ECON 3010
Intermediate Macroeconomics

Chapter 18
Stabilization Policy
Question 1: Should policy be active or passive?
**Arguments for active policy**

- Recessions cause economic hardship for millions of people.
- The Employment Act of 1946: “It is the continuing policy and responsibility of the Federal Government to...promote full employment and production.”
- AD-AS model (Chaps. 10–14) shows how fiscal and monetary policy can respond to shocks and stabilize the economy.
Arguments against active policy

Policies have lags:

**inside lag:**
time between the shock and the policy response.
  - takes time to recognize shock
  - takes time to implement policy, especially fiscal policy

**outside lag:**
time it takes for policy to affect economy.

*If conditions change before policy’s impact is felt, the policy may destabilize the economy.*
Automatic stabilizers

- **definition:**
  policies that stimulate or depress the economy when necessary without deliberate policy.

- Designed to reduce the lags associated with stabilization policy.

- **Examples:**
  - income tax
  - unemployment insurance
  - welfare
Forecasting the macroeconomy

- Because policies act with lags, policymakers must predict future conditions.
- Forecasting one or two quarters out is good.
- Long-run macro forecasting is poor.
The Jury’s out...

Looking at recent history does not clearly answer Question 1:

- It’s hard to identify shocks in the data.
- It’s hard to tell how outcomes would have been different had actual policies not been used.
Question 2:

Should policy be conducted by rule or discretion?
Rules vs. discretion: Basic concepts

- **Policy conducted by rule:** Policymakers announce in advance how policy will respond in various situations and commit themselves to following through.

- **Policy conducted by discretion:** As events occur and circumstances change, policymakers use their judgment and apply whatever policies seem appropriate at the time.
Arguments for rules

1. Distrust of policymakers and the political process
   ◦ misinformed politicians
   ◦ politicians’ interests sometimes not the same as the interests of society
Arguments for rules

2. The time inconsistency of discretionary policy
   ◦ def: A scenario in which policymakers have an incentive to renege on a previously announced policy once others have acted on that announcement.
   ◦ Destroys policymakers’ credibility, thereby reducing effectiveness of their policies.
Monetary Policy Rules and Central Bank Independence

- A policy rule announced by the central bank will work only if it’s credible.

- Credibility depends in part on degree of independence of central bank.
Inflation and central bank independence

![Graph showing the relationship between average inflation and the index of central bank independence for various countries.]