Topics for Today

1.) Temporary Changes in Monetary + Fiscal Policies

2.) Stabilization Policy
   - Monetary or Fiscal ?

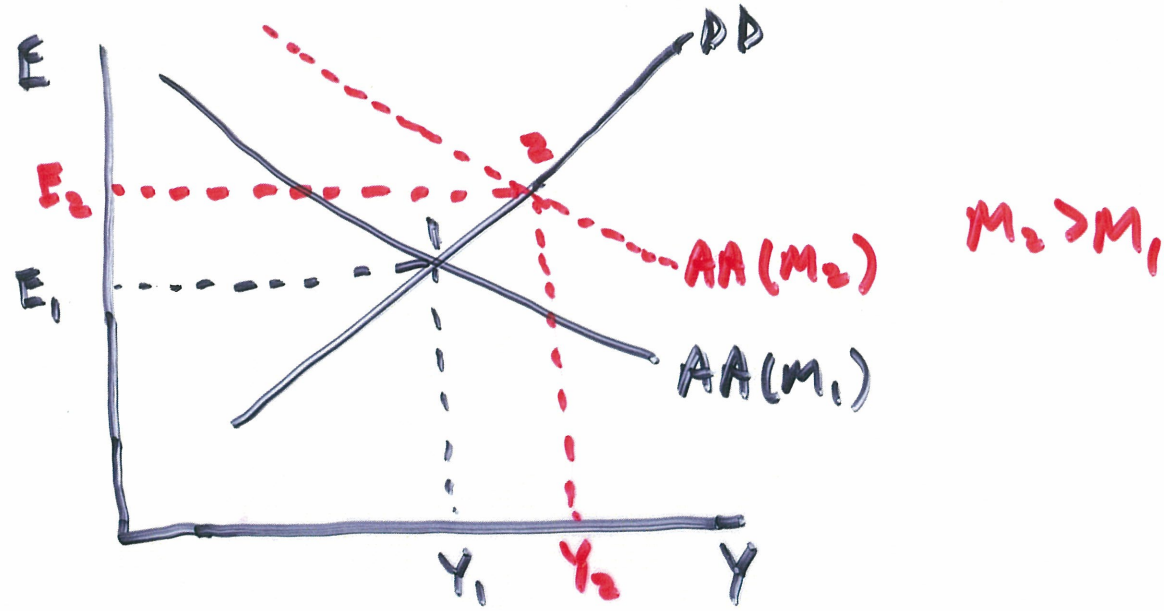
3.) Permanent Changes in Monetary + Fiscal Policies
   - Dynamic Adjustment

4.) Some Practical Difficulties with Stabilization Policy

Monetary + Fiscal Policies

① Temporary Policy : Reversed before price level adjusts. No effect on E^e.

Temporary Monetary Policy ($M\uparrow$)



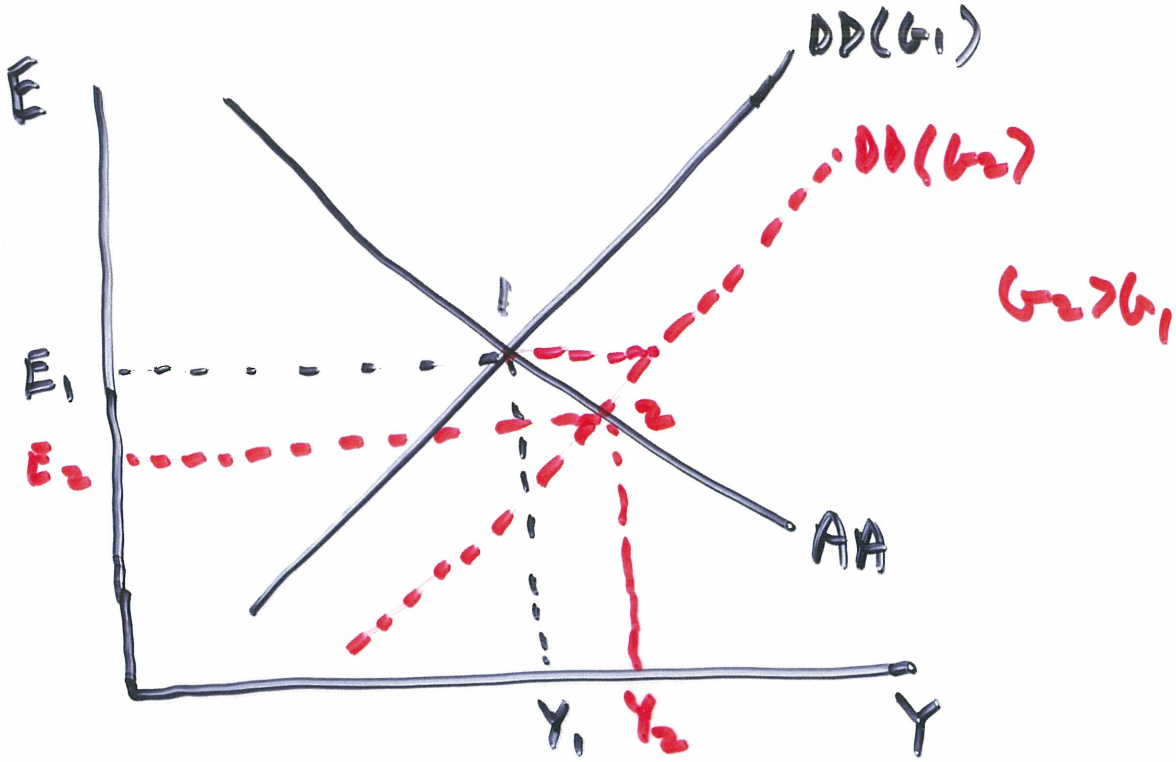
$M\uparrow \Longrightarrow R\downarrow \Longrightarrow E\uparrow \Longrightarrow NX\uparrow \Longrightarrow Y\uparrow$

✓ money market equil.

✓ ~~fx~~ market equil.

✓ goods market equil.

Temporary Fiscal Policy ($G\uparrow$, $T\downarrow$)



$G\uparrow \Longrightarrow Y\uparrow \Longrightarrow R\uparrow \Longrightarrow E\downarrow$

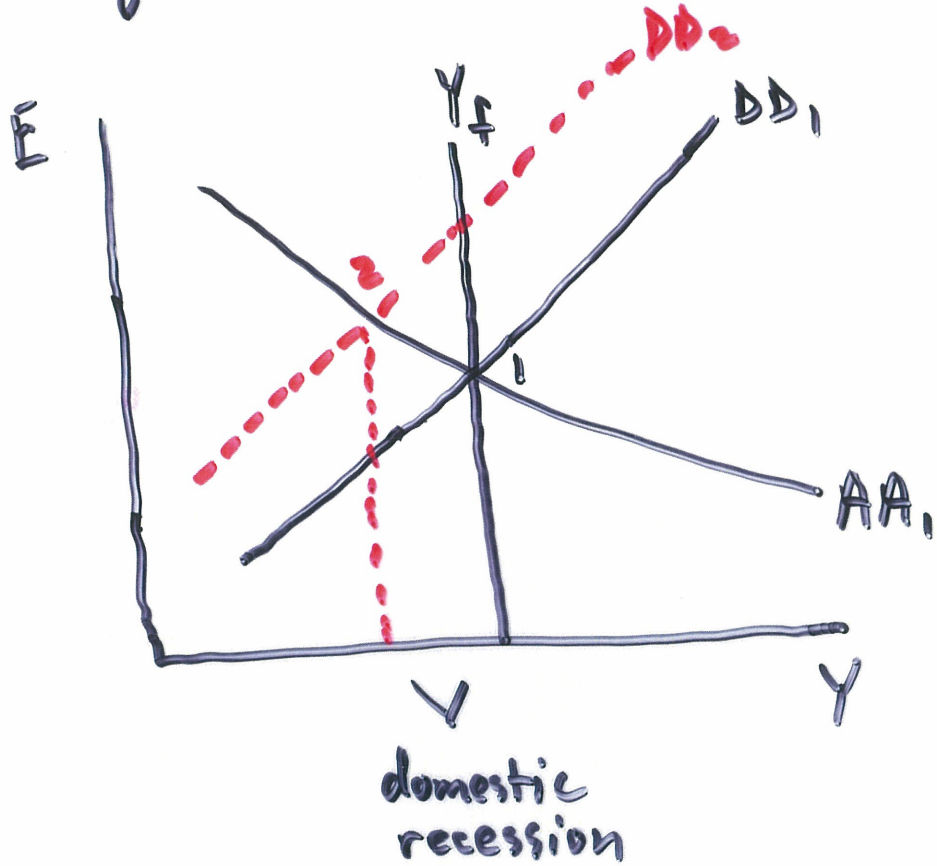
goods mkt. equil.

money mkt. equil.

fx mkt. equil.

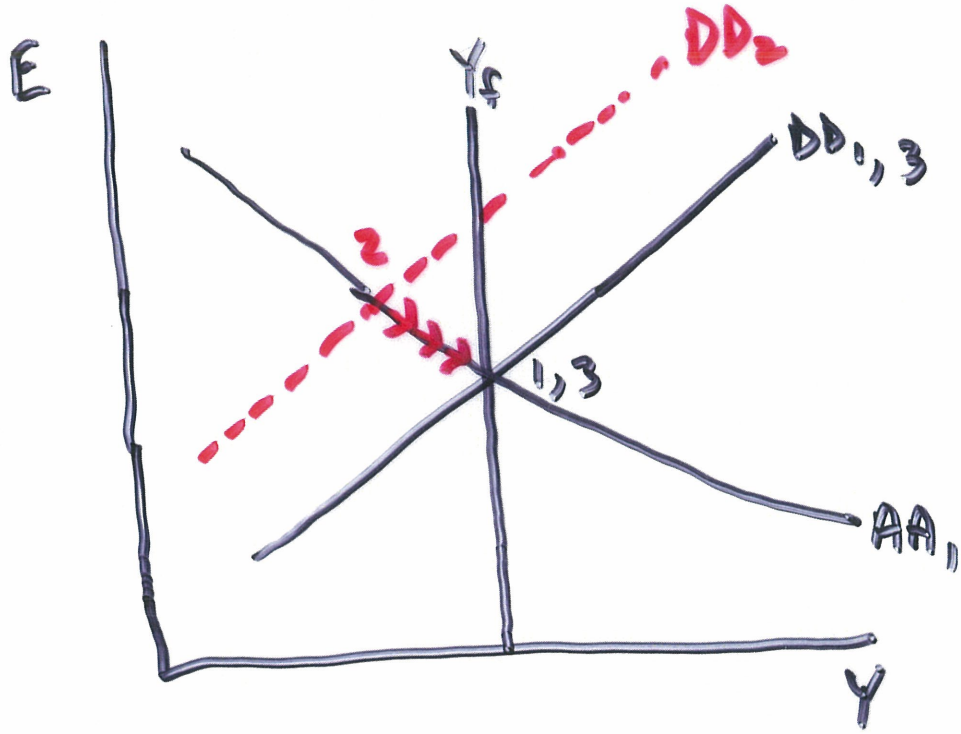
Stabilization Policy

Suppose a foreign recession leads to a temporary reduction in domestic exports. (NX↓).

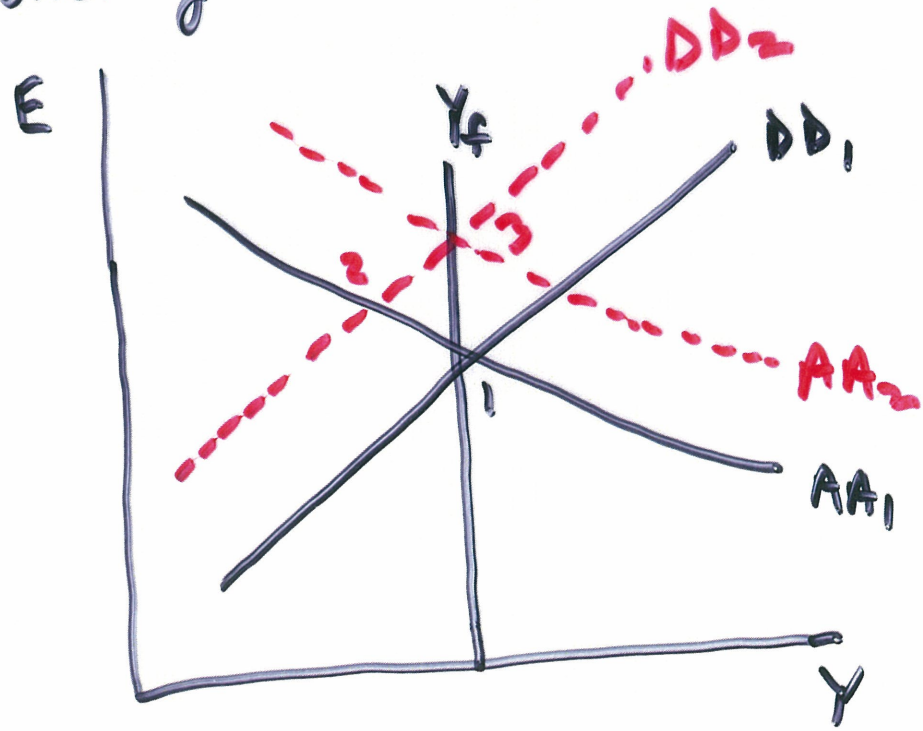


How should domestic policymakers respond?

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.

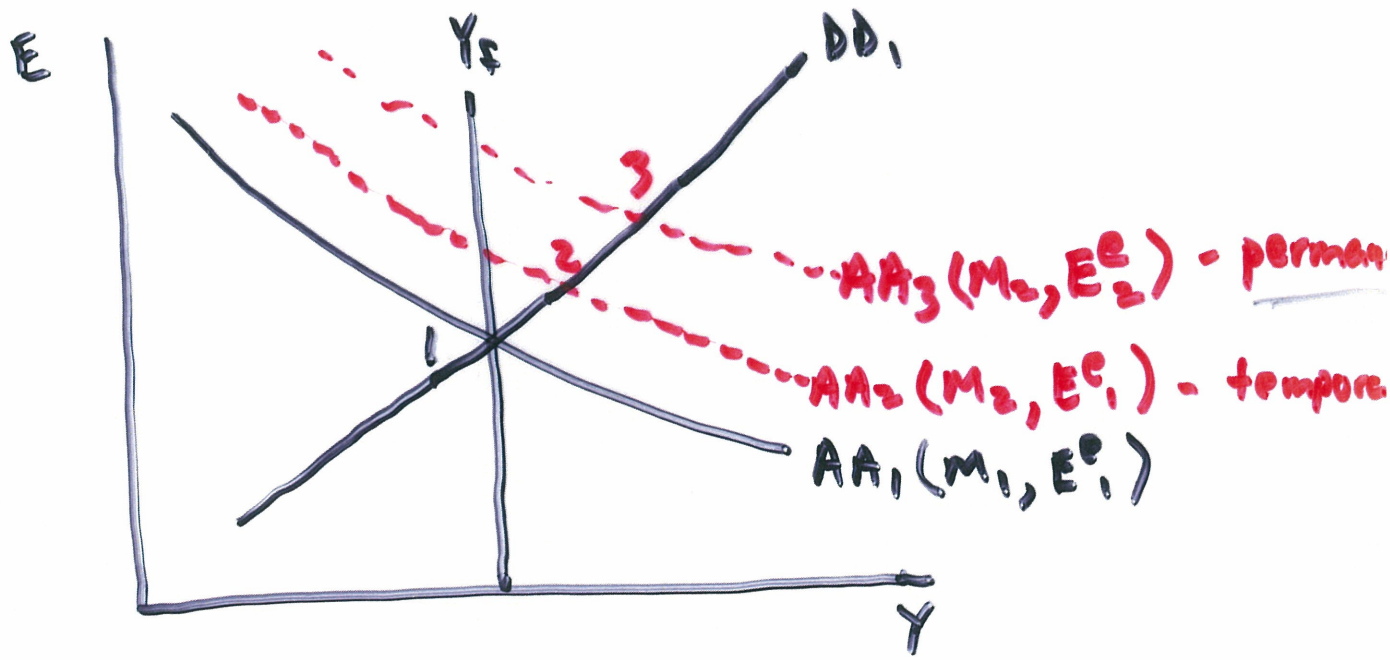
Permanent Monetary Expansion

Suppose $M^s \uparrow$ by $x\%$ permanently.

Monetary Neutrality $\Longrightarrow$ P and E $\uparrow$ by $x\%$ eventually

$\Longrightarrow$ $E^e \uparrow$ by $x\%$

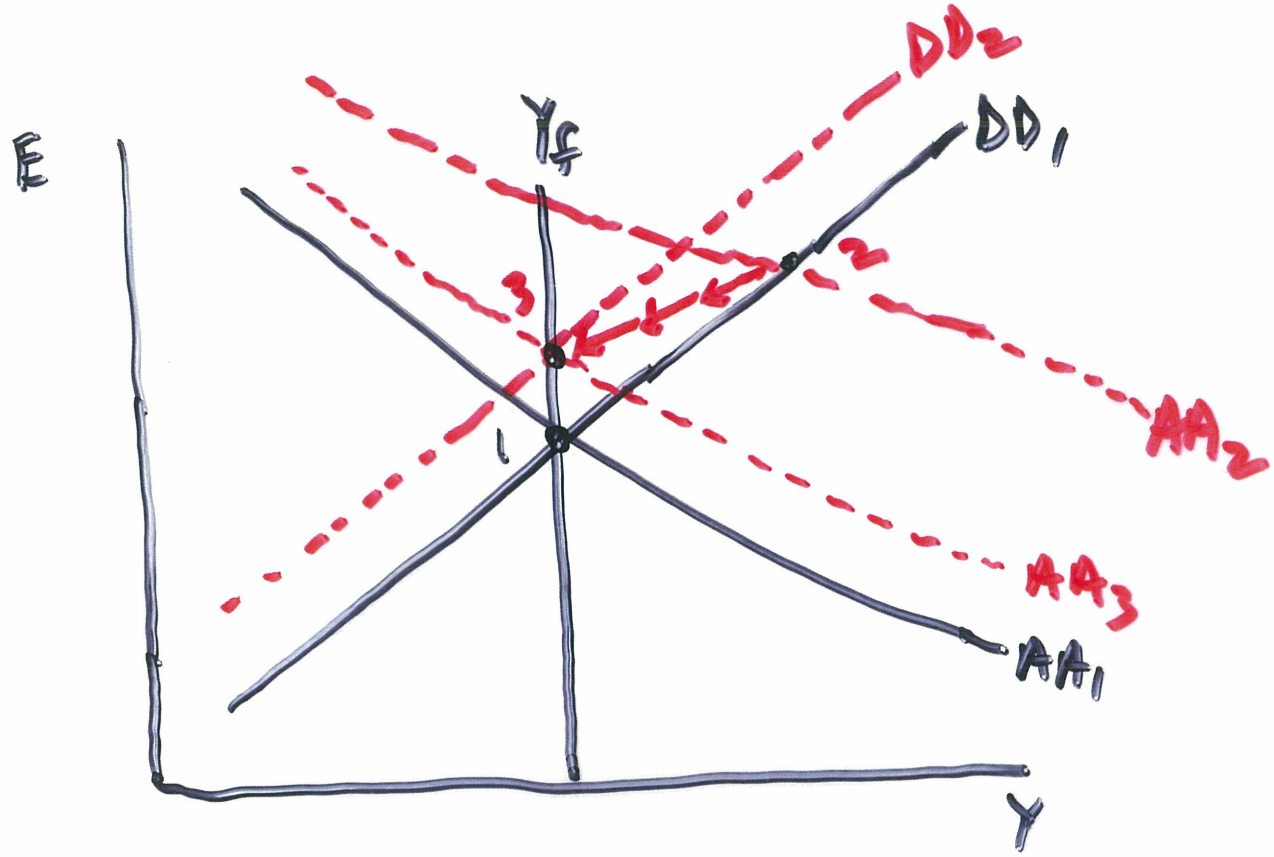
$\Longrightarrow$ Additional upward shift in AA



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

$\Longrightarrow$ More expansionary than temporary expansion

Long-Run Adjustment to Permanent $M^s \uparrow$



At pt. 2, $Y > Y_f$ $\Longrightarrow$ Price level gradually rises

$\Longrightarrow$ AA shifts down ($M/P \downarrow$)

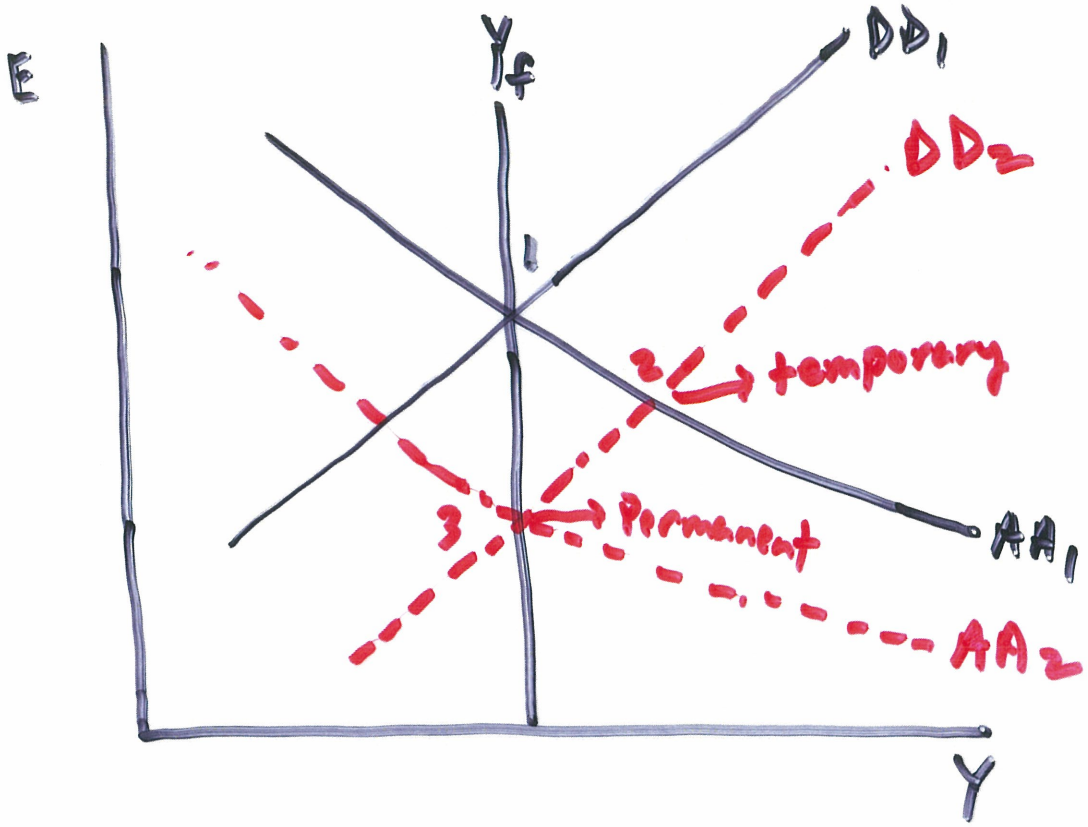
DD shifts left (Domestic goods lose competitiveness)

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 $M^s \uparrow$

Permanent Fiscal Expansion



Key point: Permanent fiscal expansion leads to a long-run real (and nominal) appreciation of the currency

$\Longrightarrow E^e \downarrow$

$\Longrightarrow$ AA shifts down

$\Longrightarrow$ Further ex. rate appreciation and crowding-out of NX

Note: If Y did rise then R↑ $\Longrightarrow$ Expected real depr.
$\Longrightarrow$ Further goods mkt. disequ.

Caveats to Long-Run Fiscal Policy Conclusions

1.) Assumes <u>perfect</u> capital mobility
- no risk premium
  - domestic interest rates may rise <u>without expected depreciation</u> if $G\uparrow$ financed by bonds.

2.) More generally, ignores financing of $G\uparrow$.
- Y could rise with either $M\uparrow$ or $T\uparrow$ financing.

3.) Assumes you start at Y_f

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