

Macroeconomic Theory and Policy: BSc Year Three

The Loose Consensus

There currently exists a loose consensus over how macroeconomic policy should be run:

- aim for low, preferably zero, inflation
- achieve low inflation primarily through monetary policy
- monetary policy should itself be to some degree independent of government
- fiscal policy should be geared to maintaining a budget deficit of about zero in a reasonable time frame
- governments should not manipulate monetary and fiscal policy to achieve a particular level of output or unemployment
- government restrictions on international trade in goods and in financial assets should be minimised or even eliminated
- the government should not directly restrict movements in price or wages
- the government should encourage as much economic activity as possible to be conducted through private markets

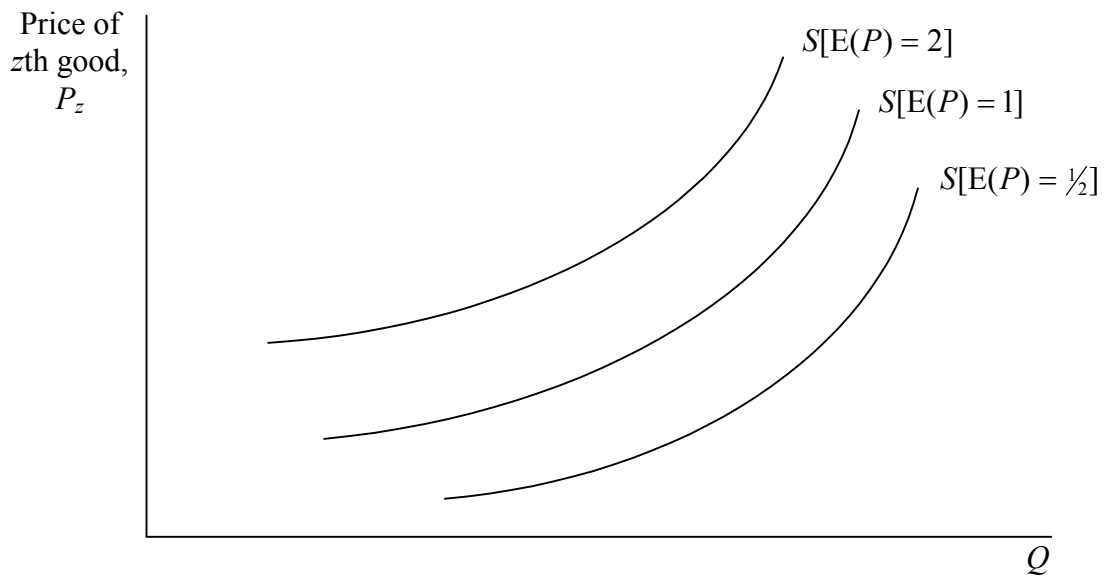
Governments worldwide seem to be working towards these aims. For example, the Bank of England was been given independence over interest rates in 1997, an idea which was inconceivable 20 years earlier. The European Central Bank similarly has a very marked independence. Under the Maastricht Treaty, European governments are obliged to run low budget deficits and keep inflation low. Some countries (not just in Europe) use a currency board system – they give responsibility of monetary policy to other countries with proven records.

However, this is not the case in all countries and for all areas of policy. In 1999, Malaysia introduced exchange controls, against the consensus outlined above. Also, the British government is continuously putting pressure on the Bank of England to act in a certain way.

The Natural Rate Hypothesis

There are two basic concepts (*italicised below*) behind the Natural Rate hypothesis. This helps us to understand why it is that governments are unable to fine-tune the economy by considering how firms are acting and reacting.

Suppliers of goods are motivated purely by the relative price of their good to other goods.

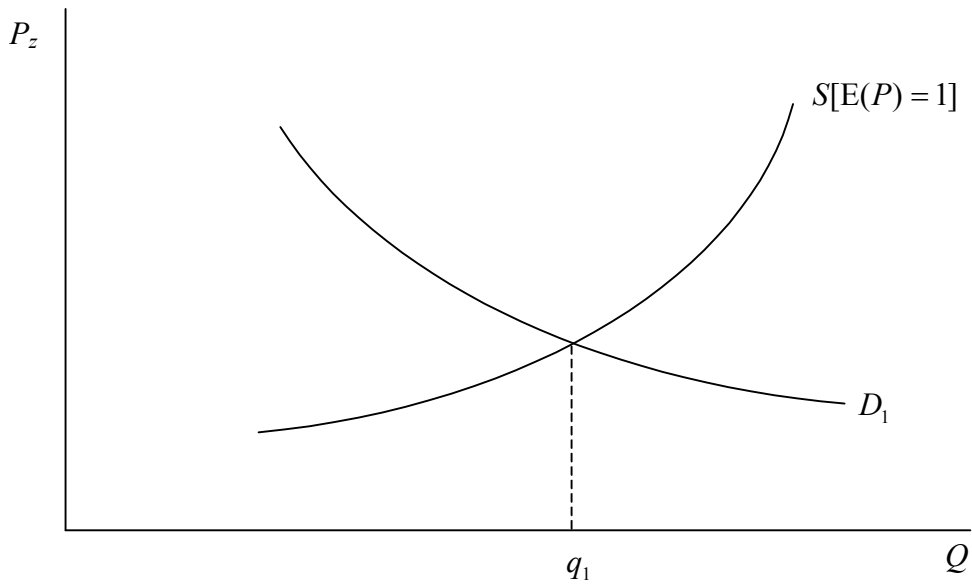


The important ratio here is $\frac{P_z}{E(P)}$; we are interested in how supply will vary given the prices throughout the rest of the economy. This can be explained with reference to inflation – a supplier will wish to price their product relative to the buying power of a price level.

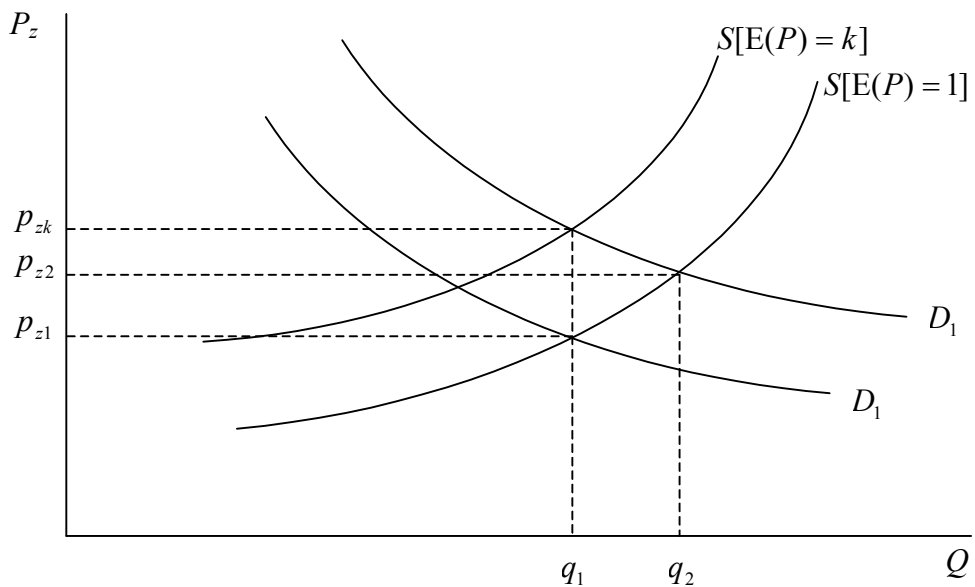
There is imperfect information in the world.

Suppliers know what happens in their market, but don't know what happens in other markets at the same time. Consider the demand curve for a good – there are two types of influence, aggregate (affecting all markets in the same way, as per the IS/LM model) and relative (affecting only this market).

The manufacturer may expect supply and demand to fall at the levels shown below:



But may instead find that demand has shifted to a higher level:

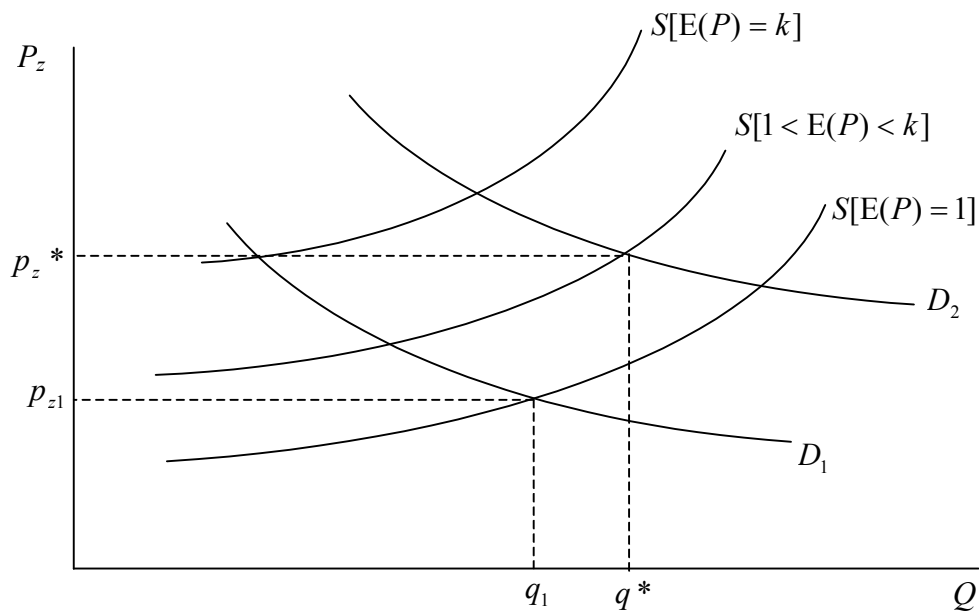


We cannot tell if this shift in demand is aggregate or relative, since we cannot see what is happening in other markets. If this were a relative shift, there would be no reason to change expectations about other markets, so the supply curve would stay the same, moving to q_2 . If, however, this were an aggregate shift, all prices would go up, the supply curve would shift to $S[E(P) = k]$, and the price should be set at p_{zk} .

The Rational Expectations Hypothesis

When people form their expectations they will form them in line with the true state of the world. If relative demand shifts are typically small, but aggregate demand shifts are quite large, the general expectation will be that any shift in demand will be caused mostly by an aggregate shift. With the above analysis, the quantity supplied will be kept constant.

In most economies, shifts tend to be part aggregate and part relative, so the outcome will lie between the two extremes, due to expectations over the general price level.



The exact placing will naturally depend on the relative size and quantity of aggregate and relative shifts.

Application to policy

The real business cycle is due to unpredicted shifts in aggregate demand, which are not properly countered for – if a demand shift is purely aggregate in an economy with some relative shifts, quantity will rise because the shift will be misinterpreted. The crucial thing to note here is that movements in aggregate demand must be unpredictable. The business cycle is an aggregate demand phenomenon, caused by unpredictable movements in nominal aggregate spending.

The government cannot maintain a target level of economic activity by systematically changing monetary or fiscal policy whenever actual activity differs from their target. The best they can do is to try and keep nominal aggregate demand as steady as possible.

The policy implications are therefore:

① Give up Keynesian fine-tuning of the economy

In the 50s to the 70s, many governments had an approach to macro policy of fixing a target (such as the unemployment rate) and adjusting policy to reach this in a systematic way. However, if this target is set at a non-natural rate, it cannot be reached and aggregate spending will be unstable, leading to accelerating inflation. Also, such a policy would be entirely predictable, making it ineffective under rational expectations.

Policy makers have become less ambitious about what can be achieved – now any targets are set with a policy of non-accelerating inflation, so targets must be realistic.

② Keep nominal aggregate spending as steady as possible

If nominal aggregate spending is steady, it reduces the severity of the business cycle, and makes the economy more efficient. The first of these follows from the ideas of unpredictable demand shocks outlined previously – if and only if aggregate spending is predictable, firms will not be fooled into thinking such shocks are industry-specific.

The second can be explained thus: if a shock occurs in the market Z that is a relative shock ($D1$ increases to $D2$), an efficient economy should produce more of good Z .

③ Avoid interfering in setting of prices and wages

This obviously follows from above. Any interference may not necessarily be aimed at the correct price level, and has the potential to unbalance the economy even further.