

OUTLINE — November 5, 2018

- Overview of Policy
 - Contractionary and Expansionary Policy
 - Monetary and Fiscal Policy
- Fiscal Policy
 - Effect on GDP in the short run
 - Deficits and Debt
 - Concerns regarding deficit spending

*Midterm #2 is tomorrow tonight
(if that's news, we should talk...)*

MT #2 reflection will be due on bCourses by 11/13 8 pm

Review: PPF & AD

- Productivity & supply of inputs ("supply side")
 - Determine location of PPF; determines Y_{FE}
- Aggregate demand ("demand side")
 - Determines whether economy is on its PPF; determines Y_E
- $Y_E = Y_{FE}$?
 - Economy is on its PPF
- $Y_E < Y_{FE}$?
 - Economy is inside its PPF

How close an output gap?

- Any initial increase in AD will help close an output gap
 - C
 - I
 - G
 - EX
 - IM
- And the initial increase in AD will kick off multiplier process
 - Total $\Delta Y =$

Three types of policy

Monetary Policy	Fiscal Policy	Credit Policy
Federal Reserve (Fed) Interest rates & money supply	Congress & President G, TR, and TA	Combination of Fed & Congress Policies & laws relating to mortgage and consumer credit: <i>Availability, marketing, consequences of default</i>

Direct, Indirect. Expansionary, Contractionary.

- **Direct Policy**
 - Directly changes some component of AD
- **Indirect Policy**
 - Changes some other economic variable, which eventually changes AD
- **Expansionary Policy**
 - Increases (expands) GDP
- **Contractionary Policy**
 - Decreases (contracts) GDP

Overview of Policy

Fiscal Policy & GDP

Deficits & Debt: Definitions

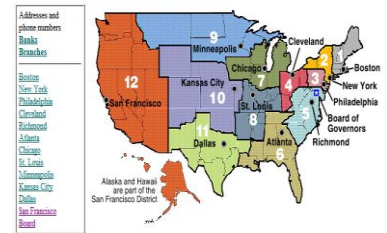
Extensions

Monetary Policy Overview

Conducted by the Federal Reserve

- U.S. central bank established in 1913
- Headquarters in Washington DC
- Board of Governors
- 12 regional Federal Reserve Banks

The Twelve Federal Reserve Districts



Overview of Policy

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Extensions

The Fed

- Federal Reserve Board (7 people)
 - Chairman Jerome Powell
 - 6 additional members of the board
 - All appointed by the President & approved by US Senate
 - 14 year terms, to limit political influence
- Fed's Mission – a “dual mandate”
 1. Maximum **employment**
 2. Stable **prices**

Overview of Policy

Fiscal Policy & GDP

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Extensions

Monetary Policy

- **Who:** Federal Open Market Committee (FOMC)
- **What:** Changes in interest rates & money supply
- **How:** Majority decision of the 12 members of the FOMC (7 members of the Federal Reserve Board, President of the Federal Reserve Bank of New York, and 4 other Federal Reserve Bank presidents)

Overview of Policy

Fiscal Policy & GDP

Deficits & Debt: Definitions

Extensions


Monetary Policy

	Contractionary Policy	Expansionary Policy
Indirect Policy		
Direct Policy		

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Fiscal Policy

- **Who:** Congress with the approval of the President
- **What:** Changes in G, TR, and TA
- **How:** Bills approved in committee, passed by both houses of Congress, (perhaps then a compromise bill to reconcile differences between the Senate & House versions), then signed into law by the President



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Fiscal Policy

	Contractionary Policy	Expansionary Policy
Indirect Policy		
Direct Policy		

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How gov't spends money matters!

Suppose spending multiplier = 4

<p>Direct Policy Action Suppose $\Delta G = 50$ So, initial $\Delta \text{spending} =$ and $\Delta Y_E =$</p>	<p>Indirect Policy Action Suppose $\Delta TR = 50$ So, initial $\Delta \text{spending} =$ and $\Delta Y_E =$</p>
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Government spending has a greater effect on GDP than do changes in taxes or transfer payments

Overview of Policy Fiscal Policy & GDP Deficits & Debt: Definitions Extensions

Assuming what . . .

- Step 1 of multiplier process is initial change in AD
 - ΔG
 - ΔTR
 - ΔTA

Overview of Policy **Fiscal Policy & GDP** Deficits & Debt: Definitions Extensions

Deficits and Debt

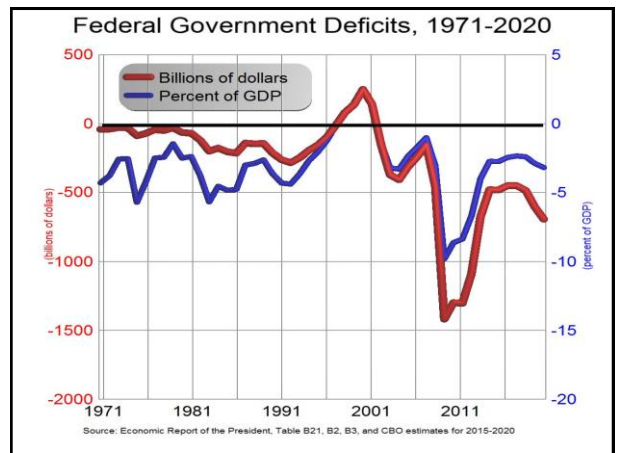
- **Budget Deficit or Budget Surplus**
 - If, in one year, $G + TR > TA$: **budget deficit**
 - If, in one year, $TA > G + TR$: **budget surplus**
 - $G + TR$ = Government outlays
 - TA = Government receipts
- **Government debt**
 - Cumulative total, since 1790, of annual budget deficits minus annual budget surpluses
 - Government borrows by issuing IOUs: government bonds

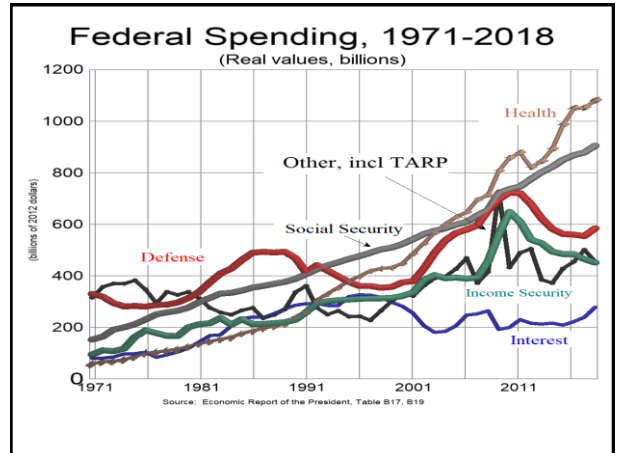
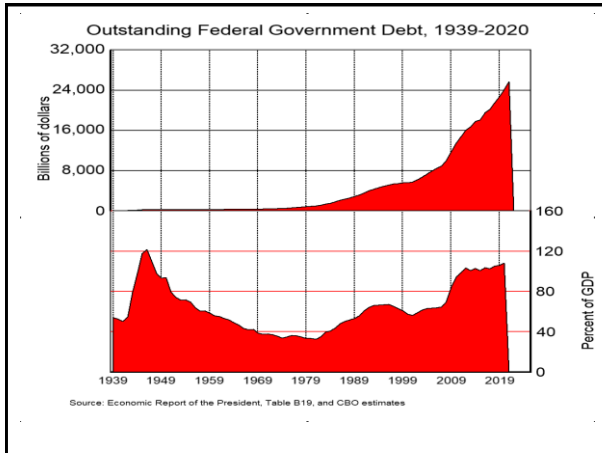
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Fiscal Policy Effect on Deficit

- Expansionary fiscal policy
- Contractionary fiscal policy

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Fiscal policy & Output gap

- If we are trying to close an output gap, fiscal policy should be expansionary
 - That is, increase budget deficit this year relative to last year

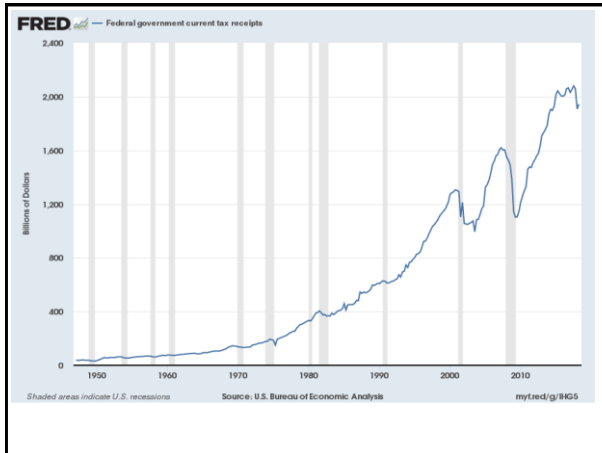
- **But!** If there is no output gap, expansionary fiscal policy may be *too* expansionary
 - Does fiscal policy affect PPF? Or just affect AD?
 - Pushing economy beyond PPF can trigger inflation

Overview of Policy Fiscal Policy & GDP **Deficits & Debt: Definitions** Extensions

Automatic vs Discretionary Policy

Automatic stabilizers	Discretionary fiscal policy
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Structural vs Cyclical Deficit

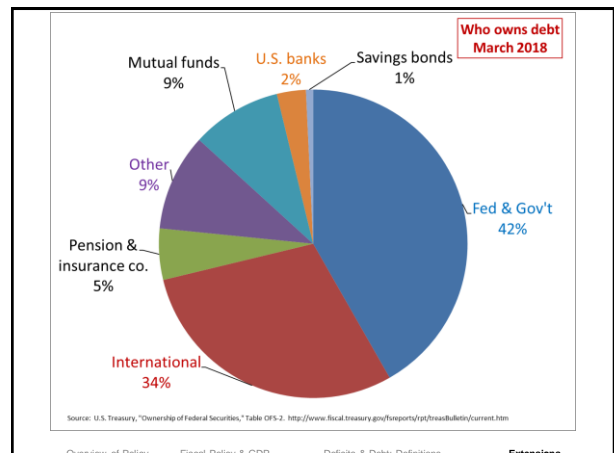
- A counterfactual question: How big would the deficit be if the economy were at full employment (eg, 4%)?
- How much larger is the actual deficit when unemployment is above full employment rate of 4 percent?
- It is problematic (many say) when the structural deficit > 0

Overview of Policy Fiscal Policy & GDP Deficits & Debt: Definitions Extensions

How pay bills when run a deficit?

- Federal government does **not** "print money" to pay its bills
 - Deficit? **Federal government borrows**
 - Annual borrowing = $(G + TR) - TA$
 - Borrow by issuing "Treasuries" = I.O.U. from government
 - "Maturity" = how many months/years until fully repaid
 - T-Bills: Short-term, mature in 1 year or less
 - Notes: Mature in 2 to 10 years
 - Bonds: Long-term, mature in 20 to 30 years
- Who lends?
 - Everyone

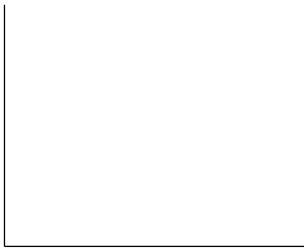
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Concern: Impact on Interest Rates

- Market for loanable funds



- *But ... Are assumptions of model valid in this case?*

Overview of Policy

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Extensions

What if Supply changes too?

- Market for loanable funds



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