Issues in International Finance

Stabilization policy

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Roadmap

▶ Now

  ▶ Stabilization policy

  ▶ Solidify our understanding of IS-LM-FX

▶ Coming up

  ▶ Return to the fixed vs. flexible debate

  ▶ The gold standard, Bretton Woods, ERM

  ▶ Exchange rate crises / models

Stabilization policy

- ► Economies are constantly buffeted by "shocks"
    - ► Changes in technology
    - ► Changes in regulation
    - ► Changes in consumer/business confidence
    - ► Market bubbles
- ► These shocks change the components of goods/money demand
    - ► Shift IS/LM/FR
    - ► Change output, interest rates, exchange rates
- ► These shocks create recessions and expansions
- ► *Stabilization policy* is an effort to smooth out these shocks
    - ► Stable environment for long-term decision making
    - ► Smoother income $\rightarrow$ smoother consumption

Stabilization policy

- ▶ A target level of output (potential GDP)
  - ▶ This is closely related to "keeping the economy at full employment"
- ▶ Would like to minimize deviations (above or below) from target
- ▶ We have already seen how to model shocks in IS-LM-FX (PS#4, Q1, Q2)
- ▶ Stab. policy responds to shocks that move us away from target GDP
  - ▶ Look for policy that offsets shocks
- ▶ Which policy? Fiscal? Monetary?
  - ▶ Monetary policy more flexible and timely
  - ▶ Fiscal policy in deep recessions (otherwise set for long-term goals)
  - ▶ In fixed fx countries, monetary policy constrained (need fiscal)
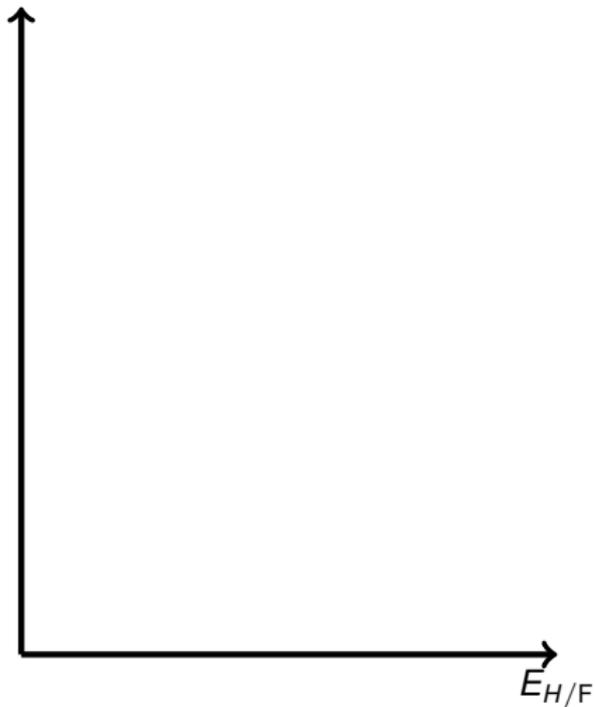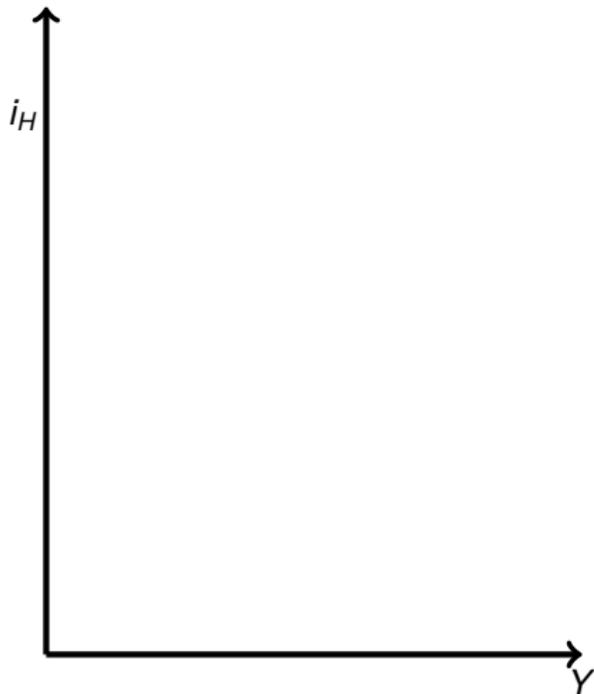
Stabilization policy in the model

► Typical scenario

  1. Country at target GDP level

  2. Shock arrives, knocks IS-LM off target GDP

  3. How would monetary policy respond? Fiscal policy? (fx regime?)

  4. Follow the effects of policy response

► Example: Potential repeal of ACA depresses stock market (lowering consumer wealth) and decreases investment opportunities in very large health care industry. Flexible exchange rate regime.

Decrease in *I*, *C*

IS-LM

FX market

i_H

Y

$E_{H/F}$

Problems with stabilization policy

▶ Seems pretty easy. Why do we have business cycles?

▶ **Policy constraints**: Fixed fx regimes; balanced-budget rules; politics; tax avoidance

▶ **Incomplete information**: Takes time to collect data; uncertainty over shock's cause

▶ **Lags**: Inside lag: time between shock and policy response. Outside lag: time between policy response and effect on markets. Lags are uncertain.

▶ **Policy efficacy**: Sometimes policy has a strong effect, sometimes a weak effect. Hard to predict. Depends on expectations, too.

Problems with stabilization policy in open economy

► What extra problems do we have in an open economy?

  ► In the model: $E \rightarrow q \rightarrow TB \rightarrow IS$

► **Nominal to real link**: Moving E doesn't always mean moving q. Extent of response of P to E (exchange rate pass through) weakens link. This is a related policy efficacy concern.

► **Real fx to TB link:** Response of TB to change in relative price depends on price elasticity (oil? beer?) and other factors (lock in) that affect ease of switching between foreign and domestic goods.

Stabilization in reality

► Monetary policy

    ► Incomplete information + lags + policy efficacy $\rightarrow$ policy response happens slowly and gradually

    ► https://fred.stlouisfed.org/graph/?g=m2nm

► Fiscal policy

    ► extreme lags + policy efficacy $\rightarrow$ used infrequently

    ► Difficult to spend money both quickly and efficiently

    ► Often tied up for political reasons

► Overall, monetary policy is in a better position to respond to short-run shocks. Most countries have settled on independent central bank for stabilization policy.

The limits of monetary policy

▶ The key to monetary policy is the interest rate

    ▶ Decrease *M*, increase *i*: hold less money, spend less today

    ▶ Increase *M*, decrease *i* hold less money, spend less today

    ▶ Shifts in LM

▶ Nominal interest rate cannot go below zero (why?)

    ▶ Call this the *zero lower bound*

▶ When $i = 0$ monetary policy no longer works

    ▶ Call this the *liquidity trap*

▶ Important role for fiscal policy

The liquidity trap

The liquidity trap

▶ Two prominent examples

    1. Japan in early 2000s

    2. United States (and most of world) in 2008–

▶ In both cases, real estate bubble collapse dramatically decreasing wealth. Over leveraged households and business cut back on consumption and investment, generating a large shift left in IS. Interest rates fall to zero.

▶ https://fred.stlouisfed.org/graph/?g=m2oW

The U.S. response

- ▶ American Recovery and Reinvestment Act (ARRA)

  - ▶ Initially to be $1.4 tril in extra government spending and tax cuts. Ended up being $787 bil.

  - ▶ Lags: Recession begins 2007Q4. ARRA signed into law Feb. 2009. Most stimulus started in 2010.

  - ▶ Very political process. Tea party wanted no new borrowing.

- ▶ ARRA not thought to be very effective

  - ▶ Total government spending did not change much

  - ▶ State and local governments cut back on spending about as much as federal government increased spending