

Chapter 36 / 18

Limitations of Stabilization Policy

Chapter Objectives

After you have read and studied this chapter you should be able to explain the difficulties for macroeconomic policymaking posed by such factors as mistimed policies, or improper dosages of stimulation or contraction; how private adjustments may frustrate even well intended discretionary policymaking; discuss the ways that policymaking may be misused to introduce “political” business cycles and the long-term trend for growth in government relative to the private sector; and discuss incomes policies and their possible effects on the economy.

Chapter Review: Key Points

1. Macroeconomic policymaking is at least as much art as it is a science. A multitude of problems preclude perfect analysis and policy.
2. A *recognition lag* occurs because it takes time to get even a modestly accurate picture of changes in the state of the economy. An *administrative (implementation) lag* exists because it takes a while to get the tax and monetary machinery in gear even when policymakers’ plans are made. An *impact lag* confounds the proper timing of policy; the economy bounces only stubbornly to the prods of the policymakers’ tools. These lags, which may be long and variable, may cause discretionary policy to be more destabilizing than stabilizing.
3. Lack of precise knowledge about recessionary gaps, inflationary gaps, and GNP gaps, as well as uncertainty about multipliers and velocity, mean that estimating the correct doses of monetary and fiscal medicine is extremely difficult.
4. Some modern Keynesians challenge the long-term effectiveness of monetary policy, arguing that adjustments in financial technologies will ultimately *insulate financial institutions* and make monetary tools inoperative.
5. Incumbents’ re-election prospects improve as per capita disposable income grows immediately prior to elections. There is some evidence that policymakers try to manipulate Aggregate Demand to enhance their positions in the eyes of voters, which induces *political business cycles*.

6. Critics of Keynesian fiscal policies also suggest that the government grows relative to the private sector when policymakers increase spending and cut taxes during downturns policymakers neither cut spending nor restore taxes, however, during periods of prosperity or inflation.
7. *Intentional recessions* can decompress accumulated inflationary pressures and inflationary expectations. However, recessions tend to be very hard on political incumbents, so many politicians favor incomes policies of various sorts.
8. *Incomes policies* (mandatory wage-price freezes or controls, voluntary guidelines, or “jawboning”) muzzle the effectiveness of the price system, creating shortages and widespread misallocations of resources.
9. The more involved a country is in international trade and finance, the less will be the impact of any given monetary or fiscal policy because the effects are diffused by foreign markets.

Matching Key Terms and Concepts

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|---|---|
| <ul style="list-style-type: none"> ___ 1. Incomes Policies ___ 2. Cost-plus pricing ___ 3. Political business cycles ___ 4. Wage and price freezes ___ 5. Overdosing the economy ___ 6. Underdosing the economy ___ 7. Recognition lag ___ 8. Administration lag ___ 9. Impact lag ___ 10. Financial insulation | <ul style="list-style-type: none"> a. Caused by underestimation of multipliers or overestimation of the economy’s capacity. b. Financial institutions learn to counteract monetary policies. c. The period between adoption and effect of a change in policy. d. Most stringent form of incomes policy. e. Range from jawboning to freezes. f. The period between an event and the availability of information about it. g. The money supply grows rapidly in years divisible by 4. h. Caused by overestimating multipliers or underestimating the economy’s capacity. i. The time required to alter the course of policy. j. Marking up costs by a fixed percentage to set prices. |
|---|---|

True/False Questions

- ___ 1. The recognition lag occurs because it is generally difficult for monetary and fiscal policymakers to determine quickly how much of which policies to use in steering our sluggish economy along a proper course.
- ___ 2. Since changes in monetary policy can be implemented quickly through the FED's Open Market Committee, administration lags are not much of a problem for monetary policymaking.
- ___ 3. Wage and price controls have a long history of considerable success at reducing inflation.
- ___ 4. The impact lag of monetary policy is comparatively regular and short.
- ___ 5. Critics contend that wage and price controls may actually increase inflationary expectations.
- ___ 6. The longer that wage and price controls are in force the more difficult it is for economic transactors to distinguish real from artificial price signals.
- ___ 7. There is little empirical evidence of political business cycles.
- ___ 8. The Federal Funds Market provides banks with the opportunity to lend or to borrow millions of dollars for one or two days at comparatively low interest rates.
- ___ 9. Various studies indicate that voters tend to re-elect incumbents more often the faster disposable income grows during the year immediately preceding elections.
- ___ 10. Impact lags make it more difficult to cure the economy than simple Keynesian analysis would suggest.

Standard Multiple Choice

There is one best answer for each question.

- ___ 1. Which of the following is an example of financial insulation?
 - a. The FED's discount window.
 - b. A wage and price freeze.
 - c. A wage and price control.
 - d. A bank holding on to excess reserves.
 - e. The federal funds market.
- ___ 2. Which lag is longer for fiscal policy than for monetary policy?
 - a. Discretionary lag.
 - b. Recognition lag.
 - c. Administration lag.
 - d. Dosage lag.
 - e. Impact lag.

- ___ 3. Which one of the following generalizations about economic theories is not correct?
- Keynesians believe that macroeconomic policy works.
 - New classical macroeconomists believe that macropolicy does not work.
 - Natural rate theorists believe macropolicy works only temporarily but is harmful in the long run.
 - Post-Keynesian monetarists believe Keynesian analysis is correct for the very short run but classical assumptions are correct for the long run.
 - Classical economists believed that macropolicy was effective in both the short and long run.
- ___ 4. Incomes policies disturb the price system and cause:
- efficient usage of resources.
 - surpluses.
 - politicians' jawbones to swell.
 - inflation upon their implementation.
 - shortages and misallocation of resources.
- ___ 5. Mandatory price controls are an example of:
- monetary policy.
 - fiscal policy.
 - automatic stabilizers.
 - tax policy.
 - incomes policies.
- ___ 6. Some new-Keynesians believe that financial technologies change in response to changes in:
- the size of the workforce.
 - monetary policy.
 - the capital stock.
 - fiscal policy.
 - All of these.
- ___ 7. Assume OPEC hikes the price of oil, and policymakers attempt to offset the resulting tendency for the economy to slide into a recession. Which of the following is NOT a likely consequence of these events?
- The "real" price OPEC gets for oil will be less than it expects.
 - The "real" wages of labor will fall.
 - "Real" national income will fall because of the OPEC hike.
 - Our "real" national income will fall solely because of overly expansionary policies.
 - The price level will rise.
- ___ 8. Wage and price controls are intended to:
- dampen inflationary expectations.
 - shift the economy's supply curve to the left.
 - shift the economy's demand curve to the right.
 - reduce corporate profits.
 - increase corporate profits.
- ___ 9. Price ceilings are likely to result in:
- shortages.
 - black markets.
 - queuing.
 - rationing by favoritism.
 - All of the above.

- ___ 10. Incumbent policymakers that manipulate macroeconomic policies to obtain reelection may cause:
- political business cycles.
 - stagflation.
 - excessive unemployment.
 - countercyclical cycles.
 - tax rates to rise just before election.
- ___ 11. During an election year, incumbents are most likely to support:
- tax increases.
 - reduction of subsidies to all special interest groups.
 - growth of the money supply.
 - campaign finance reform.
 - reduction of the money supply.
- ___ 12. Critics of discretionary monetary and fiscal policy point to:
- political manipulation of the business cycle.
 - failures to raise taxes and cut spending during inflation.
 - problems with lags and incorrect doses.
 - these policies' reliance on "fooling" people.
 - All of these.

Chapter Review (Fill-In Questions)

- Even well-intentioned policymakers suffer from a _____ lag because it takes time and resources to acquire sufficient _____ about the state of the economy to make judgments about the proper course of policy.
- Once a problem is recognized, there is a(n) _____ lag because it takes time for _____ policymakers to tilt open market directions properly, and even more time for _____ policymakers to change _____ laws or alter appropriations for government outlays.
- Once a policy is changed, the time it takes for policy to affect economic activity results in a(n) _____ lag. The _____ lag is usually longer for fiscal policy than monetary policy, while the _____ lag is longer for monetary policy if changes in _____ policies are the tools used by fiscal policymakers.
- Tight money policies may teach financial institutions new ways to conserve on their holdings of reserves. Such changes in financial technology are known as _____, and make repeatedly used monetary policies _____ or useless in their effects on macroeconomic activity.
- Reluctance in using _____ to combat inflation has channeled many political decisionmakers into experiments with _____ policies. Wage-price curbs have ranged from _____ by the president, to mandatory _____.

6. Opponents point to the wage-price controls of _____ to show that incomes policies do not work. They argue that controls _____ can create expectations that prices will _____ when controls are lifted.

Unlimited Multiple Choice

There are four to zero answers for each question.

- ___ 1. It may be difficult to design and to implement appropriate countercyclical policies:
- because of the timing problems inherent in both monetary and fiscal policies.
 - because adjustments made by private individuals and firms to certain monetary and fiscal policies can eliminate the desired effects of the countercyclical measures.
 - because policymakers do not possess current or perfect information about the condition of the economy.
 - because politicians sometimes base policy on the effects that specific countercyclical measures might have on their prospects for re-election.
- ___ 2. Mandatory wage and price controls:
- have typically been associated with wartime efforts.
 - were imposed by President Nixon in August of 1971.
 - are imposed to mitigate recessionary pressures which develop automatically in the economy.
 - seldom distort relative prices.
- ___ 3. Wage and price guideposts and guidelines:
- assume that rates of price increases can parallel increases in labor productivity without causing upward pressure on wage rates.
 - have traditionally been mandatory.
 - are typically tied to a socially accepted level of unemployment.
 - are very effective in relieving inflationary pressures.
- ___ 4. Proponents of incomes policies argue that controls:
- effectively reduce deflationary expectations.
 - can reduce inflationary expectations.
 - distort relative price signals and misallocate resources.
 - can reconcile the goals of monopolistic industries with the goals of society.
- ___ 5. Decreasing Aggregate Demand in order to reduce inflation:
- is generally favored by politicians.
 - may cause a recession.
 - might also 'discipline' a 'slack' labor force.
 - should increase employment.

Problem

Answer the True/False questions below based on the following scenario:

After moderate sales during the Christmas season of 2005 business pessimism leads to a decline in production in the first part of 2006. Consumers' expectations mirror firms' uncertainty, and outlays on durable goods are delayed or forgotten. First quarter statistics compiled in mid April indicate that a contraction is taking place. Upon receiving the news, the FED undertakes actions to boost the money supply. In Congress rumors begin to circulate about a possible tax cut to deal with the downturn in business activity.

- a. The time between January 2005 and mid April 2006 is known as a recognition lag.
- b. If the FED implements an expansion of the money supply by mid May, the administrative lag (of monetary policy) is approximately one month.
- c. The impact lag will most likely be longer for a tax cut than for open market operations which expand the money supply.
- d. The administrative lag will most likely be longer for monetary policy as compared to fiscal policy.
- e. The recognition lag is longer for fiscal policy than for monetary policy.
- f. Government purchases to combat declining Aggregate Demand will have a shorter administrative lag than lowering the discount rate.
- g. The impact lag of open market purchases will be of short duration because money expansion is almost instantaneous.
- h. If a tax cut is finally passed in October of 2007 and implemented in 2008, there is a chance that the tax cut will help to overheat the economy (cause inflation).
- i. The impact lag of expansionary monetary policy will increase if banks are reluctant to loan out additionally funds acquired through the sale of government securities to the FED.
- j. The recognition lag could be decreased by compiling business statistics at intervals of 1 month as opposed to each quarter.

ANSWERS

Matching	True/False	Multiple Choice	Unlimited MC	Fill-In
1. e	1. F	1. e	1. abcd	1. recognition; information
2. j	2. T	2. c	2. ab	2. administration; monetary; fiscal; tax
3. g	3. F	3. e	3. none	3. impact; administration; impact; tax
4. d	4. F	4. e	4. bd	4. financial insulation; unpredictable
5. a	5. T	5. e	5. bc	5. recessions; incomes; jawboning; wage/price freezes
6. h	6. T	6. b		6. 1971-73; rise
7. f	7. F	7. d		
8. i	8. T	8. a		
9. c	9. T	9. e		
10. b	10. T	10. a		
		11. c		
		12. e		

Problem

- a. T
- b. T
- c. F
- d. F
- e. F
- f. F
- g. F
- h. T
- i. T
- j. T