LECTURE SIX - PART SIX

Question #3: Rules Or Discretion?

- Should policymakers rely on rules or discretionary activism?

Key Point
Activism is warranted only if the economy is not self-correcting or may be very slow to correct.

How The Debate Is Framed

- Monetarists/New Classicals: Should the government adhere to rules that prohibit it from causing instability in an economy that would otherwise be stable?
- Keynesians: Should the government use discretionary policies to stabilize a sometimes unstable economy?
- Supply Siders: Should the government pursue discretionary policies to shift out the AS curve to increase real GDP and lower price level?

Monetarist/New Classical View

- Supports policy rules for the conduct of monetary policy and balancing the budget.
- Purpose: Prevent government from trying to "manage" aggregate demand.
- Government Failure: Management is misguided and thus likely to *cause* more instability than it cures.

Example of a Monetary Rule

- Why a Rule? Monetarists believe discretionary monetary policy is a major source of macroeconomic instability.
- Rule Example: Direct the Fed to expand the money supply at the same annual rate as the typical growth of the economy's production capacity.

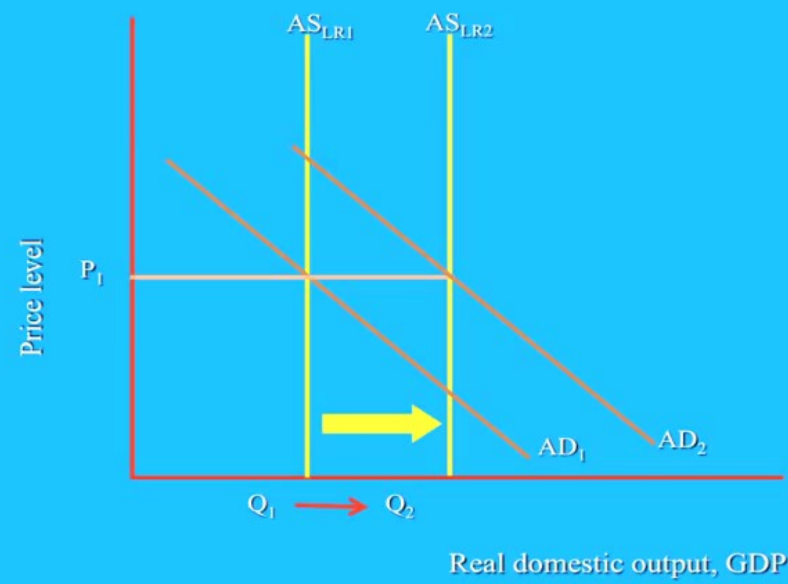
Implementing a Monetarist Rule

- Use open market operations and changes in the reserve requirement and discount rate to ensure steady money supply growth.

Milton Friedman Speaks!

"[S]uch a rule…would eliminate…the major cause of instability in the economy--the capricious and unpredictable impact of countercyclical monetary policy."

Graphing a Monetary Rule



The New Classical View of Rules

- New Classical economists support a monetary rule.
- New Classicals believe an easy or tight money policy increases or decreases inflation but not real output.

How Monetary Policy Creates Inflation Under Rational Expectations

- The Fed: An easy money policy to reduce interest rates, expand investment spending, and boost real GDP.
- The Public: Anticipates inflation and takes self-protective action.
- The Result: Workers demand higher wages, firms increase prices, & lenders raise interest rates.

A Perverse Result If Rational Expectations Theory Holds

- Wages and price levels rise immediately.
- Inflation offsets the increase in aggregate demand brought about by easy money.
- Real output and employment do not expand!
- Wages and prices do expand!