Macroeconomic Policy
Active vs. Passive Policy

• “Automatic [fiscal] stabilizers” smooth out business cycles, reduce volatility

• But also lower multiplier (hence growth?)
  – Examples: income and VAT taxes, transfers to unemployed

• A “Passive” policy which need not be activated
  – Europe: more passive policy; Asia, Americas: less
Issues with Active Stabilization Policy

• Before Authorities Actively Try to Smooth Business Cycles, must ask:

  1. Is private sector intrinsically stable or unstable?
     • (Private) Investment volatile (Keynes’ “animal spirits”)
     • (Public) Many shocks though from monetary/fiscal spending

  2. Does policy typically stabilize or destabilize the economy?
Lags

• *Inside* policy-making mechanisms
  – Recognition – how long does it take to determine business cycle state?
  – Decision/Implementation – how long does it take to change policy?

• *Outside* policy apparatus
  – Effectiveness – how long it take for policy to take effect?
Another Problem

• Lags can be *long and/or variable* (Friedman)
  – Can make policy *pro-cyclic*
Rules vs. Discretion

• Rules have advantage of being *transparent*

• Discretionary policy may be *time-inconsistent*
  
  — *Ex post*, discretion may lead to different optimal policies from those stated *ex ante*
  
  — If rational agents realize this before the events have occurred, poor outcomes may arise (act as if policy will change)
Many Examples

- Hostages and terrorists
- Predictable natural disasters (floods, fires and earthquakes)
- Patents
- Taxing Capital
- Inflating away debt through surprise inflation
A Key Macroeconomic Example: Solutions to Inflation/Debt Problem

• Government has incentive to issue debt at low nominal rates and subsequently inflate it away
• If agents expect this, nominal interest rates rise through Fisher effect
• Responses vary by country:
  1. Independent Central Bank with inflation target (NZ)
  2. Real bonds (UK)
  3. Foreign-denominated bonds (Argentina)
  4. Short-term bonds (Italy)
Examples of Monetary Rules

• Friedman: money supply growth = k%

• Inflation target

• Fixed exchange rate

• “Taylor “ rule

\[ i = \pi + r^{LR} + \alpha(\pi-\pi^*) + \beta(y-y^{LR}) \]

where: \( \alpha, \beta > 0; \) “LR” denotes long run; and \( \pi^* \) is target inflation
Examples of Fiscal Rules

• Balanced Budget Requirement
  – Popular at sub-national levels of government

• Stability and Growth Pact
  – Limits deficits to <3% GDP for EMU members
    • Widely flouted in practice
Generic Issue for All Rules

• All rules need an “Escape Clause”

• Must be able to deal with extraordinary events (e.g., wars)
  – But possibility of abuse then exists (everything becomes extraordinary)
Key Takeaways

- Lags complicate policy
- Expectations and the future constrain the current
- Rules often dominate discretion