The Conduct of Stabilization Policy

Conduct of Stabilization Policy

• Stabilization Targets and Instruments in the Activists’ Paradise
  – The Need for Multiple Instruments
    • Achieving multiple targets requires multiple instruments
      – Targets
      – Instruments
        » Figure 14 - 1

Conduct of Stabilization Policy

• Stabilization Targets and Instruments in the Activists’ Paradise (continued)
  – Targets, Instruments, and Structural Relations
    • Target variables: the economic aggregates whose values society care the most about
    • Policy instruments: the variables the government can use to try to achieve its targets
    • Structural relations: the link between policy instruments and target variables
      – Also influenced by exogenous demand and supply factors
    • Irrelevant variables: not important for econ welfare

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• The Central Role of Demand Shocks
  – Unrealistic Precision of Policy Control
    • In the real world, the ability to control for demand or supply shocks is less certain than suggested by our models
      – Reasons
        » Time lags
        » Uncertain multipliers
        » Changing structure of the economy
      – Implications
        » Activist policies
        » Rules-based policies

Figure 14 - 1: A Flowchart Showing the Relationship Between Policy Instruments, Policy Targets, and Economic Welfare

THE THEORY OF ECONOMIC POLICY

POLICY INSTRUMENTS:
Fiscal instruments: Government spending, taxes, interest rates
Monetary instruments: Open market operations, reserve requirements
Structural relations: The link between policy instruments and target variables

STRUCTURAL RELATIONS:
Consumption function
Investment function
Government spending
Money market
Phillips curve
Real interest rate

TARGET VARIABLES:
Unemployment rate
Inflation rate
Nominal and GDP
Rates of unemployment and inflation and changes over time

ENDOGENOUS NONPOLICY VARIABLES:
Business cycle
Foreign trade
Interest rates
Consumer prices

EXOGENOUS NONPOLICY VARIABLES:
Business cycle
Foreign trade
Interest rates
Consumer prices

ECONOMIC WELFARE:
National GDP
Distribution of income
Quality of the environment
Productivity of workers
Quality of the educational system
National health
Conduct of Stabilization Policy

- Stabilization Targets and Instruments in the Activists’ Paradise (continued)
  - Rules Advocates and the Activists' Paradise

<table>
<thead>
<tr>
<th>Activists</th>
<th>Belief Regarding Automatic Self-Correcting Properties of Private Economy?</th>
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<th>Rules Advocates</th>
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<td>Optimistic</td>
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- Policy Rules
  - Introduction
    - A Policy Rule can call for a fixed path of
      - an intermediate variable, or
      - a target variable
    - A policy rule can also call for a specified response of a policy instrument in response to a given change in an intermediate or target variable
    - Rules based on intermediate or target variables can lead to wide swings in policy instruments
      - Leads to feedback rules

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- Policy Rules (continued)
  - The Positive Case for Rules
    - Three main arguments
      - Insulates the central bank from political pressure
      - Allows for a metric judgment
      - Reduces uncertainty about future policy moves
    - Weaknesses in these arguments
      - Central banks are part of government; political choice is necessary
      - Valuable only if public cares about rules variable
      - Depends on structural linkages in economy

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- Policy Rules (continued)
  - The Positive Case for Rules (continued)
    - Difficult to make a general case for rules without specifying the exact nature of the rule
    - Dilemma:
      - A rigid rule for a policy instrument that the Fed can actually control directly may lead to undesirable behavior on the part of target variables
      - A rigid rule for a target variable may require activist management of policy variables themselves and may lead to conflicts among the target variables

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- Policy Rules (continued)
  - The Negative Case for Rules
    - Activists policy will do more harm than good
      - Many of the defects for activists policies are also relevant for rules

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- Policy Pitfalls: Lags, Uncertain Multipliers
  - The Five Types of Lags
    - The Data Lag (1 - 2 months)
    - The Recognition Lag (2 - 6 months)
    - The Legislative Lag (short for MP, long for FP)
    - The Transmission Lag (short for MP, long for FP)
    - The Effectiveness Lag (long and variable)
  - Evidence on the Effectiveness Lag
    - The most difficult to measure and the longest
      - Figure 14 - 2
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- Policy Pitfalls (continued)
  - Why Have MP Multipliers Changed?
    - Three real-world difficulties
      - the length of the lags
      - the change in the lag, and
      - the change in the multipliers
    - Multipliers change as the economy’s structure changes
      - Causes serious difficulties for stabilization policies
        » Activist
        » Rules-based

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- Policy Pitfalls: Lags and Uncertain Multipliers (continued)
  - Multiplier Uncertainty
    - Dynamic multipliers show the amount by which output is raised during each of several time periods after a given change in the policy instrument
    - Multiplier uncertainty stems from the lack of firm knowledge regarding the change in output caused by a change in a policy instrument
      - The change in the policy instrument is rarely the only influence on the economy

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- Why Have MP Multipliers Changed?
  - Three structural changes in economy
    - Housing finance
      » Thrift loans to mortgage securities
      » Short lag became much weaker
    - Consumer finance
      » Bank loans to credit cards
      » Short lag became much weaker
    - Flexible exchange rates
      » Long lag became stronger

CASE STUDY: How Accurate Are Forecasts?

- Forecasting Failures
  - The 1974-75 Debacle
  - The 1979-80 Supply Shock and the 1981-82 Recession
  - The Expansion of the 1980s
  - The 1990-91 Recession and the Recovery of the 1990s

Figure 14-2     The Percent Change in Real GDP Following a 1 Percentage Point Change in the Treasury Bill Rate, Three Intervals, 1962–96

Figure 14-3     Actual and Predicted Values of the Unemployment Rate (U) and of the Growth Rates of Real GDP (y) and the GDP Deflator (p), 1971–96
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• CASE STUDY: How Accurate Are Forecasts? (continued)
  – Reasons for Forecasting Errors
  • Forecasts of various policy instruments
  • Forecast of various nonpolicy exogenous variables
  • Assume stable structural relationships
    – Econometric models based on long historical period
    – The use of judgment
    – Particular difficulty at turning points
  – Implications of Forecasting Errors for the Policy Debate

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• CASE STUDY: Did the Federal Reserve Pilot a “Soft Landing”
  – Introduction
    » Figure 14-4
  • Uncertainty about the structure of the economy and the effects of policy should temper the recommendations of activist policymakers
  • Future demand and supply shocks cannot be forecast

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• CASE STUDY: Did the Federal Reserve Pilot a “Soft Landing” (continued)
  – Soft Landings
    • A soft landing changes the policy instruments so that actual real GDP glides smoothly onto the “runway” of natural real GDP
    • A soft landing implies that actual real GDP avoids both overshooting and undershooting natural real GDP by large amounts
      – Dampens booms and busts

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• Time Inconsistency, Credibility, and Reputation
  – Time Inconsistency
    • Time inconsistency describes the temptations of policymakers to deviate from a policy after it is announced and private decisionmakers have reacted to it
      – Relation to rational expectations
      – Monetary versus fiscal policy
    • Implies that economic performance may be enhanced by a policy rule

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• Time Inconsistency, Credibility, and Reputation (continued)
  – Credibility and Reputation
    • Policy credibility is the belief by the public that the policymakers will actually carry out an announced policy
      – It probably pays for a central bank to invest in its reputation
  – Implications for Rules versus Discretion
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- CASE STUDY: Should Monetary Policy Target the Exchange Rate?
  - Introduction
    - Flexible exchange rates allow central bank to set policy for strictly domestic economic concerns
      - Because expansionary monetary policy lowers interest rates, it also lowers the exchange rate which improves net exports, i.e., the IS curve shifts outward also
    - Fixed exchange rates the central banks cannot set policy for strictly domestic economic concerns
      - Interest rate policy becomes subservient to the fixed exchange rate

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- CASE STUDY: Should Monetary Policy Target the Exchange Rate? (continued)
  - Introduction (continued)
    - Fixed exchange rates (continued)
      - One way for the central bank to convey its commitment to a rigid rule is to fix the exchange rate
      - Evidence from developing countries suggests that adopting fixed exchange rates tends to reduce the average inflation rate
      - Whether the commitment to maintain a fixed exchange rate is credible is also relevant

Conduct of Stabilization Policy

- Rules versus Discretion: An Assessment
  - Introduction
    - Two major points
      - Money multiplier shocks, money demand shocks, commodity demand shocks, and supply shocks loosen the links between the Fed’s policy instruments and its targets
      - A nominal anchor is inherently desirable because
        - It prevents inflation from accelerating without limit,
        - It increases the chance that inflation expectations will turn out to be accurate

Conduct of Stabilization Policy

- Rules versus Discretion: An Assessment (continued)
  - Rules for Policy Instruments
    - Table 14.1
  - Rules for Target Variables
    - A real GDP rule requires an “accommodating” policy
    - An inflation rule requires an “extinguishing” policy
    - A nominal GDP rule requires a “neutral” policy
      - Compromise solution
    - Provides a nominal anchor
  - Is a Nominal GDP Rule Feasible?
    - Still have to deal with long lags and the difficulty of forecasting turning points

Conduct of Stabilization Policy

- Rules versus Discretion: An Assessment (continued)
  - A Final Word
    - Debate between rules and discretion is misleading
      - Unless it is an instrument rule the central bank will need discretion to achieve either intermediate or final targets
      - In deciding what structural model to use
      - In deciding what economic forecast to use
    - Nevertheless, there is a difference between a nominal GDP rule and pure discretion
      - Provision of a nominal anchor
Figure 14-5
The Output Ratio in Three Recessions and in Three Recoveries

Figure 14-6
The Federal Funds Interest Rate and the Output Ratio, 1984–96