Global Economic Issues and Policies

Chapter 13
Rules versus Discretion—Can Policymakers Stick to Their Promises?

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PowerPoint Presentation by Charlie Cook
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1. What are the ultimate goals of policymakers in open economies?

2. What are the main problems with discretionary policymaking?

3. Why is policy credibility a crucial factor in maintaining low inflation, and how might nations attain policy credibility?

4. What is structural interdependence, and how can it lead nations to cooperate or to coordinate their policies?
Fundamental Issues

5. What are the benefits and costs of international policy coordination?

6. Could nations gain from adopting a common currency?
Policy Goals in Open Economies

• Ultimate Goals
  ➢ The final objectives of national economic policies.

• Internal Goals
  ➢ Inflation objectives
  ➢ Output goals
  ➢ Employment goals

• External Goals
  ➢ Attainment of various objectives related to the conduct of international commerce.
Policy Goals in Open Economies (cont’d)

• Mercantilism

  A view that a primary determinant of a nation’s wealth is international trade and commerce, so that a nation can gain by enacting policies that spur exports while limiting imports.
<table>
<thead>
<tr>
<th>Type of Cost</th>
<th>Cause</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resources expended to economize on money holdings (more trips to banks, etc.)</td>
<td>Rising prices associated with inflation</td>
</tr>
<tr>
<td>Costs of changing price lists and printing menus and catalogs</td>
<td>Individual product/service price increases associated with inflation</td>
</tr>
<tr>
<td>Redistribution of real incomes from individuals to the government</td>
<td>Inflation that pushes people into higher, nonindexed nominal tax brackets</td>
</tr>
<tr>
<td>Reductions in investment, capital accumulation, and economic growth</td>
<td>Inflation variability that complicates business planning</td>
</tr>
<tr>
<td>Slowed pace of introduction of new and better products</td>
<td>Volatile price changes that reduce the efficiency of private markets</td>
</tr>
<tr>
<td>Redistribution of resources from creditors to debtors</td>
<td>Unexpected inflation that reduces the real values of debts</td>
</tr>
</tbody>
</table>
Rules versus Discretion in Economic Policymaking

- **Discretionary Policymaking**
  - The act of responding to economic events as they occur, rather than in ways it might previously have planned in the absence of those events.

- **Policy Rule**
  - A commitment to a fixed strategy no matter what happens to other economic variables.
Rules versus Discretion in Economic Policymaking (cont’d)

• Policy Time Lags
  - Time intervals between the need for a countercyclical monetary policy action and the ultimate effects of that action on an economic variable.

• Policy-Making Constraints
  - Limited information, particularly in the presence of time lags, about current events.
  - Inability to recognize and respond appropriately to changing circumstances.
  - Lack of certainty about the actual effects, and timing of those effects, on policies that they may enact.
Time Lags and Rules Versus Discretion

- **Recognition Lag**
  - The interval between the need for a countercyclical policy action and the recognition of this need by a policymaker.

- **Response Lag**
  - The interval between the recognition of a need for a countercyclical policy action and the actual implementation of the policy action.

- **Transmission lag**
  - Time between implementation of a countercyclical policy and its effects on an economic variable.
Policy Goals and the Inflation-Output Trade-Off

• Game Theory
  - The theory of strategic interactions among individuals or institutions.
    - Assumes target output should equal capacity output.
    - Assumes policymakers prefer to keep down inflation.

• Capacity Output
  - The real output that the economy could produce if all resources were used to their utmost.
Figure 13-1  Inflation in Selected Nations

Source: International Monetary Fund, World Outlook, various issues; IMF and authors’ estimates for 2001 and 2002.

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Credibility and the Inflation Bias of Discretionary Economic Policy

• Inflation Bias

- The tendency for the economy to experience continuing inflation as a result of discretionary monetary policy that takes place because of the time inconsistency problem of monetary policy.
Figure 13-2  The Inflation Bias of Discretionary Monetary Policy

A = Commitment Policy Equilibrium
C = Discretionary Policy Equilibrium

Price Level

Inflation Bias

Real Output

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Figure 13-3  Inflation Rates and Unemployment Benefit Levels in Selected Nations


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Establishing Policy Credibility

• Policy Credibility
  ➢ The believability of a commitment by a central bank or governmental authority to follow specific policy rules.

• Time Inconsistency Problem
  ➢ A policy problem that can result if a policymaker has the ability, at a future time, to alter its strategy in a way that is inconsistent both with the desires and strategies of private individuals and with its own initially announced intentions.
Establishing Policy Credibility (cont’d)

• Possible Solutions to the Credibility Problem
  ➢ Enacting constitutional limitations on monetary policy.
  ➢ Maintaining credibility through reputation.
  ➢ Having a “conservative” Central Banker.
  ➢ Establishing a politically and economically independent Central Bank.
Establishing Policy Credibility (cont’d)

• Conservative Central Banker
  ➢ A central bank official who dislikes inflation more than an average citizen in society and who thereby is less willing to induce discretionary increases in the quantity of money in an effort to achieve short-run increases in real output.

• Central Banker Contract
  ➢ A legally binding agreement between a government and a central banking official that holds the official responsible for a nation’s inflation performance.
Figure 13-4  Central Bank Independence, Average Inflation, and Inflation Variability


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Policymaking in an Interdependent World

• Structural Interdependence
  ➢ The interconnectedness of national markets for goods, services, and financial assets causes events in one nation to affect the economies of other nations.

• International Policy Externalities
  ➢ Spillover benefits or costs that policy actions within one nation have for the economies of other nations.

• Locomotive Effect
  ➢ Economic activity in one nation stimulated by increased economic activity in another country.
Policymaking in an Interdependent World
(cont’d)

• Strategic policymaking
  - The formulation of national policies in light of the structural linkages among nations and the ways in which policymakers in other nations make decisions.
Accounting for Interdependence: International Policy Cooperation and Coordination

- **International Policy Cooperation**
  - The development of institutions and procedures through which central banks share data and inform one another about their policy objectives and strategies.

- **International Policy Coordination**
  - The joint determination of monetary policies by a group of central banks for the intended combined benefit of the nations they represent.
Potential Benefits of International Policy Coordination

• Internalizing International Policy Externalities.
  - The act of coordinating policies for the mutual benefit of a group of countries effectively requires the nations’ policymakers to behave as if their countries were a single entity.

• Getting the Most Out of Policy Instruments.
  - If national policymakers have few policy instruments but related goals, then by working together the policymakers potentially could come closer to achieving their multiple objectives.
Potential Benefits of International Policy Coordination (cont’d)

• Gaining Support from Abroad
  ➢ Policymakers in various countries might gain additional strength to withstand domestic political pressures by banding together with other policymakers.
Potential Drawbacks of International Policy Coordination

• Policy Coordination May Entail National Sacrifice.
  ➢ A nation’s citizens and leaders must willing to give up some degree of sovereignty to pursue international objectives along with purely domestic goals.

• Other Countries May Not Be Trustworthy.
  ➢ Each nation’s commitment to an international policy coordination arrangement must be credible to other participating nations.
### Hypothetical Welfare Levels for Two Nations with and without Policy Coordination

<table>
<thead>
<tr>
<th>Country A Does Not Coordinate</th>
<th>Country B Does Not Coordinate</th>
<th>Country A Coordinates</th>
<th>Country B Coordinates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Welfare = 150</td>
<td>Total Welfare = 175</td>
<td>Total Welfare = 175</td>
<td>Total Welfare = 200</td>
</tr>
</tbody>
</table>
Potential Drawbacks of International Policy Coordination (cont’d)

- Other Policymakers Could Be Incompetent.
  - A nation must have confidence that other countries’ policymakers will honor the coordination agreement and have the ability to do their jobs effectively.

- “Successful” Coordination Can Sometimes Be Counterproductive.
  - Even if nations agree to coordinate, stick to their agreement, and determine their policies taking joint welfare into account, there is still the possibility that in the end their residents could be worse off.
Optimal Currency Areas and Monetary Unions

• Monetary Union
  - A set of countries that choose to use a common currency.

• Theory of Optimal Currency Areas
  - An approach to determining the size of a geographic area within which residents’ welfare is greater if their governments fix exchange rates or adopt a common currency.
Optimal Currency Areas and Monetary Unions (cont’d)

• The Advantage of Separate Currencies and a Floating Exchange Rate
  
  Adopting individual currencies and a floating exchange rate protects trading nations from unemployment dangers that arise from language, cultural, or legal barriers to worker migration.
Optimal Currency Areas and Monetary Unions (cont’d)

• When Could Nations Benefit from Using a Single Currency?
  
  ➢ Separate regions may find it beneficial to adopt a common currency if the cost of converting currencies for regional trade exceeds any perceived gain from having separate currencies.
Optimal Currency Areas and Monetary Unions (cont’d)

• Optimal Currency Area

  A geographic area within which labor is sufficiently mobile to permit speedy adjustments to payment imbalances and regional unemployment to permit exchange rates to be fixed and a common currency to be adopted.