Topics for Today

1.) Temporary Changes in Monetary & Fiscal Policies

2.) Stabilization Policy
   - Monetary or Fiscal?

3.) Permanent Changes in Monetary & Fiscal Policies
   - Dynamic Adjustment

4.) Some Practical Difficulties with Stabilization Policy
Monetary & Fiscal Policies


Temporary Monetary Policy (MT)

\[ MT \implies R \downarrow \implies E \uparrow \implies NX \uparrow \implies Y \uparrow \]

- \checkmark money market equil.
- \checkmark fx market equil.
- \checkmark goods market equil.
Temporary Fiscal Policy \((G \uparrow, T \downarrow)\)

\[ G \uparrow \Rightarrow Y \uparrow \Rightarrow R \uparrow \Rightarrow E \downarrow \]

- goods mkt. equil.
- money mkt. equil.
- fx mkt. equil.
Stabilization Policy

Suppose a foreign recession leads to a temporary reduction in domestic exports. \((\text{NX} \downarrow)\).

How should domestic policymakers respond?
1. Fiscal Expansion

2. Monetary Expansion
What's the Difference?

- Monetary expansion works by lowering interest rates and depreciating the currency. This benefits interest rate sensitive sectors (housing, construction) and import-competing sectors.

- Fiscal Expansion benefits whichever sector receives the govt. spending, or whoever receives the tax cuts. It tends to strengthen the currency and raise interest rates (relative to pt. 2), and would be opposed by interest rate sensitive sectors and import-competing sectors.
Suppose $M^s \uparrow$ by $\%$ permanently.

Monetary Neutrality $\Rightarrow P$ and $E \uparrow$ by $\%$

$\Rightarrow E^e \uparrow$ by $\%$

$\Rightarrow$ Additional upward shift in $AA$

Permanent $M^s \uparrow \Rightarrow$ Movement to Pt. 3

$\Rightarrow$ More expansionary than temporary expansion
Long-Run Adjustment to Permanent M^*↑

At pt. 2, \( Y > Y_f \) ⇒ Price level gradually rises

⇒ AA shifts down \((M/P ↓)\)

DD shifts left \((Domestic goods lose competitiveness)\)

Long-Run Equil. restored at pt. 3, where

\[
\frac{E_3 - E_1}{E_1} = \frac{M_2 - M_1}{M_1}
\]

Ex. rate depreciates by the same % amount as
**Key point:** Permanent fiscal expansion leads to a long-run real (and nominal) appreciation of the currency.

- \( \Rightarrow E^e \downarrow \)
- \( \Rightarrow AA \) shifts down
- \( \Rightarrow \) Further ex. rate appreciation and crowding-out of NX

Note: If \( Y \) did rise then \( RT \uparrow \Rightarrow \) Expected real deprecation \( \Rightarrow \) Further goods mkt. decline
Caveats to Long-Run Fiscal Policy Conclusions

1.) Assumes perfect capital mobility
   - no risk premium
   - domestic interest rates may rise without expected depreciation if G↑ financed by bonds.

2.) More generally, ignores financing of G↑.
   - Y could rise with either MT or TT financing.

3.) Assumes you start at Y*

4.) Ignores potential supply-side effects

5.) Assumes RE and complete knowledge of the policy

6.) Assumes a small country.

7.) Even if it doesn’t change Y, still affects the composition of domestic output.
Practical Difficulties

1.) Signal Extraction / Identification Problem
    - DD. or AA shift?
    - Temporary or Permanent?

2.) Non RE or model may be wrong!

3.) Lags
    - Effects of Policy
    - Implementation Lag

4.) Budgetary Consequences.

5.) Time - Consistency Problem
    - If private sector recognizes ability (and incentive) of govt. to expand output, it may factor this into their price expectations.
      ⇒ higher expected inflation
      ⇒ govt. must expand just to keep the economy from contracting