ECONOMICS 2

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Week 11

Discussion on economic policy

Chapter 13

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Questions to discuss

- Based on the models learnt up to now we might think that in a given situation it can be said what economic policy measures are needed.
- But it is questionable
  - if the policy should play active role in stabilization;
  - discretionary decisions or decisions based on rules lead to better results?

Active or passive economic policy?

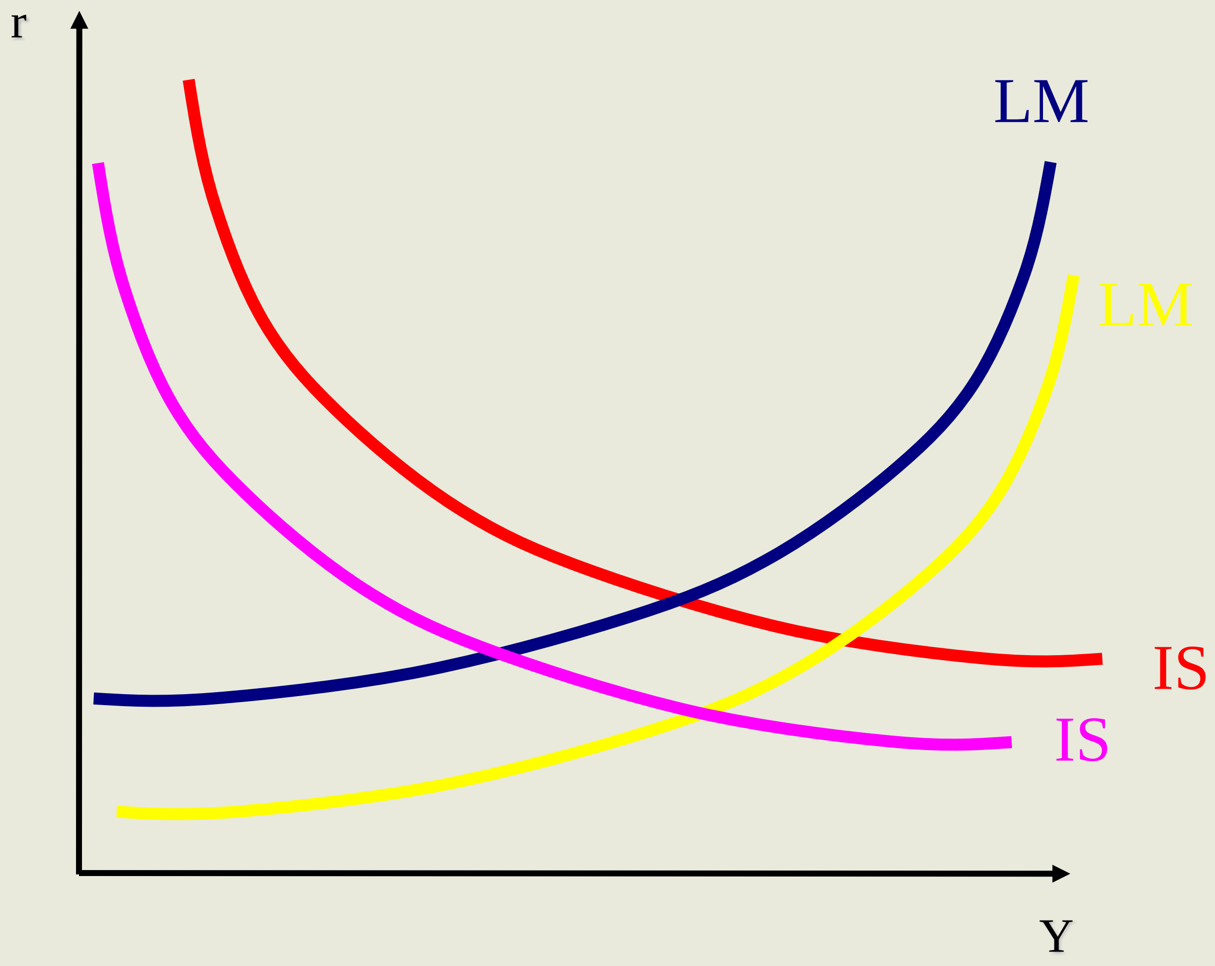
Proper handling of economic fluctuations requires first of all to appropriately perceive what kind of crisis we face. Then the proper decisions have to be made to handle the situation, and the decisions have to have the intended effect.

The economic policy intended to mitigate economic fluctuations can be successful if these three phases work properly and not too much time passes between the development of the problem and the effect of the economic policy.

The 1990 recession in the U.S.

- The U.S. was in recession in 1990, the unemployment increased from 5,1% to 7,7%.
- One reason of the recession was the tightening monetary policy, which was treated with only slow interest rate cuts by the Fed. The tightening of the money market shifted the LM curve to the left.
- At the same time the IS curve also shifted due to bank bankruptcies and the crisis in Kuwait.
- What was the problem? The Fed misjudged the decreasing interest rate level, and thought that the LM curve shifted because the income statistics became available only later.

The mistake graphically



Timing and delays

- The effects of economic policy decisions are realized not immediately but with delay.
- **Internal delay** is between the shock and the response to that.
- **External delay** is between the economic policy measure and its effect.
- The result of the delays can be that the policy stimulates the economy in such a period when tightening would be needed, and vice versa.

Fiscal policy and internal delays

Preparatory phase

- The **budget directives** (by April 15) and the **budget plan** (by August 31) are proposed by the Ministry of Finance to the Government.
- The Government proposes the **bill of budget** to the Parliament by September 31 (and a lot of other calculations, balance sheets by October 15).

Decision phase

- The Parliament discusses the budget by November 30, **passes a resolution,** then **passes a** law (possible by the end of December).

Monetary policy and external delays

- The monetary policy influences the amount of money and interest rates.
- Through the interest rates it influences the investments.
- The investment decisions are typically made long ahead.
- Therefore external delay is characteristic of monetary policy.
- Even six months can pass between the decision and its effect.

Automatic stabilizators

The automatic stabilizators are such tools of economic policy which mitigate the economic fluctuations **without any distinct decision**.

Examples of automatic stabilizators:

- Proportional income tax – decreases automatically in recession.
- Unemployment benefit – increases automatically in recession.

Forecasts

- Since the economic policy can influence the economy with long delays, good economic forecasts have important role.
- This is a difficult task, we often make mistakes.

GDP growth forecast by the MNB in the beginning of 2007

Lucas critique

How is an economic model built up?

We observe the behavior of individuals in the past. We make economic policy decisions, assuming that the behavior of people remains basically unchanged.

However, the policy affects not only the economic variables but e.g. also the expectations of the people. An example is the policy mitigating the inflation.

Economic policy and the history

Historical data provide no clear answer which view on economic policy is more successful. The reason is that it is not unambiguous if a crisis is caused by the economy itself or by the economic policy. Recall what we learned about the great depression.

Discretionary or rule based economic policy?

The two questions are not the same:

Rule based passive economic policy:
The growth rate of money is 3%.

Rule based active economic policy:
The growth rate of money =

= 3% + (unemployment – 6%).

Political cycles

The politician is also a human being, he/she decides based on the own interests.

If elections approach then it is in his/her interest to inspire the economy, so that the economy seems to be in a better situation.

Economic fluctuations related to political elections are called political cycles.

Therefore making the economic policy independent from the political arena can be reasonable.

Time inconsistency

The announced economic policy influences the expectations of the people.

The modified expectations might make the policy unnecessary.

People might expect that the politicians will not carry out the announced policy.

For example, most of the countries announce that they will not negotiate with hostage-takers.

Monetary policy and the inconsistency

The aim of the monetary policy is to decrease the inflation.

We have seen that the inflation can be decreased by efficient influence on inflation expectations.

If we can make people believe that we will mitigate the inflation then there is strong temptation to rather focus on decreasing the unemployment.

Other examples of time inconsistency

- The government announces not to tax the capital, so as to enhance investments.
- The government announces to provide temporary monopoly to those who invent new drugs, so as to enhance research.
- Parents threaten the child if he breaks some rules.
- The teacher announces an end-of-the-year exam.

Alexander Hamilton and the war of independence

The U.S. took large amounts of credit during the war of independence. At the end of the war it was proposed not to pay back the credits.

Hamilton decided for paying back the credit because he knew that the U.S. will need credit later as well.

The regulation of paying back credits is still in power in the U.S.

Monetary policy rules

We have to decide not only on having rule based policy, but also on which rule to follow.

According to monetarists the growth rate of money should be defined. However, it decreases the inflation only if the velocity of money is unchanged.

Monetary policy rules

An other possible alternative for the monetary policy is to set as target the growth of GDP.

The stability of price level can also be a target.

A prerequisite of rule based monetary policy is the independence of the central bank. The inflation is negatively related to the independence of central banks.

Fiscal policy rules

Rule based fiscal policy is less common than monetary policy. A possibility for fiscal policy is a rule on the budget deficit.

Counterarguments:

- The budget deficit can help stabilize the economy.
- The budget deficit can help mitigate the distortion due to taxes.
- The deficit can reallocate income throughout the time.