Macro Module 19 + 20 Readings

(The attached PDF file has better formatting.)

Chapter 14: Public Debt (Modules 19 and 20)

Skip pages 252-254, which gives a brief history of government debt. The U..S. government was not always as profligate as it is now, but this fact is not tested on the final exam.

The United States began as a reaction to high British taxes on the colonies. From its inception until the early 20th century, Americans were wary of government taxes. The American pioneers valued frugality, and they did not like debt. Statesmen were proud if the government ran a surplus.

In the mid-20th century, some economists said that government spending could lift the economy out of a recession. The government had a rationale for spending more than it takes in, so spending rose and the deficit increased. Politicians ran a deficit to help the American people (or so they said).

Barro shows that a permanent rise in government spending has little or no effect on GDP. The economic rationale from previous generations was an error.

The section on characteristics of government bonds is not tested on the final exam, but the notation in the middle of page 255 is used in later sections. The superscript g on bonds, B^g, means government bonds.

Read pages 255-258. Know key equation 14.1 on page 256. Skip figure 14.3 on page 257. Understand the meaning of real national saving on page 258. If government savings increases, private savings decreases, and national savings tends to remain the same.

Skim pages 258-260. Know the second column of page 259, “In our simple example … “ to “… does not affect real national saving.”

Barro’s textbook uses the Ricardian Equivalence Theorem. Other economists do not agree with this theorem in the strict form that Barro presents. Know the general result, which is used in the macroeconomic model, but the mathematics is not tested on the final exam.

Skip page 261. This section generalizes the Ricardian Equivalence Theorem; the generalization is not tested on the final exam.

Read “Economic Effects of a Budget Deficit” on pages 261-265, including the “Back to Reality” box on page 265. The effect of a budget deficit is much debated. Newspapers and magazines say that the profligacy of our generation must be paid by our children, and that we are enslaving our children to pay our debts. Economists debate the true effects of a budget deficit. Note the discussion of strategic budget deficits on pages 264-265.

Read “The Standard View of a Budget Deficit” on pages 266-267. For the public as a whole, Barro does not presume that finite lifetimes affect optimal decisions. The homework assignment examines the relative preferences of families with many or few children.

Skip “Imperfect Credit Markets” on page 268. Barro rejects this hypothesis, and you are unlikely to encounter it elsewhere.

Read “Social Security” on page 269, skipping the “By the Numbers” box on page 270.

Read “open market operations” on pages 270-271, along with Table 14.2 at the bottom of page 271. Focus on the last paragraph on page 271, which summarizes the conclusions. Raising or lowering the money supply affect inflation and the price level, not real variables.

The textbook focuses on macroeconomic theory, not on the specifics of monetary policy. Other textbooks often devote a whole chapter to open market operations and other ways that the Federal Reserve Board changes the money supply. You may read in the papers that the FED met yesterday and increased interest rates a quarter of a point to (i) forestall inflation, (ii) stimulate the economy, (iii) reduce unemployment, or some other policy goal.

Barro concludes that monetary policy does not change real economic variables. It changes the price level, the nominal wage rate, and nominal prices, and it may change expected inflation and the nominal interest rate. (Be sure you can explain these effects.) But it does not accomplish the goals it seeks.

The Wall Street Journal and other newspapers mention the response of financial markets to the FED actions. If the FED action raises the price level, bond values fall, since the fixed dollar returns are worth less. The FED action cause immediate changes in the bond and stock markets, even if they do not affect the real economy.

Review Question B.4.a,b,c, and d on page 272. For part (b) of this question, Barro assumes people are rational, so people without children may differ from people with children. Part (e) uses a section that is skipped in this course.