Econ 1: The Four Topics of Macro...

J. Bradford DeLong, Lanwei Yang, etc.

April 23, 2012
Unemployment

Civilian Unemployment Rate (UNRATE)


2012 research.stlouisfed.org
• We see, therefore, that rising prices [inflation] and falling prices [deflation] each have their characteristic disadvantage. The Inflation which causes the former means Injustice to individuals and to classes--particularly to investors; and is therefore unfavorable to saving. The Deflation which causes falling prices means Impoverishment to labor and to enterprise by leading entrepreneurs to restrict production, in their endeavor to avoid loss to themselves; and is therefore disastrous to employment....
• Thus Inflation is unjust and Deflation is inexpedient. Of the two, perhaps Deflation is, if we rule out exaggerated inflations such as that of Germany [in 1923-1924], the worse; because it is worse, in an impoverished world, to provoke unemployment than to disappoint the rentier. But it is not necessary that we should weight one evil against the other. It is easier to agree that both are evils to be shunned...
Growth

Nonfarm Business Sector: Real Compensation Per Hour (COMPNHFB)

(Percent Change from Year Ago)


2012 research.stlouisfed.org
The Government’s Budget

• Unlike depression, inflation, and growth, not an immediate matter of concern for itself
• But of concern because it influences depression, inflation, and growth
• Positive and negative influences
  – Government spending boosts productivity
  – Government deficits pull wealth forward from future taxpayers to present citizens (and investors gain)
  – Government deficits provide safety and risk-spreading
    • As do social insurance programs
  – Government deficits place a drag on the economy
Economics 1: Inflation Economics

J. Bradford DeLong, Lanwei Wang, etc...

April 23, 2012
Logistics

• No Friday 11 AM Wheeler Auditorium “Office Hour” this week
• Problem Set 9 due at review lecture to your GSI on April 30
• Sample final out...
• Thoughts on course:
  – Email me at delong@econ.berkeley.edu
The Phillips Curve II

- \( \pi = E(\pi) + \beta(u* - u) \)
- Usually \( u^* \) will be stable (say, 5% in the U.S. today)
  - Sometimes not: varieties of “structural” unemployment
- Usually \( E(\pi) \) this year will pretty much be just what inflation was last year
  - But sometimes not
    - President Mitterand of France at the start of the 1980s
The Unemployment Rate and the Change in Inflation

Change in Inflation, 1959-2009
The Federal Reserve System

• The Federal Reserve Board
  – Chair (4-yr term)
  – Vice Chair (4-yr term)
  – Four members

• The FOMC
  – Chair of Fed is Chair of FOMC
  – President of FRBNY is Vice Chair of FOMC
  – Six FRB members are voting members of FOMC
  – Eleven other regional bank presidents
    • Four of whom vote in any given year
The Federal Reserve

- Moves by consensus
- Was scarred by the inflationary episode of the 1970s
- Was further scarred by the depth of the recession of the 1982 “Volcker disinflation” downturn
- Is outside of its comfort zone right now
Normal Federal Reserve Procedures

- Increase the money supply by buying short-term U.S. Treasury bonds for cash
- Decrease the money supply by selling short-term U.S. Treasury bonds for cash
- Occasionally loan via the “discount window”
- Clear checks
- Regulate banks
  - The money multiplier $\mu$: how many dollars of liquid checking account deposits are banks willing to make for each dollar of bank reserves $R$?
Hyperinflation

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Mugabe vs Milosevic

Sources:
- Steve Hanke, (ZWD/USD) and Imara Asset Management Zimbabwe
$Z100,000,000,000,000
Econ 1: Budget Economics

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April 23, 2012
The National Debt
Federal Spending and Revenue: History and Near Future

Summary Figure 1.
Total Revenues and Outlays
(Percentage of gross domestic product)

Source: Congressional Budget Office.
The “Current-Law Baseline” Is Close to Balanced

- Primary fiscal gap of 1.2% of GDP over the next 25 years
- But the CBO does not believe congress and the president will stick to the current-law baseline
  - “Middle class” tax cuts (0.7%)
  - High bracket tax cuts, estate tax, etc. (0.6%)
  - “AMT fix” (0.3%)
  - “doc fix” (0.2%)
  - R&D credit (0.1%)
  - Special tax on high-cost health plans (0.8%)
  - iPAB (0.9%)
- Alternative fiscal scenario: primary fiscal gap of 4.8% of GDP
Deficits and the Economy

• Macroeconomists work in three runs:
  – Short run
    • Productive capabilities of the economy do not change significantly, prices do not fully adjust. Production can deviate from potential output.
  – Medium run
    • Short-run deviations of production from potential output are ironed out. Prices adjust so inflation finds its level. Economy grows.
  – Long run
    • Government debt must be paid back (or at least balanced) or defaulted upon
Questions About “Runs”

• What is the time frame appropriate for each “run”?
• How do we stitch the conclusions reached by analyzing different “runs” together?
The Short Run: What Is to Be Done in Depression?

• Normally the Federal Reserve boosts the money supply, and people spend more
• The Federal Reserve can try all kinds of expedients—non-standard monetary policy—to try to cajole people into spending more
• Or the government can spend more: the government’s money is, as far as buying stuff, as good as anybody else’s
  – So in the short run—which lasts as long as unemployment is substantially elevated—the government should spend more
  – And perhaps the government should tax less as a way of cajoling private-sector households to spend more—but that is less certain and sure
The Short Run: How Long Will It Last?

Civilian Unemployment Rate (UNRATE)

The view from the unemployment rate: we are making progress and will be back to normal by 2016

FRED and 2012 research.stlouisfed.org
The Short Run: How Long Will It Last?

The view from the employment rate: already a lost half decade; we are flatlining; we are looking forward to a lost decade or decades; the "short run" could last for a generation.
Reconciliation of Unemployment and Employment Views

- The transformation of cyclical into structural unemployment
- Come 2016, we may no longer be able to use policies to boost employment and production without incurring unacceptable increases in inflation
- Why? Because once people have dropped out of the labor force, it may be hard to get them back.
- Each month that the strong recovery we have been waiting for is delayed:
  - We lose $100 billion in useful commodities we would be producing at full employment, but aren’t.
  - We lose $267 billion because the fact that people are dropping out of the labor force means that our future booms will be weaker
The Medium Run

• Someday our period of elevated unemployment will end
  — Then $Y = Y^*$
• The equation we then want to look at is the full-employment national income identity
  — $Y^* = C(Y - T) + I + G + (NX)$
• If we boost $G$, we should then also take steps to reduce $C$ by raising $T$
• If not, then $I$ will fall
• And if $I$ falls, economic growth over any five or ten year span will fall
• And right now it looks as though we don’t have economic growth to spare
The Medium Run: Baseline and Alternative Fiscal Scenario Deficits

Deficits or Surpluses (Percentage of GDP)

- Actual
- Projected
- CBO's Baseline Projection
- Alternative Fiscal Scenario

Baseline and Alternative Fiscal Scenario Debts Held by the Public

Federal Debt Held by the Public Projected in CBO's Baseline and Under an Alternative Fiscal Scenario

(Percentage of gross domestic product)

Source: Congressional Budget Office.

Note: The alternative fiscal scenario incorporates the assumptions that all expiring tax provisions (other than the payroll tax reduction), including those that expired at the end of December 2011, are instead extended; that the alternative minimum tax is indexed for inflation after 2011 (starting at the 2011 exemption amount); that Medicare's payment rates for physicians' services are held constant at their current level; and that the automatic enforcement procedures specified by the Budget Control Act of 2011 do not take effect. The budgetary effects under the alternative fiscal scenario also include the incremental interest costs associated with projected additional borrowing.
Is Running the Debt-to-GDP Ratio Up to 92% Over the Next Decade a Catastrophe? No

The bond market doesn't think it is a problem.
The Long Run: Beyond 2020

Federal Debt Held by the Public

Percentage of GDP

Actual
Projected

Alternative Fiscal Scenario
Extended-Baseline Scenario
Beyond 2020...

- Either we fix our politics
  - I.e., stick to PAYGO
  - Milton Friedman’s “A Program for Fiscal Stability” proposal in the early post-WWII years that no government spending program be passed without a funding source
- Or—if we continue to (a) have and (b) elect the Republican Party we have had since 1980—we have a big problem
And at Some Point the Bond Market Vigilantes Will Show Up, and Force Us

The bond market vigilantes, come to kill us all, crest the horizon...
But We Don’t Have to Worry Until the 2020s or 2030s, Right? Right?

The long run comes when the bond market says it comes... The long run comes when the bond market says: "show us the money"...