ECON 3010
Intermediate Macroeconomics

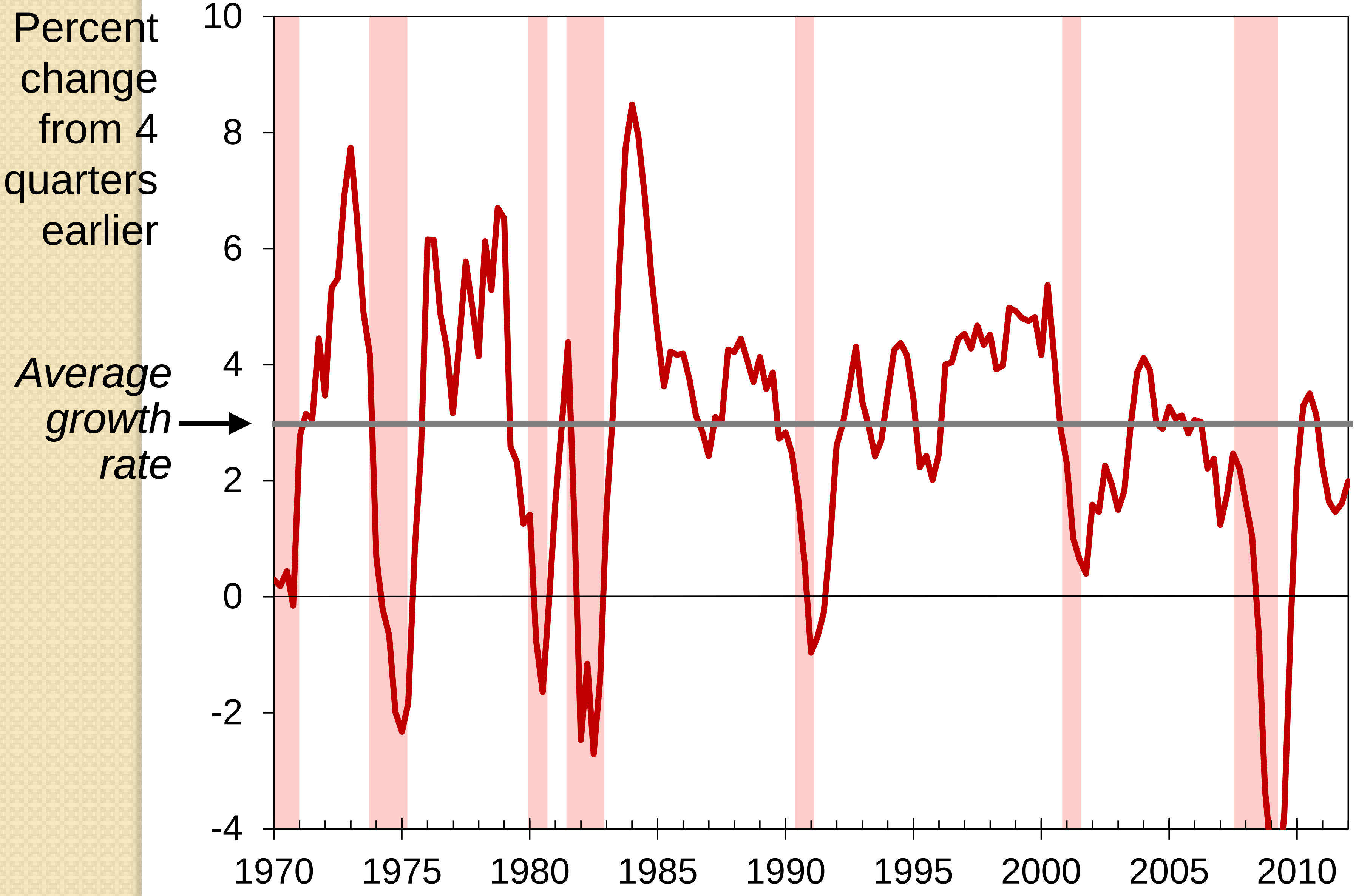
Chapter 18

Stabilization Policy

Question 1:

Should policy be active or passive?

Growth rate of U.S. real GDP



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."
- AD-AS model (Chaps. 10–14) shows how fiscal and monetary policy can respond to shocks and stabilize the economy.

Arguments against active policy

Policies have lags:

inside lag:

time between the shock and the policy response.

- takes time to recognize shock
- takes time to implement policy, especially fiscal policy

outside lag:

time it takes for policy to affect economy.

If conditions change before policy's impact is felt, the policy may destabilize the economy.

Automatic stabilizers

- definition:
  policies that stimulate or depress the economy when necessary without deliberate policy.
- Designed to reduce the lags associated with stabilization policy.
- Examples:
  - income tax
  - unemployment insurance
  - welfare

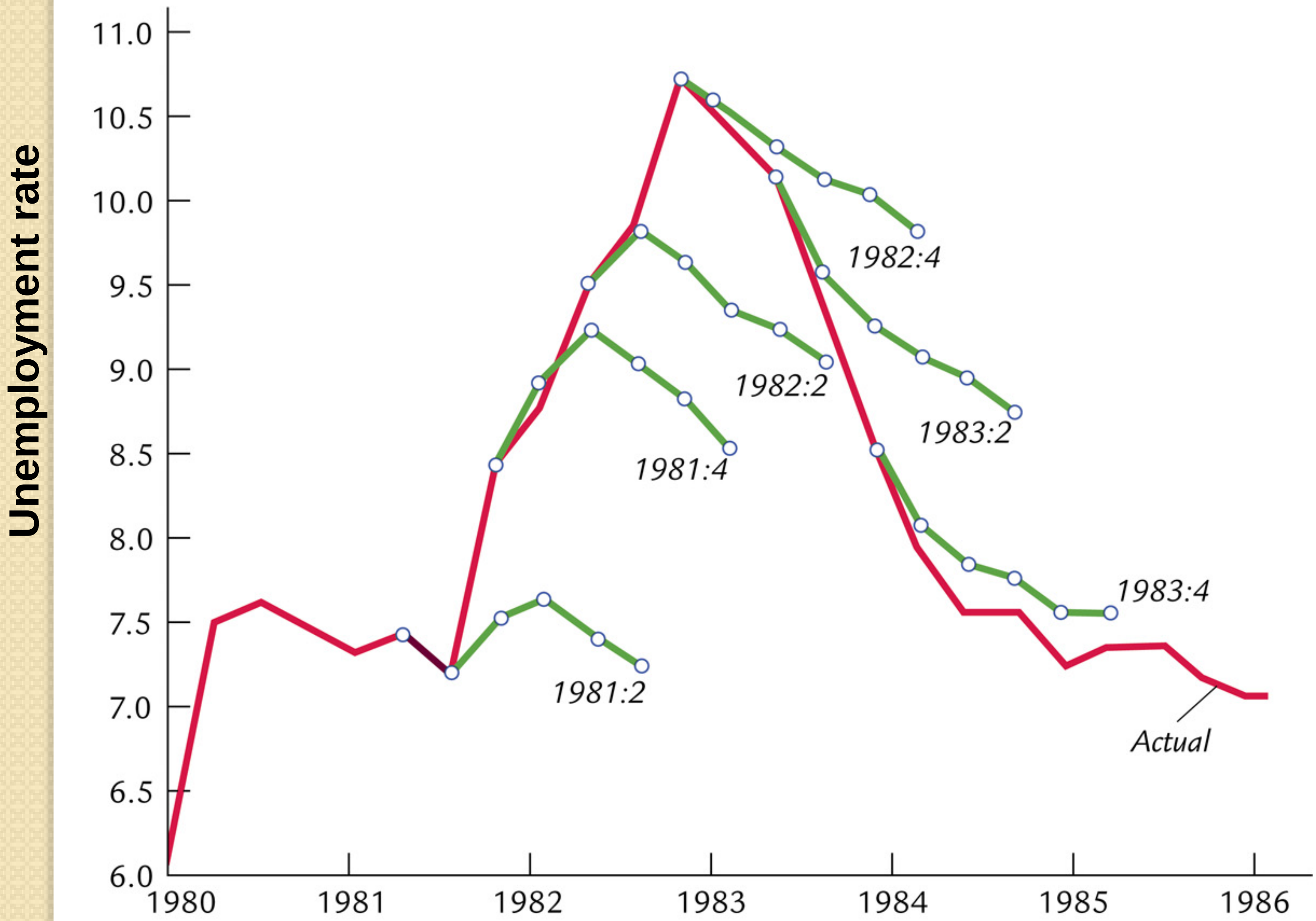
Forecasting the macroeconomy

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

- Forecasting one or two quarters out is good

- Long-run macro forecasting is poor

Mistakes forecasting the 1982 recession



The Jury's out…

Looking at recent history does not clearly answer Question 1:

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

Question 2:

Should policy be conducted by rule or discretion?

Rules vs. 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.

Arguments for rules

1. **Distrust of policymakers and the political process**
   - misinformed politicians
   - politicians' interests sometimes not the same as the interests of society

Arguments for rules

2. **The time inconsistency of discretionary policy**
   - def: A scenario in which policymakers have an incentive to renege on a previously announced policy once others have acted on that announcement.
   - Destroys policymakers' credibility, thereby reducing effectiveness of their policies.

Monetary Policy Rules and Central Bank Independence

- A policy rule announced by the central bank will work only if it's credible.
- Credibility depends in part on degree of independence of central bank.

Inflation and central bank independence