Monetary and Fiscal Policy

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Monetary Policy & Fiscal Policy

- We saw that shifts in aggregate demand and aggregate supply can lead to short run periods of expansion and recession, as well as affect both the short run and long run inflation rate in an economy.
- Given this, is there anything the Federal reserve or the federal government can do that mitigates such fluctuations?

Monetary Policy

- Suppose that a change in consumption and investment spending was such that the AD curve shifted to the left. What can the Fed do to offset this decrease in aggregate demand?
    1. Do nothing - AD will shift back right if the change in spending was temporary. If permanent, SRAS will shift down as expected inflation adjusts.
    2. Increase $\vec{M}$ to shift AD curve back.

Monetary Policy

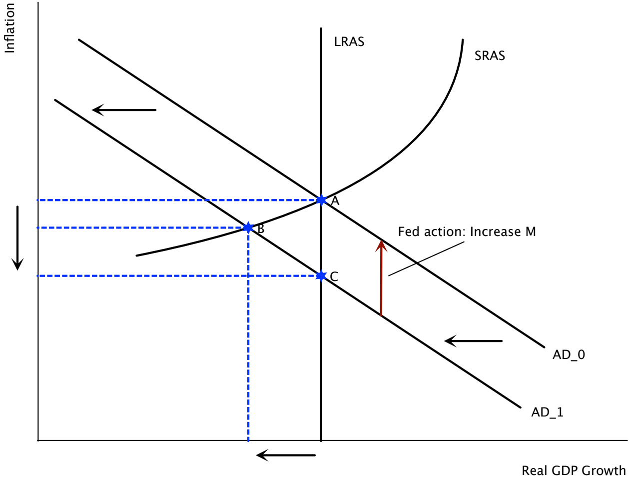


Figure: Monetary Policy

Monetary Policy

- Policies that attempt to pull an economy back from a recession are referred to as expansionary policies, while those that attempt to slow down an "overheated" economy are contractionary policies.

Monetary Policy

- Issues with monetary policy:
  1. Recognition lag: Time between start of recession and when policy is enacted.
  2. Imperfect control over the money supply: Don't know how much the money supply will increase in response to a higher monetary base.
  3. Exact impact of changes in $\vec{M}$ is not certain: Transmission mechanism: $\Delta\vec{M} \Rightarrow \Delta i \Rightarrow \Delta\vec{C}, \Delta\vec{I} \Rightarrow \Delta AD$.
  4. Effectiveness lag: Time it takes for changes in MS to affect AD.
- All these issues arise due to either the timing orprecision of the policy.

Monetary Policy

- Now, consider a real shock that causes the LRAS curve to shift left. How can the Fed combat decreasing real GDP?

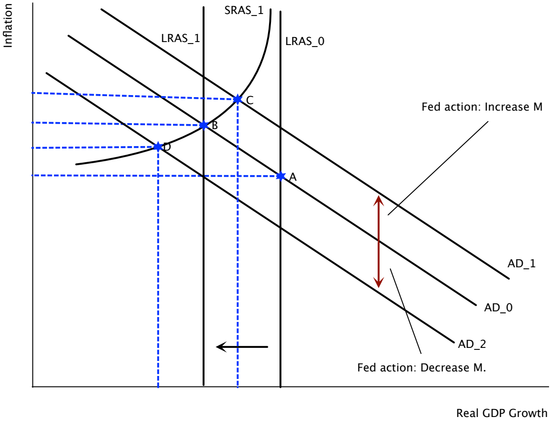


Figure: Negative Real Shock

Monetary Policy

- When faced with a negative real shock, the Fed has to trade-off between too low a rate of GDP growth (and thus high unemployment) and too high a rate of inflation.
- **Stagflation:** A stagnant economy (low/negative rates of output growth) with rising inflation.

Fiscal Policy

- An increase in government spending will shift AD to the right, while a decrease in government spending will shift AD to the left.
- The government can finance increases in spending either through taxes or borrowing. In either case, fiscal policy is most effective when the economy is in a recession caused by low aggregate demand.
- Importantly, the shift in AD will not perfectly respond to the change in government spending.

Fiscal Policy

- Multiplier effect: Additional shifts in AD that result when expansionary fiscal policy increases incomes and thus spurs additional spending by consumers.

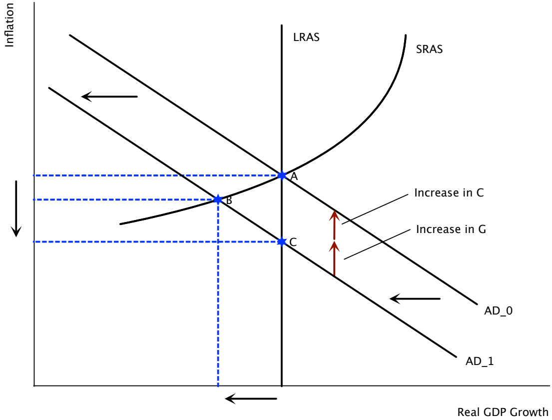
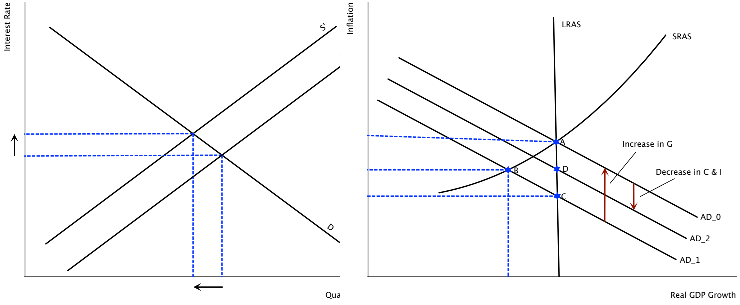


Figure: Multiplier Effect

Fiscal Policy

- Crowding out effect: The offset in AD that results when expansionary fiscal policy raises interest rates and thereby reduces private investment.

Figure: Crowding Out



(a) Market for Loanable Funds (b) AS-AD Model

Fiscal Policy

- Another tool the government can use is changes in taxes. Specifically, to spur spending the government would decrease taxes and to decrease spending growth the government would increase taxes.
- The size of the AD shift as a result of changing tax rates is also affected by the multiplier and crowding out effects, so the analysis is similar.
- Additionally, an important determinant of the size of the AD shift in response to tax change is the perceptions of households about whether the tax change is permanent or not.

Fiscal Policy

- Issues with fiscal policy:
  1. Crowding out limits effectiveness of fiscal policy.
  2. Difficult to spend enough money to have appreciable effect.
  3. Lags: recognition, legislative, implementation, and effectiveness.
- Because fiscal policy has a lag between implementation and effectiveness, the efficacy of the policy as a tool to stabilize the economy in the short run is reduced.
- To avoid some of these potential lags, the government can implement automatic stabilizers: changes in fiscal policy that stimulate AD in a recession without the need for explicit action by policymakers

Readings and Assignments

- Today: Mankiw Ch. 34
- Next time: ☹ ☹ ☹
- Problem Set 6, section 4