**Aim: What are the costs of fiscal vs. monetary policy**

**Topic: Policy Lags**

**Document #1: Policy Lags**

1. **Inside lag (also known as implementation lag):** The amount of time it takes policy makers to recognize the policy and take action. This includes the **recognition lag** (amount of time it takes to recognize the problem), and the **decision/response lag** (amount of time it takes to come to agreement to implement a policy.

 **ii**. **Shorter for Monetary Policy** (about one quarter or 3 months)because:

 1) small board of people discussing policy.

 2) When the Open Market Committee decides on a particular policy, policy can happen quickly (buying of securities)

 **ii. Longer for Fiscal Policy because:**

 1) Needs to be discussed and debated in both houses of legislative branch (3-6 months for recognition of economic problem, then at least 1 quarter to a year to decide on/implement policy).

**B. Outside lag (also known as impact or transmission lag):** The amount of time it takes for the policy to have an effect on the economy.

**i. Shorter for Fiscal Policy** (immediately, with recovery in estimated 6-12 months) because:

 1) since it has been debated and discussed so much, people are ready to respond to it.

 2) Tax change: felt within a year’s time

 3) Expenditure change: felt almost immediately

**ii. Longer for Monetary Policy** (long and variable) because:

 1) works through changes in the money supply and circulation of money

 2) works through changes in interest rates

 3) works through the response of investment and consumption

1. **What is the difference between an inside lag and outside lag?**

**2) Which policy has a longer inside lag? Why?**

**3) Which policy has a longer outside lag? Why?**

**4) Based on the concepts of lags, which policy do you think is best to use for economic problems? Why?**

**Document #2: Three Problems for Fiscal Policy**

**1. Recognition lag** - time to recognize that there is a problem that needs correction. Recession is two consecutive quarters of neg. real GDP growth. Suppose growth in the first quarter (Jan - Mar) is neg., and growth in the second quarter (Apr - June) is negative. But there is a three month lag period to get the final statistics. Therefore, the final estimate of real GDP in second quarter isn't released until October 1. We don't know until October that the economy was in recession back in January.

**2. Decision/Administrative/legislative Lag** - time to enact a policy to correct the course of the economy. Fiscal policymakers have to pass legislation to increase/decrease taxes, increase/decrease the deficit, etc. Both the House and Senate have to agree, has to be signed by the president, could be a veto, etc., which means it takes an indefinite amount of time to be enacted.

**3. Impact lag** - time for a change in fiscal policy to affect the economy. Even after the legislation is passed, there may be a 6-12 month period before the legislation actually affects the economy.

*Problem:* for fiscal policy to really be effective, policymakers would have to know more than a year in advance what was going to happen to the economy.  If we somehow knew now that there would be a recession in early 2013 and that the proper tax stimulus package would help the economy, we would have to start preparing legislation now that would pass in the middle of 2012 and would start to stimulate the economy in early 2013. How likely is that? Economic conditions are very hard to forecast accurately.

*Danger:* because of the problems with lags, and because fiscal policy does not work instantly, expansionary fiscal policy may take effect when the economy has already self corrected, and instead of stabilizing the economy, it will de-stabilize the economy.

**How can they destabilize the economy?**

The goal of stabilization policies is to stabilize the business cycle, to counter contractions and expansions. However, policy lags can actually make stabilization policies destabilizing. That is, they can worsen the ups and downs of the business cycle.

For example, if the impact of expansionary fiscal policy is not seen for a year or more after the onset of a business-cycle contraction, then the stimulation might occur during the ensuing expansion, which can then overstimulate the economy and cause inflation.

Alternatively, the impact of contractionary monetary policy designed to reduce inflation created during an expansion might not occur until the onset of an subsequent contraction. In both cases, the resulting policy is not counter-cyclical, but pro-cyclical. The policies reinforce and thus destabilize the business cycle.

**1) Which of these do you think is the worst problem for fiscal policy? Why?**

**2) How does the lack of ability to predict affect lags and creating effective fiscal policy?**

**3) How can lags lead to destabilization of the economy?**

**4) How would classicists use lags to justify their philosophy? Would you agree/disagree?**