27
ECONOMIC POLICY

OVERVIEW

1. Policy starts with goals. Before we can decide what tools to use and how to use them, we must decide what goals we wish to pursue. Which goals we choose to pursue will depend upon our values. Economic goals include economic growth, efficiency, economic freedom, equitable distribution of income, clean environment, full employment, and price stability. Why not pursue them all? The goals conflict.

2. The relationship showing the trade-off between inflation and unemployment is called the Phillips curve. The Phillips curve shows that if we get more of one we will get less of the other.

3. One problem with the Phillips curve is that it moves. There are times when we get more of both unemployment and inflation. When both increase, we have stagflation. Stagflation is shown by the outward shift of the Phillips curve. Stagflation can also be shown on aggregate supply and demand by a decrease in aggregate supply.

4. The traditional tools of fiscal and monetary policy are not successful in reducing stagflation. This is because either tool can reduce inflation by reducing aggregate demand, but the cost is more unemployment.

5. Classical economists believe that the economy always achieves equilibrium at full employment. Thus there is no reason for the government to interfere in the economy. The Keynesian believes that equilibrium can occur at any level of income, and that fiscal and monetary policy can be used to achieve full employment.

6. The monetarists believe that the money supply can be used to affect the level of income and the price level. The equation of exchange states that the money supply times the velocity equals the price level times the quantity of output. Monetarists also believe that fiscal policy will not be effective because every change in government spending will offset investment spending. The only workable policy is to set the money supply growth equal to the growth of the productivity of labor.

7. Neither Keynesians nor monetarists are able to provide policies that can overcome stagflation. The supply-side economists argue that stagflation can be overcome by shifts in the aggregate supply. By increasing aggregate supply, both inflation and unemployment will be reduced.

8. Rational expectationists say that there cannot be any long term unemployment or inflation, and that government policy will generally be ineffective. People know what the policy will be before it is enacted and will act to offset the impact of the policy.

MATCHING

_______ 1. Phillips curve

_______ 2. stagflation

_______ 3. classical economists

_______ 4. Keynesian economists

_______ 5. equation of exchange

_______ 6. velocity of circulation

_______ 7. monetarists

_______ 8. supply-side economists

_______ 9. rational expectations

a. economists who believe that the economy will always return to full employment

b. economists who believe that fiscal policy will not work due to crowding out, so the only useful policy tool is monetary policy

c. the equation that says MV = PQ

d. economists who emphasize the importance of policy on the aggregate supply

e. the number of times a dollar is spent in purchasing GDP in a year

f. the trade-off between inflation and unemployment

g. economists who believe that people adjust to expected actions by the government to offset the action; the modern form of Classical economics

h. economists who believe that the economy will not return to full employment and government intervention will be needed

i. undesirable rates of unemployment and inflation at the same time

TRUE-FALSE

______ 1. All economists agree on the policy to pursue.

______ 2. Economic goals do not trade off.

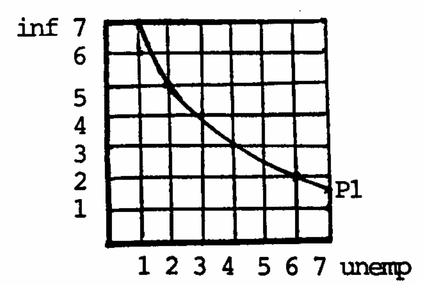
______ 3. Keynesian economists and Classical economist differ on whether the government should interfere in the economy.

______ 4. Rational expectations economists and Classical economists have a similar view that the government should not interfere in the economy.

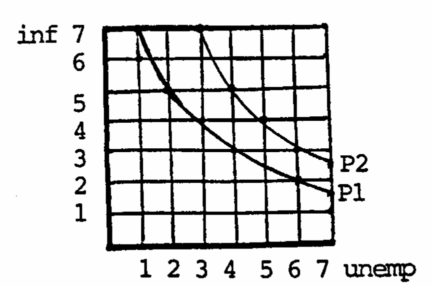
______ 5. The Phillips curve illustrates that we cannot reduce both inflation and unemployment at the same time.

PROBLEMS

1. Consider the Phillips curve shown here. Start at an inflation rate of 7 percent.
   a. What is the unemployment rate?
   b. If the inflation rate is 2 percent, what is the unemployment rate?
   c. What happens to the unemployment rate as the inflation rate goes down?
   d. As you move down this curve, inflation ____________ and unemployment______________.
   e. As you move up this curve, inflation__________________ and unemployment _________________.
   f. The Phillips curve shows that inflation and unemployment. ____



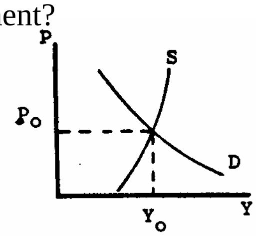
2. Suppose that we are on Phillips curve Pl. The rate of inflation is 3 percent.
   a. What is the rate of unemployment? ____
   b. What does a shift to the right of the Phillips curve show?



c. Suppose that the Phillips curve now shifts out to P2 and the inflation rate goes up to 4 percent. What is the rate of unemployment? ____________________

d. If we compare P1 and P2, what can we say is true at each rate of inflation?
____
____

3. a. Use the graph below and show the impact of an increase in aggregate demand. What happens to prices and employment?



b. Is this a movement along or a shift of the Phillips curve?
____

c. If we decrease aggregate demand, what happens to prices and employment?
____

d. Is this a movement along or a shift of the Phillips curve?
____

e. Suppose that we increase the aggregate supply. What happens to prices and employment? ____

f. Is this a movement along or a shift of the Phillips curve? ______________________

IN THE NEWS

1. Usually, recessions are considered bad. But the most recent recession had some positive aspects. For one, the recession is credited with reducing inflation. Also, some firms were forced to become more efficient and reduce waste. Unions were forced to allow wages to fall. Wages more accurately reflected productivity and the economy became more competitive.

   a. Would you expect these benefits to be erased in the next recovery? ______________
   ____

   b. Do these benefits outweigh the costs of unemployment? ________________________
   ____

2. One of the debates in economics is whether there really is a business cycle. People who claim there is a cycle need to show that there is something in the recovery that causes the next downturn. An exhaustive analysis of the data using rational expectations shows that there are not cycles, but there are a growth trend and random shocks around the trend.

a. If there are no cycles, what role does policy have? ____________________________
____

b. What difference is there between cycles and random shocks? Are random shocks another name for cycles? ____

3. Although we all suffer under inflation, having the rate of inflation reduced is not all good. Workers accustomed to a 10 percent pay increase with inflation at 8 percent can now expect only a 6 percent raise when the inflation is 4 percent. And those who earned 15 percent interest will be hard pressed to find even a 7 percent rate of return now that inflation is reduced.

   a. Was the higher unemployment needed to reduce the inflation worth it?
   ____

   b. Are the higher wages and interest rates really advantages of inflation? Explain.
   ____

4. The downturn in the economy in the early 1980s involved both unemployment and inflation at the same time. The unemployment rate was above 9 percent and the inflation rate was 13 percent.

   a. What impact on unemployment and inflation would you expect from fiscal policy?____
   b. What impact on unemployment and inflation would you expect from monetary policy? ____
   c. The supply-side economist would recommend shifting aggregate supply. Should aggregate supply be increased or decreased? Explain. _________________________
   ____
   d. What can we do to increase aggregate supply? _______________________________
   ____

PRACTICE TEST

Circle the correct answer.

1. The Phillips curve indicates that:
   a. less inflation means more unemployment.
   b. less inflation means less unemployment.
   c. more inflation means more unemployment.
   d. none of the above.

2. Stagflation is shown by:
   a. an outward shift of the Phillips curve to the right.
   b. an inward shift of the Phillips curve to the left.
   c. a movement up the Phillips curve.
   d. a movement down the Phillips curve.

3. If an economist favors using fiscal policy to stabilize the economy, then the economist is likely to be:
   a. a classical economist.
   b. a Keynesian economist.
   c. a supply-side economist.
   d. a rational expectations economist.

4. The equation of exchange is:
   a. MP = QV.
   b. PV = QM.
   c. MV = PQ.
   d. MQ = VP.

5. When goals trade off:
   a. to get more of one goal requires getting less of another.
   b. we must decide which goals are more important.
   c. there is an opportunity cost of the forgone goal.
   d. all of the above.

ANSWERS

Matching
1. f
2. i
3. a
4. h
5. c
6. e
7. b
8. d
9. g

True-False
1. F
2. F
3. T
4. T
5. T

Problems

l. a. 1 percent unemployment rate
   b. 6 percent unemployment rate
   c. The unemployment rate went up.
   d. decreases, increases
   e. increases, decreases
   f. trade off.

2. a. 4 percent unemployment rate
   b. stagflation
   c. 5 percent unemployment rate
   d. Unemployment is higher.

3. a. The shift in the aggregate demand curve to the right causes prices to rise and the output to rise. Thus employment rises.
   b. This is a movement along the Phillips curve because inflation increases but unemployment decreases.
   c. Prices and employment both decrease as aggregate demand shifts to the left.
   d. This is a movement along the Phillips curve because inflation is reduced, but unemployment goes up.
   e. Prices fall but employment rises as aggregate supply shifts to the right.
   f. This is an inward shift in the Phillips curve because we reduce inflation and unemployment at the same time.

In the News

l. a. Some of the benefits may be erased in the next recovery. Wages may go up. But if productivity is going up faster, the increase in wages will be less significant. The inflation may reoccur. But careful control of spending and the money supply can reduce the likelihood of more inflation. The firms that gained efficiency may be able to maintain their position, but they-will have to work at it. So some of the gains may be erased and some may not.
   b. To the extent that the inflation is considered worse than the unemployment, then the cost of the unemployment is justified. One might wonder if there were a better way to achieve the same goal.
2. a. If there are no business cycles, then there is no need to try to use policy tools to stabilize the business cycle. It could be that the only role for policy is an attempt to alter the trend.
   b. Cycles presumably are predictable. Random shocks are not predicable, so the two are not the same.
3. a. Is higher unemployment too high a cost to pay to achieve reduced inflation? It depends. If the benefits of inflation went to everyone, then perhaps yes. But if the costs of inflation are too uneven so r that some suffer more than others, perhaps the cost of higher employment was not so great.

b. The higher wages and higher interest rates were needed to offset the higher prices while real income in terms of purchasing power may remain the same.

4. a. If fiscal policy were used, we would expect that either the unemployment could be reduced or the inflation could be reduced but not both.
   b. If monetary policy were used, we would expect that either the unemployment could be reduced or the inflation could be reduced but not both.
   c. If aggregate supply were increased, we would get lower prices and more employment. That would reduce inflation and unemployment at the same time.
   d. Aggregate supply can be increased by lowering tax rates so that people keep more of their income. This provides an incentive to produce more. Another possibility would be to lower taxes on business so that business will invest more, which in turn will allow business to produce more at each price level.

Practice Test

1.a., 2.a., 3.b., 4.c, 5.d.