Stabilization Policy

• Introduction to Stabilization Policy.
  ➢ Goals,
  ➢ Framework, and
  ➢ Challenges.

Stabilization Policy

• Goal: Dampen the business cycle, i.e., to keep \( Y_e \) close to \( Y_n \).
  ➢ Less volatility is “better” because of less uncertainty.
  ➢ Success!
    • Volatility since 1984 has been about \( \frac{1}{2} \) of what it was between 1959–84.

Stabilization Policy

• Framework:
  ➢ Identify the target variables:
    • Economic output,
    • Unemployment rate, and
    • Inflation.

• Goal: Dampen the business cycle.
  ➢ Reasons for Success:
    • Better application of technology,
    • Deregulation,
      ➢ Financial markets,
      ➢ Transportation, energy, etc.
    • Better policy implementation, and
    • Luck.

Stabilization Policy

Real Gross Domestic Product

Output Ratio

\[ \text{Year-on-Year Percent Change} \]
Stabilization Policy

• Framework (continued):
  ➢ Use (major) policy variables:
    • Monetary policy, and
    • Fiscal policy.

Stabilization Policy

• Framework (continued):
  ➢ Use (minor) policy variables:
    • Miscellaneous policies:
      • Regulatory policy,
      • Wage and price policies, and
      • Employment policies.
    • International policies:
      • Trade treaties,
      • Tariffs and quotas, and
      • Exchange rates.

Stabilization Policy

• Stabilization Challenges:
  ➢ Unrealistic precision of models and data,
  ➢ Structural uncertainties,
  ➢ Multiplier uncertainties,
  ➢ Time (or policy) lags,
  ➢ Asymmetries, and
  ➢ Expectations.

Stabilization Challenges

• Unrealistic precision and simplicity of models & data.
  ➢ Models imply a precision that does NOT exist in the real world.
  ➢ Models imply a simplicity that does NOT exist in the real world.
    • Interest rates and the yield curve.
  ➢ Unrealistic precision of data.
    • Particularly, potential output, \( Y_n \) and
    • Productivity growth.

Stabilization Challenges

• Structural uncertainties:
  ➢ Structure of the economy is more complicated.
  ➢ Structure of the economy is not stable.
    • Financial deregulation.
    • Production deregulation.
    • Globalization.
  ➢ Transmission mechanisms are more complicated and subtle.

Stabilization Challenges

• Multiplier Uncertainties:
  ➢ Multiplier effects are not instantaneous.
  ➢ There is often more than 1 change taking place.
  ➢ Multipliers change with changes in the economy.
    • Housing finance:
      • Consumer finance.
      • Flexible exchange rates.
    ➢ Asymmetries; the importance of initial conditions.
Stabilization Challenges

- Fiscal Policy Multipliers:
  - Start large, grow, then fade.
  - Large initial impact.
  - Multiplier effects.

Fiscal Policy Multipliers

Stabilization Challenges

- Fiscal Policy Multipliers:
  - Start large, grow, then fade.
  - Fade because:
    - Higher \( r \) crowds out \( I_p \),
    - Higher \( r \) raises $ which reduces \( X - M \),
    - Higher \( r \) increases debt burdens,
    - Higher \( r \) reduces wealth, and
    - Higher inflation.

Stabilization Challenges

- Monetary Policy Multipliers:
  - Start small, build, then fade.
  - No direct spending effect.
  - Multiplier effect.

Monetary Policy Multipliers

Stabilization Challenges

- Monetary Policy Multipliers:
  - Start small, build, then fade.
  - Fade because:
    - Higher \( r \) (after initial drop), and
    - Higher inflation.
Stabilization Challenges

• Time (or policy) lags:
  ➢ Changes in policy variables do not happen instantaneously (i.e., the inside lag).
  ➢ Changes in policy variables do not have an instantaneous impact on the economy (i.e., the outside lag).

Stabilization Challenges

• Time (or policy) lags:
  ➢ The Inside Lag (Time to policy action).
    • The data lag.
    • The recognition lag.
    • The decision/legislative lag, and
    • The action/implementation lag.

Stabilization Challenges

• The Outside Lag (Time to effect the economy).
  • The transmission lag
  • The effectiveness lag
    Initial change in Ep until ½ of change is complete

Stabilization Challenges

• Policy Lags in Fiscal Policy:
  ➢ Lags can be long.
    • Up to 2 years.
    • Long inside lag but short outside lag.
    • Initial conditions important for outside lag.
      ➢ Asymmetry.
  ➢ Makes policymaking more difficult.
    • Must forecast effects.
      ➢ Size and timing are difficult to estimate.
    • Must forecast other influences on the economy.

Stabilization Challenges

• Policy Lags in Monetary Policy:
  ➢ Lags can be long and variable.
    • 3 months to 2 years.
    • Short inside lag but long and variable outside lag.
    • Initial conditions important for outside lag.
      ➢ Asymmetry.
  ➢ Makes policymaking more difficult.
    • Must forecast effects.
      ➢ Size and timing are difficult to estimate.
    • Must forecast other influences on the economy.

Stabilization Challenges

• Asymmetries:
  ➢ Between economic conditions.
  ➢ Between expansionary and contractionary policy.
  ➢ Between monetary and fiscal policy.
Stabilization Challenges

• Expectations:
  ➢ Economic behavior may or may not change in anticipation of policy changes.
  ➢ Do expectations then match actual policy change?
  ➢ If not, this can generate a dynamic feedback loop.

Stabilization Policy Summary

• The Role of Monetary and Fiscal Policy:
  ➢ Theoretically, equally capable of achieving Yn.
    • But at different r’s.
  ➢ In the real world,
    • Monetary policy is better at achieving Yn.
      ➢ Faster, more flexible (easily reversible).
      ➢ But it is an indirect influence on spending.
    • Fiscal policy becomes responsible for setting r.
      ➢ Slower, less flexible (not easily reversible).
      ➢ But it has a direct influence on spending.
      ➢ This gives it a long-run growth orientation.

Stabilization Policy Summary

• Dealing with Stabilization Challenges.
  ➢ Don’t try to “fine tune” the economy.
  ➢ Make use automatic stabilizers.
  ➢ Be humble about your abilities to forecast and control the economy.