DEG
DEPARTAMENTO
DE ENGENHARIA E GESTÃO
TÉCNICO LISBOA

Introductory Economics

Introdução à Economia

Problems

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3rd Quarter (P3)

5. Economic Policy

5. Política Económica

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5.1 Classify the following sentences as True or False. Justify. (Adapted from CORE, The Economy)

a. The marginal propensity to consume (MPC) is normally less than 1 as some households can smooth their consumption.

True. Households that smooth consumption will increase spending by less than the amount their income increases.

b. The MPC is the proportion of current income spent on consumption, C/Y.

False. MPC is the effect of one additional unit of disposable income on consumption, $\frac{\partial C}{\partial Y_d}$.

c. The decrease of the interest rate increases the investment.

True. Lower interest rates increase investment spending by making it cheaper and easier for businesses to borrow money to finance new projects. The same happens for consumers, who might decide on a big purchase (e.g., buy a house) due to low interest rates.

5.2 Classify the following sentences as True or False. Justify. (Adapted from CORE, The Economy)

a. Tax policy is the only way to dampen fluctuations in the economy using fiscal policy.

False. Giving benefits to unemployment and changes in the size of the Government can also be used.

b. Maintaining fiscal balance in a recession helps to stabilize the economy.

False. If the government maintains fiscal balance, then it is not offsetting the decline in private demand.

c. A fiscal stimulus can be implemented by raising spending to directly increase demand, or by cutting taxes to increase private sector demand.

True. A rise in G increases aggregate demand directly, while a cut in taxes can increase C and/or I, representing increased private sector demand.

d. Automatic stabilizers refer to the fact that economic shocks are partly offset by households smoothing their consumption in the face of variable income.

False. Automatic stabilizers refer to government policies that smooth household disposable incomes, such as taxes and unemployment benefits.

5.3 Quantitative Easing (QE) is a recent type of monetary policy, introduced after the 2008 financial crisis. What is its objective? How does it work?

The objective of QE is to increase aggregate demand by buying assets, even when the policy interest rate is zero. First, the central bank buys bonds and other financial assets (it creates additional base money for this purpose). As a consequence, the demand for bonds and other financial assets increases. This means that the central bank shifts the demand curve for those assets to the right, which pushes up the price. This also decreases the yield and interest rate on bonds. The result of this policy is a boost in spending, particularly on housing and consumer durables, because both the cost of borrowing and return to holding financial assets have gone down.

5.4 The table below illustrates the fiscal and monetary policy mix used during the US recession in 2001 when, after a decade of expansion, the growth rate of the US economy slowed. (Adapted from CORE, The Economy)

		2000	2001	2002	2003
Real gross gomestic product (annual % change)		4.1	0.9	1.8	2.8
Contribution to % change in GDP	Change in non-residential investment	1.15	−1.2	−0.66	0.69
	Change in residential investment	−0.07	0.09	0.39	0.66
	Change in government expenditure	0.10	0.88	0.74	0.36
	Change in other contributions	2.92	1.13	1.33	1.09
Federal Reserve nominal interest rate (annual average, %)		6.24	3.89	1.67	1.13
Unemployment rate (%)		4	4.47	5.8	6
Inflation rate (%)		3.4	2.8	1.6	2.3

a. By how much did the US economy slow down from 2000 to 2001?

By 4.1-0.9=3.2 percentage points. It grew much slower in 2001 than in 2000 (although it still grew).

b. Describe the monetary and fiscal policies used to increase demand and, consequently, GDP. Did these policies work in the planned way? Justify.

Monetary policy: the Central Bank decreased the Federal Reserve nominal interest rate in order to stimulate investment. As it is possible to see, in the end, the contribution of both types of investment (non-residential and residential) to GDP growth increased, meaning that this policy worked.

Fiscal Policy: to compensate for the stagnation in firms' private investment, the government used expansionary fiscal policy. It introduced large tax cuts and increased spending in 2001 and

2002. This resulted in an increase in investment. Also, from 2002 to 2003, it is possible to see that the inflation rate increased, which may indicate an increase in consumption.

c. In which year, 2002 or 2003, did fiscal policy give a stronger contribution to US recovery?

In 2002, because $0.74 + 1.33 > 0.36 + 1.09$.

d. Are indicators for the labor market in line with the rest of the figures presented?

No, because although GDP growth recovered and inflation increased (in 2003), unemployment did not fall.

e. How do you interpret the inflation rate figure recorded in 2002?

This inflation is the lowest in the period considered, in response (with some delay) to the 2001 recession. During a recession, aggregate demand contracts and inflation falls.

5.5 What are inflation targeting policies? How do they work?

Inflation targeting policies are monetary policies that have the objective to keep a steady inflation growth (set an inflation target). Whenever the economy experiences lower unemployment than the inflation-stabilizing rate, the central bank raises the interest rate, resulting in a decrease in the aggregate demand. Then, following a fall in aggregate demand (as a result of a fall in business confidence, for example), and facing the threat of recession, the central bank cuts the interest rate and brings the economy back toward its inflation target.

5.6 The Government is an economic actor. It is the only entity within a territory that can dictate what people must do/not do and can legitimately use force and restraints on an individual's freedom to achieve that end.

a. How does Government differ from other economic actors?

There are 2 main characteristics that differentiate the Government from other political actors:

Size – Governments are much larger than the other economic actors. Their size has grown over time.

Public influence – They have the ability and interest in engaging in activities that can improve the quality of life for citizens.

b. How can Governments adopt policies to address the inefficiency and unfairness that may result from private economic interactions?

Governments have several methods to address these problems:

Incentives – altering the costs/benefits of activities through taxes, subsidies, and other expenditures.

Regulation – for example, antitrust policy, pollution taxes.

Persuasion or information – altering available information or expectations about what others will do, to promote coordination.

Public provision – including transfers to citizens that may need them (e.g., goods and services, unemployment benefits, or family allowances).

c. Should Governments be allowed to act freely, without constraints, in order to address inefficiency and unfairness? Why?

No. Any organization with enough power to address the problems of efficiency and fairness also has the power to do great harm, including Governments. For example: using force to silence opponents, using natural resources for its own benefit (corruption). Therefore, Governments must operate with constraints, such as:

- Democratic elections: bad governments can be dismissed;
- Constitutional restrictions on what the government can do;
- Political competition also works as a constraint. If a Government does not operate well, it may be substituted by its political rivals.

5.7 Political Institutions are one of the most important parts of Governments. Political systems, such as Democracy, are composed of political Institutions.

a. What are political institutions?

The political institutions of a country are the rules that determine who has power and how it is exercised in a society.

b. What are the political institutions of Democracy?

Democracy is composed of 3 Political Institutions:

- Rule of law (all individuals are bound by the same laws);
- Civil liberties (the rights of free speech, assembly, and the press);
- Inclusive, fair, and decisive elections (fair elections in which no major population group is excluded from voting and after which the losing party leaves office).

In a Democracy, political parties compete through elections in order to decide who runs the country.

c. Why do political parties often adopt similar platforms?

Median voter model. Political parties try to maximize their votes. Hence, they may try to use similar platforms to their competitors in order to capture some of their voters.

d. Do all parties try to adopt similar platforms? Why?

Not all parties only have the objective to be elected. Some parties have the objective to defend their values, even though they are not very popular. Hence, in these cases, they may use different platforms, in order to differentiate themselves.

5.8 Even though Democracy is considered to be one of the best political systems, it also has some flaws associated. What are the most common ones?

Principal-agent problem: it may not be easy to motivate the elected official to do what is best for the people. Since he knows that elections are regular, he may choose to undertake projects that show results in the short-term, even though they are not better for people compared to projects that take more time to show their outputs (short-termism).

Citizen’s equality: not all citizens opinion weights the same. Wealthy citizens may have more influence and control some lobbies, so the Governments acts for them and not or the people in some sectors.