends in part on degree of independence of central bank.

Inflation and Central Bank Independence



CHAPTER 14 Stabilization Policy

slide 21

Chapter summary

1. Advocates of active policy believe:
 - frequent shocks lead to unnecessary fluctuations in output and employment
 - fiscal and monetary policy can stabilize the economy
2. Advocates of passive policy believe:
 - the long & variable lags associated with monetary and fiscal policy render them ineffective and possibly destabilizing
 - inept policy increases volatility in output, employment

CHAPTER 14 Stabilization Policy

slide 22

Chapter summary

3. Advocates of discretionary policy believe:
 - discretion gives more flexibility to policymakers in responding to the unexpected
4. Advocates of policy rules believe:
 - the political process cannot be trusted: politicians make policy mistakes or use policy for their own interests
 - commitment to a fixed policy is necessary to avoid time inconsistency and maintain credibility

CHAPTER 14 Stabilization Policy

slide 23
