Macroeconomic Policy

Active versus Passive Policy

• Is private sector intrinsically stable or unstable?

• Does policy typically stabilize or destabilize the economy?
Lags

- *Inside* policy-making mechanisms
  - Recognition
  - Decision and implementation

- *Outside*
  - Effectiveness

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

- Rules have advantage of being transparent
  - Can be either passive or active

- Optimal 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
Examples:

- Predictable natural disasters (floods, fires and earthquakes)
- Hostages and terrorists
- Patents
- Taxing Capital
- Inflating away debt through surprise inflation
Solutions to inflation/debt nexus:

- Independent Central Bank with inflation target
- Real bonds
- Foreign-denominated bonds
- Short-term bonds.
Macro Rules

• Monetary
  • Friedman's $\%\Delta M = k\%$
  • Inflation target
  • Fixed exchange rate

• Fiscal
  • Balanced budget

• Generic Issue
  • How to deal with extraordinary events (e.g., wars)?