

EC 202: Principles of Macroeconomics

Week 9: Fiscal vs. Monetary Policy

Important Considerations:

- The Shape of the Aggregate Supply Curve
- Lags in implementation of policy.
- Rules vs. Discretion

Should We Rely on Fiscal or Monetary Policy?

∞ Which policy works faster?

∞ Lags in stabilization policy

- Delays between the time when the need for stabilization policy arises and the time when the policy has its actual effects on the economy

∞ Delays

- Data collection, make decision, implement decision, have policy take effect

Should We Rely on Fiscal or Monetary Policy?

∞ Fiscal policy

- Conventional decisions – G or T affect aggregate demand faster than monetary policies
- But fiscal policy has long policy lags

∞ Monetary policy

- Policy lags normally much shorter
 - FOMC meets often and on short notice if necessary
 - Policy decisions executed immediately

Should We Rely on Fiscal or Monetary Policy?

⌘ Conventional wisdom

- Although monetary policy takes longer to take effect, short policy lags win out

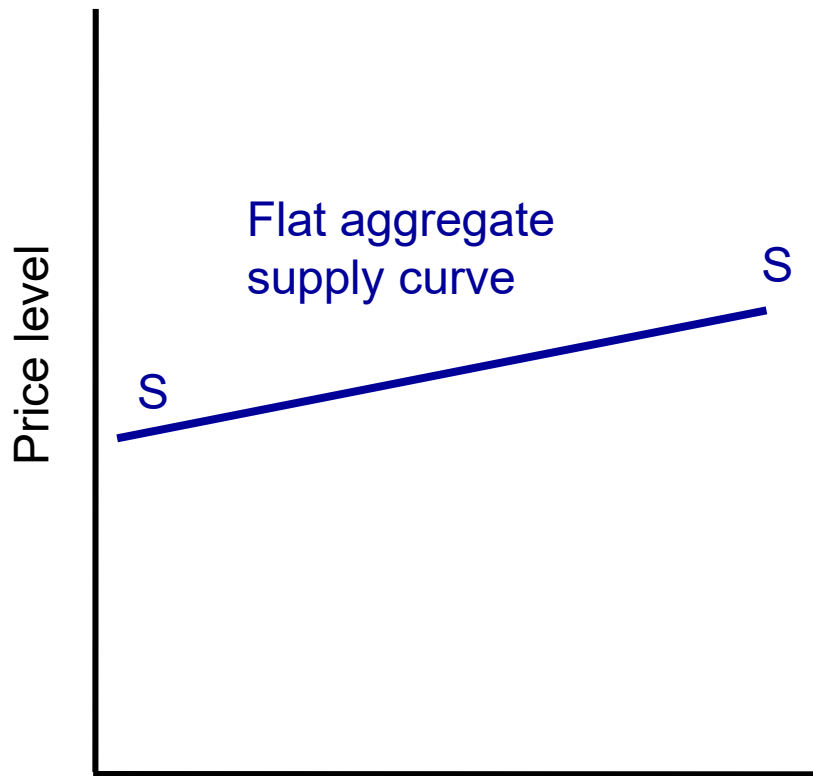
⌘ Questioning conventional wisdom

- Congress can act quickly when it must
- Massive recessionary gap suggested both necessary
- Once the federal funds rate reaches zero conventional monetary policy could use help from fiscal policy

The Shape of the AS Curve: Flat or Steep

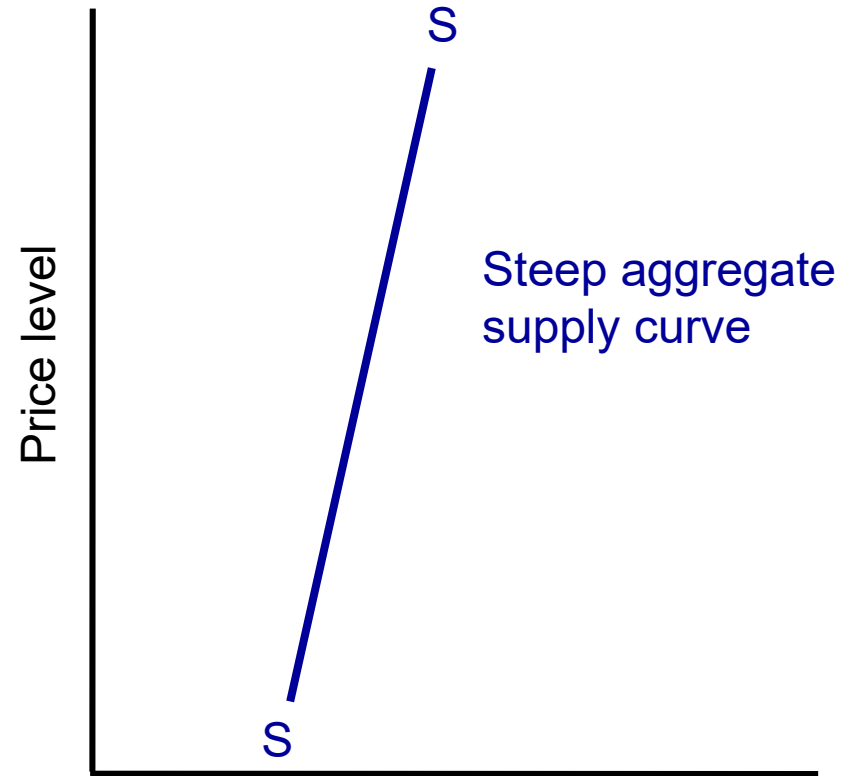
- ∞ Why does the shape of the aggregate supply curve matter?
 - Thinks about what happens to price and GDP

Alternative Views of the Aggregate Supply Curve



Real GDP

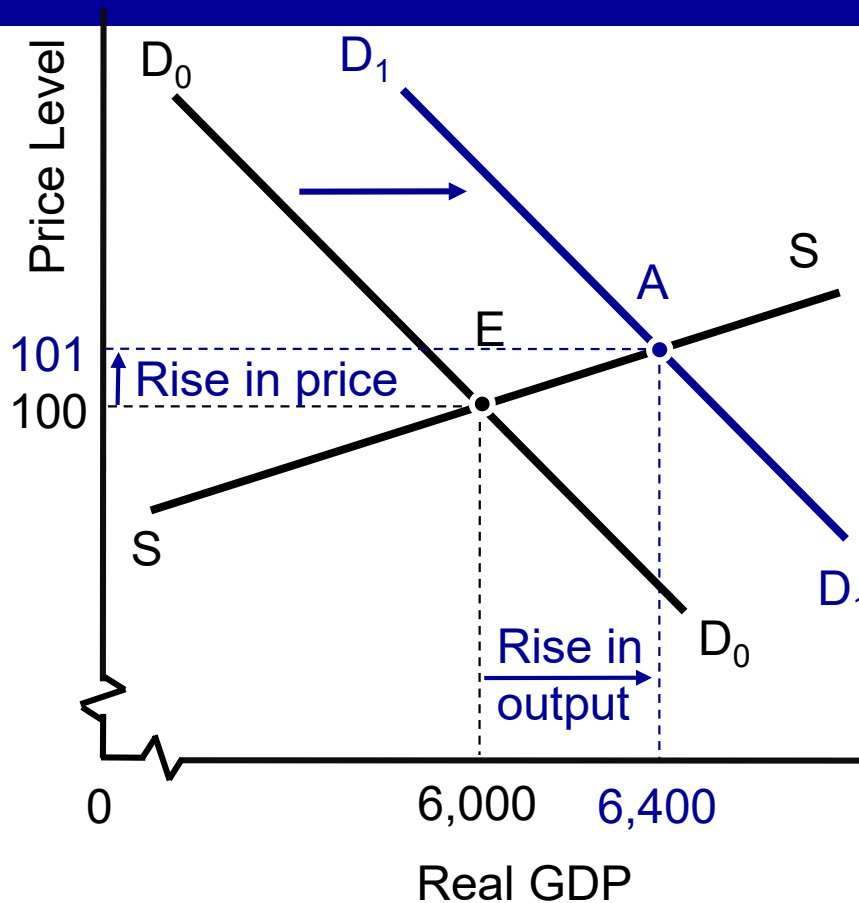
(a)



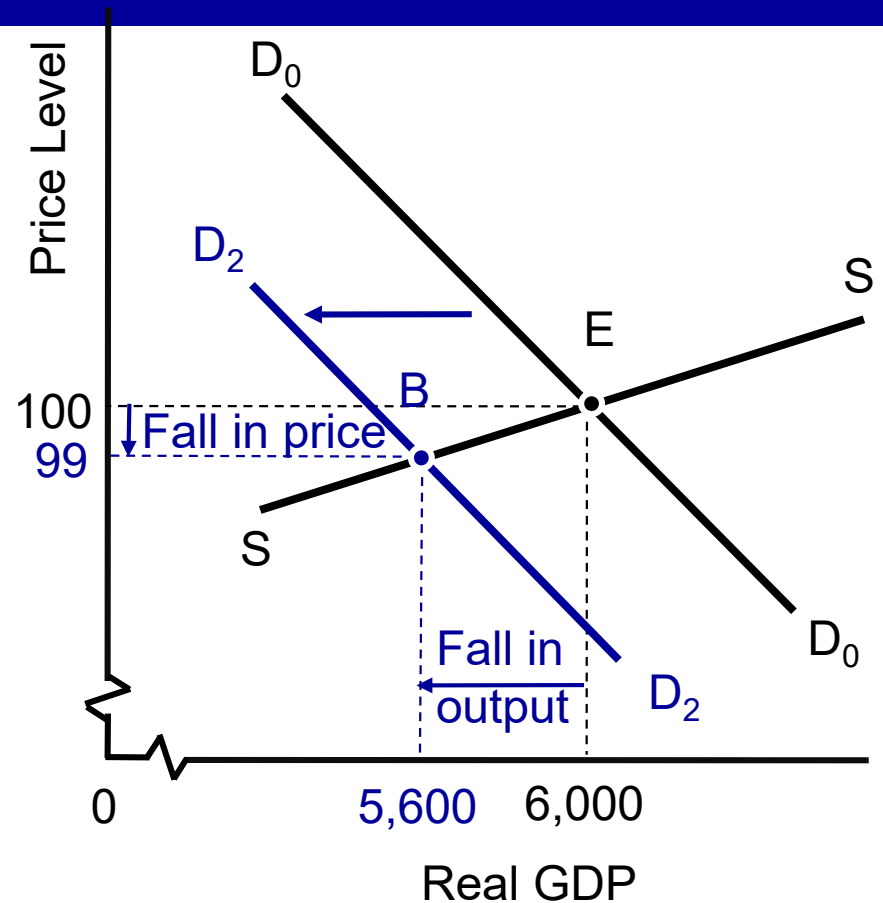
Real GDP

(b)

Stabilization Policy with a Flat Aggregate Supply Curve



(a) Expansionary policy

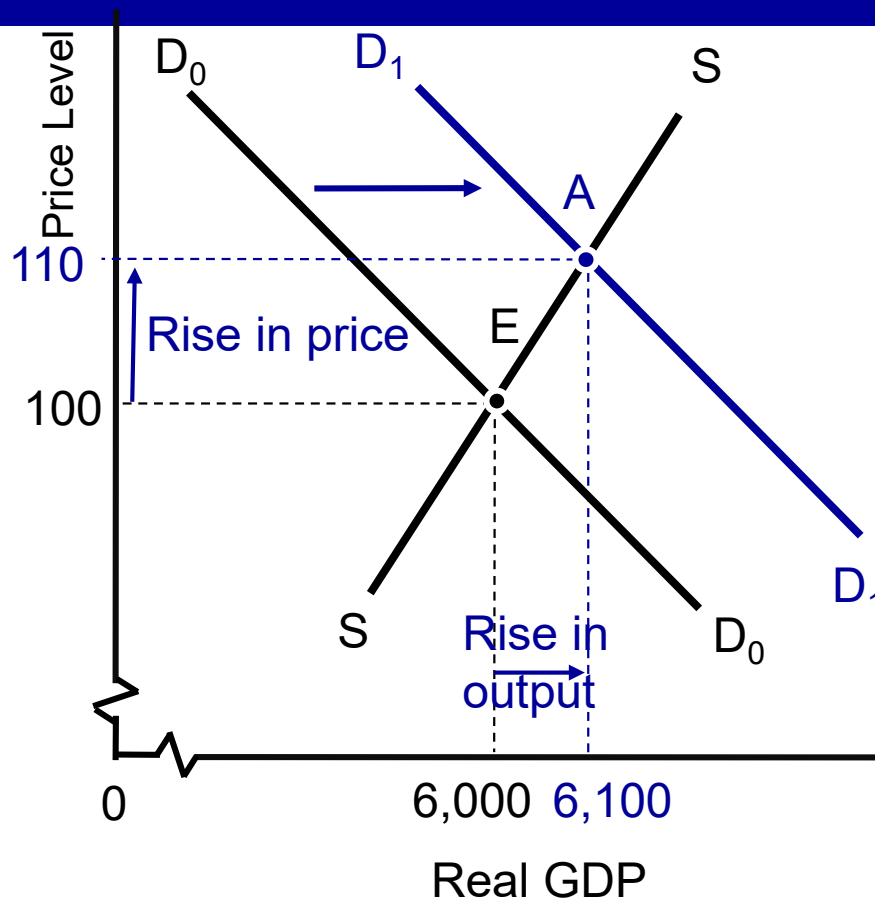


(b) Contractionary policy

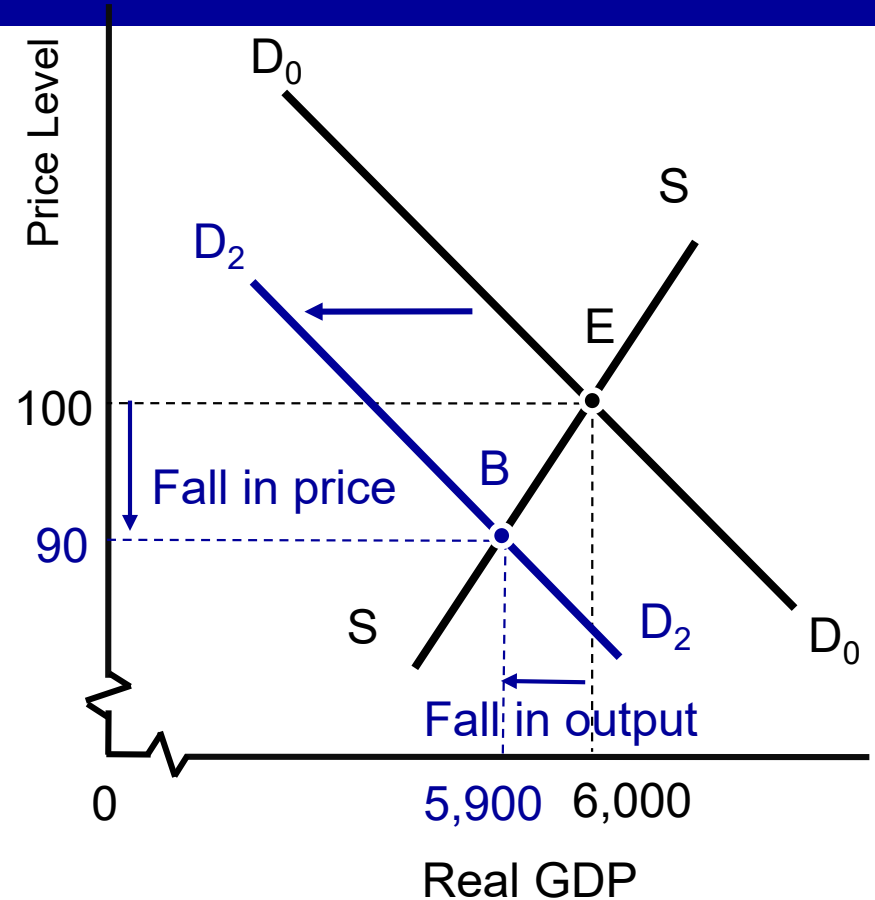
The Shape of the AS Curve: Flat or Steep

- ∞ Why does the shape of the aggregate supply curve matter?
 - When the aggregate supply curve is flat
 - Expansionary policy leads to a substantial increase in real GDP with only a small increase in inflation
 - Contractionary policy leads to only a small decrease in inflation but a substantial decrease in real GDP

Stabilization Policy with a Steep Aggregate Supply Curve



(a) Expansionary policy



(b) Contractionary policy

The Shape of the AS Curve: Flat or Steep

- ∞ Why does the shape of the aggregate supply curve matter?
 - When the aggregate supply curve is steep
 - Expansionary policy leads to a substantial increase in inflation with only a small increase in real GDP
 - Contractionary policy leads to a large decrease in inflation with only a small decrease in real GDP

The Shape of the AS Curve: Flat or Steep

∞ So is AS flat or steep?

- Depends on the time frame
- Short run – flat aggregate supply
 - Fluctuations in aggregate demand have large effects on output and minor effects on prices
- Long run – steep aggregate supply
 - Fluctuations in aggregate demand have large effects on prices and minor effects on output

Should the Government Intervene?

∞ Main issue

- Can government policy successfully stabilize the economy?
- Or do well-intentioned efforts do more harm than good

∞ Conservative vs. Liberal views

- Conservatives favor hands off government and favor fixed rules
- Liberals more favorably disposed toward an activist stabilization policy

Should the Government Intervene?

∞ Critics of stabilization policy

- Lags and uncertainties - fiscal and monetary policies
- Skeptical about our ability to forecast the future
- Stabilization policy may fail
- Advise: passive policies

Should the Government Intervene?

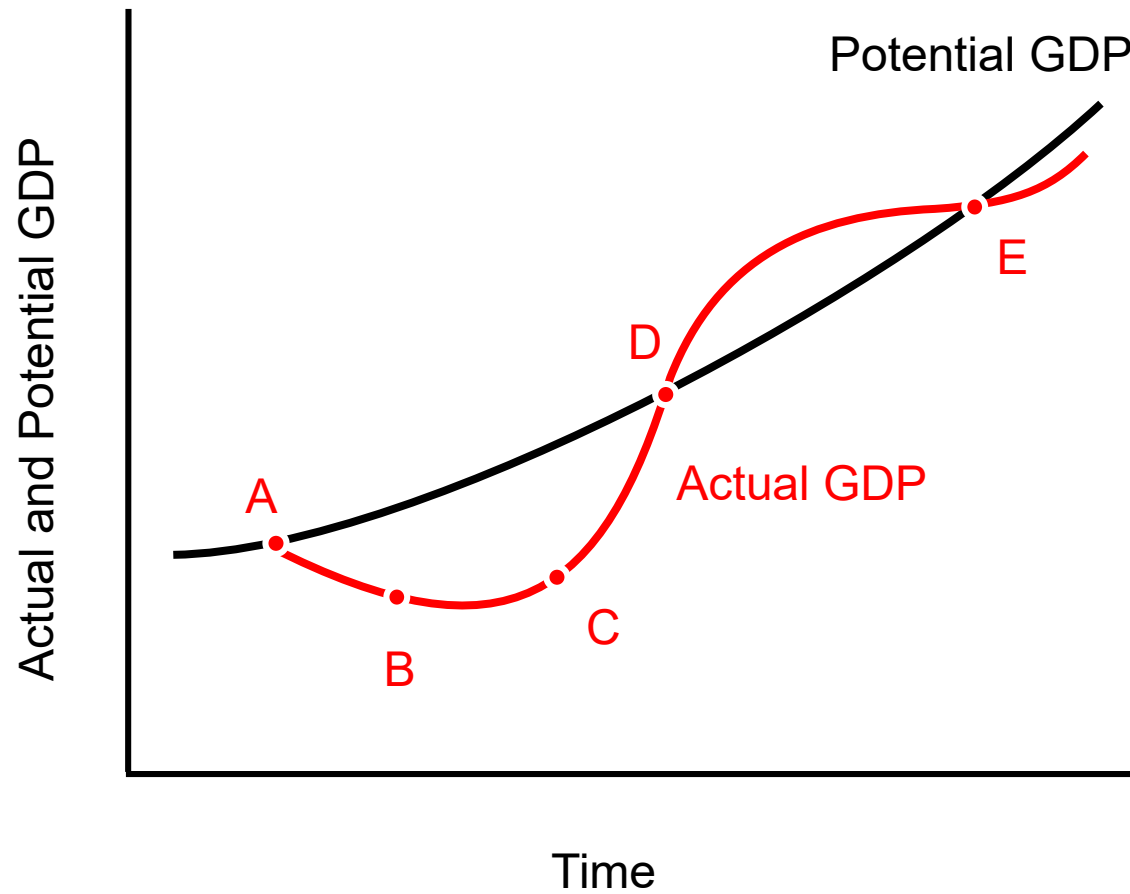
∞ Advocates of active stabilization policies

- Perfection is unattainable
- More optimistic about the prospects for success
- Much less optimistic about how smoothly the economy would grow
- Advocate active policies

Should the Government Intervene?

- ∞ Lags and the Rules-versus-Discretion Debate
- ∞ Problem with lags
 - Attempts at stabilizing the economy may actually succeed in destabilizing it

A Typical Business Cycle



Dimensions of Rules vs. Discretion Debate

- ⌘ What issues matter when deciding policy course?
- ⌘ Speed of the economy's self-correcting mechanism
 - Economy slow to recover so discretion warranted
- ⌘ Length of lags in stabilization policy
 - Mixed evidence on lag timing, so no conclusion
- ⌘ Accuracy of economic forecasts
 - Good enough to close persistent gaps between actual GDP and potential

Dimensions of Rules vs. Discretion Debate

∞ Size of government

- Proper size of government issue separate from rules vs. discretion debate
- Monetary policy neither increase nor decreases size

∞ Uncertainties caused by government policy

- Frequent changes in policy make it difficult to make rational plans – favors rules
- But economic instability also creates problems

Dimensions of Rules vs. Discretion Debate

∞ Political business cycle

- Fiscal policy decisions subject to “political manipulations”
 - But so are all decisions made by Congress
- Monetary policy made by the Fed - apolitical