

CHAPTER **36**


**Five Debates over
Macroeconomic Policy**

PRINCIPLES OF
Economics
N. Gregory Mankiw

Premium PowerPoint Slides
by Ron Cronovich

© 2009 South-Western, a part of Cengage Learning, all rights reserved

**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?

1

Introduction

- § This course has introduced you to the tools economists use to analyze the behavior of the economy as a whole and the impact of policies on the economy.
- § This final chapter presents both sides in five classic debates over macroeconomic policy.

FIVE DEBATES OVER MACROECONOMIC POLICY

2

1. Should Policymakers Try to Stabilize the Economy?

Arguments for active stabilization:

1. Should Policymakers Try to Stabilize the Economy?

Arguments against active stabilization:

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?

2. Should Monetary Policy Be Made by Rule or Discretion?

- § The Federal Reserve has almost complete discretion over monetary policy.
- § Some argue that the Fed should be forced to follow a rule, such as
 - § constant money growth rate
 - § **inflation targeting:**

2. Should Monetary Policy Be Made by Rule or Discretion?

Arguments against discretion:

- § Allowing central bankers discretion

- § Discretion allows the possibility of

- § Central bankers who promise price stability

2. Should Monetary Policy Be Made by Rule or Discretion?

Arguments for discretion:

- §

- § Political business cycles and time-inconsistency

- §

3. Should the Central Bank Aim for Zero Inflation?

§ Recall two of the Ten Principles of Economics from Chapter 1:

Prices rise when the govt prints too much money.

Society faces a short-run tradeoff between inflation and unemployment.

§ How much inflation should the central bank accept? Is zero the right target?

3. Should the Central Bank Aim for Zero Inflation?

Arguments for a zero inflation target:

3. Should the Central Bank Aim for Zero Inflation?

Arguments against a zero inflation target:

§ The benefits of moving from moderate to zero inflation are small, but the costs are large:

§ Estimates:

§ A disinflation would leave permanent scars:

§ Some of inflation's costs could be reduced through

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?

13

ACTIVE LEARNING 2
Answers

14

4. Should the Government Balance Its Budget?

Arguments for balancing the budget:

FIVE DEBATES OVER MACROECONOMIC POLICY

16

4. Should the Government Balance Its Budget?

Arguments against balancing the budget:

5. Should the Tax Laws Be Reformed to Encourage Saving?

Arguments for tax reform to encourage saving:

§ One of the Ten Principles of Economics:

A nation's standard of living depends on its ability to produce g&s.

§ Higher saving

5. Should the Tax Laws Be Reformed to Encourage Saving?

Arguments for tax reform to encourage saving:

§ Another of the Ten Principles of Economics:

People respond to incentives.

§ The current U.S. tax system

§ Better: replace income tax with a consumption tax to increase the incentive to save

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?

5. Should the Tax Laws Be Reformed to Encourage Saving?

Arguments against tax reform to encourage saving:

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.
