Policymakers should not try to stabilize the economy essay

The development of macroeconomic theory has shown policymakers how to reduce the severity of economic fluctuations. By " leaning against the wind" of economic change, monetary and fiscal policy can stabilize aggregate demand and, thereby, production and employment. Although monetary and fiscal policy can be used to stabilize the economy in theory, there are substantial obstacles to the use of such policies in practice. One problem is that monetary and fiscal policy does not affect the economy immediately but instead work with a long lag.

Monetary policy affects aggregate demand by changing interest rates, which in turn affect spending, especially residential and business investment. But many households and firms set their spending plans in advance. As a result, it takes time for changes in interest rates to alter the aggregate demand for goods and services. Many studies indicate that changes in monetary policy have little effect on aggregate demand until about six months after the change is made.

Fiscal policy works with a lag because of the long political process that governs changes in spending and taxes. To make any change in fiscal policy, a bill must go through congressional committees, pass both the House and the Senate, and be signed by the president. It can take years to propose, pass, and implement a major change in fiscal policy. Because of these long lags, policymakers who want to stabilize the economy need to look ahead to economic conditions that are likely to prevail when their actions will take effect.

Unfortunately, economic forecasting is highly imprecise, in part because macroeconomics is such a primitive science and in part because the shocks that cause economic fluctuations are intrinsically unpredictable. Thus, when policymakers change monetary or fiscal policy, they must rely on educated guesses about future economic conditions. All too often, policymakers trying to stabilize the economy do just the opposite. Economic conditions can easily change between the time when a policy action begins and when it takes effect.

Because of this, policymakers can inadvertently exacerbate rather than mitigate the magnitude of economic fluctuations. Some economists have claimed that many of the major economic fluctuations in history, including the Great Depression of the 1930s, can be traced to destabilizing policy actions. One of the first rules taught to physicians is “ do no harm. ” The human body has natural restorative powers. Confronted with a sick patient and an uncertain diagnosis, often a doctor should do nothing but leave the patient’s body to its own devices.

Intervening in the absence of reliable knowledge merely risks making matters worse. The same can be said about treating an ailing economy. It might be desirable if policymakers could eliminate all economic fluctuations, but that is not a realistic goal given the limits of macroeconomic knowledge and the inherent unpredictability of world events. Economic policymakers should refrain from intervening often with monetary and fiscal policy and be content if they do no harm.