LECTURE SIX - PART SEVEN

A Balanced Budget Rule

- Both Monetarists and New Classical economists question the effectiveness of fiscal policy.
- Some favor a Constitutional amendment to annually balance the Federal budget.

The "Passive" Fiscal Policy View

- The government should not intentionally create budget deficits or surpluses.
- Deficits and surpluses caused by recession or inflationary expansion correct themselves as the economy self-corrects to full-employment output.

The Keynesian Defense of Discretionary Stabilization Policy

- How do Keynesians respond to calls for rules-based fiscal and monetary policy?
- Keynesians argue that the rationale for a monetary rule is flawed.
- While there is typically a close relationship between the money supply and nominal GDP, it can break down during periods of instability.

Keynesians: Velocity Is Variable!

- V varies both cyclically and overtime.
- A constant annual rate of increase in M need *not* eliminate fluctuations in aggregate demand because V varies.

Key Point
A steady rise in M does *not* guarantee a steady expansion of aggregate demand because the velocity V can change.

Does "Crowding Out" Neutralize Keynesian Stimulus?

- A Big Debate: Does expansionary fiscal policy "crowd out" private sector investment?

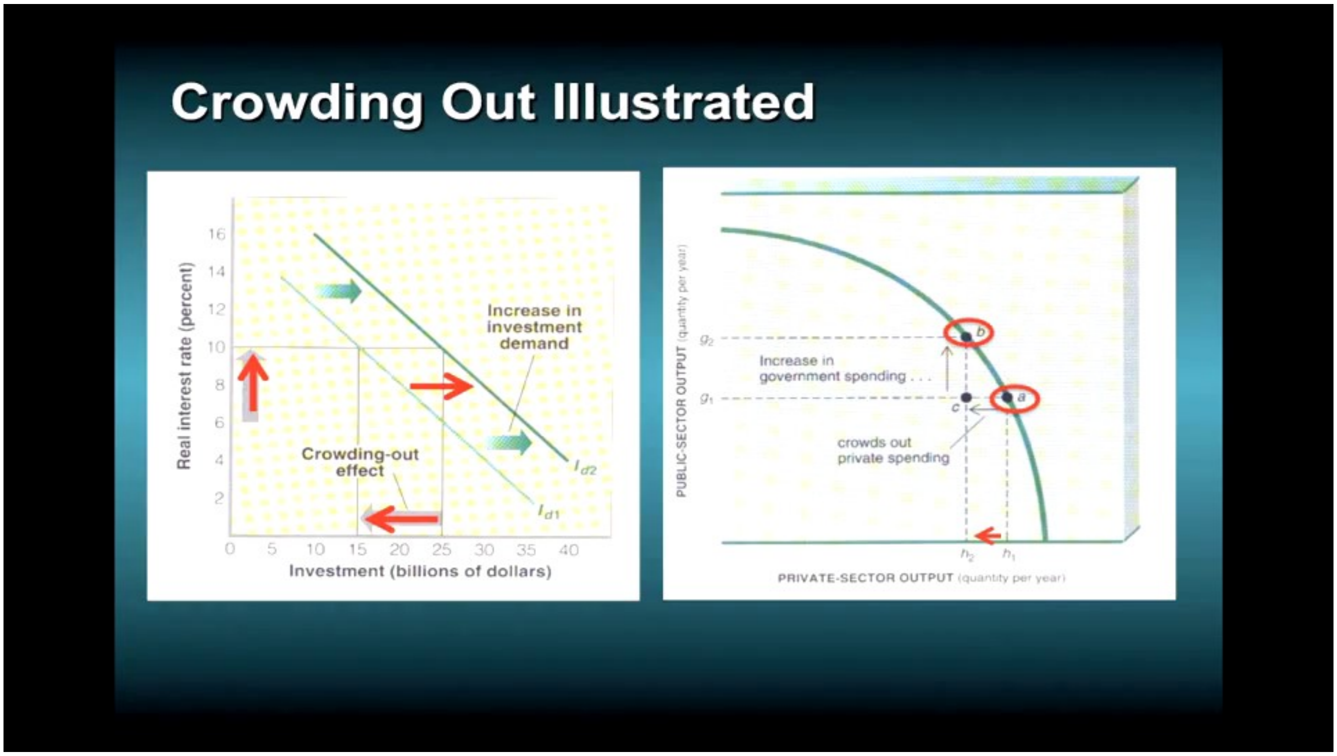
Key Concept
Crowding Out: The offsetting effect on private expenditures caused by the government's sale of bonds to finance expansionary fiscal policy.

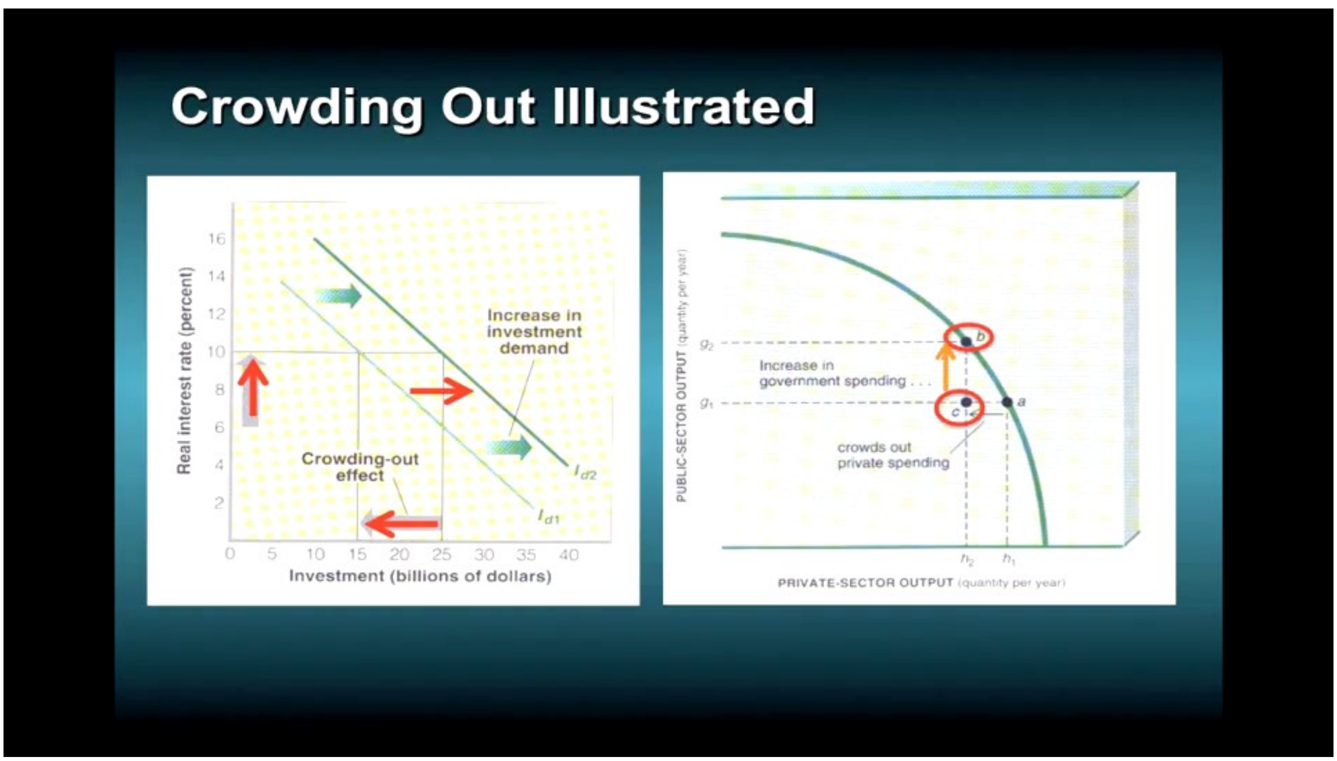
The Nuts & Bolts of Crowding Out

- To finance a budget deficit, the U.S. Treasury sells bonds directly to the private capital markets.
- The Federal Reserve is out of the loop.
- The U.S. Treasury competes directly in the capital markets with private corporations.
- Corporations sell bonds and stocks to raise capital to invest in new plant and equipment.

Deficits Lead to Higher Interest Rates

- To compete in bond market, the Treasury must raise the interest rate it is offering to attract enough funds.
- A "Zero Sum Game": Funds to finance government spending would otherwise have been spent on private investment.
- As G rises and I falls, deficit spending thereby "*crowd outs*" private investment.


Crowding Out Illustrated
Real interest rate (percent)
16
14
12
10
8
6
4
2
0
Increase in investment demand
Crowding-out effect
I_{d2}
I_{d1}
5 10 15 20 25 30 35 40
Investment (billions of dollars)
PUBLIC-SECTOR OUTPUT (quantity per year)
g_2
g_1
b
a
c
Increase in government spending . . .
crowds out private spending
h_2 h_1
PRIVATE-SECTOR OUTPUT (quantity per year)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The Policy Implication

- Monetarists believe substantial crowding out is associated with discretionary expansionary fiscal policy.

Key Point
Monetarists conclude fiscal policy shouldn't be used because increases in G are largely, or wholly, offset by declines in I.

The Keynesian Rejoinder

- Keynesians recognize the possibility of crowding out.
- They don't think it is a problem when business borrowing is depressed, as is the case in a recession.
- Therefore, activist expansionary fiscal policy is appropriate!

Why Keynesians Oppose A Balanced Budget Rule

- Tax revenues fall during recessions and rise during demand-pull inflation.
- A Balanced Budget rule would require contractionary fiscal policy during a recession and deepen it!
- A Balanced Budget rule would require cutting taxes during an expansion and increase inflation!!

The Supply Side View of Activism

- Taxes and regulations must be reduced to get more output without inflation.
- Thus, Supply Siders favor discretionary policy actions much like Keynesians do.
- Supply Siders often seek to reduce the negative effects of existing government regulations or tax policies.

Where The Warring Schools Converge

- Despite disagreements, the warring schools of macroeconomics share common ground.
- Most Keynesians agree with Monetarists that "money matters."
- They acknowledge excessive growth of M is the major cause of long-lasting, rapid inflation.
- Keynesians also agree with Rational Expectations proponents that expectations are indeed important.

Some More Convergence

- If government can create expectations of price stability, full employment, and growth, households & firms will act to make that happen.
- Keynesians concur with Supply Siders that government needs to focus on policies that shift out the AS curve and increase economic growth.

The Bottom Line
Because of ongoing challenges, macroeconomics remains very much an evolving policy science.

Coming Up Next!

Lesson Seven:

Economic Growth & Productivity

THE POWER OF MACROECONOMICS

Professor Peter Navarro

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END OF LESSON SIX