I. DEFICITS AND DEBT

A. Definitions

1. Deficit = G – T
   a. deficit occurs [the number is positive] when G > T
   b. surplus = –deficit when T > G

2. Debt = cumulative Deficit

B. History

C. Behavior

1. Deficit is government spending which is not financed by taxes
   a. borrow [Treasury bonds]
   b. but strange accounting practices

2. Government's deficit [and debt] is an asset to somebody else
   a. bondholders
   b. and thus deficit in Government implies surplus somewhere else
      i. in Governed model: S > I
      ii. in Open model: could also be M > X
      iii. → twin deficits

D. Evaluation

1. Opportunity Cost: would real resources have been used otherwise?
   a. if so, for what?
   b. if not there would have been a real opportunity cost of not using the resources

2. Growth [capacity]

3. Distribution
   a. beneficiaries of spending
   b. interest payment on debt
   c. ownership of debt

E. Size, revisited

1. relation to GDP?
2. real per capita…
II. KEYNESIAN – MONETARIST DEBATE

A. Introduction

1. Cast of characters
   a. two groups of economists
      i. Monetarists
      ii. neo-Keynesians
   b. two kinds of “demand-side” policies
      i. Monetary
      ii. Fiscal

2. Framework of analysis
   a. neo-Keynesian synthesis
   b. elasticities

B. Monetarists’ assumptions

1. “Markets, markets, markets”

2. Assumptions
   a. transactions demand $\rightarrow LP$ is very inelastic
   b. Commercial banks desire to hold no excess reserves
      i. revenue and profit motive
      ii. $\rightarrow$ Supply of Money is very inelastic
   c. MEI is very elastic

C. neo-Keynesians’ Assumptions

1. “behaviorists”

2. Assumptions
   a. precautionary & speculative demand $\rightarrow LP$ is very elastic
   b. Commercial banks may hold some excess reserves
      i. risk
      ii. especially if interest rates are low
         1) larger probability of default in corresponding bad times
         2) lower opportunity cost of excess reserves
      iii. $\rightarrow$ Supply of Money is very elastic
   c. non-interest rate determinants of Investment behavior are important
      i. technical change, physical depreciation, demography, expectations
      ii. MEI is inelastic
D. Monetary Policy
1. Represent Monetary Policy by a shift of the Money Supply Curve
2. Monetary Policy is very effective under the Monetarists’ assumptions
   a. inelastic LP $\rightarrow$ large $\Delta i$
   b. elastic MEI $\rightarrow$ even larger $\Delta I$
   c. by multiplier, huge $\Delta Y_e$
3. Monetary Policy is ineffective under the neo-Keynesian assumptions
   a. elastic LP $\rightarrow$ $\Delta i$ is smaller than $\Delta S_M$
   b. inelastic MEI $\rightarrow$ $\Delta I$ is smaller still
   c. even with multiplier, $\Delta Y_e$ is quite small
4. paradigm: “kick & response”

E. Fiscal Policy
1. How represent?
   a. shift MEI (MEJ) directly with $\Delta G$
   b. shift MEI (MEJ) indirectly with $\Delta T$ which causes $\Delta Y_d$ so also $\Delta C$ and $\Delta I$
   c. we shall focus on $\Delta G > 0$
   d. and remember that $\Delta G \rightarrow \Delta Y_e$ by multiplier
2. Fiscal Policy is not effective under the Monetarists’ assumptions
   a. $\Delta Y_e > 0 \rightarrow \Delta D_M > 0$
      i. by the Transactions Demand for money
      ii. $\Delta D_M$ is large according to the Monetarists’ assumptions
   b. $\Delta D_M > 0 \rightarrow \Delta i > 0$
      i. move up $S_M$
      ii. $\Delta i$ would be large because $S_M$ is assumed to be inelastic
   c. $\Delta i > 0 \rightarrow \Delta I < 0$
      i. move up the MEI
      ii. $\Delta I$ would be large because MEI is assumed to be inelastic
      iii. note carefully that $\Delta I < 0$: “crowding out”
   d. by multiplier, $\Delta I \rightarrow \Delta Y_e$
      i. $Y_e$ declines nearly to its pre-fiscal policy level
      ii. crowding out means that government spending merely substituted for, or replaced, some of the private [household or firm] spending
      iii. thus with little or no net new spending, $\Delta Y_e$ is tiny
3. Fiscal Policy is very effective under the neo-Keynesian assumptions
   a. same steps but different amounts because of different elasticity assumptions
   b. small $\Delta D_M$
      i. Transactions demand is seen as relatively far less important
      ii. thus changes in Transactions have little impact on total demand for money
   c. smaller $\Delta i$ because small shift in $D_M$ to begin with, moving along elastic $S_M$
   d. very very small $\Delta I$ because tiny $\Delta i$ moving along inelastic MEI
   e. so very little crowding out
   f. so lose very little $Y_e$
   g. so Fiscal Policy is very effective under the neo-Keynesian assumptions
F. Comments

1. How can these disagreements persist?
   a. economics is not a laboratory science
   b. "identification problem"
   c. are LP and MEI curved? [so elastic in some regions, inelastic in others?]

2. possible Monetarist response
   a. stack deck by using neo-Keynesian synthesis in the first place?
   b. claim MV=PQ works just as well
   c. but neo-Keynesian reply that it does so only if Velocity is constant; is it?

3. Liquidity Trap

4. Targets Debate
   a. what is the monetary target?
   b. stabilizing one may destabilize the other

III. SECOND POLICY DEBATE: PREVIOUSLY STUDIED "DEMAND-SIDE" THEORIES AND POLICIES re INFLATION AND UNEMPLOYMENT vs. ALTERNATIVE VIEWS

A. Previously-Studied "Demand-Side" Theories

1. Theories
   a. Classical
      i. always at YFE
      ii. prices adjust to changes in demand
   b. "9-o'clock"
      i. most of the income determination model implicitly assumed this
      ii. ΔAD affect
          1) Yc if operate below YFE
          2) price level if operate at YFE
   c. Phillips' Curve
      i. ΔAD cause movement along Phillips curve
      ii. trade-off between unemployment and inflation

2. inflation in these models is "demand-pull"
   a. Monetarists explain in terms of equation of exchange: MV = PT
   b. neo-Keynesians [and others] explain it in terms of AE, MEI, gaps

3. policy remedies affect economic actors as buyers or demanders
   a. fiscal
      i. ΔG: directly, as government buys commodities
      ii. ΔT: indirectly, affecting Yd and thus household and firm purchases of goods
   b. monetary
      i. M allows purchases: transactions
      ii. affects purchases of durables and [real; economic] capital
B. Other theories and policies
   1. often called "supply-side"
   2. many are structural and/or institutional
   3. framework for our discussion: shifting Phillips' Curves

C. Shifting Phillips' Curves
   1. Structural Unemployment and related issues
      a. \(\Delta\)Product Demand
      b. \(\Delta\)technology
      c. union restrictions and minimum wage laws
      d. extension of unemployment benefits
      e. increases in labor force participation rates
      f. regulation?
   2. discrete, exogenous price shocks in 1970s
      a. agriculture
      b. devaluation of the $ 
      c. OPEC
   3. → Wage-Price Spiral
      a. cost-push
      b. necessary for inflation to continue
      c. role of inflationary expectations

D. Monetarists' Response
   1. interesting stories re how inflationary pressures may begin
   2. claim requires \(\Delta M > 0\) to ratify price increases
   3. but again: is velocity constant?

E. Government Policies
   1. if problem is structural unemployment
      a. deal directly with causes
      b. training, labor market information, antitrust?
   2. if problem is wage-price spiral
      a. "incomes policy" has been attempted with little success
      b. must defeat inflationary expectations
   3. "supply-side" of the Reaganomics flavor
      a. limited
      b. focus on incentives
         i. notion: marginal tax rates influence incentives to work, produce, invest, etc.
         ii. notion that regulations inhibit some activity
      c. Laffer Curve