Discussion Handout 9: Chapter 21-23 Policy and Aggregate Demand

April 24, 2020

Ch. 21 - Influence of Monetary Policy and Fiscal Policy on Aggregate Demand

Overview: Chapter 20 - developed a model to think about short-run and long-run effects. Chapter 21 & 22 want us to think about policy.

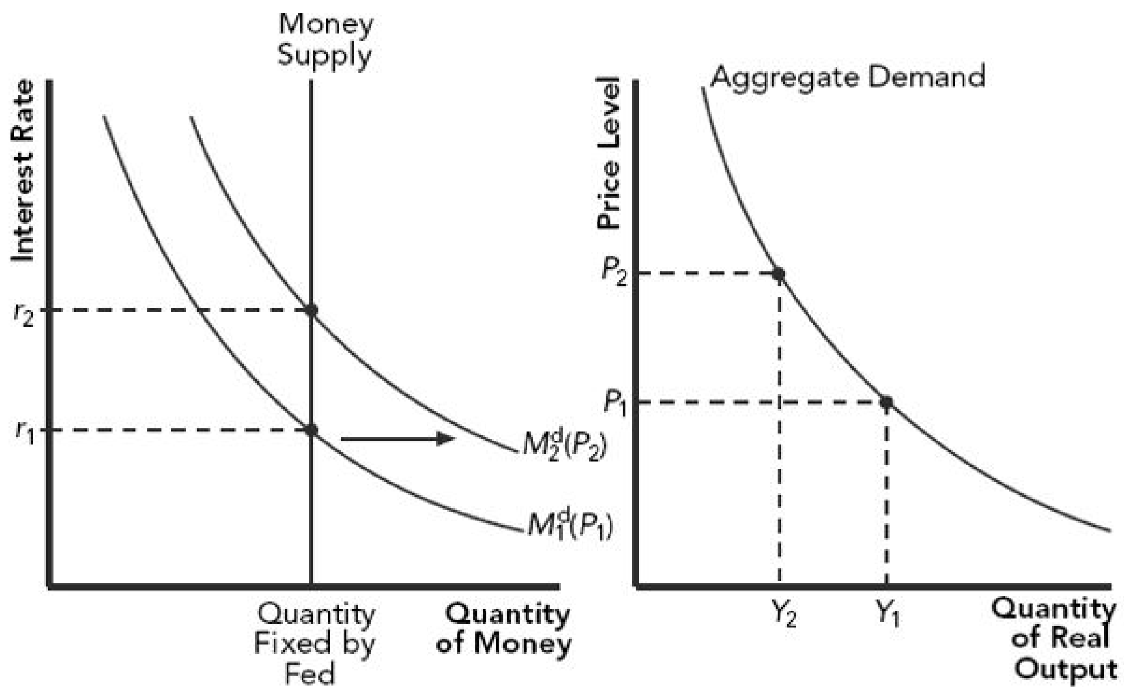
Background Info:

- Interest rate effect is the key determinant of downward sloping aggregate demand
- The liquidity preference model suggests that interest rate is determined by the supply and demand for money in the short-run. In the long-run it is determined by the loan for marketable funds.
- The interest rate is both the real and the nominal since in the short-run changes to these are equal.

Liquidity Preference Theory helps us explain:

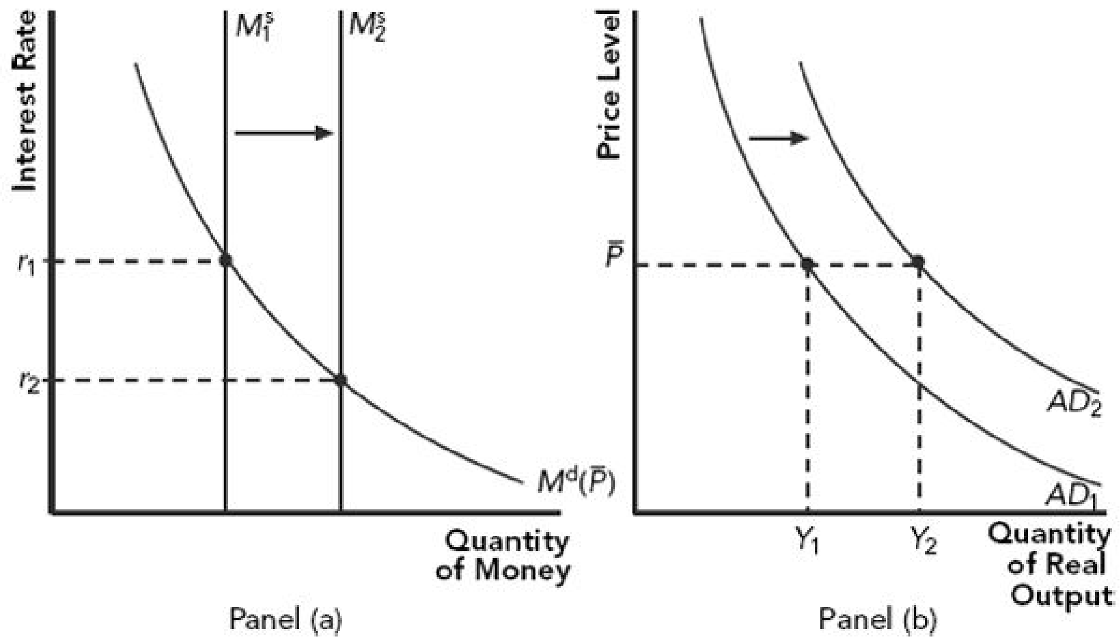
A. Why Aggregate Demand is downward sloping:

1. With higher prices, people need more money to buy the same amount of goods.
2. This shifts the Money Demand Curve
3. With a fixed money supply, interest rates rise.
4. With higher interest rates investment, and thus AD falls.



B. How monetary policy effects aggregate demand

1. The Fed shifts the Money Supply Curve to the right
2. The interest rate falls
3. Costs less to invest, demand for goods and services increases at each price level, so aggregate demand shifts right



C. How fiscal policy effects aggregate demand

- Increase in government spending directly shifts the aggregate demand curve
- How much it shifts depends on the multiplier effect (increases) and the crowding-out (decreases) effect
- Taxes can also shift the aggregate demand curve via household consumption.

D. Deciding to use policy to stabilize the economy:

Two points of view:

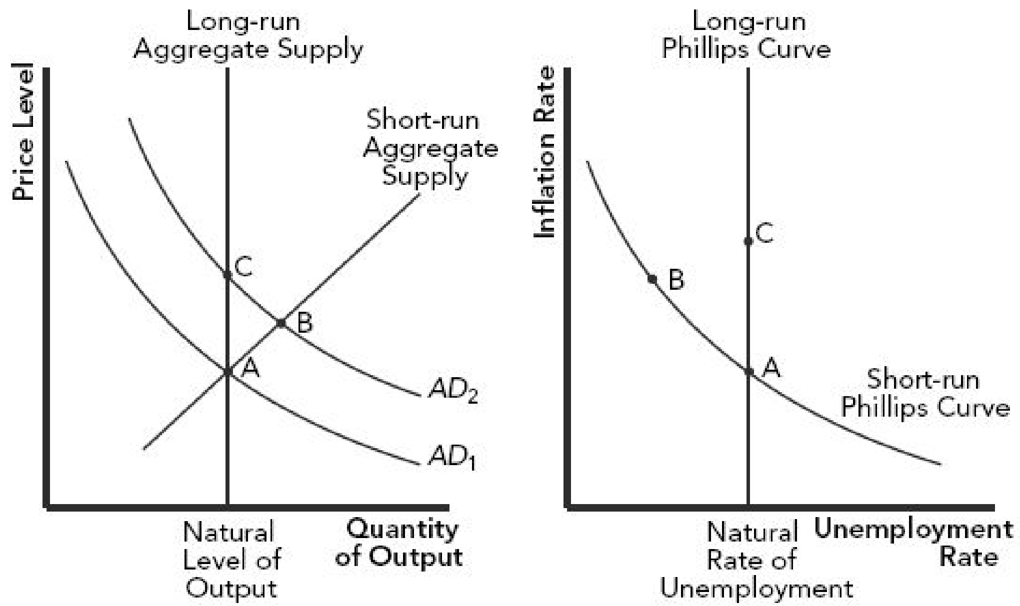
1. Keynes - government should use policy to reduce fluctuation, called stabilization policy
2. Others - policy is too slow, so the policy itself could have unintended consequences

Definition: Automatic stabilizers - changes that automatically stimulate aggregate demand in recession so that policymakers do not have to take deliberate action. For instance, the tax system collects less taxes in a recession because incomes are lower.

Ch. 22 - Trade-off between inflation and unemployment

The Phillips Curve - negative relationship between unemployment and inflation. How this works:

- Increase in aggregate demand
- Moved along the short-run aggregate-supply curve
- Now have higher price level, higher output, and lower unemployment
- Increased price level = Inflation



Notes:

- In long-run Phillips curve should be vertical, at the natural rate of unemployment, which corresponds to long-run aggregate-supply curve. In the long-run people adjust to inflation.
- Supply-shocks (shocks that effect firms' costs and prices) can shift the Phillips curve.
- Cost of reducing inflation - reduction in the money supply reduces aggregate demand, reduces production, and increases unemployment. Over time, expected inflation falls and the short-run Phillips curve shifts down to equilibrium. The cost of this is a period high unemployment.

Ch. 23 - Macroeconomic Policy Debates

- Should policymakers try and stabilize the economy?
- Should the government fight recessions with spending hikes?
- Should monetary policy be made by rule or discretion?
- Should the goal be zero-inflation?
- Should the government balance its budget?
- Should there be tax reform?