**Chapter 8** Impact of Policy Decisions on the Rate of Inflation

**“The Stabilization Function of Government”**

# Relevant Readings from the Required Textbooks:

* ***Chapter 8, Impact of Policy Decisions on the Rate of Inflation***

# Definitions and Concepts:

* **stabilization function** – attempts by government to minimize fluctuations in overall macroeconomic activity.
* **Fiscal Policy** – Government policies related to spending and revenue generation.
* **Monetary Policy** – Government policies which determine a nation’s Money Supply.
* “The General Theory of Employment, Interest and Money” (1936) by John Maynard Keynes – a book, written against the backdrop of the Great Depression, which was in many ways an assault on “traditional macroeconomic thought” (previous argument was for *direct control of the macroeconomy*)
  + central argument of “The General Theory…”: markets are volatile and might not result in “full employment”
  + observed outcomes during Great Depression:
    - people don’t have jobs/incomes
    - without income people don’t buy output from firms
    - firms can’t make profits, so they shutdown and layoff workers
    - stable state with low resource use and low output
  + low output equilibria caused by too little spending => recall, from our discussion of GDP that: *Y* = *C* + *I* + *G* + *NX* => a low value of *C* can bring down *Y*
    - solution: replace missing private spending with government spending (i.e.,

offset the low value of *C* with a higher value of *G* ) => deficit spending as an economic stimulus during downturns [a **budget deficit** occurs when government spending exceeds revenues]

* + - corollary: government should cut back spending and run a surplus during an

expansion (*this has often been overlooked*) [a **budget surplus** occurs when government revenues exceed spending]

* + - Key implication: Fiscal Policy can indirectly stabilize macroeconomic activity (“spending against the wind”)
* **Expansionary Fiscal Policy** – increases in government spending or decreases in taxes with the aim of stimulating overall economic activity
* **Contractionary Fiscal Policy** – decreases in government spending or increases in taxes with the aim of dampening overall economic activity
* **Crowding Out** – decreases in private spending that occur following increases in government spending
  + as *G* is increased, does *C* remain constant or decrease? => a decrease in *C*

reveals “crowding out”

* + If a significant amount of crowding out occurs, then the effectiveness of stimulative Fiscal Policy will be reduced, since the government spending does not

create any new economic activity, but rather replaces private economic activity with government economic activity (in a likely inefficient way)

* + However, if instead productive resources are not fully employed, then government spending will use otherwise idle resources and thus will generate new economic activity => could lead to a significant short term increase in overall economic activity as desired
* **money supply** – the amount of money in circulation in an economy (denoted *M* )
* **velocity of money** – the number of times that a typical dollar is used in market transactions in a single year (denoted *V* )
* **overall price level** – the “average” of all the prices of goods/services traded (denoted

*P* )

* **aggregate level of output** – a measure of the real quantity of goods/services produced (denoted *Q* )
* **Equation of Exchange** – an identity which relates the money supply, velocity of money, overall price level, and aggregate level of output to each other: *MV* = *PQ*
* “A Monetary History of the United States, 1867-1960” (1963) written by Friedman and Anna Schwartz – provided strong evidence to support a claim that the money supply has a direct impact on short run levels of income, employment, and inflation
  + In the decades following WW-II “Monetarism” emerged as an alternative to “Keynesianism” => Monetarism argued that economic fluctuations depended more on Monetary Policy than on Fiscal Policy
  + Milton Friedman (1912-2006; Nobel Prize in 1976)
* **loanable funds market** – the collection of all markets in which lenders and borrowers interact (e.g., mortgage markets, auto loan markets, consumer credit markets, business loan markets)
  + when loanable funds are more readily available, interest rates decrease => businesses are more inclined to build factories, expand production, and hire workers, while households are more inclined to make major purchases
  + starting at a point where *Q* is below its maximum, increasing the money supply can lead to a real increase in economic activity (i.e., in *Q* )
* **expansionary monetary policy** – an increase in the money supply which provides a short term stimulus to the macro-economy, resulting in higher levels of output, employment, and incomes
* **contractionary monetary policy** – a decrease in the money supply which dampens overall economic activity, resulting in lower levels of output, employment, and incomes in the short term (but greater stability in the long term)
* **central bank** – entity which has the ability to alter the money supply of an economy
  + Primary task is to control the nation’s money supply.
  + U.S.: Federal Reserve (created in 1913)
  + U.K.: Bank of England (created in 1694)
  + Federal Reserve is an independent central bank, in that its actions are not directly dictated by the legislative or executive branch
  + experience suggests that independent central banks are better at promoting stable economic growth and maintaining the value of a country’s currency => an independent central bank is less vulnerable to short term political pressures
* **fractional reserve banking system** – a system in which at any point in time a commercial bank is only required to retain a portion of the money it has accepted as

deposits

# Three policy tools of the Fed to alter the money supply:

1. **open market operations** – buying and selling of U.S. Treasury debt securities to and from the public
   * buying bonds puts more money in circulation (increases money supply); selling bonds takes money out of circulation (decreases money supply)
2. **setting of reserve requirements** – minimum restrictions on the amount of money that a bank must keep on hand at any point in time, in the form of either cash in its vault or deposits with the central bank
   * lowering the reserve requirement increases the money supply; raising the reserve requirement decreases the money supply

3.

**setting of discount rate** – setting the interest rate that the Fed charges banks on short-term loans

* + lowering the discount rate increases the money supply; raising the discount rate decreases the money supply
* *So, why not always increase the money supply in order to stimulate economic activity?* Monetarist’s answer: In the long run, changes in the money supply have no impact on the overall level of real economic activity, but rather only have an impact on price
  + in the long run, an efficient market economy will tend toward a situation in which

all resources are being used and society is producing close to its maximum level of output (i.e., *Q* is at its maximum value)

* + recalling *MV* = *PQ* , the only possible consequence of an increase in *M* is

ultimately a corresponding increase in *P* => an increase in the money supply will not alter total output in the long run but will only increase prices in the long run

* + Milton Friedman: “Inflation is always and everywhere a monetary phenomenon.”
* Inflation and Money Supply in Peru (1979-1991) => annual inflation rates of 3,398% in 1989 and 7,482% in 1990

# Multiple Choice Questions:

1. “Fiscal Policy” can be described as government policy
   1. which determines the “money supply” of an economy.
   2. aimed at changing the underlying institutions of a nation’s economy.
   3. related to spending and revenue generation.
   4. related to securing the borders of and protecting the homeland of a nation.
2. The refers to government policies with the primary aim of minimizing fluctuations in overall macroeconomic activity.
   1. Allocation Function of Government
   2. Distribution Function of Government
   3. Stabilization Function of Government
   4. Taxation Function of Government
3. The refers to the periodic but irregular fluctuation in overall macroeconomic activity which occurs over time.
   1. Stabilization Function of Government
   2. Business Cycle
   3. velocity of money
   4. None of the above answers are correct.
4. Which of the following is NOT one of the primary policy tools used by a central bank?
   1. Setting the “discount rate.”
   2. Loaning money to low income home buyers at below market interest rates (in order to make housing “affordable for all”).
   3. Setting “reserve requirements.”
   4. None of the above answers are correct (since each of the choices listed is one of the primary policy tools used by a central bank).
5. can potentially be used by the government in order to stabilize the performance of the macroeconomy (i.e., to minimize fluctuations in the rate of economic growth) over time.
   1. Neither Monetary Policy nor Fiscal Policy
   2. Monetary Policy, but not Fiscal Policy
   3. Fiscal Policy, but not Monetary Policy
   4. Both Fiscal Policy and Monetary Policy
6. The phase of the business cycle that refers to the point in time at which overall economic activity reaches its maximum is the
   1. Recovery.
   2. Peak.
   3. Recession.
   4. Trough.
7. “The General Theory of Employment, Interest and Money” was written by
   1. Milton Friedman
   2. Anna Schwartz
   3. Margaret Thatcher
   4. John Maynard Keynes
8. The U.S. economy grew for an uninterrupted 10 year period from
   1. August 2002 to the present day.
   2. March 1991 through March 2001.
   3. September 1979 through September 1989.
   4. June 1967 through June 1977.
9. The arguments made by John Maynard Keynes suggest that during an economic downturn, the government should
   1. have the government seize ownership of and directly control the “Commanding Heights” of our economy.
   2. deploy the military in order to conquer and colonize other countries with large amounts of natural resources (e.g., Middle Eastern countries with tremendous oil reserves).
   3. run a budgetary deficit, in order to stimulate the economy by replacing missing private spending with government spending.
   4. run a budgetary surplus, so that we do not accumulate a tremendous amount

of debt that will ultimately burden our children and grandchildren.

1. The Fed can increase the Money Supply in the U.S. by
   1. selling U.S. Treasury debt securities to the public.
   2. increasing the reserve requirement.
   3. decreasing the discount rate.
   4. More than one (perhaps all) of the above answers is correct.
2. The equation of exchange is defined as

*A. MV* = *PQ*. *B.MQ* = *PV*.

1. *MP* = *VQ*.
2. *V* = *PQ*.
3. Monetary Policy in the United States is determined by
   1. the Federal Reserve.
   2. the Judicial Branch of the Federal Government.
   3. the Executive Branch of the Federal Government.
   4. the Legislative Branch of the Federal Government.
4. If the money supply is $80 billion, the velocity of money is 5, and real GDP is$320 billion, then the price level equals

A. 51.20.

B. 20.00.

C. 4.00.

D. 1.25

1. According to the equation of exchange, if the money supply is $600 million, real GDP is

$2,100 million, and nominal GDP is $3,600 million, then the velocity of money is equal to

A. 3.5.

B. 1.7.

C. 10.3

D. 6.0.

1. If nominal GDP is $18,600 million, and the money supply is $6,000 million, then the velocity of money is equal to

A. 3.1.

B. 12.4.

C. 0.02.

D. 49.6.

1. The ultimate goal of monetary policy is
   1. interest rate stability.
   2. economic growth with low inflation.
   3. zero unemployment.
   4. a favorable exchange rate of the dollar.
2. Which function of money is deteriorating when there is a high inflation?
   1. Medium of exchange
   2. Unit of account
   3. Standard of deferred payment
   4. Store of value

# Answers to Multiple Choice Questions:

1. C
2. C
3. B
4. B
5. D
6. B
7. D
8. B
9. C
10. C
11. A
12. A
13. D
14. D
15. A
16. B
17. D