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Stabilization Policy, Output, and Employment

Full Length Text — Part: 3 Chapter: 14
Macro Only Text — Part: 3 Chapter: 14

To Accompany "Economics: Private and Public Choice 12th ed."
James Gwartney, Richard Stroup, Russell Sobel, & David Macpherson
Slides authored and animated by:
James Gwartney, David Macpherson, & Charles Skipton


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Economic Fluctuations -- *The Historical Record*

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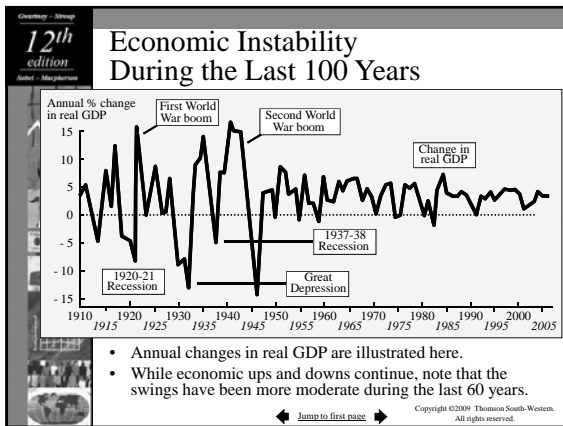


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Economic Fluctuations – *the Historical Record*

- Historically, the United States has experienced substantial swings in real output.
- Before the Second World War, year-to-year changes in real GDP of 5% to 10% were experienced on several occasions.
- During the last six decades, the fluctuations of real output have been more moderate.

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Can Discretionary Policy Promote Economic Stability?

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The Goals of Stabilization Policy

- Economists of almost all persuasions favor the following goals:
 - a stable growth of real GDP
 - a relatively stable level of prices
 - a high level of employment (*low unemployment*)
- But there is disagreement about how these goals can be achieved.

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Activist and Non-activist Views

- If monetary and fiscal policies could inject stimulus during economic slowdowns and apply restraint during inflationary booms, this would help reduce the ups and downs of the business cycle.
 - **Activists believe** that policy-makers can respond to changing economic conditions and institute policy in a manner that will promote economic stability.
 - **Non-activists argue** that discretionary use of monetary and fiscal policy in response to changing economic conditions is likely to do more harm than good.
- Both activists and non-activists recognize that conducting macro policy in a stabilizing manner is not an easy task.

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Practical Problems with Timing

- The **time lag problem**: It takes time to identify when a policy change is needed, additional time to institute the policy change, and still more time before the change begins to exert an impact on the economy.
- The **forecasting problem**: Because of the time lag problem, policy makers need to know what economic conditions will be like 12 to 24 months in the future. But, our ability to forecast future economic conditions is limited.
 - Forecasting tools like the index of leading indicators can help, but they sometimes give incorrect signals.
- The **political problem**: Policy changes may be driven by political considerations rather than stabilization needs.

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Index of Leading Indicators

- The **Index of Leading Indicators** is a composite statistic based on 10 key variables that generally turn down prior to a recession and turn up before the beginning of an expansion.
- It is a forecasting tool.
- While it correctly forecast each of the 7 recessions during the 1959-2007 period it forecast 4 recessions that did not occur.
- The index predicts with variable advance notice. The arrows below show how far ahead the index predicted recession.

Note: Recessions indicated by shading.

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Questions for Thought:

1. Why are macro policymakers interested in the index of leading indicators?
2. "Because policy changes exert an impact on the economy only after a period of time and forecasting is an imprecise science, trying to stabilize the economy with macroeconomic policy is likely to do more damage than good." Would an activist agree with this statement? Would a non-activist?
3. What are some of the practical problems that limit the effectiveness of discretionary macro economic policy as a stabilization tool?

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How are Expectations Formed?

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Two Theories of How Expectations are Formed

- **Adaptive Expectations:** Individuals form their expectations about the future on the basis of data from the recent past.
- **Rational Expectations:** assumes people use all pertinent information, including data on the conduct of current policy, in forming their expectations about the future.

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Macro Policy Implications of Adaptive and Rational Expectations

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The Implications of Adaptive & Rational Expectations

- With *adaptive expectations*, an unanticipated shift to a more expansionary policy will temporarily stimulate output and employment.
- With *rational expectations*, decision-makers do not make systematic errors and therefore the impact of expansionary policies is unpredictable.
- Both expectations theories indicate that sustained expansionary policies will lead to inflation without permanently increasing output and employment.

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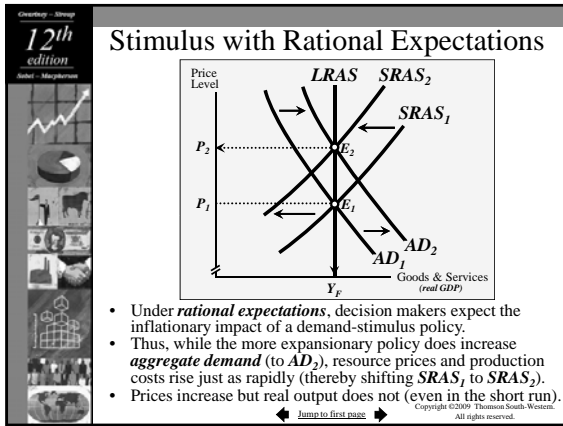
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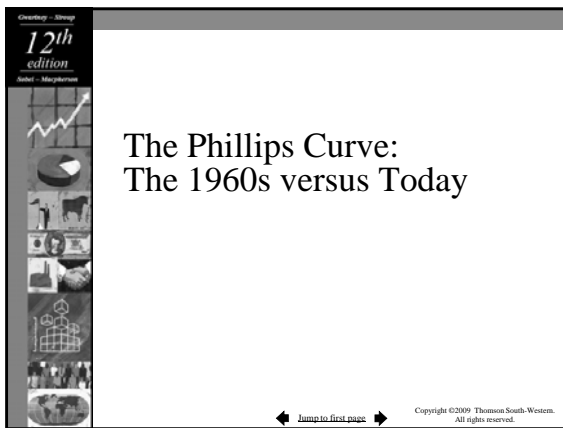
Stimulus with Adaptive Expectations

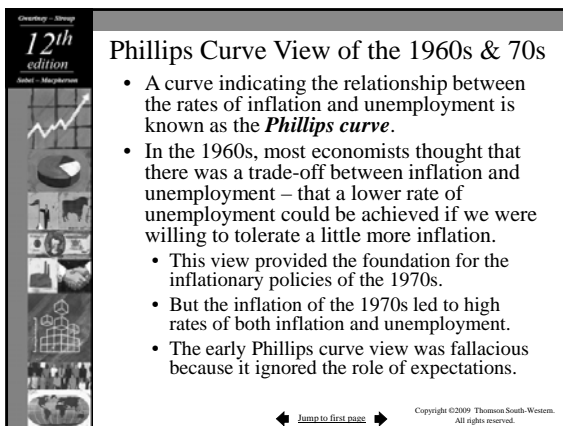
- Under *adaptive expectations*, anticipation of inflation will lag behind its actual occurrence.
- Thus, a shift to a more expansionary policy will increase *aggregate demand* (to AD_2) and lead to a temporary increase in GDP (to Y_2) and modest increase in prices (to P_2).

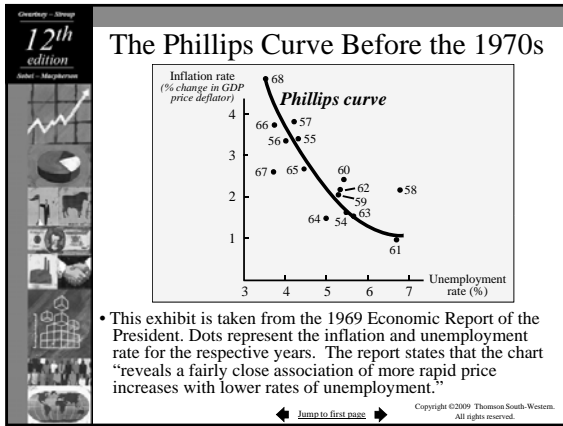
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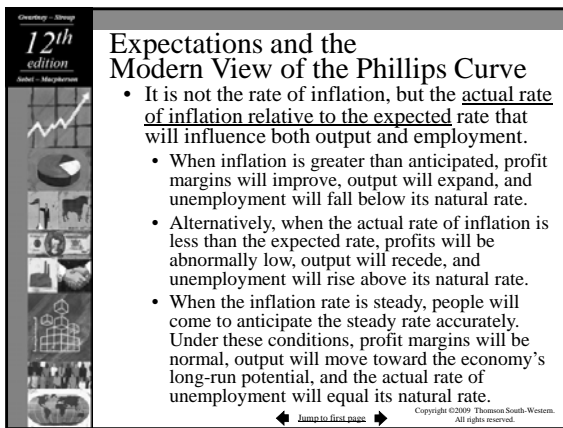
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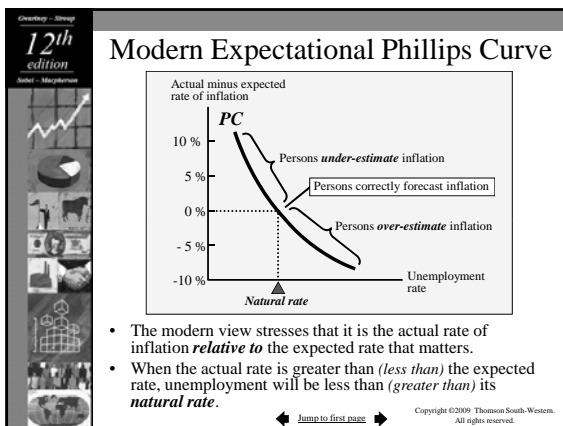


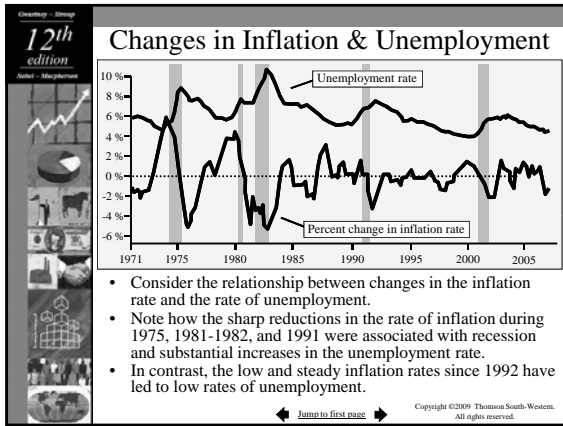












Application in Economics:
Perverse Macroeconomic Policy and the Great Depression

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The Great Depression of the 1930s

- The Great Depression is the most severe economic contraction in U.S. history.
 - Real GDP declined by nearly 30% between 1929 and 1933 and the unemployment rate soared to nearly a quarter of the labor force.
 - While real output expanded between 1934 and 1937, the economy dipped again in 1938 and the rate of unemployment rose to 19%.

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Economic Policy and the Great Depression

- The following economic policies were instituted **during** the Great Depression:
 - Between 1929 and 1933 the money supply decreased by nearly 30%.
 - In 1932, the largest tax rate increase in the history of the United States was instituted.
 - The lowest marginal rate was increased from 1.5% to 4% and the top rate was increased from 25% to 63%.
 - In 1930, tariffs (taxes on imports) were increased by nearly 50%.
- What is the predicted impact of these policies on output, employment, and living standards?
- Why do you think these policies were instituted?

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The Modern Consensus View

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The Modern Consensus View

- There are four major elements of the modern consensus view of stabilization policy:
 - Demand stimulus policies cannot reduce the rate of unemployment below the natural rate – at least not for long.
 - Wide swings in both monetary and fiscal policy should be avoided.
 - Using discretionary fiscal policy as an effective stabilization tool is impractical, particularly in countries like the U.S. where substantial checks-and-balances are present.
 - Monetary policy should focus on price stability.

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Key to Prosperity: Price Stability

- Monetary policy that provides approximate price stability (*persistently low rates of inflation*) is the key to sound stabilization policy.
- Modern living standards are the result of gains from trade, specialization, division of labor, and mass production processes. Price stability will facilitate the smooth operation of the pricing system and the realization of these gains.
- In contrast, high and variable rates of inflation create uncertainty, distort relative prices, and reduce the efficiency of markets.

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The Recent Record of Stability

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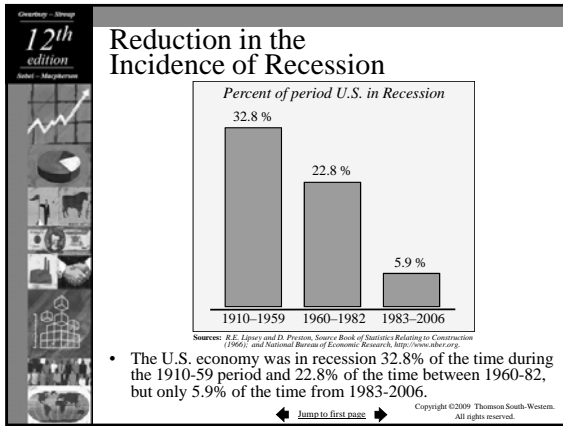
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Who Deserves Credit for the Recent Stability of the U.S. Economy?

- During the last quarter of a century, macro policy (*particularly monetary policy*) focused on keeping the inflation rate low.
- As the year-to-year changes in the inflation rate were reduced, so too were the ups and downs of the business cycle.
- Most economists believe that the increased stability is primarily the result of the more stable policies of the Federal Reserve (the Fed).

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Questions for Thought:

- “Under the adaptive expectations hypothesis, a shift to a more expansionary monetary policy will increase the real rate of output in the short run, but not in the long run.” Is this statement *true*? Would it be *true* under the rational expectations hypothesis?
- “If monetary policy keeps the rate of inflation low (for example, 2%) and the low rate is maintained over a lengthy period of time, the rate of unemployment will be approximately equal to the economy’s natural rate of unemployment.”
-- Is this statement *true*?

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Questions for Thought:

- Suppose that the inflation rate had been constant at approximately 2% during the last several years. However, monetary policy has become substantially more expansionary during recent months. How will this shift to a more expansionary monetary policy affect the expected rate of inflation under the adaptive expectations hypothesis? Under the rational expectations hypothesis?
- Is discretionary fiscal policy likely to be an effective stabilization tool in a country like the United States? Why or why not?

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Questions for Thought:

5. Are the following statements true or false?

- a. In the long run, the primary impact of expansionary monetary policy will be on real output and employment rather than the general level of prices.
- b. Economic fluctuations would be both less common and less severe if monetary policy kept the rate of inflation low and (approximately) constant.
- c. Once people come to expect a given rate of inflation, the inflation will neither stimulate real output nor reduce unemployment.

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Questions for Thought:

6. What was the dominant view of the Phillips curve during the 1960s? Was this view correct? Did this view exert an impact on macro policy? How does the modern view differ?

7. Are the following statements true or false?

- a. Decision makers are likely to underestimate sharp and abrupt reductions in the inflation rate.
- b. Demand stimulus policies introduce inflation without permanently reducing unemployment.
- c. Demand stimulus policies that result in inflation that is higher than anticipated will temporarily reduce unemployment below the natural rate.

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**End
Chapter 14**

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