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Five Debates over  
Macroeconomic Policy

PRINCIPLES OF

MACROECONOMICS

FOURTH CANADIAN EDITION

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PowerPoint® Slides

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In this chapter, look for the answers to these questions:

What are the arguments on both sides of each of the following debates?

▪ Should policymakers try to stabilize the economy?

▪ Should monetary policy be made by rule or discretion?

▪ Should the central bank aim for zero inflation?

▪ Should the government balance its budget?

▪ Should the tax laws be reformed to encourage saving?

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Introduction

▪ This course has introduced you to the tools economists use to analyze the behaviour of the economy as a whole and the impact of policies on the economy.

▪ This final chapter presents both sides in five leading debates over macroeconomic policy.

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1. Should monetary and fiscal policymakers try to stabilize the economy?

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**Pro: Policymakers should try to stabilize the economy**

- The economy is inherently unstable, and left on its own will fluctuate.
  - Policy can manage aggregate demand to offset this inherent instability and reduce the severity of economic fluctuations.
- Society should not have to suffer through the booms and busts of the business cycle.
- Monetary and fiscal policy can stabilize aggregate demand and, thereby, production and employment.

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**Con: Policymakers should not try to stabilize the economy**

- Monetary policy affects the economy with long and unpredictable lags between the need to act and the time that it takes for these policies to work.
  - Many studies indicate that changes in monetary policy have little effect on aggregate demand until about six months after the change is made.

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**Con: Policymakers should not try to stabilize the economy**

- Fiscal policy works with a lag because of the long political process that governs changes in spending and taxes.
- It can take years to propose, pass, and implement a major change in fiscal policy.

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**Con: Policymakers should not try to stabilize the economy**

- All too often policymakers can inadvertently exacerbate rather than mitigate the magnitude of economic fluctuations.
- It might be desirable if policy makers could eliminate all economic fluctuations, but this is not a realistic goal.

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**ACTIVE LEARNING 1:**  
**Active policy stabilization**

Would you be more likely to support active stabilization policy if wages, prices, and expectations adjust quickly in response to economic changes, or if they adjust slowly?

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**ACTIVE LEARNING 1:**  
**Answers**

If wages, prices, and expectations adjust slowly, it will take longer for the economy to return to its natural rates of output and employment.

In that case, there's a better chance that expansionary policy will act in time to alleviate the recession, rather than push the economy into an inflationary boom.

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2. Should monetary policy be made by an independent central bank?

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**Pro: Monetary policy should be made by an independent central bank**

- Allowing elected officials influence in conducting monetary policy has two problems
  - Politicians are sometimes tempted to use monetary policy to affect the outcome of elections
  - To the extent that central bankers ally themselves with politicians, discretionary policy can lead to economic fluctuations that reflect the electoral calendar—the political business cycle.

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**Pro: Monetary policy should be made by an independent central bank**

- Such influence might lead to more inflation than is desirable
  - There may be a discrepancy between what policymakers say they will do and what they actually do—called time inconsistency of policy.
  - Because policymakers are so often time inconsistent, people are skeptical when central bankers announce their intentions to reduce the rate of inflation.

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**Pro: Monetary policy should be made by an independent central bank**

- One way to avoid these difficulties is to conduct monetary policy independent of political influence
- Comparisons of average rates of inflation across countries show that those countries with the most independent central banks tend to have the lowest rate of inflation

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**Con: Monetary policy should not be made by an independent central bank**

- An important advantage of elected officials having a say in conducting monetary policy is accountability
- The practical importance of time inconsistency is far from clear

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**Con: Monetary policy should not be made by an independent central bank**

- The supposedly enhanced credibility of monetary policy announcements that comes from central bank independence seems to yield few dividends
- The idea that elected policymakers might use monetary policy to generate political business cycles seems at odds with the concept of rational expectations

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**ACTIVE LEARNING 2:**  
**Another issue in the zero inflation debate**

Suppose a structural change has reduced the demand for university administrators, lowering their equilibrium real wage by 3%.

- A. If the actual real wage paid to university administrators remains constant, what would be the consequences?
- B. Would it be easier to achieve the 3% real wage reduction if the inflation rate is 0% or if it is 4%? Why?

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**ACTIVE LEARNING 2:**  
**Answers**

- A. If the actual real wage paid to university administrators remains constant, what would be the consequences?

Whenever the actual real wage exceeds the equilibrium real wage, there is a surplus of labour, which represents wasted resources.

A fall in the wage would encourage some administrators to switch to university teaching or private sector employment.

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## ACTIVE LEARNING 2: Answers

- B.** Would it be easier to achieve the 3% real wage reduction if the inflation rate is 0% or if it is 4%? Why?

To restore labour market equilibrium under 0% inflation, administrators would have to accept a 3% nominal wage cut.

Under 4% inflation, they would have to accept a 1% nominal wage increase.

The second scenario is more likely, as many people suffer from "money illusion" and focus on nominal variables rather than real ones.

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3. Should the central bank aim for zero inflation?

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## Pro: The central bank should aim for zero inflation

- Inflation confers no benefit to society, but it imposes several real costs.
  - Shoeleather costs
  - Menu costs
  - Increased variability of relative prices
  - Unintended changes in tax liabilities
  - Confusion and inconvenience
  - Arbitrary redistribution of wealth

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**Pro: The central bank should aim for zero inflation**

- Reducing inflation is a policy with temporary costs and permanent benefits.
- Zero provides a more natural focal point for policymakers than any other number

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**Con: The central bank should not aim for zero inflation**

- Zero inflation is probably unattainable, and to get there involves output, unemployment, and social costs that are too high.
- Policymakers can reduce many of the costs of inflation without actually reducing inflation.

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4. Should fiscal policymakers reduce the government debt?

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**Pro: Policymakers should reduce the government debt**

- Budget deficits impose an unjustifiable burden on future generations by raising their taxes and lowering their incomes.
- When the debts and accumulated interest come due, future taxpayers will face a difficult choice:
  - They can pay higher taxes, enjoy less government spending, or both.

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**Pro: Policymakers should reduce the government debt**

- Deficits reduce national saving, leading to a smaller stock of capital, which reduces productivity and growth.

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**Con: Policymakers should reduce the government debt**

- The problem with the deficit is often exaggerated.
- The transfer of debt to the future may be justified because some government purchases produce benefits well into the future.

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**Con: Policymakers should reduce the government debt**

- The government debt can continue to rise because population growth and technological progress increase the nation's ability to pay the interest on the debt.

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5. Should the tax laws be reformed to encourage saving?

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**Pro: Tax laws should be reformed to encourage saving**

- A nation's saving rate is a key determinant of its long-run economic prosperity.
- A nation's productive capability is determined largely by how much it saves and invests for the future.
- When the saving rate is higher, more resources are available for investment in new plant and equipment.

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**Pro: Tax laws should be reformed to encourage saving**

- The Canadian tax system discourages saving in many ways, such as by heavily taxing the income from capital and by reducing benefits for those who have accumulated wealth.

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**Pro: Tax laws should be reformed to encourage saving**

- The consequences of high capital income tax policies are reduced saving, reduced capital accumulation, lower labor productivity, and reduced economic growth.

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**Pro: Tax laws should be reformed to encourage saving**

- The GST is a **consumption tax**.
  - An important step the federal government took to encourage greater saving was to introduce the Goods and Services Tax (GST) in 1991.
  - A household pays taxes based on what it spends not on what it earns.
  - Income that is saved is exempt from taxation until the saving is later withdrawn and spent on consumption goods.

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**Con: Tax laws should not be reformed to encourage saving**

- Many of the changes in tax laws to stimulate saving would primarily benefit the wealthy.
  - High-income households save a higher fraction of their income than low-income households.
  - Any tax change that favours people who save will also tend to favour people with high incomes.

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**Con: Tax laws should not be reformed to encourage saving**

- Economic theory does not give a clear prediction about whether a higher rate of return would increase saving
  - Outcome depends on relative size of *substitution effect* and *income effect*
  - Substitution effect: A higher rate of return raises the benefit of saving—tends to raise saving
  - Income effect: A higher rate of return lowers the need for saving—tends to reduce saving

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**Con: Tax laws should not be reformed to encourage saving**

- Raising public saving by eliminating the government's budget deficit would provide a more direct and equitable way to increase national saving.

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### ACTIVE LEARNING 3: Switching to a consumption tax

- Suppose the income tax were replaced with a consumption tax, and the tax rate was chosen carefully to ensure that the *average* person's tax burden remains unchanged.
- Who would benefit? Who would be worse off?

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### ACTIVE LEARNING 3: Answers

- People with higher incomes save a bigger percentage of their incomes, so would benefit most from this change.
- People with low incomes use most or all of their incomes for consumption, and would be worse off.

*(This is why most consumption tax proposals include exemptions for necessities, such as groceries, which comprise a larger share of the budgets of low-income persons.)*

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### CONCLUSION

- Economics teaches us "there's no such thing as a free lunch." There are few easy answers, and many unresolved questions.
- Crafting the best policy requires knowing the pros and cons of every alternative.
- Being an informed voter requires the ability to evaluate the candidates' policy proposals.
- Knowing the principles of economics helps in these endeavors.

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## CHAPTER SUMMARY

- Advocates of active monetary and fiscal policy view the economy as inherently unstable and believe policy can be used to offset this inherent instability.
- Critics of active policy emphasize that policy affects the economy with a lag and our ability to forecast future economic conditions is poor, both of which can lead to policy being destabilizing.

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## CHAPTER SUMMARY

- Advocates of an independent central bank argue that
  - such independence guards against politicians using monetary policy to try to influence voters.
  - A lower rate of inflation and a more favourable short-run tradeoff between inflation and unemployment is possible.
- Critics of an independent central bank argue that because it has large and lasting influences on aggregate demand, output, and employment, citizens should have a say on monetary policy

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## CHAPTER SUMMARY

- Advocates of a zero-inflation target emphasize that inflation has many costs and few if any benefits.
- Critics of a zero-inflation target claim that moderate inflation imposes only small costs on society, whereas the recession necessary to reduce inflation is quite costly.

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## CHAPTER SUMMARY

- Advocates of reducing the government debt argue that the debt imposes a burden on future generations by raising their taxes and lowering their incomes.
- Critics of reducing the government debt argue that the debt is only one small piece of fiscal policy.

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## CHAPTER SUMMARY

- Advocates of tax incentives for saving point out that our society discourages saving in many ways such as taxing income from capital and reducing benefits for those who have accumulated wealth.
- Critics of tax incentives argue that many proposed changes to stimulate saving would primarily benefit the wealthy and also might have only a small effect on private saving.

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## End: Chapter 17

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