ECONOMICS II
MACROECONOMICS

BMEGT30A101
BMEGT30A103
Monday: 8.15–9.45 (QA240)

ECONOMIC POLICY
– Alternative Perspectives –
CH 18

Zsombor LIGETI
associate professor
Department of Economics
ligetizs@kgt.bme.hu
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MŰEGYETEM 1782

Gazdaság- és Társadalomtudományi Kar • Közgazdaságtan Tanszék

közgazdaságtan tanszék

CONTENTS

1. INTRUDUCTION

The macro roles of the government

1. **Allocation** – market failures: public goods, externalities, imperfect information, monopolies
2. **Redistribution** – fairness, dignity
3. **Stabilization**
4. **Creating and functioning economic and political institutions**
   – Inclusive vs Extractive economic and political institutions **(see CH 9)**

2. WHICH POLICY?

A. Stabilization policies: fiscal or monetary

How should policymakers respond to business cycle?

Which policy is more effective?

- Fiscal: $\Delta Y / \Delta G = ?$
- Monetary: $\Delta Y / \Delta M = ?$

IS-LM model

- **Crowding out effect**: that rises in public sector spending drive down or even eliminate private sector spending
- Suppose P=1 (short-run):
- IS: $$Y = \frac{1}{1-\hat{c}}\left[C_0 + I_0 + G_0 - \hat{c}T_0 + \hat{c}TR - ai\right]$$
- LM: $$i = \frac{m}{k}Y - \frac{1}{k}\frac{M^S}{P}$$

B. Active or Passive

- **Views of economists : *the economy…***

as naturally stable ←→ is inherently unstable

- **Unpredictable future**
- **Lags** (inside, outside)
- **Lucas critique –** (need to know how people's expectations will respond to a policy change)
- **Automatic stabilizers** (income tax, unemployment benefit)

- **The economy is hit by frequent shocks**

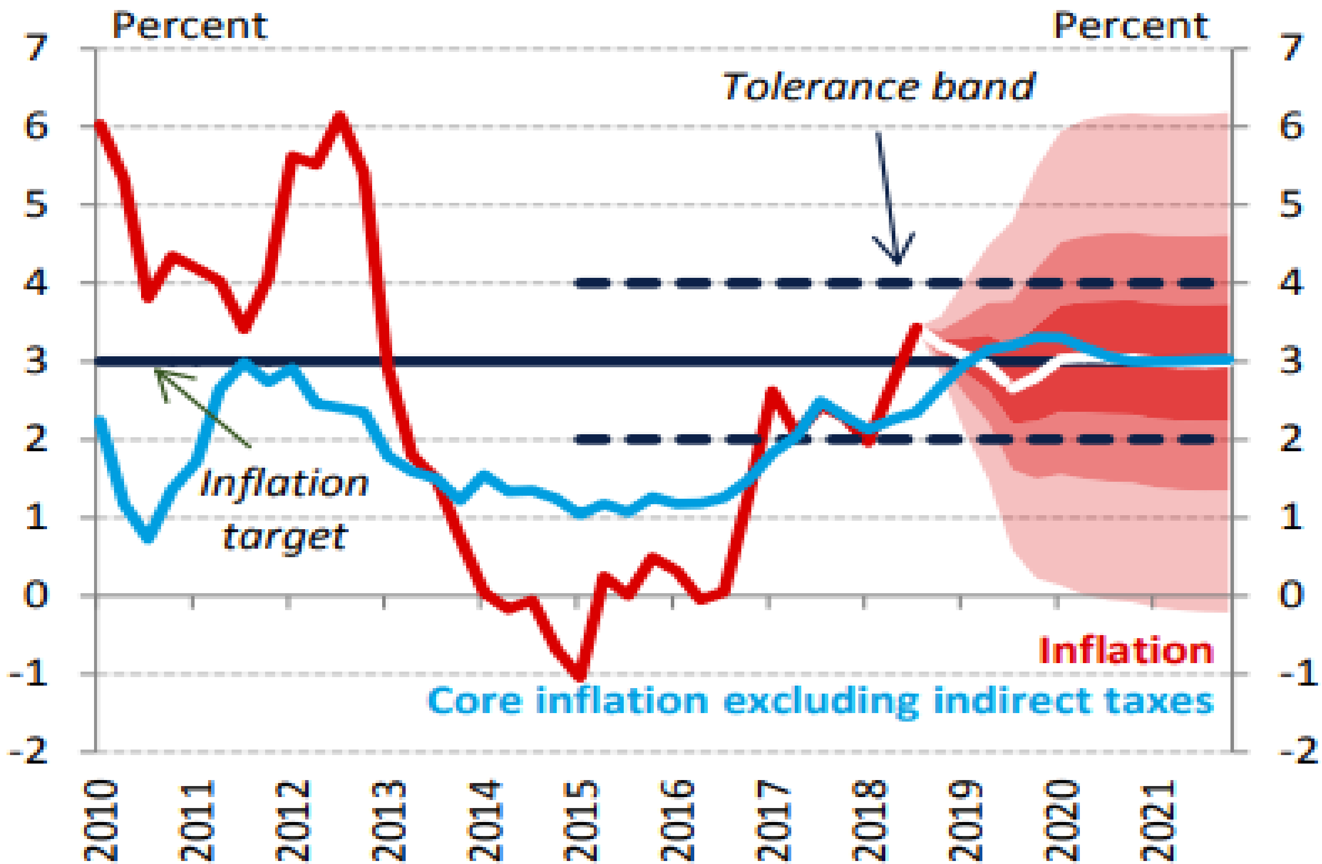
C. Conducted by Rule or by Discretion

- **<u>By rule</u>**: policymakers announce in advance how policy will respond to various situations and commit themselves to following through on this announcement
  - Inflation targeting, Central- Bank independence

- **<u>By discretion</u>**: policymakers are free to size up events as they occur and choose whatever policy they consider appropriate at the time
  - More flexible in responding to various unforeseen situations

- **Time inconsistency** – unless credibility the announcement has little effect (No negotiation over hostages)

Inflation targeting in Hungary



[20. 12. 2018. Inflation Report (December 2018)]

3. FINANCING BUDGET DEFICIT

Keynesian cross

- $Y=C+I+G= 100+0{,}5(Y–200–0{,}2Y)+500+1000$
- $Y^E=2500$
- **BD**$=G–T =1000–(200+0{,}2\cdot 250)=$ **+300**

- If BD=0 ➔ $G=T_0+tY= 200+0{,}2Y$
- $Y=C+I+G= 100+0{,}5(Y–200–0{,}2Y)+500+ 200+0{,}2Y$
- $Y^E=1750$ ➔ $G=T_0+tY= 200+0{,}2Y = 550$
- **ΔG**$= G – G =$ **–450**

4. CONCLUSION

- Economics is a young science, and there is still much that we do not know.
- Lessons from **Lucas critique**:
  - Need to consider how policy affects expectations and behavior
  - Economists must show requisite humility
- **The economy is complex.** (See *The Economist* article CH 18 – Economic Complexity)