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Principles of
Macroeconomics
Sixth Edition

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**Six Debates over
Macroeconomic Policy**

*Premium
PowerPoint
Slides by
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***In this chapter,
look for the answers to these questions:***

What are the arguments on both sides of each of the following debates?

- Should policymakers try to stabilize the economy?
- Should fiscal policy fight recessions with spending hikes or tax cuts?
- Should monetary policy be made by rule or discretion?
- Should the central bank aim for zero inflation?
- Should the government balance its budget?
- Should the tax laws be reformed to encourage saving?

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Introduction

- This course has introduced you to the tools economists use to analyze the behavior of the economy as a whole and the impact of policies on the economy.
- This final chapter presents both sides in six classic debates over macroeconomic policy.

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1. Should Policymakers Try to Stabilize the Economy?

Arguments for active stabilization:

-
- Policymakers can “lean against the wind,” i.e.
- A more stable economy benefits everyone.

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1. Should Policymakers Try to Stabilize the Economy?

Arguments against active stabilization:

-
-
- If policy takes effect too late, it will worsen fluctuations.
- So,

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ACTIVE LEARNING 1

Active stabilization policy

- Would you be more likely to support active stabilization policy if wages, prices, and expectations adjust quickly in response to economic changes, or if they adjust slowly?

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2. Should the Government Fight Recessions with Spending Hikes or Tax Cuts?

Arguments for fighting recessions with spending:

-
- Since most states must keep balanced budgets,

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2. Should the Government Fight Recessions with Spending Hikes or Tax Cuts?

Arguments for fighting recessions with tax cuts:

- Tax cuts increase households' disposable income and therefore increase consumption spending.
- Tax cuts can increase aggregate demand
- Tax cuts can increase aggregate supply by
- Rapid spending increases

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3. Should Monetary Policy Be Made by Rule or Discretion?

- The Federal Reserve has almost complete discretion over monetary policy.
- Some argue that the Fed should be forced to follow a rule, such as
 - constant money growth rate
 - **inflation targeting:**

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3. Should Monetary Policy Be Made by Rule or Discretion?

Arguments against discretion:

- Allowing central bankers discretion
 -
- Discretion allows the possibility of
- Central bankers who promise price stability

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3. Should Monetary Policy Be Made by Rule or Discretion?

Arguments for discretion:

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- Political business cycles and time-inconsistency
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4. Should the Central Bank Aim for Zero Inflation?

- Recall two of the Ten Principles of Economics from Chapter 1:

Prices rise when the govt prints too much money.

Society faces a short-run tradeoff between inflation and unemployment.

- How much inflation should the central bank accept? Is zero the right target?

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4. Should the Central Bank Aim for Zero Inflation?

Arguments for a zero inflation target:

- The costs of inflation (shoeleather, menu, etc.)
- Achieving zero inflation
- And these costs could be reduced if

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4. Should the Central Bank Aim for Zero Inflation?

Arguments against a zero inflation target:

- The benefits of moving from moderate to zero inflation are small, but the costs are large:
 - Estimates:
 - A disinflation would leave permanent scars:
- Some of inflation's costs could be reduced through

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ACTIVE LEARNING 2

Another issue in the zero inflation debate

Suppose a structural change reduces the demand for university administrators, lowering their equilibrium real wage by 3%.

- If the actual real wage paid to university administrators remains constant, what would be the consequences?
- Would it be easier to achieve the 3% real wage reduction if the inflation rate is 0% or if it is 4%? Why?

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ACTIVE LEARNING 2

Answers

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5. Should the Government Balance Its Budget?

Arguments for balancing the budget:

- Govt debt
- Budget deficits
- While deficits may be justified during recessions or wars,

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5. Should the Government Balance Its Budget?

Arguments against balancing the budget:

- The burden of the gov't's debt
- Cutting the deficit
- Focusing on the deficit
- Debt/income ratio more relevant than debt itself

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6. Should the Tax Laws Be Reformed to Encourage Saving?

Arguments for tax reform to encourage saving:

- One of the Ten Principles of Economics:
A nation's standard of living depends on its ability to produce g&s.
- Higher saving

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6. Should the Tax Laws Be Reformed to Encourage Saving?

Arguments for tax reform to encourage saving:

- Another of the Ten Principles of Economics:
People respond to incentives.
- The current U.S. tax system
- Better:

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ACTIVE LEARNING 3

Switching to a consumption tax

- Suppose the income tax were replaced with a consumption tax, and the tax rate was chosen carefully to ensure that the average person's tax burden remains unchanged.
- Who would benefit? Who would be worse off?

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6. Should the Tax Laws Be Reformed to Encourage Saving?

Arguments against tax reform to encourage saving:

- Such tax reform
-
- Reducing taxes on capital income
- Better: increase national saving directly

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CONCLUSION

- Economics teaches us “there’s no such thing as a free lunch.” There are few easy answers and many unresolved questions.
- Crafting the best policy requires knowing the pros and cons of every alternative.
- Being an informed voter requires the ability to evaluate the candidates’ policy proposals.
- Knowing the principles of economics helps in these endeavors.

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