Should Policymakers Be Restrained?

Chapter 24

24.a Uncertainty and Policy

There is substantial uncertainty about the effects of macroeconomic policies. Some macroeconomists argue that this uncertainty should lead policy makers to be more cautious, to use less active policies.

24-b Expectations and Policy

- People and firms try to anticipate what policy makers will do. Hence, macroeconomic policy is a game between policy makers and the public.

- An announcement of a policy change induces a change in firms/households behavior: policy changes are *internalized* by firms and households.

Illustration with monetary policy

* The relation between unemployment and inflation is as follows:

$$\pi = \pi^e - \alpha(u - u_n)$$

This is the ***Phillips Curve***

Suppose the Fed announces that it will keep inflation constant , and wage setters believe that expected inflation will be zero. Then:

$$\pi = -\alpha(u - u_n)$$

In the U.S., $\alpha \approx 1$. If $\pi = 0$, then the announced policy calls for $\pi = \pi^e = 0$, and $u=u_n$.

* But the Fed could deviate from its stated policy and achieve an unemployment rate of 1% below the natural rate with just a 1% increase in the inflation rate.

$$\pi = -\alpha(u - u_n)$$

- If $\alpha = 1$ and $\pi = 1\%$, then $(u - u_n.) = -1\%$. This incentive to deviate from the announced policy once the other player (in this case wage setters) has made its move is known as **time inconsistency**.

- Subsequently, wage setters wise up and begin to expect positive inflation of 1%. Eventually, the economy returns to the natural rate of unemployment, but with higher inflation.

- The ultimate outcome is likely to be high inflation. The economy ends up with the *same unemployment rate*, but with *much higher inflation*.

Establishing Credibility

*Ways to deal with the problem of time inconsistency, without totally stripping the central bank of policy-making power include:

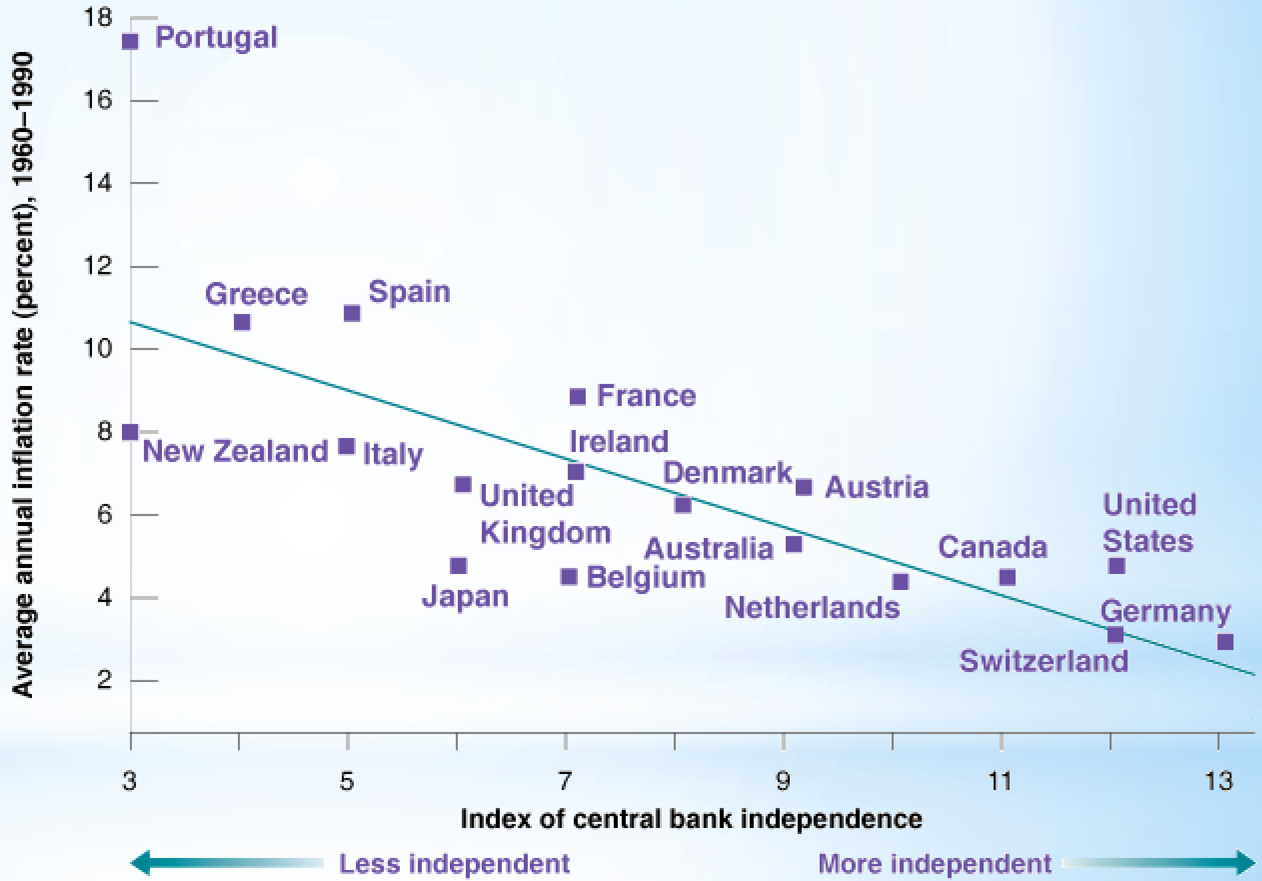
- Make the central bank **independent**. This way, the central bank resists political pressure to decrease unemployment by increasing money growth.
- Give incentives to the central banker to take the long-term view; that is, to take into account the long-run costs of higher inflation.
- Choose a “**conservative**” central banker; i.e., one who dislikes inflation.

Central bank independence and credibility

Figure 24 – 3

Inflation and Central Bank Independence

Across OECD countries, the higher the degree of central bank independence, the lower the rate of inflation.



Time Consistency and Restraints on Policymakers

* When time inconsistency is a concern, tight restraints on policymakers— such as a fixed-money-growth rule in the case of monetary policy, or a balanced budget rule in the case of fiscal policy—can provide a rough solution.

* But the solution carries costs because it limits the role of macroeconomic policy.

* Better solutions typically involve designing better institutions (such as an independent central bank or a better budget process) that can reduce the problem of time inconsistency while, at the same time, allowing the use of policy to manage the economy.

24-c Politics and Policy

* We have assumed so far that policy makers are ***benevolent***, i.e., that they try to do what is best for the economy. Politicians or policy makers, however, often do what is best for themselves, and this is not always what is best for the economy.

Games between Policymakers and Voters

* If voters are shortsighted, the temptation for politicians to cut taxes may prove irresistible.

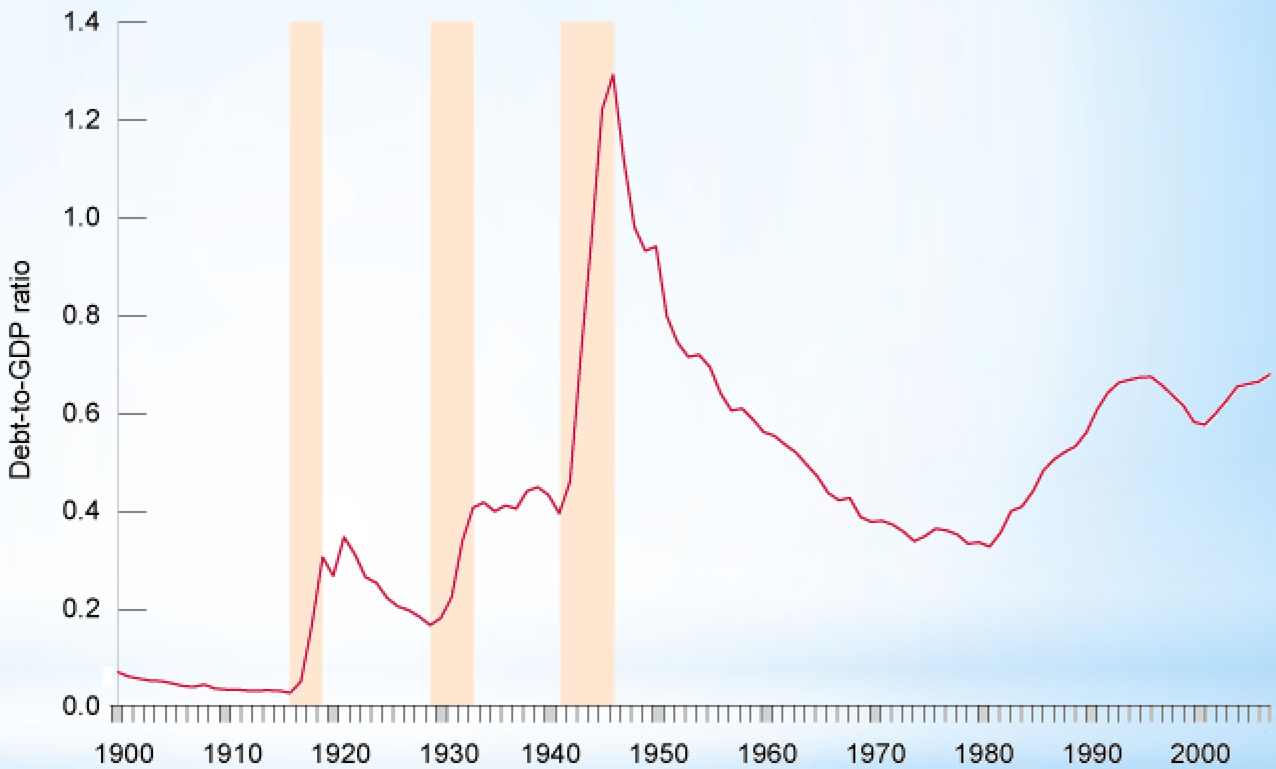
* With the right timing and shortsighted voters, political parties can win elections. Thus, we might expect a clear **political business cycle**, with higher growth on average before elections than after elections.
  * In that context, debt cycles would be closely related to political cycles.

Is debt build up related to policy cycles?

Figure 24 – 4

The Evolution of the Ratio of U.S. Debt to GDP since 1900

The three major buildups of debt since 1900 have been associated with World War I, the Great Depression, and World War II. The buildup since 1980 appears to be different in nature.



Suggested short readings on the debate on Deficits and the “Fiscal Cliff”

Robert Pollin (Umass) “Why Professor John Taylor and Other Deficit Hawks are Wrong” http://backtofullemployment.org/page/3/

John Weeks (SOAS) “Public Sector Deficits are the Solution, not the Problem Ideology of Balancing Budgets.”

http://www.insightweb.it/web/files/ideology_of_balancing_budgets.pdf

Paul Krugman (Princeton) “The Conscience of a Liberal”

http://krugman.blogs.nytimes.com/

Games between Policymakers

* Game theorists refer to **wars of attrition** the situations in which each side holds out, hoping that the other side will give in. These wars usually result in delays in the implementation of policy.

* Republicans <u>arguably</u> worry more than Democrats about inflation and less than Democrats about unemployment. We would then expect to see stronger growth during Democratic administrations.

Table 24-1 Average Growth During Democratic and Republican Administrations (percent per year) since 1948

	Year of the Administration				
	First	Second	Third	Fourth	Average
Democratic	3.4	5.5	4.4	3.5	4.2
Republican	2.9	0.9	2.2	4.0	2.5
Average	3.2	2.9	3.2	3.7	3.3

Politics and Fiscal Restraints

* A balanced-budget amendment would eliminate the problem of deficits, but it would also eliminate the use of fiscal policy as macroeconomic policy instrument.
* The "Budget Enforcement Act" passed in 1990, and extended in 1993 and 1997, introduced two main rules:

1. It imposed constraints on spending. Constraints, called **spending caps**, were set on discretionary spending for a period of 5 years.

2. It required that a new transfer program could only be adopted if it could be shown not to increase deficits in the future. This rule is known as the **pay-as-you-go** or the **PAYGO rule**.

*Is a balanced-budget amendment a good idea?

House Republican
Contract with America

A Program for Accountability

We've listened to your concerns and we hear you loud and clear. If you give us the majority, on the first day of Congress, a Republican House will:

Force Congress to live under the same laws as every other American
Cut one out of three Congressional committee staffers
Cut the Congressional budget

Then, in the first 100 days there will be votes on the following 10 bills:

1. Balanced budget amendment and the line item veto: It's time to force the government to live within its means and restore accountability to the budget in Washington.

2. Stop violent criminals: Let's get tough with an effective, able, and timely death penalty for violent offenders. Let's also reduce crime by building more prisons, making sentences longer and putting more police on the streets.

3. Welfare reform: The government should encourage people to work, not have children out of wedlock.

4. Protect our kids: We must strengthen families by giving parents greater control over education, enforcing child support payments, and getting tough on child pornography.

5. Tax cuts for families: Let's make it easier to achieve the American Dream: save money, buy a home, and send their kids to college.

6. Strong national defense: We need to ensure a strong national defense by restoring the essentials of our national security funding.

7. Raise the senior citizens' earning limit: We can put an end to government age discrimination that discourages seniors from working if they want.

8. Roll back government regulations: Let's slash regulations that strangle small business and let's make it easier for people to invest in order to create jobs and increase wages.

9. Common-sense legal reform: We can finally stop excessive legal claims, frivolous lawsuits, and overzealous lawyers.

10. Congressional term limits: Let's replace career politicians with citizen legislators. After all, politics shouldn't be a lifetime job.

(Please see reverse side to know if the candidate from your district has signed the Contract as of October 5, 1994.)

IF WE BREAK THIS CONTRACT, THROW US OUT. WE MEAN IT.

Figure 24 – 1 ***The Contract with America***