

Outline

1. Stabilization "reasons not to stabilize"

- (a) Data problems.
 - (b) Lucas Critique.
 - (c) Time Consistency. "New" Idea.
- } information.

Maastricht Treaty.

Countries in Europe are not allowed to have big deficit.

$$(G - T)/Y \leq 3\%$$

Principle: "doing what seems to be the optimal thing can get you into trouble" when the optimal plan is "time inconsistent".

Examples:

{ Homework (studying for midterm)
Smoking
Drugs
Saving

Terrorism

Taxes

Monetary Policy. Expectation Traps.

(d) Inflation: Monetary thing.

(e) Discussion of high inflation of 1970's.
Great big Expectation trap.
Arthur Burns.

2. Open Economy

Exchange rates, appreciation, depreciation.

Often the decision, PLAN Looks
Like this:

	today/now	tomorrow	later	...
decision today	x	y	y	y
optimal ton.		x	y	y y
optimal day after			x	y y

Danger: x x x x x . . .

Midterm

today	x = party	y = study	y = study	y = study . . .
ton.		x = party	y = study	y = study.

Danger/ton: ~~x~~ = party party party . . .

Smoking

today	x = smoke	y = quit	y = quit, . . .
ton.	x = smoke,	y = quit, . . .	

Saving

x = VACATION, CAR, Nice	y = SAVE	y = SAVE . . .
	x = VACATION	y = SAVE, . . .

x, x, x, . . .

Solution :

tie your hands
a little. Don't
use discretion.
Imitate a robot a
little.

homework : Commit to doing presentation
to study group.

Stoking: patch

Terrorism. hijack airplane.

$x = \text{negotiate}$, $y = \text{don't negotiate, ...}$

$x = \text{negotiate}$, $y = \text{don't negotiate}$

~~x~~, negotiation, ...

Law : illegal for any official to negotiate.

tie your hands.

Taxes

$x = \text{don't tax}$, tomorrow $y = \text{tax}$,

don't don't tax, ...

Pass Balanced Budget Law.

Solution :

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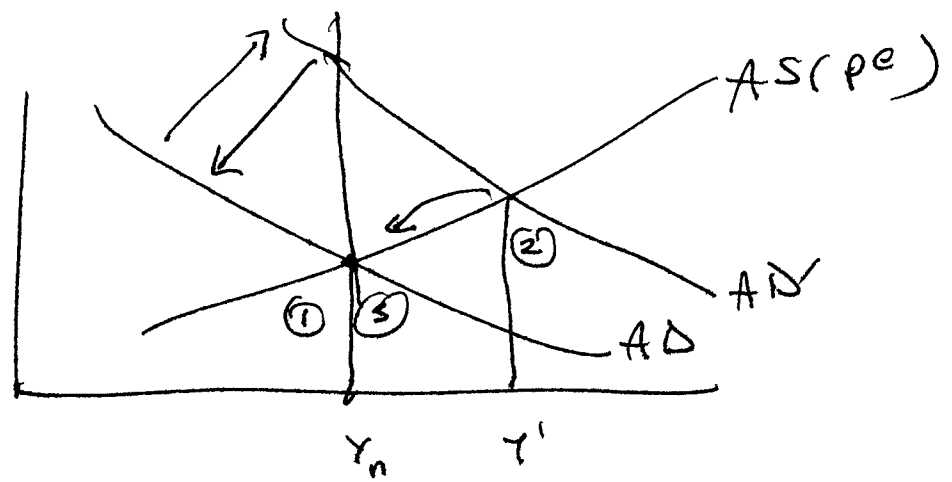
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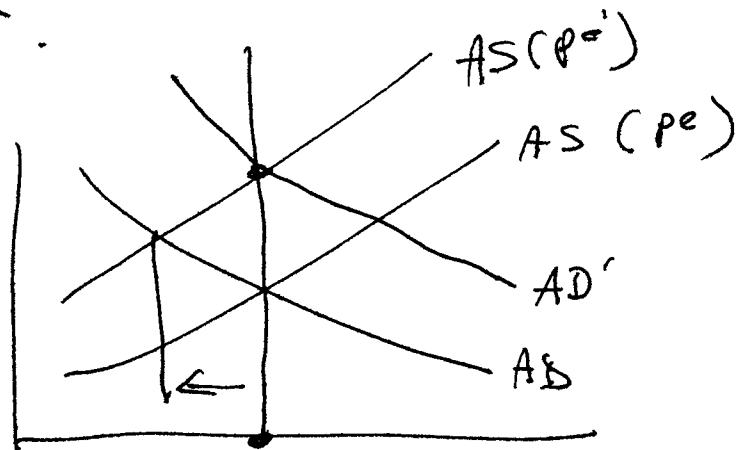
$x = \pi$ high

$y =$ or low again
in the future.

Optimal policy not time consistent

Now	x	y	y	y	y	y
Later when at (3)	x	y	y	y	y	y

Public understands what is going on,
so, $p^e \uparrow$.



C.B. which does "optimal thing",
because this is likely to be
time inconsistent, will create
expectation p^e , (p^e), then,
raise M over & over, just
to prevent output from falling.

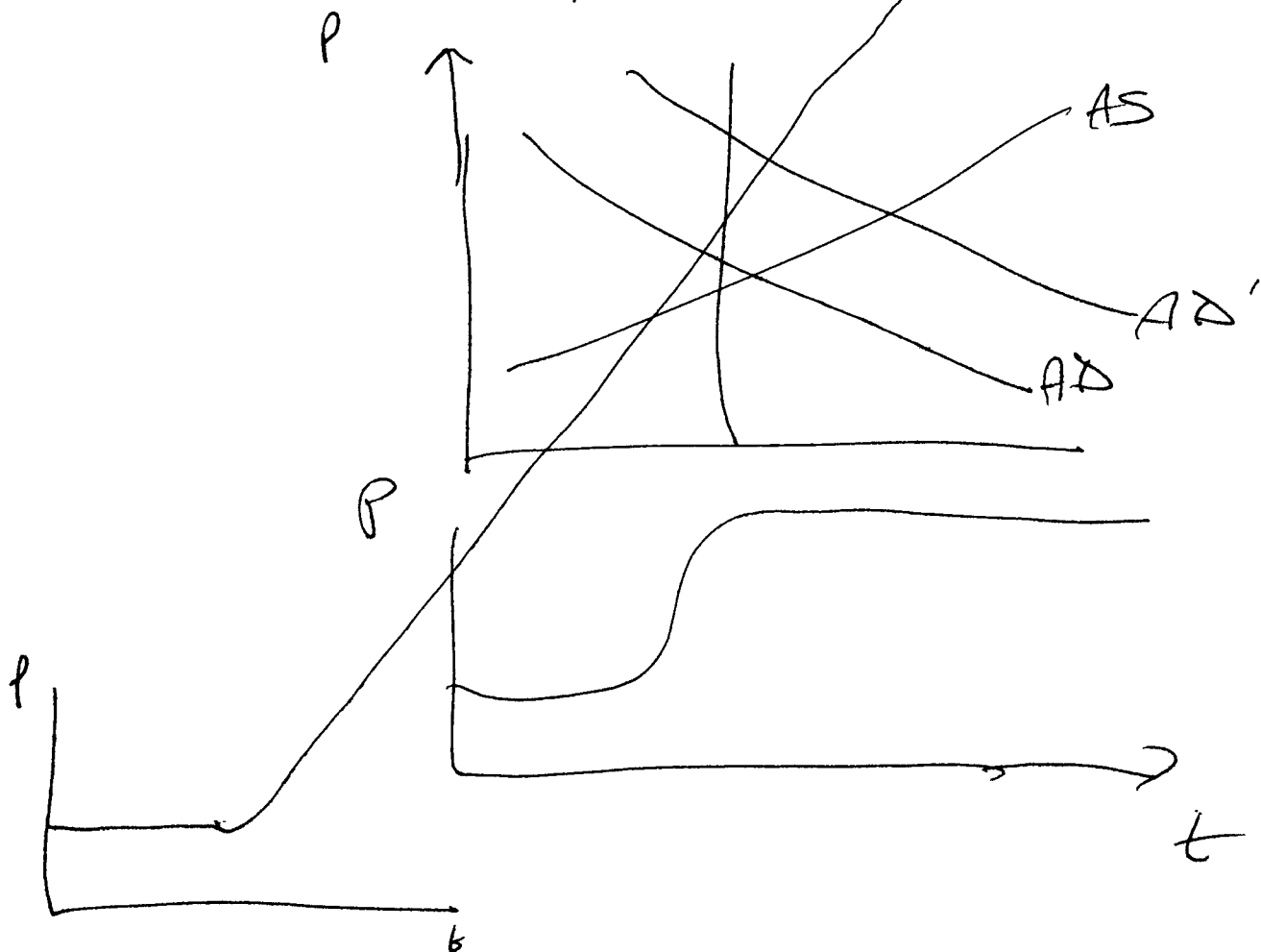
Bad outcomes perpetual rise in
 P , No improvement on Y .

Solution in monetary: don't
tinker with economy.

Name for the situation where
 $P^e \uparrow \Rightarrow$ monetary authority
feels compelled to
accommodate

Expectation

TRAP



Arthur Burns, Chairman of Federal Reserve During 1970s Inflation

Burns thought that the inflation of the 1970s was VERY costly

Commencement address, Jacksonville University, Jacksonville, Fla., August 13, 1977.

"Debasement of the currency had a great deal to do with the destruction of the Roman Empire. In our own times, excessive creation of money has released powerful inflationary forces in many countries around the globe. And once a nation's money is debauched, economic stagnation and social and political troubles usually follow."

Burns understood that inflation was caused by the Fed creating too much money, but he felt that simply stopping money creation was too costly. In our terminology, he felt he was caught in an 'expectation trap'.

"Some of you in this audience may be wondering, I suspect, whether the Federal Reserve may not have something to do with the inflation we have been experiencing. It may fairly be asked: Has not the Federal Reserve been creating too much money? And may not this be one of the causes of our inflation?...Neither I nor, I believe, any of my associates would quarrel with the proposition that money creation and inflation are closely linked and that serious inflation could not long proceed without monetary nourishment. We well know--as do many others--that if the Federal Reserve stopped creating new money, or if this activity were slowed drastically, inflation would soon either come to an end or be substantially checked. Unfortunately, knowing that truth is not as helpful as one might suppose. The catch is that nowadays there are tremendous nonmonetary pressures in our economy that are tending to drive costs and prices higher..[Note: here Burns had in mind the strong wage increases workers were receiving because of the general expectation that inflation would continue]..If the Federal Reserve then sought to create a monetary environment that seriously fell short of accommodating the nonmonetary pressures that have become characteristic of our times, severe stresses could be quickly produced in our economy. The inflation rate would probably fall in the process but so, too, would production, jobs, and profits. The tactics and strategy of the Federal Reserve System--as of any central bank--must be attuned to these realities."

How to avoid getting caught in an expectation trap:

Central bank must stress that it is only interested in controlling inflation, and not in stabilizing the economy. This is done in the US, but is not entirely credible because of 'dual mandate' on Fed: maintain 'full employment' and low inflation.

European Central Bank: it has a single mandate – keep inflation low.

US is more vulnerable to expectation trap than Euro Area.