Hi, welcome to macroeconomics. This is Kate. This tutorial is on the pros and cons of monetary and fiscal policy. As always, my key terms are in red, and my examples are in green.

So in this tutorial, we will look at the pros and cons of both monetary and fiscal policy. So let's get started.

You've seen this before, it's a business cycle. And you know now that it's normal for the economy to go through periods of growth and periods of contraction. Over time, GDP does tend to grow. And that's what this grey line here represents, the overall growth trend.

So you can see that there are times it's growing quickly, and times that it can actually shrink. When it's growing more quickly than the growth trend, that's up here. And when it's shrinking, that's known as a contraction.

Many economists feel that both monetary and fiscal policy are really important in order to reduce the severity of business cycles. We know that this is always going to happen, but in order to make sure that expansionary periods aren't too rapid, and we see a whole lot of inflation, or to make sure that contractions don't become so severe that they become years and years long recessions or depressions, they feel it's really important that either the government, and/or the Federal Reserve System step in and enact some policies.

So let's start with monetary policy, and talk about the pros and cons of it. One major advantage of monetary policy is how it's put into place, or implemented. There is no legislative process required. This is not the government with a political process, with the political parties arguing. The FOMC is a much smaller group of people than our overall federal government.

The FOMC is the Federal Open Market Committee. They meet and they can make very swift decisions. And so since it's not a political process, and because it involves a lot fewer people, the time it takes to implement monetary policy is pretty minimal.

And when the housing market crisis occurred in the early 2000s, our Fed took serious and quick action. First of all, they made sure that banks were solvent. They made sure banks were not going to fail, and that they could continue making loans. They also took measures pretty quickly to lower rates in the economy, and to encourage people to continue borrowing and to continue spending money.

And many believe that without these kinds of measures taken by our Federal Reserve System, we could have been headed for another Great Depression. So they feel that monetary policy was really, really crucial in their actions here.

There are some issues though that some critics will point to with monetary policy. So let's go through some of those.

First of all, although it doesn't take long to implement monetary policy, there can be a significant amount of time for us to see the intended effects of that monetary policy. So I'm posing you a hypothetical question, would you go out and buy a car or a house tomorrow, just because you heard that interest rates were falling? Probably not. Maybe a few people would, but these are decisions that-- it's what we call interest sensitive components of aggregate demand. And these are things that people take a little bit longer to decide.

Since monetary policy is working mainly through these interest rates and the money supply, there can be a really significant lag between the time they put it in place, and the time when consumers or businesses start altering their behaviors. So because of this lag and because we can't predict a recession ahead of time, monetary policy generally cannot prevent a recession from happening.

There's also issues here with predictions. So when we change monetary policy, that can alter the outcome of investment decisions that individuals and businesses are making. When a business person decides to make an investment purchase, or when an individual decides to make an investment in general, they're doing so because they've predicted that it's going to be a profitable one. And often that profitability has to deal with things like current interest rates. Things that monetary policy could very well change.

And so all of a sudden, when someone has made an investment decision that is going to reach for years and years and years, now their decision might not actually turn out to be a profitable one.

On the contrary, someone who had an actually pretty bad idea, could actually luck out and benefit from changes in monetary policy in this way.

So because of this, there are some kind of major issues with the predictability component. And so some people think that, to make things more predictable for businesses or investors, that they would suggest monetary policy should be more rule based, meaning if x happens in the economy, then y monetary policy will be used.

All right, let's look at some fiscal policy pros and cons. First of all, unlike monetary policy, which like I was explaining to you before, takes time to see the intended effects, fiscal policy is going to be a little bit quicker here. It can encourage a pretty quick increase or decrease in aggregate demand.

It doesn't work through interest rates, so let's say, the government cuts taxes, and I get an additional $50 in my next paycheck, I'm pretty quick to figure out what I'm going to do with that. I either immediately spend it, or I don't. I stick it in the bank.

So the government can see pretty quickly whether their policy is going to work or not.

Along with the Federal Reserve, the government took a lot of actions to ensure that the recession following that housing crisis did not result in an even lengthier depression. So they did take measures to cut taxes, and there were a lot of stimulus programs. The one that I put in this tutorial was the one that came to my mind at first, because it impacted my husband and I. And it was an $8,000 tax credit for first time home-buyers. That's actually what got us out looking for a home back then. Because we were going to be offered this kind of stimulus.

So those kinds of things, a lot of people, again, point to and say, you know what? These things really did make some people get out there and spend money, and not be so afraid to do so.

So unlike the Federal Reserve, though fiscal policy does have to go through the legislative process. So it's quick on the back end of it, to see the intended effect, but the process to put in place can really be held up through this political process. Because it can be really influenced by politics, obviously. So it can involve a huge time lag in implementation, as political parties are debating and arguing and it can get nasty. So it can be subject to special interests. And by the time fiscal policy is decided, then it can actually be too late.

Here's another thing to consider. In order to finance expansionary fiscal policy, the government generally has to borrow money. We've talked about that in other tutorials. So they become additional demanders for loans in an otherwise private market. And that's what I'm showing you here in this graph for loanable funds.

When they become additional demand, in this market for loans, what that does is it can drive up interest rates. This is known as crowding out. Essentially the government is pushing us out of the way. They're crowding us out from getting lower interest rates, because they're now demanding loans as well.

Other people point to the disadvantages of stimulating aggregate demand here this way. So economists have criticized attempts to achieve long run economic growth by stimulating aggregate demand, when we're already at long run aggregate supply. So here, we're already at our full potential. And if we continue to stimulate aggregate demand past that point, all that's going to happen, in the short run, certainly we can do that. But we've talked about before how, in the long run, that causes prices to go up. As prices rise, they rise also for suppliers. So suppliers can end up decreasing their ability to produce.

So short run aggregate supply shifts right back to the left, and notice where we are. We're attempting to achieve more economic growth, but we ended up right back where we were. And just with inflation in the economy.

In the 1970s and early '80s, our government used expansionary policies to try to lower the unemployment rate. And the Phillips Curve suggests that we would experience some inflation, but that the unemployment rate would come down. And you've seen a Phillips Curve before, here it is. It shows this inverse relationship between inflation and unemployment.

We know that with lower employment, we can expect higher inflation, and vice versa. As we lower inflation, unemployment tends to go up. So critics of this model point to the time when our economy experienced very high rates of inflation at the same time as high unemployment, which is known as stagflation. So there were times when our inflation was way over 10% with an unemployment rate over 8%. We can't find that on that initial Phillips Curve.

So why didn't expansionary fiscal policies work to lower the unemployment rate. Well critics suggest the problem was not low demand, but instead, it was a supply shock. There were disruptions to our supply of oil, which caused our long run aggregate supply to shift to the last. It lowered the sustainable amount our economy could produce. And that caused our economy to enter the recession.

Since the problem wasn't with aggregate demand, just stimulating aggregate demand through expansionary policy, did absolutely nothing to alleviate the supply shock, and it just caused inflation.

So here's a look at what we talked about, we looked at the pros and cons of both monetary and fiscal policy. You can read the summary there. Thank you so much for listening. Have a great day.