We have already looked at the long-term growth policies that the government can adopt. We shall now look at policies it can adopt with regard to its other concerns.

**Business Cycle & Unemployment Policy**

Many different fiscal & monetary policies may be adopted to stabilize the business cycle and combat unemployment. All such policies fall under 3 categories:

1. **Fixed-rule policies**
   
   These policies specify an action to be pursued independently of the state of the economy. Examples of fixed-rule policies are: To keep the quantity of money in the economy growing at a certain fixed percentage, regardless of the state of the economy. Another fixed-rule policy might be to balance the Federal Budget always.

2. **Feedback-rule policies**
   
   These policies specify actions dependent on the state of the economy. Examples: Adopting money growth rates, tax rates, etc., dependent on the state of the economy. Sometimes feedback rules are automatic: for example, increases or decreases in transfer payments to households dependent on whether the economy was in a recession or boom, respectively.

3. **Discretionary policies**
   
   These policies respond to the state of the economy in a possibly unique way, tailored to a particular situation, using all available information (including lessons from past ‘mistakes’). For example, given two feedback policies, say one that involves the use of fiscal policy & the other monetary policy, the government might use discretion to chose the fiscal policy tools over the monetary policy one.

**Stabilizing Aggregate Demand Shocks: Combating market pessimism (or loss of consumer confidence in the economy)**

(See Fig. 16.5, Parkin, page 394)

Let the economy start out at the full employment equilibrium. Then, due to a loss of consumer confidence or the pessimism about future profits on the part of firms, the level of demand in the economy falls and the demand curve shifts backwards. So we are now in an unemployment equilibrium.
Fixed-policy response

The government has economic advisors who are Monetarists,¹ and these advisors advocate a fixed-policy under which the government does nothing: Government purchases, taxes, and the quantity of money all remain constant.²

*Let us first consider a situation where the market pessimism is temporary.* (See Fig. 16.6, panel (a), Parkin, page 395).

In this case, since the pessimism is temporary, even with the government doing nothing the economy returns to the original equilibrium as consumer/firm confidence improves and the demand curve shifts back to its original level.

*Now we consider a situation where the market pessimism is permanent.* (See Fig. 16.6, panel (b), Parkin, page 395).

In this case, with the government doing nothing, the aggregate supply curve moves outwards as money wages decline in the long run (remember that we are in a situation of price decline here). The economy ends up in a full-employment equilibrium, with lower prices compared to the original equilibrium (which may not be great news from the firms’ point of view).

Feedback-policy response

The government has economic advisors who are Keynesians and these advisors advocate an activist feedback-policy under which the government adopts an expansionary monetary policy combined with increased government spending to combat market pessimism (i.e., policies are adopted in response to the observed situation that occurs in the economy). *Let the market pessimism be permanent.*

(See Fig. 16.6, panel (c), Parkin, page 395).

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¹ Monetarists are economists who believe that fluctuations in the quantity of money are the main sources of economic fluctuations. Monetarists would believe that economic depressions are caused due to a lower level of money supply in the economy than there should be. However, they would advocate a hands-off policy prescription as far as possible, rather than an activist monetary policy, since they believe that it is very difficult to measure/predict economic variables correctly. So, an activist monetary policy to increase employment might end up causing run-away inflation, and worsen the economic situation rather than improve it.

² Note though, that a fixed policy rule does not mean that the government does nothing in the economy. Increasing money supply at a fixed rate every year, irrespective of the state of the economy is a fixed rule policy too.
In this case the demand curve moves back to the original level (and the economy moves back to the original equilibrium) due to the activist policies adopted by the government. So the feedback policy does better compared to the fixed-policy rule in this case.

*Stabilizing Aggregate Supply Shocks: Combating a productivity growth slowdown*

Suppose, starting from a position of long-run equilibrium, the economy suffers a slowdown in the growth of productivity. This means that in the goods’ market, the long run supply curve shifts inwards, as the potential level of output falls (recall that we keep workers’ productivity constant when we draw the long run supply curve, so when that changes, the LAS will shift).

(See Fig. 16.7, Parkin, page 398)

[Parkin speaks of the Real Business Cycle theory here, which we have not studied. We can analyze this phenomenon without invoking the RBC theory: so just concentrate on the explanation in my lecture notes].

**Fixed-policy response**

The government follows a fixed policy rule, which involves doing nothing in this situation. The aggregate demand curve stays where it was originally, and the economy converges to a new long run equilibrium with higher prices and lower output.

**Feedback-policy response**

The government follows a feedback policy rule, which involves increasing government purchases as a response to the fall in output. This shifts up the aggregate demand curve from its original level. However, in this case the economy converges to a new long run equilibrium in which output is the same compared to the fixed-policy situation, but the price level is higher. So the feedback policy does worse compared to the fixed-policy rule in this case.

**Anti-Inflation Policy**

There are two inflation policy problems. In times of price stability, the goal is to stop inflation from breaking out. In the times of inflation, the problem is to reduce its rate and restore price stability.

Avoiding demand-pull inflation is the flip side avoiding demand-driven recession, so it is achieved by stabilizing aggregate demand. So the business cycle and unemployment
policies we have discussed above can be suitably modified into anti demand-pull inflation policies.

We shall now look at two inflation policy concerns:

1. Avoiding cost-push inflation
2. Slowing down an inflationary process

Avoiding Cost-Push Inflation: Combating an oil-shock

As we have seen earlier, starting from a position of long run full employment equilibrium, a rise in an input (oil) price that increases firms’ costs would shift the SAS curve leftwards, leading to stagflation in the economy.

Fixed-policy response

The government follows a fixed policy rule, which involves doing nothing in this situation. With unemployment in the economy, given a long enough period of time (over which re-contracting of wage agreements is possible and the money wage becomes flexible) the money wage rate will eventually fall. Also, the low level of GDP and low sales might bring a fall in the price of oil. This would shift back the SAS to its original level. This whole process, however, might take a long time and various economic agents might be worse off in between.

(See Fig.16.8, panel (a), Parkin, page 400)

(Recall one of our early discussions regarding the fact that the ideological positions of various economists may be thought of as arising from their different beliefs regarding the length of this adjustment process).

Feedback-policy response

Let the government follow a Keynesian feedback policy rule that involves an activist fiscal and monetary policy in case of a supply shock. The question is here is that whether this is an effective policy, if the government is interested in controlling inflation? Clearly it is not. The government’s policy shifts up the aggregate demand curve: this restores full employment, but leads to a price rise. More significantly, it clears the deck for another round of price increase on the part of the oil producers (Recall our discussion of a cost-push inflation spiral). The government’s policy might lead to an upward spiraling price level over time.

(See Fig.16.8, panel (b), Parkin, page 400)
**Slowing Down Inflation**

How can an inflationary process be cured, once it has started? We shall look at 2 cases:

1. A surprise inflation reduction
2. An announced credible inflation reduction

**A surprise reduction in inflation**

We shall study the problem of lowering inflation in the economy using both the AD-AS analysis, as well as the Phillips curve analysis.

(See Fig.16.9, Parkin, page 402)

Suppose the economy is at the full employment level with the inflation rate at 10%. In the goods market diagram, this equilibrium is given by the intersection of the LAS, AD 0 & SAS 0. (See Fig.16.9, panel (a), Parkin, page 402).

Equivalently, in the Phillips curve diagram, the economy is at the intersection of the LRPC & SRPC 0. The inflation rate of 10% is anticipated, so unemployment is at its natural rate. (See Fig.16.9, panel (b), Parkin, page 402)

Now suppose next year aggregate demand is expected to increase to AD 1, and this invokes a supply-side response (by workers who demand more money wages on the basis of the expected inflation that this increase in demand would bring about, which in this case is the going inflation rate of 10%). However, if the government surprises economic agents by reducing the supply of money in the economy, then the demand curve might not shift as much. Suppose it shifts up to AD 2, which lies in between AD 0 & AD 1. This will mean that the price level in the economy will not increase as much as if the demand curve had shifted to AD 1, but we will have a situation of output falling below its potential level. Thus, the government has managed to control the rise of the price level in this economy at the cost of creating unemployment.

(See Fig.16.9, panel (a), Parkin, page 402)

In the Phillips curve diagram, we see that since the actual inflation rate has fallen below the expected rate, we have an increase in the unemployment from the NRU.

(See Fig.16.9, panel (b), Parkin, page 402)

**An announced credible reduction in inflation**

Suppose the government were to announce the monetary policy discussed above beforehand to agents in the economy, in a way that it is believed. Then the supply curve
in the AD-AS framework above would not shift back to SAS 1 (as in the above case), but would shift less backwards to SAS 2 (as workers are now satisfied with a lower increase in their money wages) in keeping with the actual shift in aggregate demand to AD 2. In this case GDP would remain at potential GDP, and the price rise is going to be lower than in the surprise policy case above. The main difficulty here is for the government to make a credible (believable) commitment, since if the supply curve shifts back to SAS 2, then it would be tempted to adopt an even tighter monetary policy to control inflation even further: and other economic agents know that.

(See Fig.16.9, panel (a), Parkin, page 402)

In terms of the Phillips curve analysis, a credible commitment shifts the short run Phillips curve by changing the expected inflation rate. Thus, we are still on the LRPC (& hence at the NRU, but with a lower inflation rate.

(See Fig.16.9, panel (b), Parkin, page 402)