Keynes vs. Hayek rap:  http://www.youtube.com/watch?v=d0nERTFo-Sk

last of three lectures on macroeconomic stabilization policy: macro policy debates
It is fun to look at the debates that rage in the economics profession, most of which focus on macroeconomics rather than microeconomics
debates have their basis in different models or theories of how the world works
these theories generally have testable implications that can be compared against data, so you’d think we could decide which one was right and which one was wrong,
--but different theories may appear to apply in different circumstances
--people may complain that the tests weren’t properly specified
--some aspects of theory may be hard to test, or are naturally very general (like assuming perfect competition in most markets)
--people may just choose to believe theories even in the face of evidence against them

some of the main policy debates/dichotomies regarding macro stabilization policy:
Austrians vs. everyone else (don’t intervene vs. intervene)
Keynesians vs. Monetarists (how to intervene)
--fiscal vs monetary policy
--rules vs. discretion (where strictest rule of all is to do nothing)
supply-siders vs. demand-siders (of which both Keynesians and Monetarists are demand-siders)
--AS vs. AD
--is the Phillips curve stable?

[powerpoints]
NAIRU is an acronym for Non-Accelerating Inflation Rate of Unemployment
consider differences re investment and money demand functions in terms of slope and shifts

Krugman on why deflation is bad:

an Austrian economist on why Krugman is bad:
http://mises.org/daily/1318
Macroeconomic Policy Debates

• Keynesianism vs. Monetarism
• Fiscal vs. monetary policy
• Rules vs. discretion
• AS vs. AD and the Phillips Curve

Keynesianism vs. Monetarism

• Monetarists start with a different model of how the economy works
• The quantity theory of money is based on the equation of exchange:

\[
MV = PY
\]

• Monetarists argue that \( V \), the velocity of money, is relatively constant, and thus changes in \( M \) cause changes in nominal GDP

Fiscal vs. monetary policy

• Keynesians think fiscal policy is more effective in affecting the level of real output, while monetarists think monetary policy is more effective
• This difference hinges on different beliefs about what the economy looks like
  – the investment function and shifts in it
  – the money demand curve and shifts in it
  – the AS curve and shifts in SRAS

Milton Friedman (1912-2006)

“The Quantity Theory of Money: A Restatement” (1956)
Fiscal vs. monetary policy in an open economy

• If a country’s interest rates rise due to expansionary fiscal policy, the effect on the exchange rate will cause NX to fall and counteract the fiscal policy effect on AD
• Thus international capital flows reduce the power of fiscal policy

Fiscal vs. monetary policy in an open economy (cont.)

• If a country’s interest rates fall due to expansionary monetary policy, the effect on the exchange rate will cause NX to rise and augment the monetary policy effect on AD
• Thus international capital flows increase the power of monetary policy

Rules vs. Discretion

• Should the government (including the Fed) intervene in the economy at all?
  – problem of implementation lags—policy might actually destabilize the economy by the time it takes effect
  – prefer to use automatic stabilizers?
  – government policy changes increase uncertainty
• Strict monetarists think the Fed should announce a Money Supply growth rate and stick to it rather than practicing monetary policy
• Another possible rule: target a particular interest rate

Rules vs. Discretion (cont.)

• Monetization: If the Fed does not change its behavior, then an expansionary fiscal policy will tend to raise interest rates
  – This tends to cause “crowding out” as G replaces I as a proportion of AD
  – If the Fed does not want interest rates to rise, it will have to increase the money supply, for instance by purchasing government securities, thus “monetizing” the deficit

Fiscal Expansion and Interest Rates

Monetization and Interest Rates
Rules vs. Discretion (cont.)

- Strongest rule of all: Do nothing. Make sure you announce that you’re not going to do anything so that people don’t expect that you’re going to do something.
- Is such an announcement credible?

Friedrich Hayek (1899-1992)

“The Road to Serfdom”
(1944)

AS vs. AD and the Phillips Curve

- If changes in GDP are primarily caused by AD, then high inflation will be associated with low unemployment, and vice versa
- This relationship between unemployment and inflation can be graphed, and is known as the Phillips Curve

AS vs. AD and the Phillips Curve (cont.)

- But if changes in GDP are primarily caused by AS, then this downward-sloping relationship does not occur; instead it would be upward-sloping
- In addition, the sloping Phillips Curve need not be stable over long periods; in the long run we would expect the Phillips Curve to be vertical at the rate of natural unemployment
A Phillips Curve for the U.S.?