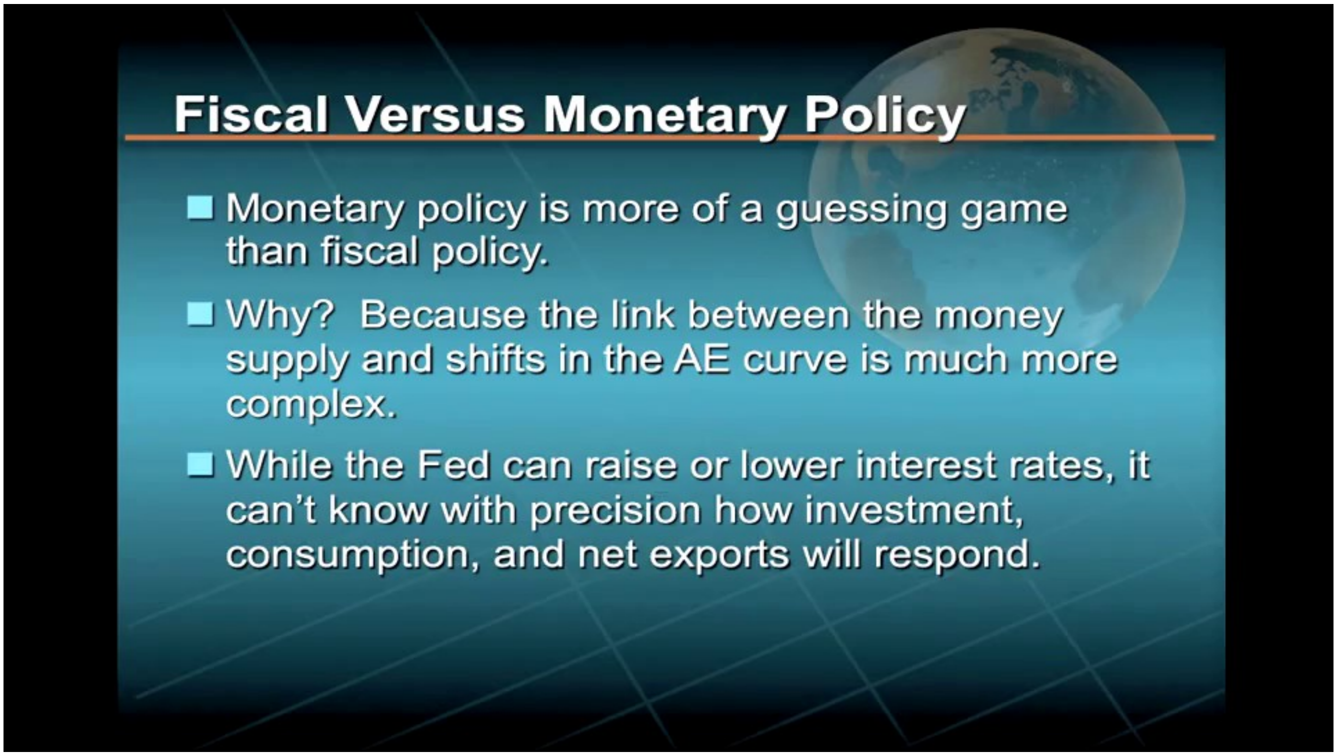
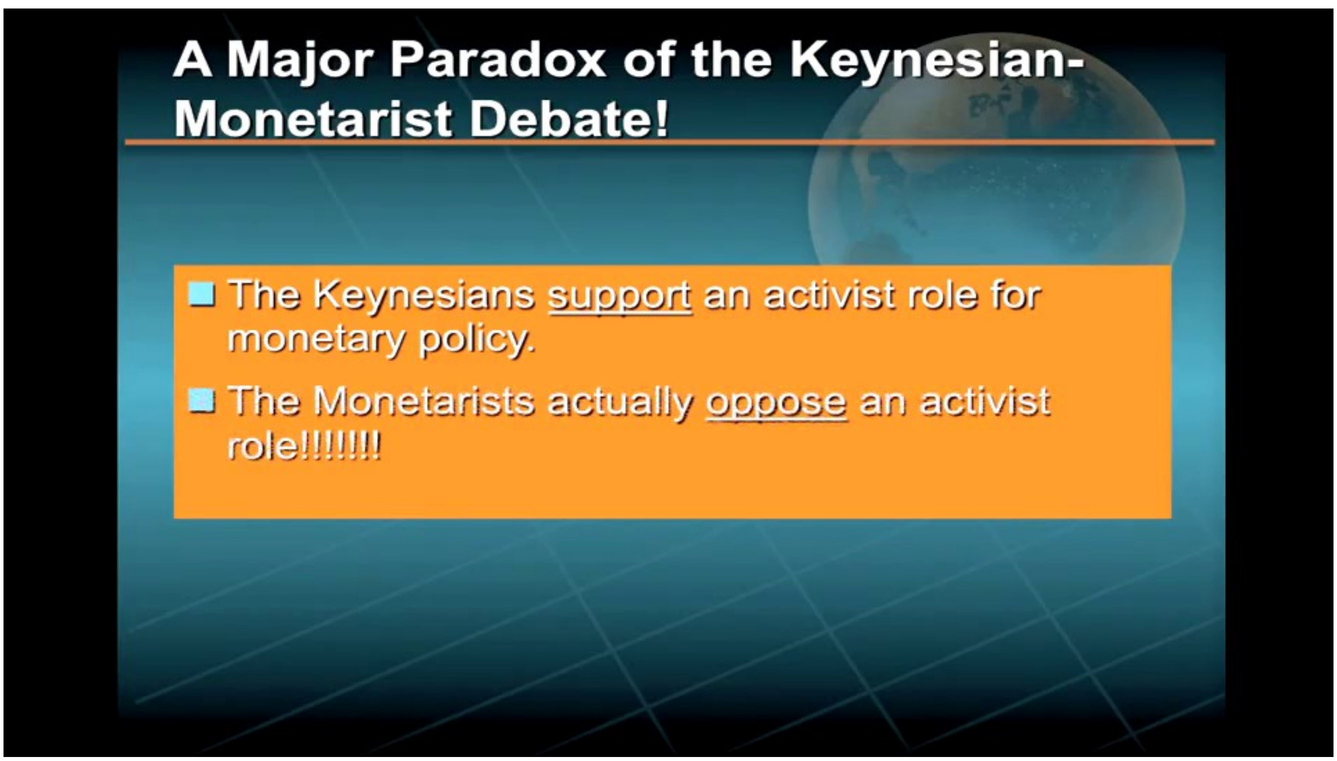
LECTURE FOUR – PART SEVEN

Monetary Policy Is Less Precise Than Fiscal Policy!!!

- From a mechanistic Keynesian point of view, monetary policy is conducted with less precision than fiscal policy.
- With fiscal policy, if we know the size of the recessionary gap and the multiplier…
- We can <u>exactly</u> calculate the increase in G or reduction in taxes needed to close the gap.


Fiscal Versus Monetary Policy
Monetary policy is more of a guessing game than fiscal policy.
Why? Because the link between the money supply and shifts in the AE curve is much more complex.
While the Fed can raise or lower interest rates, it can't know with precision how investment, consumption, and net exports will respond.


A Major Paradox of the Keynesian-Monetarist Debate!
The Keynesians support an activist role for monetary policy.
The Monetarists actually oppose an activist role!!!!!!!

When Monetary Policy is Effective

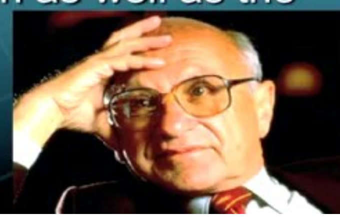
- Keynesians believe monetary policy is a “fine tuning” tool most effective when the economy is near full employment.
- Investment and aggregate expenditures respond swiftly to changes in the interest rate caused by changes in the money supply.
- With an inflationary gap, contractionary monetary policy is like “pulling on a string.”

When Monetary Policy is Ineffective

- Keynesians believe monetary policy is ineffective in a recession or depression.
- Cutting interest rates in these conditions is like “pushing on a string.”
- Investment does not respond as forcefully to easier money and lower interest rates in a severe downturn.
- In the recessionary and depressionary ranges of the economy, Keynesians believe expansionary fiscal policy is more appropriate.

The Monetarist View Summarized

- The Monetarist School does not believe in an activist fiscal and monetary policy.
- Inflation happens when the government prints too much money.
- Recession happens when it prints too little.
- Friedman rejected the Keynesian view of the origins of the Great Depression as well as the Keynesian fiscal policy cure.



Monetarists Blame the Great Depression on Monetary Policy

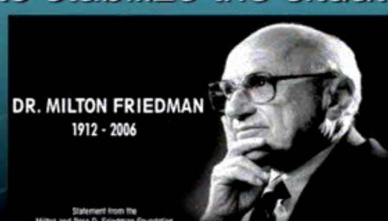
- The Great Depression resulted from bad monetary policy by the Federal Reserve – not Keynes' income adjustment mechanism.
- The Federal Reserve sharply contracted the money supply at the worst possible time.
- This fall in M plunged a private economy that would otherwise have been stable into a depression.

Is the Monetarist Explanation of the Great Depression Correct?

- There is much truth in Friedman's argument.
- In the wake of numerous bank failures, people began hoarding cash rather than leaving it in banks.
- The banks themselves dramatically increased reserves in case nervous depositors triggered a bank run.

Milton Friedman Blames the Fed

- This fall in demand deposits, coupled with an increase in the bank's own, self-imposed reserve requirements, led to a sharp contraction of M.
- Ultimately, Friedman faulted the Federal Reserve for not stepping into the monetary policy breach to stabilize the situation.



Friedman's Rejection of Keynesianism

If the Federal Reserve had acted promptly and injected enough currency to stabilize the money supply, an activist fiscal policy, as embodied in Franklin Delano Roosevelt's New Deal, would never have been necessary.

The Bad Driver Fed

- In their critique of activist monetary policy, Monetarists liken the Fed to a bad driver.
- The Fed is always accelerating too fast or braking too hard on M.
- This analogy actually describes quite well the behavior of the Fed during the 1970s as it tried to cope alternatively with recession and inflation and then both at the same time.

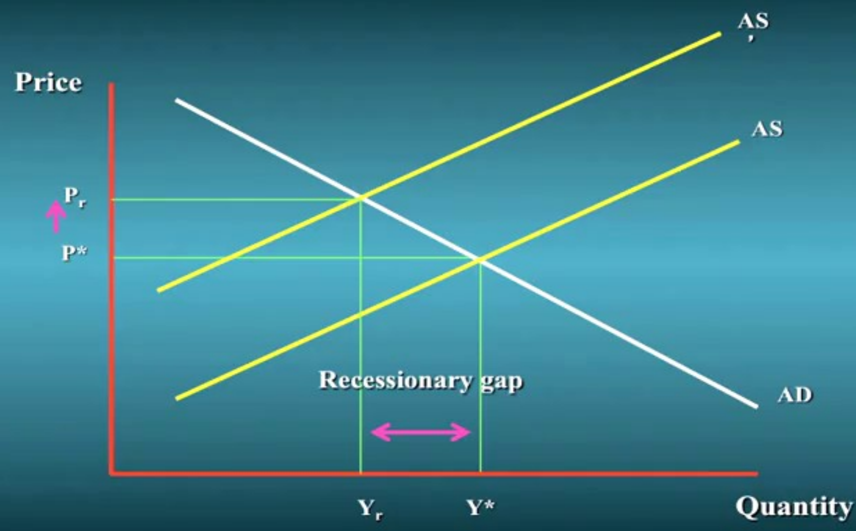
The Bad Driver Fed Plunges the Economy Into Recession

- In response to a soaring inflation in the early 1970s, the Fed stomped on the monetary brakes and interest rates climbed dramatically.
- Investment slowed, and the economy plunged into a recession.
- In 1975, the "Bad Driver" Fed stomped back on the accelerator, using a Keynesian-style tax cut to stimulate the economy.

The Bad Driver Fed Helps Spawns Stagflation

- To accommodate this tax cut, the Fed reluctantly increased the money supply.
- This monetary stimulus helped spawn a new and ugly macroeconomic phenomenon called "stagflation."
- Stagflation is simultaneous high unemployment and high inflation, and it began to tighten its deadly grip on the nation.

Stagflation Illustrated



Stagflation a NEW Phenomenon!

- Prior to the 1970s, economists didn't believe stagflation was possible.
- If unemployment went up, inflation had to go down and vice versa.
- The 1970s proved economists wrong on this point and exposed Keynesian economics as being incapable of solving stagflation.

QUESTION

How would you use Keynesian fiscal policy to fight stagflation?

The Keynesian Stagflation Dilemma

- Using expansionary policies to reduce unemployment simply created more inflation.
- Using contractionary policies to curb inflation only deepened the recession.
- Traditional tools could solve only half of the problem at any one time--and only by making the other half worse!!!!!!!
- This inability of Keynesian economics to cope with stagflation set the stage for the Monetarist challenge to the Keynesian orthodoxy.

The Monetarist Cure

- To fight stagflation and prevent the roller coaster ride of economic booms and busts, the Monetarist solution is to <u>set monetary growth targets</u>.

EXAMPLE

For economic growth to proceed at 3%, we should simply increase M by 3%.

The Fed's Monetarist Cure For An Inflationary Spiral

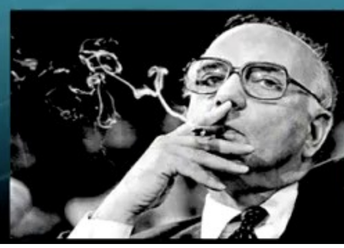
- After almost a decade of fruitless Keynesian failures, the Federal Reserve embraced the Monetarists' monetary growth targets approach.
- In October of1979, Fed Chairman Paul Volcker announced that the Fed would no longer focus on holding interest rates stable.
- Instead, the Fed would simply adopt monetary growth targets and stick by them.

The Fed's Monetarist Bitter Medicine

- Unfortunately, the Fed's Monetarist cure proved to be almost as bad as the stagflation disease.
- Interest rates soared to above 20%!!!
- Inflation remained in the double digits!!!
- And the economy entered into the beginning of a severe three-year recession!!!

The Cure Works – At Great Cost!

- Chairman Paul Volcker stuck to his Monetarist guns.
- Both tight money and a deep recession eventually helped wring inflation out of the economy.
- The cost in human terms was high.

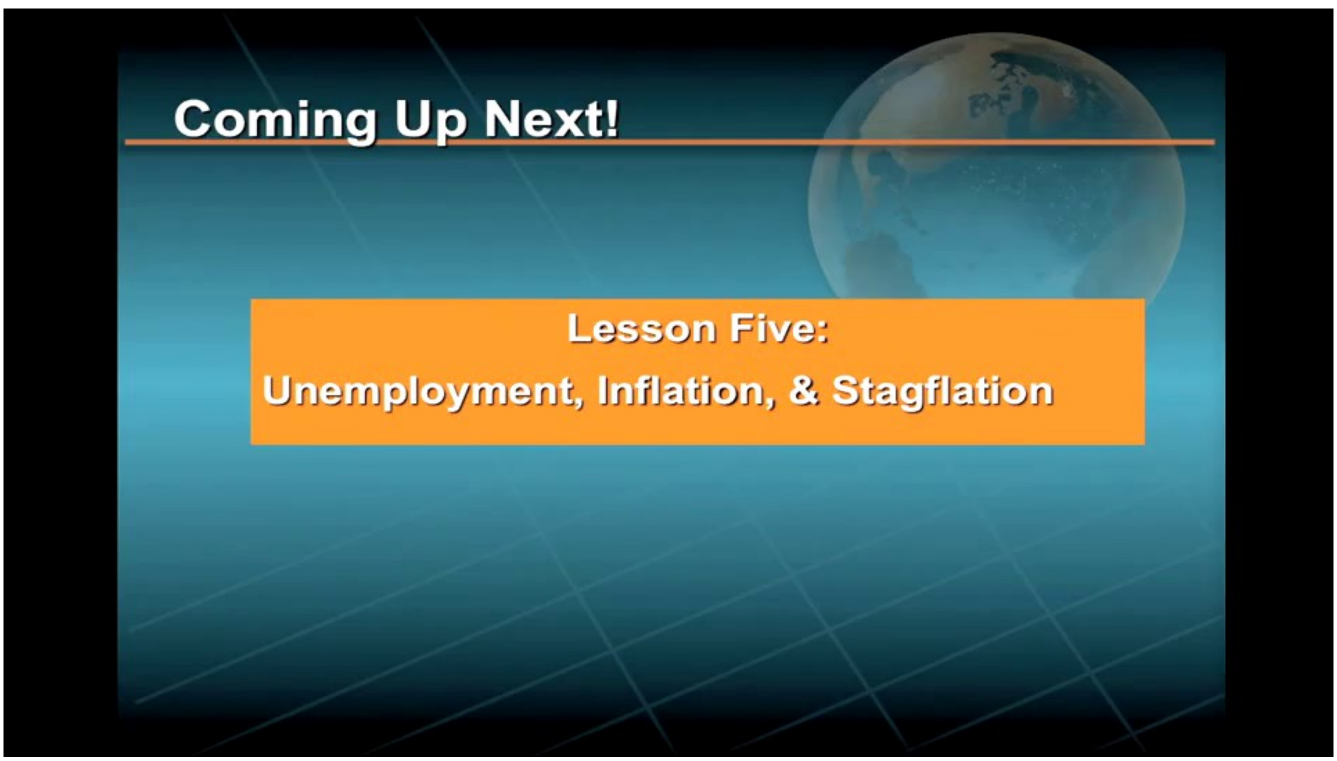


Enter Stage Right: Supply Side Economics

- In the summer of 1982, the Fed relaxed its Monetarist rules.
- By late Fall, the recession had ended.
- This was just in time to try the latest evolution in economic theory – Supply Side economics.

Supply Side Economist Arthur Laffer & President Ronald Reagan


THE POWER OF MACROECONOMICS
Professor Peter Navarro
University of California-Irvine
END OF LESSON FOUR


Coming Up Next!
Lesson Five:
Unemployment, Inflation, & Stagflation