KOFA HIGH SCHOOL SOCIAL SCIENCES DEPARTMENT

AP ECONOMICS

EXAM PREP WORKSHOP # 5 > COMBINED MONETARY AND FISCAL POLICY

NAME : *DATE :*

Review Of Tools Of Monetary And Fiscal Policy :

1. ***Both monetary and fiscal policy can be used to influence the inflation rate and real output . Indicate what effect (increase or decrease) each specific policy has on inflation and real output in the short run (9 to 18 months) :***

Monetary Policy	***Inflation***	***Real Output***
1. Buy government securities		
Sell government securities		
2. Decrease the discount rate		
Increase the discount rate		
3. Decrease the reserve requirement		
Increase the reserve requirement		
Fiscal Policy		
1. Increase government spending		
Decrease government spending		
2. Increase taxes		
Decrease taxes		

Lags In Policy Making :

As the economic situation changes , policy makers must decide when to take action and which policy action to take . Then they must implement the policy . The economy then responds to the policy . The amount of time it takes policy makers to recognize and take action is called the " inside lag " . The amount of time it takes the economy to respond to the policy changes is called the " outside lag " .

The " inside lag " is estimated to be short for monetary policy , but long for fiscal policy . The " inside lag " is long for fiscal policy because the legislative branch must come to agreement About the appropriate action . The " outside lag " however , is long and variable for monetary

policy , but very short for fiscal policy .

1. *Explain why the inside lag can be short for monetary policy , but the outside lag is long and variable .*

2. *Explain why the outside lag is short for fiscal policy .*

3. *Explain why lags are important to the discussion of stabilization policy .*

The Crowding Out Effect Using Aggregate Demand And Aggregate Supply Analysis :

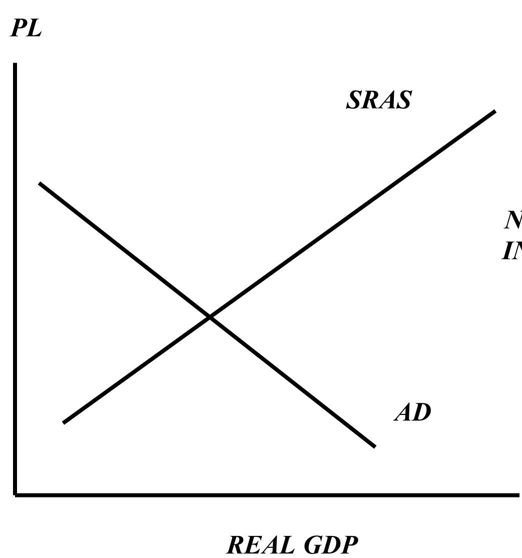
1. *Assume fiscal policy is expansionary and monetary policy keeps the stock of money constant at MS . Shift one curve in each graph below to illustrate the effect of the fiscal policy :*

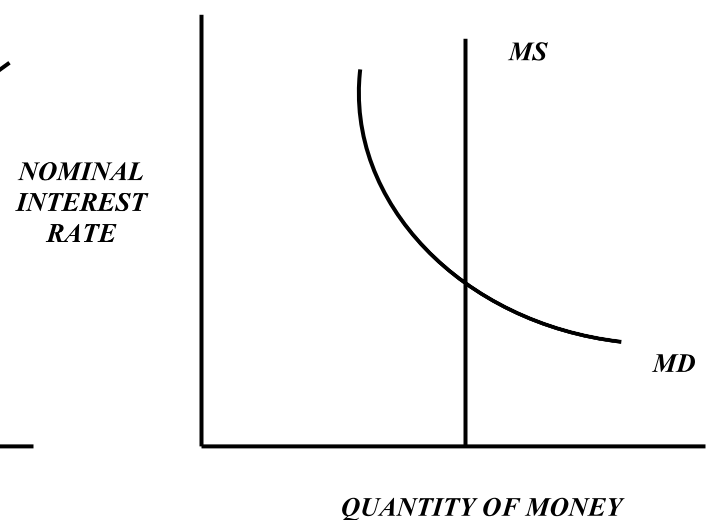
   A. *Which curve did you shift in the short run aggregate demand and aggregate supply graph ? What happens as a result of this new curve ?*

   B. *In the money market graph , which curve did you shift to demonstrate the effect of the fiscal policy ? What happens as a result of this shift ?*

   C. *Given the change in interest rates , what happens in the short run aggregate supply and aggregate demand graph ?*

   D. *How could monetary policy action prevent the changes in interest rates and output you identified in (B) and (C) ? Shift a curve in the money market graph , and explain how this shift would reduce crowding out .*





The Crowding Out Effect Using The Loanable Funds Market :

The loanable funds market provides another approach to looking at the effects of increases in the budget deficit . The demand for funds in the loanable funds market comes from the private sector (business investment and consumer borrowing) , the government sector (budget deficits) and the foreign sector . The supply of funds in the loanable funds market comes from private savings

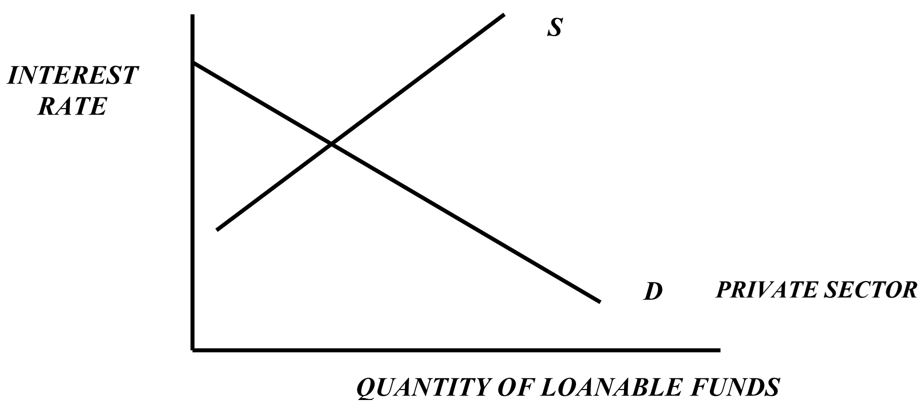
(businesses and households) , the government sector (budget surpluses) , the Federal Reserve (money supply) and the foreign sector .

1. ***Shift one of the curves in the graph below to indicate what occurs in the loanable funds market if government spending increases without any increases in tax revenue or the money supply .***

   A. ***What happens to the interest rate as a result of this expansionary fiscal policy ? Explain .***

   B. ***Indicate on the graph the new quantity of private demand for loanable funds .***

   C. ***An accommodating monetary policy could prevent the effect you described in (A) and (B) . Shift a curve in the diagram to show how the accommodating monetary policy would counteract the effects of crowding out . Explain what would happen to interest rates and the level of private demand for loanable funds as a result of this new curve .***



What Would Happen ? :

1. ***Indicate whether you agree , disagree , or are uncertain about the truth of the following statement and explain your reasoning . " Exhaustion of excess bank reserves inevitably puts a ceiling on every business boom because without money the boom cannot continue . "***

2. ***The Federal Reserve Open Market Committee wishes to accommodate or reinforce a contractionary fiscal policy .***

   A. ***Would the Federal Reserve buy bonds , sell bonds , or neither ?***

   B. ***What effect would this policy have on bond prices and interest rates ?***

   C. ***What effect would this policy have an bank reserves and the money supply ?***

   D. ***What effect would this policy have on the quantity of loanable funds demanded by the private sector ?***

E. *What effect would the change in interest rates you identified in (B) have on aggregate demand ?*

3. ***The Federal Reserve Open Market Committee wishes to accommodate or reinforce an expansionary fiscal policy .***

A. ***Would the Federal Reserve buy bonds , sell bonds , or neither ?***

B. ***What effect would this policy have on bond prices and interest rates ?***

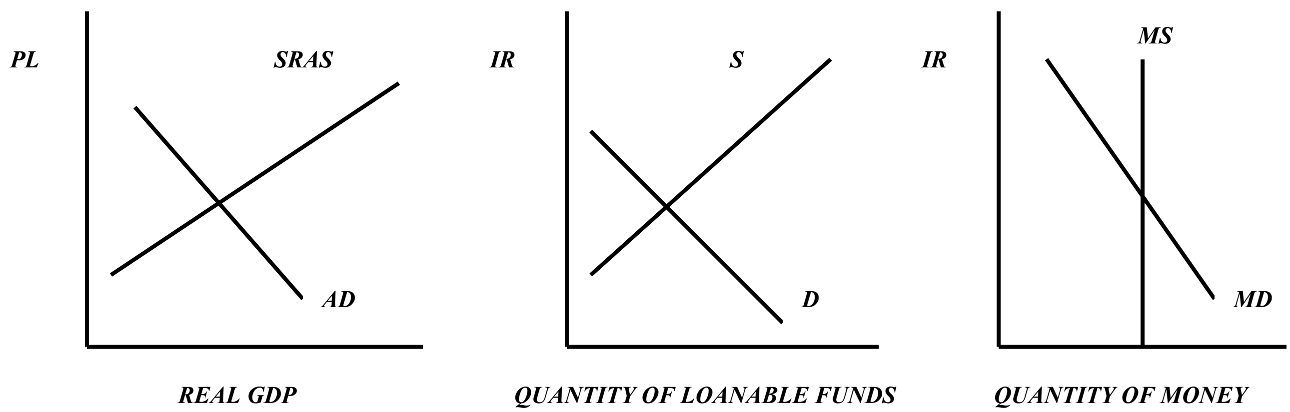
C. ***What effect would this policy have an bank reserves and the money supply ?***

D. ***What effect would this policy have on the quantity of loanable funds demanded by the private sector ?***

E. ***What effect would the change in interest rates you identified in (B) have on aggregate demand ?***

Graphing Monetary And Fiscal Policy Interactions :

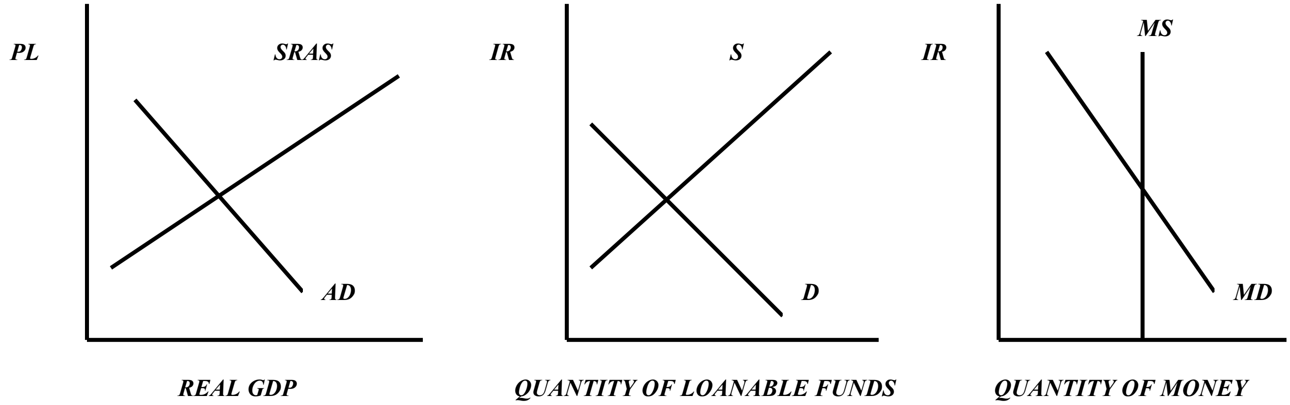
Illustrate the short run effects for each monetary and fiscal policy combination using aggregate Demand and supply curves , the money market , and loanable funds market . Once again assume that there are no changes in the foreign sector . Indicate whether there is an increase , decrease , or whether you are uncertain .



1. ***The unemployment rate is 10 percent , and the CPI is increasing at a 2 percent rate . The federal government cuts personal income taxes and increases its spending . The Federal Reserve buys bonds on the open market .***

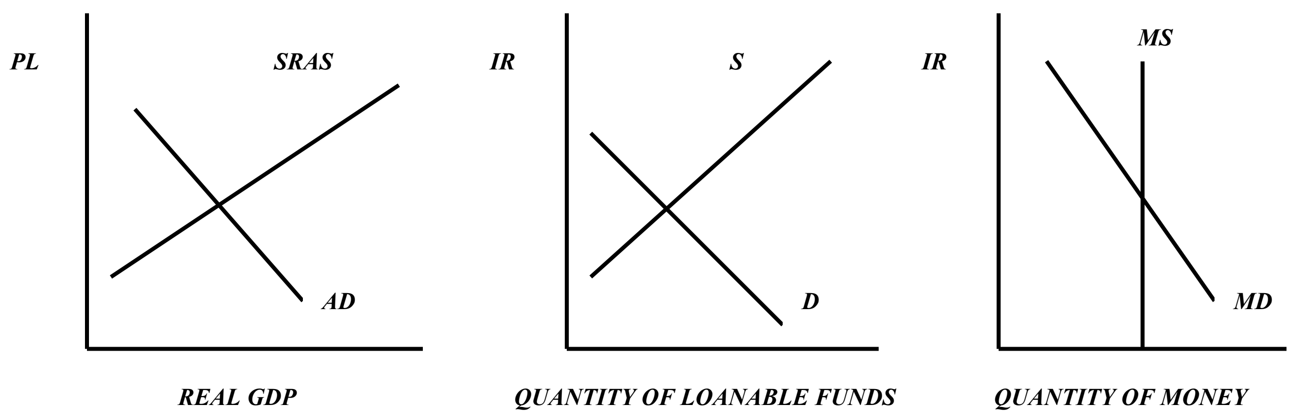
What Is Affected	***Increase***	***Decrease***	***Uncertain***
A. ***Real GDP***			
B. ***The price level***			
C. ***Unemployment***			
D. ***Interest rates***			

E. *Investment*



2. ***The unemployment rate is 6 percent , and the CPI is increasing at a 9 percent rate . The federal government raises personal income taxes and cuts spending . The Federal Reserve sells bonds on the open market .***

What Is Affected	***Increase***	***Decrease***	***Uncertain***
A. Real GDP			
B. The price level			
C. Unemployment			
D. Interest rates			
E. Investment			



3. ***The unemployment rate is 6 percent , and the CPI is increasing at a 5 percent rate . The federal government cuts personal income taxes and maintains current spending . The Federal Reserve sell bonds on the open market .***

What Is Affected	***Increase***	***Decrease***	***Uncertain***
A. Real GDP			

B. *The price level*

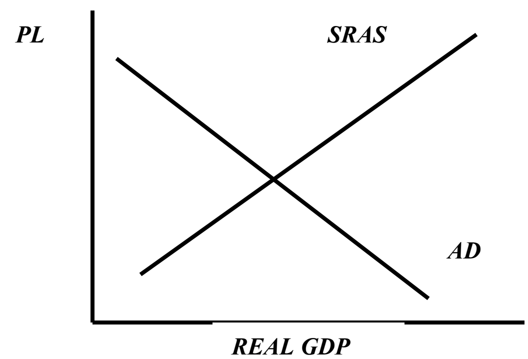
C. *Unemployment*

D. *Interest rates*

E. *Investment*

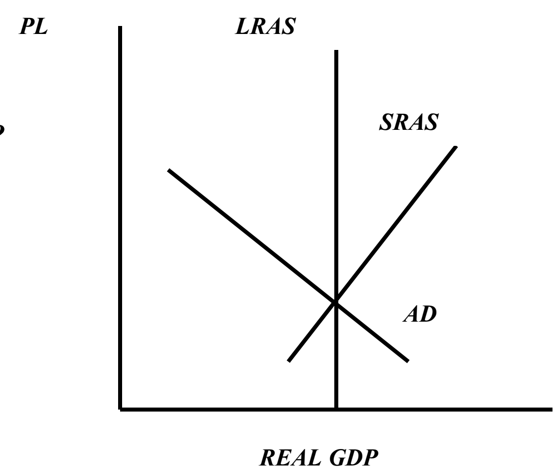
The Short Run Phillips Curve :

1. ***Suppose government policy makers want to increase GDP because the economy is not operating at its potential . They can increase aggregate demand by increasing government spending , lowering taxes , or a combination of both . Using an AD and SRAS model , draw a new ad curve that will represent the change caused by government policy designed to increase real GDP .***



- A. ***What happens to the price level in the short run ?***
- B. ***What happens to real GDP in the short run ?***
- C. ***What happens to the rate of unemployment in the short run ?***
- D. ***The Federal Reserve can use monetary policy to try to stimulate the economy . It can encourage bank lending by ___________________ bonds on the open market , ___________________ the discount rate , and / or ___________________ reserve requirements .***

2. ***Aggregate supply shocks resulting from the oil embargo imposed by Middle Eastern countries (OPEC) and worldwide crop failures helped to bring about higher inflation and higher unemployment rates . The economy , with rising prices and decreased output , was in a state of stagflation . Using an AD and SRAS model , draw a new SRAS curve that will represent the change caused by the OPEC oil embargo .***



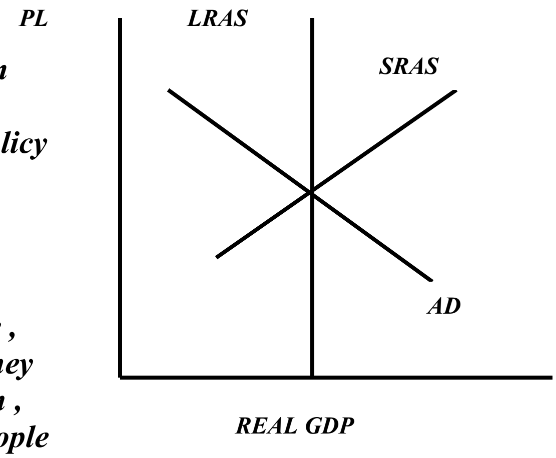
- A. ***In the short run , based on the new SRAS :***
  1. ***What happens to the price level ?***
  2. ***What happens to real GDP ?***
  3. ***What happens to the rate of unemployment ?***
- B. ***As the economy moves to the long run :***
  1. ***What happens to the wage rate ?***

2. What happens to the price level ?

3. What happens to real GDP ?

4. What happens to the rate of unemployment ?

3. Use the AD and SRAS model below to show the appropriate policy response to the oil price increases in the following instances . Be sure to show on the graph the effects of the oil price increase .



A. If unemployment were the main concern of policy makers
B. If inflation were the main concern of policy makers
C. If inflation and unemployment were of equal concern

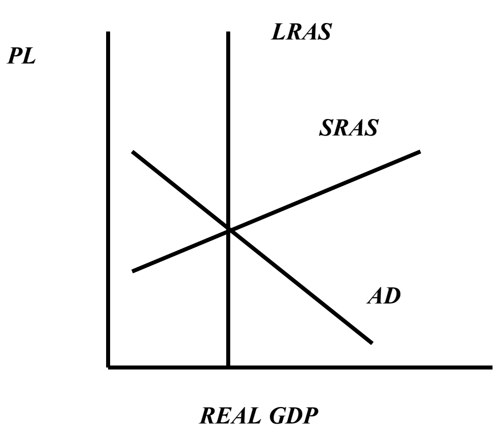
4. As inflation in the 1970's continued to increase , economists argued that , for a reduction in money growth to be fully effective in lowering inflation , the Federal Reserve would need to convince people it was serious about reducing money growth – in other words , the Federal Reserve would stick with a lower money growth policy until inflation decreased . Why would it be important for the Federal Reserve to establish this credibility ?

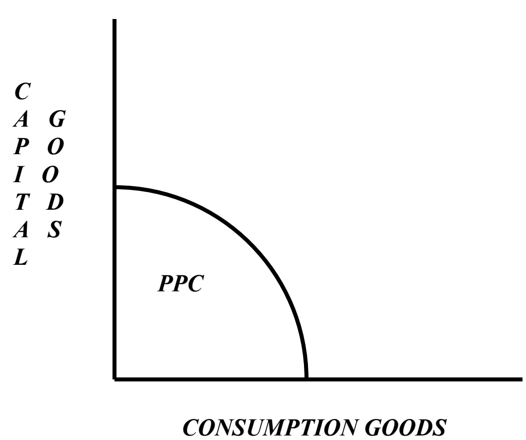
5. In 1980 , the unemployment rate was no lower than it had been in 1960 , but inflation was much higher . Between 1980 and 1982 , the economy experienced a recession and unemployment rose . Explain the general effect of a recession on unemployment and inflation . Then explain why the recession of 1980 to 82 was accompanied by high inflation .

6. Eventually the OPEC cartel was weakened , and energy prices decreased . Several United States industries , including communications and transportation , were deregulated . This caused greater competition . Explain and illustrate the effects of a weakened oil cartel and deregulation using both the aggregate demand and aggregate supply model and the Phillips curve .

Economic Growth :

1. Explain how fewer government regulations will affect economic growth . Cite an example to support your explanation . Show the effect of fewer government regulations on the graphs below :





2. Briefly explain how the following will affect economic growth and why .

A. Higher taxes on business

B. Improvements in technology

C. Less savings by people who want to enjoy the good life

D. Higher productivity of labor because of improved management styles

E. Lower interest rates

REAL MACRO FRQ s (08)

Section II Planning Time—10 minutes Writing Time—40 minutes each section

Directions: You have fifty minutes to answer the three questions . It is suggested that you spend approximately half your time on the first question and divide the remaining time equally between the next two questions. In answering the questions, you should emphasize the line of reasoning that generated your results; it is not enough to list the results of your analysis. Include correctly labeled diagrams, if useful or required, in explaining your answers. A correctly labeled diagram must have all axes and curves clearly labeled and must show directional changes.

1. Assume the United States economy is operating at full-employment output and the government has a balanced budget. A drop in consumer confidence reduces consumption spending, causing the economy to enter into a recession.

(a) Using a correctly labeled graph of the short-run Phillips curve, show the effect of the decrease in consumption spending. Label the initial position "A" and the new position "B".

(b) What is the impact of the recession on the federal budget? Explain.

(c) Assume that current real gross domestic product falls short of full-employment output by $500 billion and the marginal propensity to consume is 0.8.

(i) Calculate the minimum increase in government spending that could bring about full employment.

(ii) Assume that instead of increasing government spending, the government decides to reduce personal income taxes. Will the reduction in personal income taxes required to achieve full employment be larger than or smaller than the government spending change you calculated in part (c)(i) ? Explain why.

(d) Using a correctly labeled graph of the loanable funds market, show the impact of the increased government spending on the real interest rate in the economy.

(e) How will the real interest rate change in part (d) affect the growth rate of the United States economy? Explain.

2. ***Balance of payments accounts record all of a country's international transactions during a year.***

(a) Two major subaccounts in the balance of payments accounts are the current account and the capital account. In which of these subaccounts will each of the following transactions be recorded?

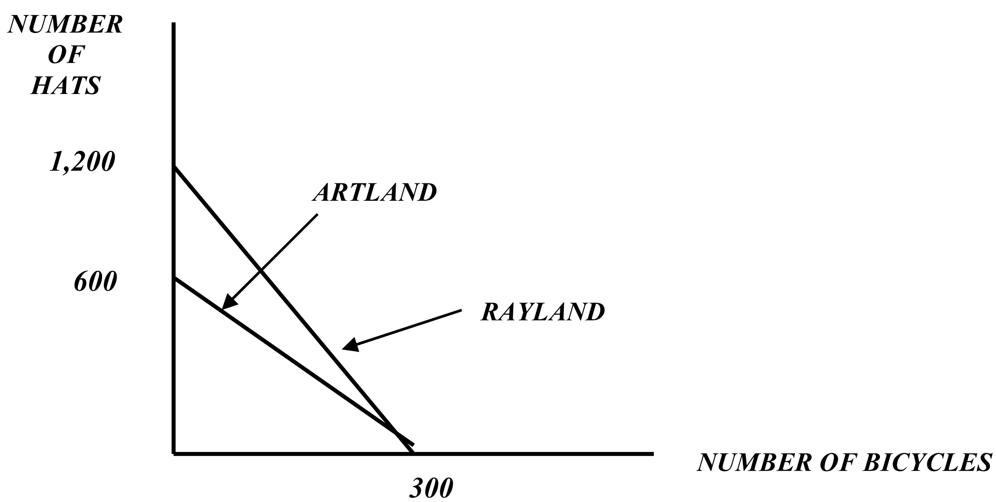
(i) A United States resident buys chocolate from Belgium.

(ii) A United States manufacturer buys computer equipment from Japan.

(b) How would an increase in the real income in the United States affect the United States current account balance? Explain.

(c) Using a correctly labeled graph of the foreign exchange market for the United States dollar, show how an increase in United States firms' direct investment in India will affect the value of the United States dollar relative to the Indian currency (the rupee).

3. ***The diagram below shows the production possibilities curves for two countries: Artland and Rayland. Using equal amounts of resources, Artland can produce 600 hats or 300 bicycles, whereas Rayland can produce 1,200 hats or 300 bicycles.***



(a) Calculate the opportunity cost of a bicycle in Artland.

(b) If the two countries specialize and trade, which country will import bicycles? Explain.

(c) If the terms of trade are 5 hats for 1 bicycle, would trade be advantageous for each of the following?

(i) Artland ***(ii) Rayland***

(d) If productivity in Artland triples, which country has the comparative advantage in the production of hats?