

33rd Class

4/20/11

sign-ups for times start for final today; again on Friday

today we'll finish up the material on movements in the economy

then we'll start on macroeconomic stabilization policy:

first fiscal policy, then monetary policy,

then a discussion of when you would prefer one over the other

show how much the debt is, both total and as a percent of GDP

http://en.wikipedia.org/wiki/United_States_public_debt

but at least we aren't Japan:

http://en.wikipedia.org/wiki/List_of_sovereign_states_by_public_debt

see what we spend our money on

http://money.cnn.com/2011/01/21/news/economy/spending_taxes_debt/index.htm

then look at what would be needed in order to close the deficit

<http://www.nytimes.com/interactive/2010/11/13/weekinreview/deficits-graphic.html?hp>

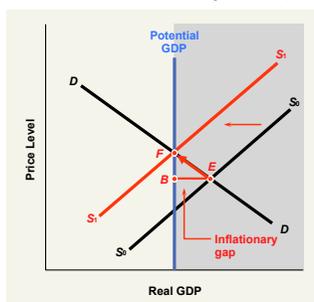
Alternative Growth Paths (cont.)

- Adjusting inflationary gaps
- Stagflation
- A growing economy
- A role for stabilization policy

Adjusting inflationary gaps

- When actual GDP > potential GDP, labor is in short supply and wages rise
- If wages rise, SRAS will shift inward towards LRAS
- Employment falls back to the full employment level, at which point the process will stop

The Elimination of an Inflationary Gap



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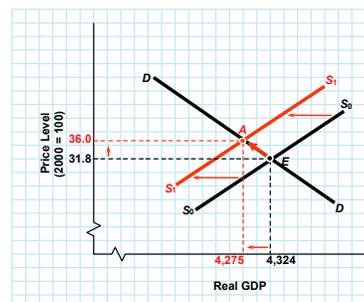
Adjusting inflationary gaps (cont.)

- During the adjustment period, both prices and unemployment are increasing
- This may be considered unacceptable politically

Stagflation

- Stagflation is the case where both inflation and unemployment occur
- Usually this would mean unemployment > full-employment (frictional) unemployment
- This could be caused by a supply shock that shifts SRAS inwards
- But we do not know exactly what the level is of full-employment unemployment
- Thus inflation combined with an increase in unemployment will be cause for worry, even if it is a reasonable adjustment for an inflationary gap

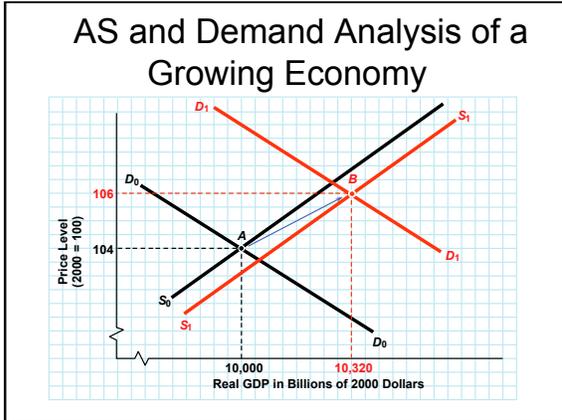
Stagflation from an Advance Shift in AS



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A growing economy

- So far we have modeled the economy as having a stable long-run equilibrium GDP
- But actually both AD and AS (both SRAS and LRAS) grow (shift rightward) over time
- AD is growing because of growing population and increased demand per person
- LRAS is growing because of the growing workforce, increased capital stock, and technological change

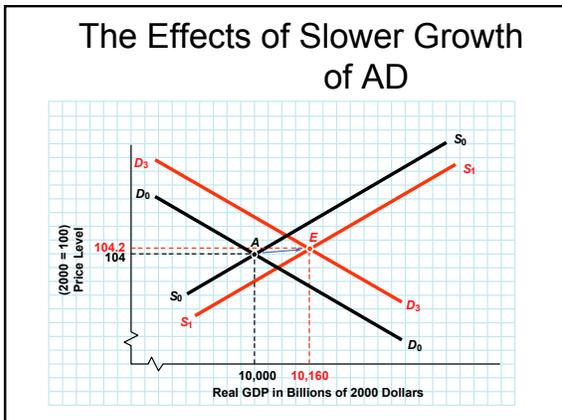
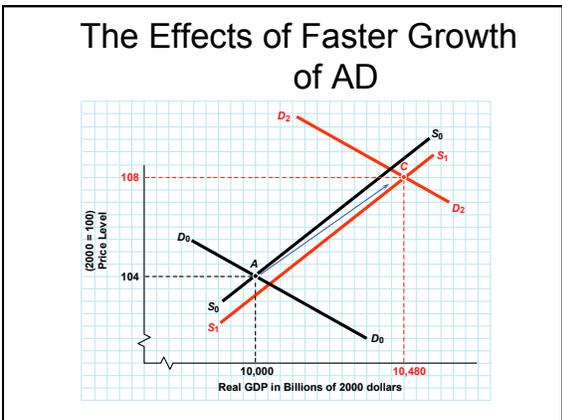


A growing economy (cont.)

- So a stable economy is one that has a stable long-run growth path (not a stable level)
- We would like AD and AS (both SRAS and LRAS) to grow at the same rate
- Then the price level will be stable as output increases
- We may be willing to settle for stable inflation (i.e., prices changing at a constant rate) along with output growth, rather than a stable price level

A growing economy (cont.)

- We can tell which is growing faster, AD or AS, by looking at price changes and output growth
- Shocks to AD and AS will also have different patterns in terms of price changes and output growth



A role for stabilization policy

- Policy may be able to move us to LRAS faster than if we let the economy equilibrate on its own
- Policy may be able to keep prices from changing while employment/output is changing due to adjustment to shocks
- Policy may be able to keep us on a stable growth path

Fiscal Policy

- What is fiscal policy?
- The tools of fiscal policy
- How does fiscal policy affect the economy?
- The politics of deficits and debt

What is fiscal policy?

- The actions of the government in deciding how much and on what to spend, and how its spending will be funded
- Fiscal policy is often used explicitly to influence the level of aggregate demand
- We tend to think of fiscal policy as occurring more at the federal level, but it is occurring (and affecting AD) at the state and local level of government as well

The tools of fiscal policy

- Government purchases (G)
- Transfers
 - fixed
 - income-varying
- Taxes
 - fixed
 - income-varying
- Net taxes (T) are Taxes - Transfers

How does fiscal policy affect the economy?

- a change in G affects AD directly
- it also affects AD indirectly through the multiplier effect via consumption
- so total $\Delta Y = \text{multiplier} \times \Delta G$

How does fiscal policy affect the economy? (cont.)

- a change in T affects AD indirectly through Disposable Income (Y_D) and thus through C
- The initial change is again magnified through the multiplier effect through C
- The multiplier effect for a change in T is smaller than the multiplier effect for a change in G because it operates through Y_D rather than directly on Y

How does fiscal policy affect the economy? (cont.)

- Government deficit = $G - T$
- If $\Delta G = \Delta T$, the deficit does not change; this would be a balanced budget change
- Because the multiplier effect for G is larger than the multiplier effect for T , a balanced budget change in fiscal policy will still have an effect on the economy
- Note a balanced budget change is not the same as a balanced budget; a balanced budget means $G = T$

How does fiscal policy affect the economy? (cont.)

- Some parts of T vary with the level of national economy and thus with the economy
- This includes any tax or transfer that is dependent on national income
 - income taxes, both personal and corporate
 - unemployment insurance
 - welfare payments (e.g., TANF)
- If these parts move countercyclically, they have a stabilizing effect on the economy and are known as automatic stabilizers

How does fiscal policy affect the economy? (cont.)

- While so far we have been discussing fiscal policy's effects on AD , fiscal policy can also have effects on AS (shift this curve as well)
- Taxes and transfers can affect the amount of labor and capital in the economy and the amount of technological change
 - personal income taxes
 - differential taxes on income from capital than from labor
 - tax credits for R&D

How does fiscal policy affect the economy? (cont.)

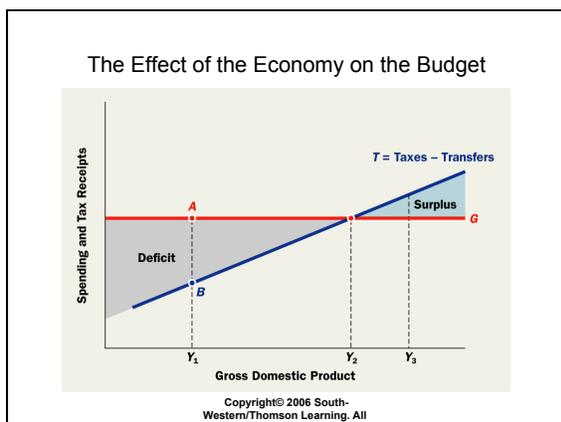
- Is it really possible to control the economy using fiscal policy?
 - economic variables change continuously
 - we have to estimate the multiplier
 - we have to estimate the full employment level of GDP
 - fiscal policy takes time to work

The politics of deficits and debt

- What should the levels be of G and T ?
- In order to expand the economy, which should we change, G , T , or both?

The politics of deficits and debt (cont.)

- Government budget deficit = $G - T$
= a flow
- National Debt = total value of government indebtedness at a moment in time
= a stock
- Structural deficit (or surplus) = what the deficit would be if the economy were at full employment



The politics of deficits and debt (cont.)

- Is the National Debt a burden?
 - Who holds it?
 - Will our children be able to pay it back more easily?
 - Will the country default/go bankrupt?
 - What did it buy?