ECN327

Depth of analysis matters.

**1. Contrast the effectiveness of fiscal policy when interest rates are exogenous versus when they are endogenous. In which case is fiscal policy more effective? Explain why?**

**Fiscal policy is**

* **IS-LM Questions presentation, last part**
* What you’re doing is comparing the effectiveness of fiscal policy in interest rates when exogenous or endogenous, then which case is more effective
* interest rates are exogenous, only changing when it is assumed they change, which contradicts reality, since changes in Y cause r to change.
* Fiscal Policy - Manipulation of AE by the federal government to move the economy in the direction deemed to be most appropriate..**AE = C + Ip + G with fiscal policy**
* Interest rates exogenous-treat most as exogenous then move as theory becomes more realistic
* - Policy is effective if it can move the economy in the desired direction and by large amounts if desired.
* - This indicates that effectiveness is related to Ye resulting from policy, among other things.
* Why do both r and Y rise? Because now, Md is endogenous, which gives a mechanism by which changes in Y (which alter the real Md) cause interest rates to change.
* Variables
  + money supply, government spending, and tax rates

Interest rates endogenous- shortlist of endogenous variables

Higher interest rates then lower fund borrowing and fewer goods

Autonomous consumption (*Ca* ) depends on the interest rate,

**2**

* - Fiscal policy alters AE and demand, thus impacting the IS (only) - Monetary policy entails altering the real money supply (Ms), so it only affects the LM curve
* - Policy is effective if it can move the economy in the desired direction and by large amounts if desired. - This indicates that effectiveness is related to Ye resulting from policy, among other things.
* expansionary monetary or fiscal policy (both shift the AD curve)
* open economy (i.e., flexible exchange rates)
* With two problems, growth and inflation, monetary policy can only help one problem while making the other worse.
* Monetary and Fiscal Policy are only effective in fighting inflation when it is demand pull, since there is only one problem: too much demand. Contractionary policy can solve this.
* - This indicates that effectiveness is related to Ye resulting from policy, among other things.

In an open economy with fixed exchange rates, fiscal policy is, indeed, more effective than monetary policy. In fact, monetary policy has absolutely no effect. (See pages 429-430.) However, in an open economy with flexible exchange rates, monetary policy should actually be more effective, since there is an additional channel through which it can affect output. Consider monetary vs. fiscal contraction. If the central bank decreases money supply, domestic interest rates increase and output decreases. But as the interest rates rises relative to the interest in the rest of the world, more investment comes in from abroad (because the return on it is higher at home), and this increases the demand for the home currency. Thus, it will appreciate making the domestic goods relatively more expensive than in the rest of the world, which will lower exports and increase imports. This will decrease US output even more. On the other hand, fiscal policy is less effective in this case. Suppose the government decreases spending (or increases taxes). People will consume less, but part of this will be manifested in lower imports. So, part of the contraction will be felt abroad.

**3. What would cause the IS curve to be vertical? Assuming that the IS curve is vertical, what will the corresponding AD curve look like?**

* Fiscal policy alters AE and demand, thus impacting the IS (only)
* that it represents that desired investment equals desired saving.

**4. Contrast crowding out in the Basic Keynesian Model, the IS-LM model, and the AD-AS models.**

* Recall, in both the basic Keynesian model and IS-LM models, there is no theory of supply.
* If the Keynesian model were to survive, it would need to be modified so that it could account for the events that were occurring (stagflation), which required it to explicitly add aggregate supply.
* The LM curve is derived keeping both the nominal money supply (Ms ) and the price level (P) constant (exogenous).
* Both Ye and Pe rise, so there is an inflationary effect of policy in the Keynesian Model. Q: Does Ye rise by the same amount it would in the Basic Keynesian Model? HINT: Think of what is constant in that model isn’t in this model.
* In the AD-AS model, as equilibrium price changes, the rate of inflation also changes.

**5. Starting at the full employment level of Y, contrast the impact of expansionary fiscal policy in the IS-LM model with that in the AD-AS model.**

- Fiscal policy alters AE and demand, thus impacting the IS (only) - Monetary policy entails altering the real money supply (Ms), so it only affects the LM curve

To Eliminate a GDP Gap:

↑G ↑Tr ↓T => ↑AE (Macro): Expansionary (Discretionary) Fiscal Policy

=> ↑D in product markets (Micro)

* Deficits raise AE (and Ye). If done appropriately, can have equilibrium at full employment
* All of these will be points of money market equilibrium. Because of this, the associated curve of money market equilibrium L (money demand) = M (money supply) is called the LM curve.
* In the IS-LM model, we get Ye and the associated re. If either curve shifts, BOTH r and Y change.
* Remember, the slope of the IS curve impacts the effectiveness of monetary policy (i.e., shifts of the LM curve). Focus on monetary policy here
* The LM curve is derived keeping both the nominal money supply (Ms ) and the price level (P) constant (exogenous).
* - Given the nominal money supply, as the price level changes, the real money supply also changes, shifting the LM, resulting in a different Ye
* In the AD-AS model, as equilibrium price changes, the rate of inflation also changes.