MONETARY POLICY: most central banks have a dual mandate:

used for

BUT! monetary policy is subject to:

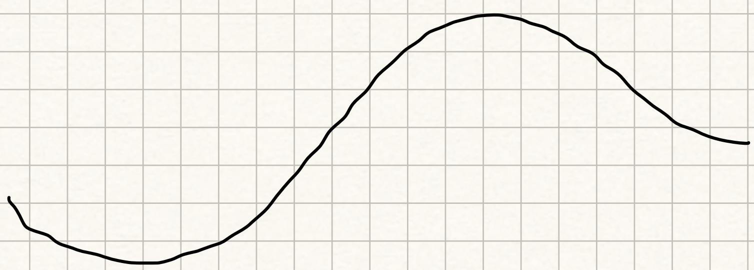
} central bank's ability to fine-tune economy

ALSO! Risk that central bank intervention will

Risk biggest at

due to

Conversely: expansionary policy



FISCAL POLICY – can also be used to COUNTERACT CYCLICAL FLUCTUATIONS IN ECONOMY

Reasons:

- fiscal decision making (taxes, aggregate spending)

- frequent significant fiscal changes

may mitigate cyclical fluctuations:

- **PROGRESSIVE TAXES**: EFFECTIVE TAX RATE

- **MEANS-BASED TRANSFER PAYMENTS**:

FOR INVESTMENT ANALYSTS: MONETARY POLICY critical to CYCLICAL FLUCTUATIONS

FISCAL POLICY → secondary consideration

BUT: in LONG-RUN:

↓↑ FISCAL POLICY (e.g. tax code reforms) more important

TAYLOR RULE → illustrates how central banks MAY use COUNTERCYCLICAL POLICY MEASURES to mitigate extremes in inflation & growth

$$i^* = r_{neutral} + \pi_e + 0.5(\underbrace{\hat{Y}_e - \hat{Y}_{trend}}_{\text{expected and trend real GDP growth rates}}) + 0.5(\underbrace{\pi_e - \pi_{target}}_{\text{expected and target inflation rates}})$$

i^* = target S-T nominal interest rate

$r_{neutral}$ = real policy rate that would be targeted if growth expected to = trend ($\hat{Y}_e = \hat{Y}_{trend}$) & inflation expected to = target ($\pi_e = \pi_{target}$)

Limitations of Taylor rule: