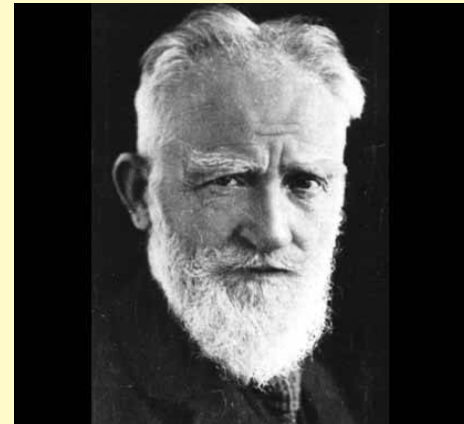
De-Mystifying
Monetary and Fiscal Policy

unemployment **inflation**

Positive vs. Normative Issues

George Bernard Shaw: "If all economists were laid end to end, they would not reach a conclusion."



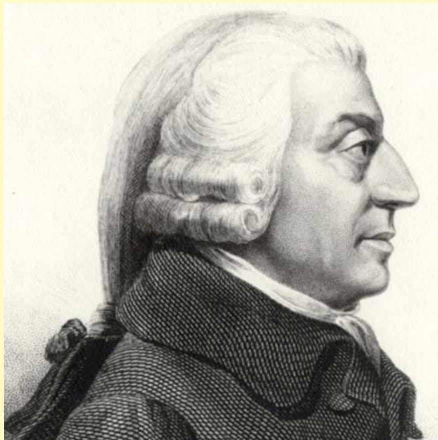
- It would be good if the Bank of Canada printed more money, since this would stimulate the economy and create jobs.

positive: ↑money → ↓unemployment & ↑inflation?

normative: ↓unemployment worth the ↑inflation ?

Basic Questions

- will the economy's self-correction mechanism eliminate recessions automatically?



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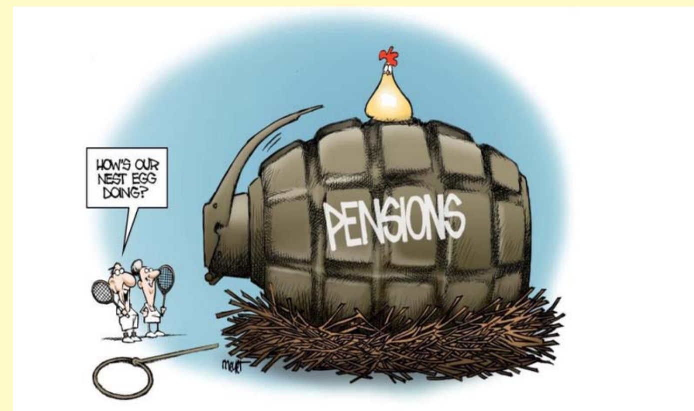
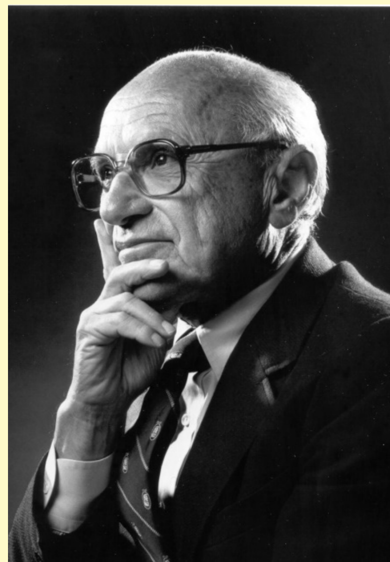
- if the Minister of Finance needs to respond, what are the benefits and costs?

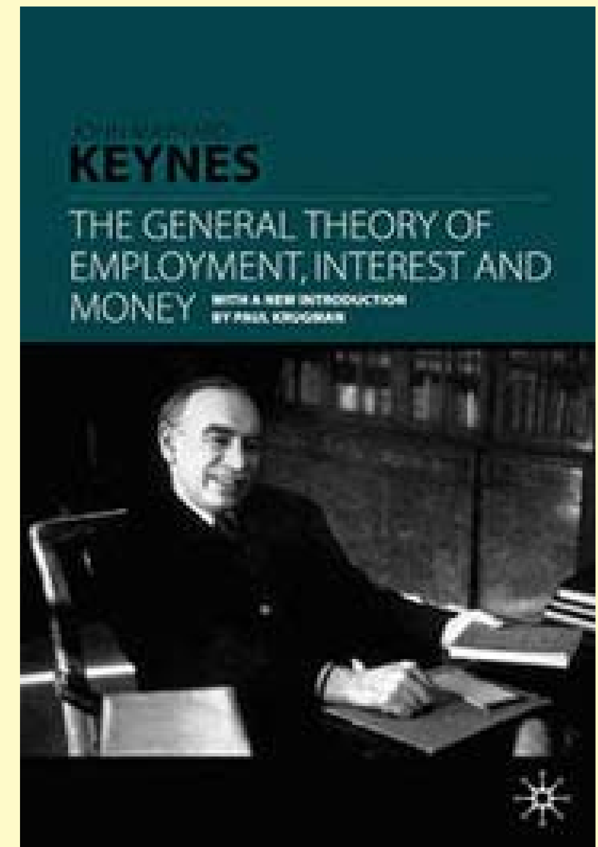


The Self-Correction Mechanism

- Can the economy's self-correction mechanism automatically eliminate recessions?
- Classical economists said "yes"
- Keynes said "no"

- consider GDP = total dollar output and income = (price)(quantity)





The Self-Correction Mechanism

total dollar output/income = GDP = (price)(output)

drop in demand (say exports) →↓GDP

prices set in short run →↓physical output

less output →↑unemployment

higher unemployment →↓wages

lower wages →↓prices

lower prices →↑demand for goods

original short-fall in demand is eliminated

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higher unemployment → ↓ wages   ↓ wages resisted

lower wages → ↓ prices   takes long time

lower prices → ↑ demand for goods

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why does lower price stimulate demand?

it makes relative price (P_c/P_{us}) lower

but not if P_{us} is falling too - if recession in US too

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what happens if falling price becomes expected?

some spending is postponed to wait for lower price

current demand can fall, so self-correction fails

Consensus View

- small shifts in demand – reply on self-correction "fine tuning" the economy is not possible

- if policy intervention is needed, the Bank of Canada should be our first line of defence
  - no implementation lags
  - no "lasting legacy" problem (no ↑ debt)
  - but - zero lower bound on interest rates

- if the Bank is constrained - the Minister of Finance should use fiscal (budgetary) policy

Monetary Policy

- central bank buys government bonds
- pays by issuing new money
- new currency adds to private bank reserves
- private banks loan out most of the new funds
- to ensure the loans wanted, banks lower interest rates
- Canadian interest rates drop temporarily below US rates, so savers withdraw funds from Canada
- Canadian dollar falls in value, exports rise, imports fall, overall demand increases, and Canadian economic activity rises

Monetary Policy

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How Might Monetary Policy Deal with the Zero Lower Bound?

- Quantitative Easing: bypass the banks by purchasing bonds and stocks issued by private firms
- Forward Guidance: promise to keep interest rates at zero for a long time
- Charge Interest on Bank Reserves: try to make interest rates go negative

Fiscal Policy

- Minister of Finance increases government spending or cuts taxes

- increases demand
- economic activity increases
- perhaps a “multiplier” effect

Fiscal Policy

- Minister of Finance increases government spending or cuts taxes

- increases demand
- economic activity increases   But:
- will new demand add to, or merely replace, pre-existing demand?
- will the resulting budget deficit have costs?

The Crowding Out Effect of Fiscal Policy

- Minister of Finance increases government spending or cuts taxes
- New government bonds must be issued to cover the resulting budget deficit
- to ensure the bonds are purchased, government offers higher interest rates
- Canadian interest rates rise temporarily above US rates, so international funds enter Canada
- Canadian dollar rises in value, exports fall, imports rise, demand for domestic goods is reduced, and Canadian economic activity falls
- Government demand just replaces net export demand

The Crowding Out Effect of Fiscal Policy

The "Coyne Affair"

- **Crowding out can be avoided by Bank of Canada keeping interest rates from rising**

  (Bank buys the newly issued bonds)

The Legacy Effect of Fiscal Policy - Debt

- **expansionary policy involves a budget deficit**
- **government needs to run a surplus later on – to retire the debt that was issued while running a deficit**
- **result:**

a smaller initial recession

but a slower recovery later

or big debt build-up followed

by years of austerity

National Debt

- why do we need to pay-down debt later ?

- government debt is an institution that lets generations that are not alive at the same time make trades

- but to do this, we need to have room to allow the debt level to rise when some bad event happens in the future

- history provides guidance

National Debt

Federal Government Debt/GDP ratio

1929 – 45%
1945 – 110%
1973 – 22%
1993 – 72%
2008 – 30%
2013 – 33%
today – 31%
target – 25-30% ??

Deficit and Debt Target Consistency

This years deficit is this year's increase in debt

This year's accumulated debt total is the sum of all past annual deficits since 1867

If we focus on ratios to GDP:

(deficit ratio) = (GDP growth rate)(debt ratio)

Deficit and Debt Target Consistency

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previous government:

0 vs (0.04)(0.25) inconsistent

current government:

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implied deficit (in dollars) today = $22 billion

implied deficit (in dollars) 2045 = $44 billion

Challenge for Zero-Deficit Fans

need to defend

- why zero debt is the best long-run target
- why eliminating government debt now is "more important" than addressing other challenges that involve similar short-term pain such as climate change and income inequality

Thanks for your attention