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Making Sense of Economic Policy Debates: Some Basic Concepts

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Some useful concepts/distinctions

Demand vs Supply side of the economy

- Supply side: what is the maximum amount of goods and services that the economy can produce? How does this change over time, ie, what is the economy's potential growth rate?
    - Growth accounting: increase in output (GDP) can come from using more labor; using more capital; or being more productive (innovation);
        - The Fed puts the US potential growth rate at about 1.9%;
- Demand side: is there enough demand (for consumption and investment goods and services) to keep the economy operating at full employment/full capacity?
- Structural or supply-side policies focus on the supply side
    - Labor market policy, competition policy, tax policy, innovation policy, trade policy, regulatory policy, financial system (including micro-prudential) policies
- Aggregate demand management policies (monetary and fiscal policy), as well as financial stability (including macro-prudential) policy focus on the demand side
- Economists call the difference between aggregate demand and aggregate supply the "output gap"
    - It matters a lot for the growth rate whether the economy is operating at full employment (capacity) or not
    - If the output gap is "negative" the economy can, and should, grow above its (normal) potential growth rate

National income accounting identity

- Real output of goods/services (GDP or Y below) is also national income

- Output can be decomposed: $Y = C - M + I + G + X$;
- So can income: $Y = C + S + T$, where C is consumption, I is private investment, G is government investment and consumption, X is exports, M is imports, S is savings, and T is (net) taxes (that is, net of transfers) (all in real, as opposed to nominal, terms);
- Rearranging, $(S - I) + (T - G) = X - M$, in words: the private sector's net savings and government's budget balance (surplus or deficit) equals the current account balance (surplus or deficit);
- At the world level, this reduces to: $S - I = G - T$ (current account balances sum to zero); in words: for the private sector to save more than it invests, the government must run a budget deficit
  - When the budget is balanced, $S = I$: society saves for the future by investing today

Macroeconomics vs Microeconomics

- Macro: the level of the overall economy and aggregated markets
  - Main focus is the demand side
- Micro: the level of individual markets and individual economic agents
  - Main focus is the supply side

Short-run vs Long-run

- Short-run/medium-run: the economy may be reacting to various "shocks" (policy, technology, weather, confidence, etc)
  - Relevant horizon for demand management policies
- Long-run: all economic variables have adjusted (but "we are all dead")
  - Relevant horizon for supply side (structural) policies

Monetary vs Fiscal policy

- Monetary policy
  - Tries to influence economic activity (demand) by influencing interest rates (the yield curve) and broader financial conditions
  - Operated by the central bank, which is independent and technocratic
  - Influences GDP indirectly
- Fiscal policy
  - Influences GDP directly (G) and indirectly (T)

    - Is the preserve of the government/political sphere
    - Is only one aspect of budgetary policy. Others include:
        - The supply of public goods
        - Trying to curb negative externalities and encourage positive ones
        - Providing a social safety net
        - Redistributing income and wealth
    - Famous macroeconomist: “in the US … there is no such thing as fiscal policy” (personal correspondence)

Relative prices vs the Price level

- Relative price changes are intrinsic to the operation of a market economy
- Policymakers (central banks) strive to keep the overall (average) price level (an index of prices like the consumer price index) stable over time

Efficiency vs Equity

- Efficiency: Is the economy operating on its production possibilities frontier (micro/supply side))? Is the economy operating at full employment/capacity (macro/demand side)?
- Equity: How to make the distribution of income/wealth “fairer” and more equitable (after all, a country is a society as well as an economy)

Real economy vs Financial/Monetary economy

- Real economy: I is key (the capital stock)
- Financial economy: it revolves S (claims on future output)
    - Financial system tries to make inherently illiquid capital stock as liquid as possible, but beware the fallacy of composition: liquidity at the system (economy) level is largely an illusion
    - Central bank as lender-of-last-resort: makes claims on illiquid assets liquid

Mundell’s Impossible Trinity

- A country can have only two of the following three: a fixed exchange rate; an open capital account; domestic monetary control
    - Flexible inflation-targeting (developed world norm): flexible exchange rate; open capital account; domestic monetary control

- Fixed exchange rate regime (common in developing world): implement capital controls to have domestic monetary control or open the capital account and "import" US monetary policy
- Example: China has been transitioning from the latter to the former since July 2005, when it started to move to a more flexible exchange rate regime

Some interesting economic policy questions/debates

Who should claim credit for the strong performance of the US economy, President Donald Trump or Fed Chair Jerome Powell (or neither or both)?

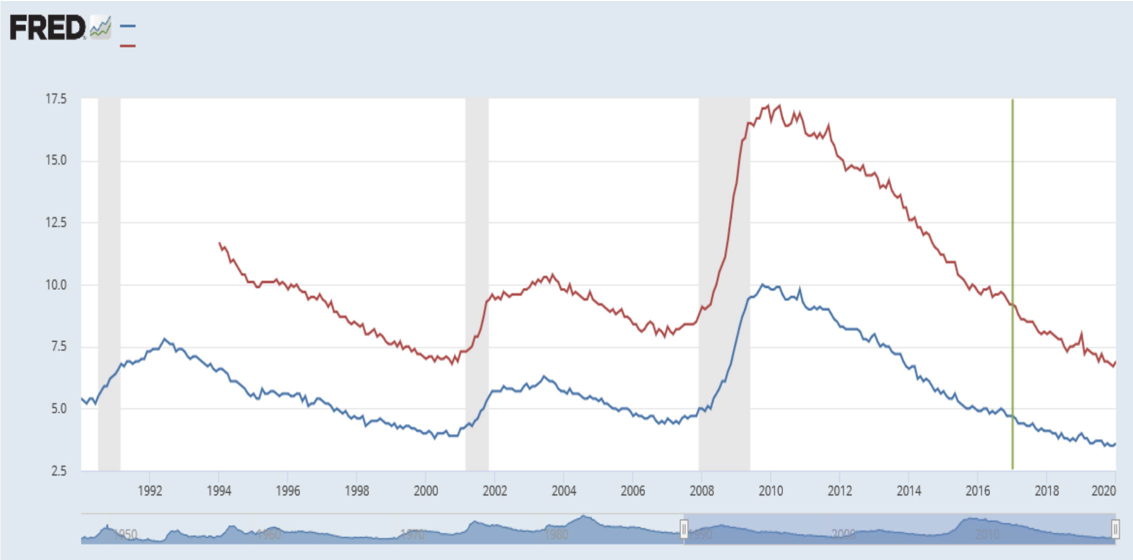
- To what extent does the growth performance of a market economy depend on government policy?
  - Keynesian (Keynes), Austrian (Hayek), Monetarist (Friedman), Rational Expectations (Lucas), Real Business Cycle (Kydland/ Prescott) all offer different perspectives
- Conventional policy framework assigns prime responsibility for managing aggregate demand to central bank and for supply side to the government

Comparison of real GDP growth and contribution to growth of its components, Trump vs Obama (12 quarters)

	Trump	Obama	Difference (pp)
Contribution to growth (pp)			
Personal consumption	1.9	2.1	-0.3
Residential investment	0.0	0.2	-0.2
Non-residential investment	0.5	0.5	0.0
Government expenditure	0.3	0.2	0.1
Inventories	-0.1	-0.1	0.1
Net exports	-0.1	-0.6	0.5
Real GDP growth (% q-o-q, saar)	2.5	2.3	0.2

Contributions do not necessarily sum to the total due to rounding error.
pp: percentage point; saar: seasonally-adjusted annualized rate.
Source: Federal Reserve of St. Louis FRED Economic Data.

US unemployment (U3) and underemployment (U6/red line), 1990-2020 (%)



Shaded areas mark recessions; Vertical line denotes beginning of Trump Administration; Source: Federal Reserve Bank of St. Louis FRED Economic Data.

Monthly payrolls growth, Trump vs Obama (000s m-o-m sa change; 3 years)

	Trump	Obama	Difference
Total non-farm payrolls	182	224	-42
Services	146	199	-52
Manufacturing	13	8	5
Construction	21	24	-3
Government	11	14	-3

Source: Federal Reserve of St Louis FRED Economic Data; sa: seasonally adjusted.

Is it possible for policymakers to run out of monetary and fiscal "ammunition"?

- The concern arises because monetary policy settings are "stretched" in the aftermath of the Great Recession
  - Fed's target federal funds rate is 1.50-1.75% and Fed has about $1.5 trillion of excess reserves on its balance sheet;
    - Fed typically needs about 500bp of interest rate ammunition to counter a recession;
  - ECB's deposit rate is minus 50 basis points (bp) and it has resumed QE at rate of €20 billion per month, on top of big stock of

    - QE accumulated since January 2015;
    - Bank of England's policy rate is 75bp and has £445bn QE stock;
    - BOJ is targeting overnight rate of minus 10bp and 10-year JGB yields at around zero percent and has committed to continue to expand its balance sheet until CPI inflation overshoots 2% target;
- Fiscal settings are stretched too: high debt-to-GDP ratios and large ongoing budget deficits
- But there is no limit on the use of monetary and fiscal policy per se
    - Central banks can purchase unlimited government bonds and (in principle) other assets (there may be legal restrictions but these are societal choices, ie, self-imposed constraints)
    - The budget deficit is the counterpart to private sector net savings
        - If S↑ and I↓ (as happens in a recession or if there is "secular stagnation"), then G↑ and T↓ has to happen
    - Abba Lerner "functional finance" perspective is useful: the tail (fiscal and monetary metrics) should not wag the dog (macro policy goals)

Do tariffs, regulations and natural disasters push up prices?

- They push up individual prices (and therefore change relative prices) and may push up the price level (raise the inflation rate) temporarily, but a corollary of Mundell's Impossible Trinity (and a significant amount of economic theory) is that the central bank can control the inflation rate in the medium- to long-term
- The effects will show up elsewhere, such as in changes in exchange rates and other asset prices, and a different pattern of consumption and production
    - The general public conceptualizes and experiences price changes very differently from policymakers

Was former Bank of Japan governor Masaaki Shirakawa correct in asserting that the cure for Japan's deflation is structural reform to raise its potential growth rate?

- Governor Shirakawa argued that the cause of Japan's deflation was the country's long-term declining potential growth rate (driven by an aging society and too low productivity growth), and was not amenable to cure by aggressive monetary easing; rather argued for more structural reform
- Seems to be mixing up demand- and supply-side issues, and nominal and

real issues
- Problem in Japan has been that monetary and fiscal policy have not been jointly mobilized on a sufficiently aggressive and sustained basis
- While the BOJ was implementing aggressive QE, the government hiked the consumption tax rate from 5% to 8% in April 2014 and then to10% in October 2019

Size of Bank of Japan's balance sheet, 1998-2020

Units: ¥100 million; First two vertical lines represent start and end of BOJ's first attempt at quantitative easing, third one denotes beginning of Governor Haruhiko Kuroda's tenure; Source: Federal Reserve Bank of St. Louis FRED Economic Data.

Does the construction of the euro area, as a monetary union but not a fiscal union, make sense?
- No, monetary and fiscal policy are two sides of the same sovereign coin: central bank independence is a valuable innovation, but monetary and fiscal policy shouldn't be separated too much
    - The euro area severely limits the ability of member states to deploy macroeconomic
        - Monetary policy is set for the euro area as a whole, the exchange rate flexibility vis-à-vis the other 18 countries is foregone, there is no virtually no euro area counter-cyclical fiscal policy capacity, and euro area membership imposes strict limits on fiscal policy

  - Exhibit A: the level of real GDP in Italy (the third largest country in the euro area) is still about 5% below its pre-crisis peak; in Germany is it 14% above and in the US it is 22% above (the euro area as a whole is about 9% above its pre-crisis peak)
  - Worst of all, the euro creates a situation which is tantamount to the (19) member states having to borrow in a foreign currency, if they run a budget deficit
- Either the euro needs to become a fiscal union too or it will eventually break up (my long-run prediction)

When and how should the central bank act as a lender-of-last-resort?

- In a financial panic, the central bank should always act as a lender-of-last-resort: S (financial claims) is always more liquid than I (the underlying capital stock)
- If the problem is just one of liquidity the central bank should use Bagehot's rule (lend freely on good collateral at a penalty rate); if the problem is one of insolvency, the government needs to inject capital into the banking system too
  - Dodd-Frank legislation imposed restrictions on the Fed's lender-of-last resort role (Section 13 (3) of the Federal Reserve Act), and there is no longer a bank recapitalization framework like the TARP (Troubled Assets Relief Program)

Does China need to grow at 6% in order to absorb the flow of new workers from the countryside every year?

- The argument seems to have things around the wrong way: the "flow of workers from the countryside" is part of what contributes to China's potential growth rate. Let's say that number is 6%. Chinese policymakers need to ensure there is sufficient aggregate demand
- The argument is a mixture of an estimate of China's potential growth rate and thesis about the country political system

<u>Background reading:</u>

Paul Sheard, 2016: "Global Growth Challenges: Horses For Courses," Standard & Poor's Ratings Services RatingsDirect, March 17, 12pp