

What's wrong with this Economic picture?

*Instructions: find **everything** wrong with the fiscal and monetary policy quandries detailed below. Some errors are of fact, some are errors of decision-making. In other words, you will see mistakes related to how things work and mistakes related to the reason for doing things. **WARNING:** there are a few things in there which may look like errors, but actually are accurate. (This is where I emit evil booming laughter...)*

The economy of Foobaria is in deep trouble. It's in a deep recession, and its people are fed up with the traditional Marxist economy and its laissez-faire approach. The military stages a coup and declares it will run the state properly. One problem: they have no economists in their ranks. The military junta then hires several out-of-work Economists from America, Europe, and Japan to jump-start their economy. As the economists arrive, they proudly proclaim that the unemployment rate for Foobaria has declined with their being hired.

The economists get straight to work. Noticing that unemployment is very high, they whip out their Phillips charts and demand inflation be cut to reduce unemployment. To that end, they order price floors, to make sure prices go that low. Then they announce a slew of fiscal policies guaranteed to drop inflation: a massive tax cut coupled with an equally massive cut in government spending. To make sure government spending decreases, the economists order that the military junta immediately open five new bases around the nation and staff them to full complement. On the tax front, the economists decide the best way to cut tax revenues is to raise all marginal tax rates to around 90%. They all look at their Lorenz curves and nod their heads in aggregate agreement. To further boost demand, the economists call for massive amounts of imports, to make Foobaria's trade numbers much higher.

Because Foobaria makes only two things, pumpernickel bread and rolled steel, the economists decide to draw a Possible-Production Tangent (PPT) graph to see where Foobaria's absolute advantages lie. Comparing Foobaria to its wealthier neighbor, Himynamistan, they notice Himynamistan can produce both pumpernickel and rolled steel in greater quantities than Foobaria. Foobaria, however, has a lower average variable cost in steel production, so the economists order Foobaria make nothing but steel and then trade it with Himynamistan for even better-quality steel, as that's what the law of cooperative advantage states must be done.

Then a cigar-puffing American economist interrupts the Neoclassical party described above by banging his fist on the conference table. "There must be a set of fiscal policies to go with all your monetarist ideals, or we're going to have runaway aggregate supply!"

The others whisper quietly to each other, "This guy must be one of those Milton Keynesian types."

The stogie-smoker, economist Nosmo King, continues: "I'm an inflation-fighter, and the last thing I want to see is out-of-control unemployment. Your short-run policies are fine, but in the long run, we're all eating a free lunch. Because there's no such thing as a free lunch, we'll be dividing by zero, and you know what *that* means for the reserve ratio! INFINITE MONEY LOANED OUT!"

The more mathematically-inclined economists shuddered at the very thought of a reserve ratio equal to zero. That would be bad because it was not good. Worse, it would mean the real interest rate would be negative, forcing banks to give away piles of cash, at interest, just to avoid losses from holding on to it.

"We're gonna make sure we have plenty of inflation. Then you can worry about cutting unemployment." Nosmo was serious as a stroke. "Step one, we counter your commie-style monetary policies with a sound fiscal practice: we're slashing the discount rate!" Horrified gasps from the other economists. "To amplify that policy, I'm also calling for a hike in the reserve ratio." Muffled shrieks from the other economists. "Finally, to go with those policies, we will immediately begin buying all outstanding Foobarian government securities to keep the money supply stable!" The other economists cheered and gave Nosmo King a standing ovation.

To comply with their economists' instructions, the military junta ordered an immediate conversion to a market economy. Troops fanned out into the streets to make sure everyone complied with the government's dictate about being a market economy. Strangely enough, the economist's ideas had some unusual effects. The price floor resulted in a shortage of basic goods, as one would expect, but the shift to steel production didn't produce the hoped-for boost in steel imports. Pumpernickel purchases proved popular, much to the surprise of those who thought Foobarians would be loyal to the government's planned market economy program.

Then, the Foobarian economy weakened. The economists rejoiced: imports could only go higher! To brace for the increased demand in Foobarian currency on the world currency exchanges, Nosmo King ordered

massive amounts of new currency to be printed off. He figured it was about time to control inflation now, anyway, what with the economy doing so well.

The military junta followed more economical advice on market reforms. To make sure foreign products did not interfere with domestic market reforms, the junta ordered that massive tariffs be imposed on all imports. This would no doubt boost revenues, as there were lots more imports than ever before, what with there being absolutely no food production in Foobaria.

But this alarmed another Foobarian economist, one Marty Friedbrain. Marty said, "We need a balanced budget! That means more exports to equal our imports!" The other economists agreed and the junta followed their advice. Soon, soldiers were taking everything in the country that wasn't nailed down and loaded it on ships. Once the ships were in international waters, they dumped all their cargo into the ocean to make sure the exports didn't wind up getting re-imported and thereby complicating government statistics gathering.

Now that everything imported got exported to the ocean floor, the economists were convinced Foobaria had the proper balance of trade. Time now to increase demand: "Demand creates its own supply" said Say. To improve domestic demand for non-exportable goods and services, the government ordered troops to go out and create a market for glass, drywall, and other building materials by smashing in windows, putting holes in walls, and otherwise destroying property. By wisely using this power of eminent domain to improve the local tax base, the government stimulated demand and gave a tremendous boost to the local building industry.

To help reduce unemployment, the government then passed labor market reforms. After the reforms, it became illegal to quit a job or to fire an employee - structural unemployment was eliminated at a stroke! To combat frictional unemployment, the government ordered that no businesses ever be shut down. They ended seasonal unemployment by burning all the calendars in the nation. The government then outlawed all recessionary activity, so those who used to be unemployed due to a business slowdown were now criminals. Once reclassified, Foobaria had zero unemployment, to the great joy of its economists.

Of course, one man's great joy is another's irrational exuberance, and Nosmo King and Marty Friedbrain both felt horribly now that the other economists were happy. Something had to be going wrong for everyone to feel so good, so they decided it must be due to understimulated aggregate demand - since recessions were now illegal - and that a war with Himynamistan would be the perfect tonic to insure continued economic growth. They planned to take out a huge amount of loans, buy weapons, get some aging British rockers to persuade the world to have their debts forgiven, then take out more loans to buy yet more weapons. Demand would be properly stimulated, that way.

Following that maneuver, war itself with Himynamistan would commence. The economists planned to surrender immediately and turn over all of Foobaria to Himynamistan, save the home of the head of the military junta. That way, Foobaria's per capita GDP would be the highest in the world!

Nosmo King concluded, "With that perfect economy, our work would be done."

Another economist, Ludwig van der Miser, objected, "If our work is done, *we'll* be unemployed. That's too high a cost for me to accept this opportunity. All other things being equal, I'd still like a paycheck." Silence fell on the gathered economists, like an invisible hand covered all their mouths.

Marty Friedbrain had an idea. He began making notes in the blank space on the sides of the peace treaty. Ludwig van der Miser asked what he was doing. Marty said, "I'm putting in a clause in the treaty to pay ourselves a hefty annual salary as observers of treaty compliance. It's just that this is the only place I have room enough to do it."

"Ah, so these are the marginal benefits, then," said Ludwig. Since Marty hadn't written down any payments the economists had to make, there were no marginal costs. "Sounds like a plan," said Ludwig.

The war went entirely according to plan, and the economists lived with rational expectations of moderate, sustained long-term growth ever after.

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