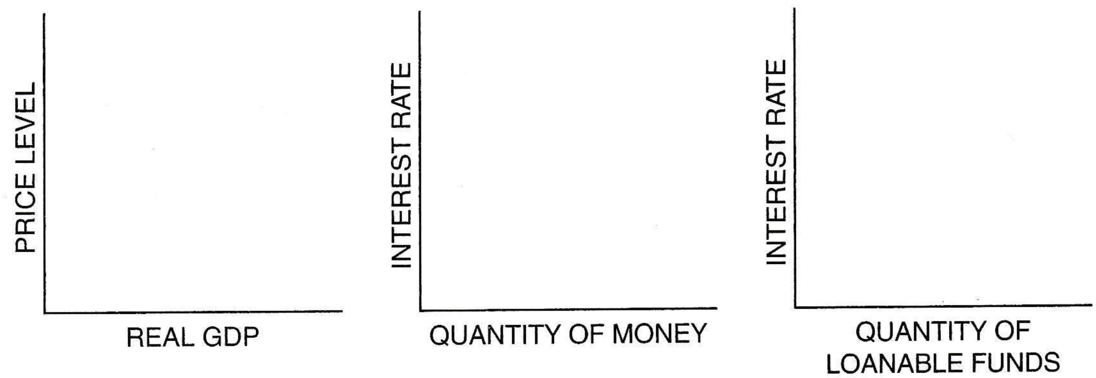
Monetary and Fiscal Policy Interactions

In the figures accompanying each question, illustrate the short-run effects for each monetary and fiscal policy combination using the money market, the loanable funds market, and aggregate supply/aggregate demand (AS/AD) graph. Circle the up or down arrow (or ? for uncertain), and explain the effect of the policies on real gross domestic product (GDP), the price level, unemployment, interest rates, and investment.

1. The unemployment rate is 10 percent, and the inflation rate is 2 percent. The federal government cuts personal income taxes and increases its spending. The Federal Reserve (the Fed) buys bonds on the open market.

Figure 5-5.1
Expansionary Monetary and Fiscal Policy



(A) Real GDP ↑ ↓ ? Explain.

(B) The price level ↑ ↓ ? Explain.

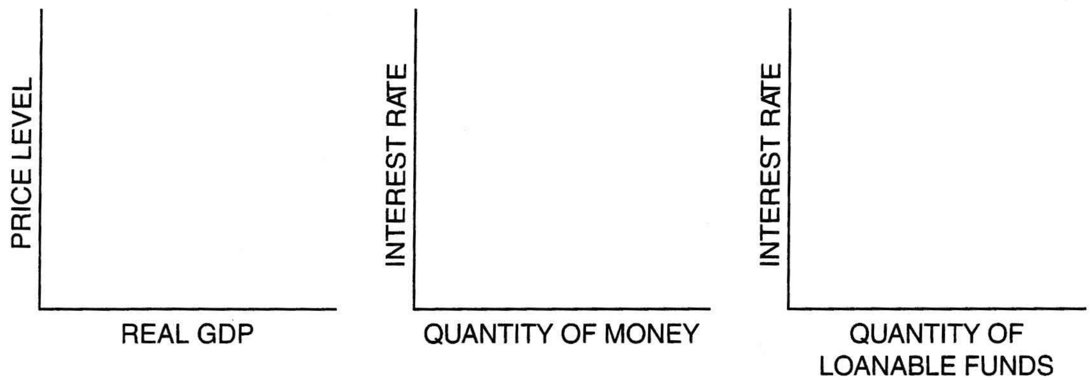
(C) Unemployment ↑ ↓ ? Explain.

(D) Interest rates ↑ ↓ ? Explain.

(E) Investment ↑ ↓ ? Explain.

2. The unemployment rate is 6 percent, and the inflation rate is 9 percent. The federal government raises personal income taxes and cuts spending. The Fed sells bonds on the open market.

Figure 5-5.2
Contractionary Monetary and Fiscal Policy



(A) Real GDP ↑ ↓ ? Explain.

(B) The price level ↑ ↓ ? Explain.

(C) Unemployment ↑ ↓ ? Explain.

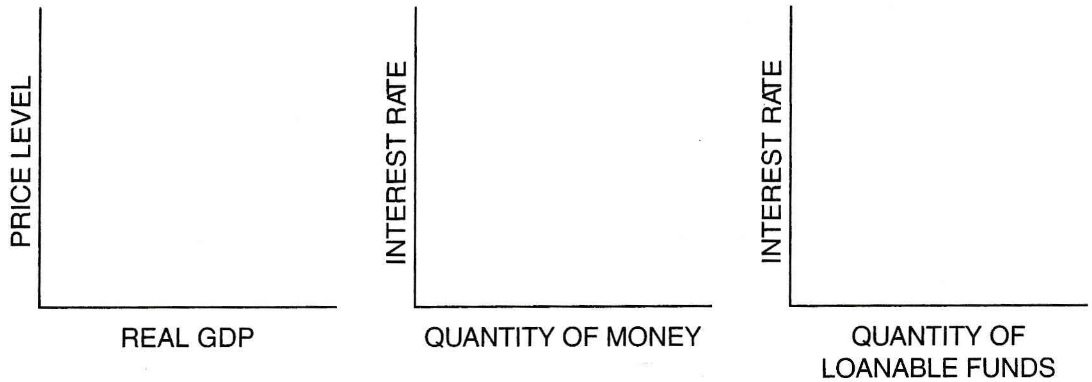
(D) Interest rates ↑ ↓ ? Explain.

(E) Investment ↑ ↓ ? Explain.

3. The unemployment rate is 6 percent, and the inflation rate is 5 percent. The federal government cuts personal income taxes and maintains current spending. The Fed sells bonds on the open market.

Figure 5-5.3

Contractionary Monetary Policy and Expansionary Fiscal Policy



(A) Real GDP ↑ ↓ ? Explain.

(B) The price level ↑ ↓ ? Explain.

(C) Unemployment ↑ ↓ ? Explain.

(D) Interest rates ↑ ↓ ? Explain.

(E) Investment ↑ ↓ ? Explain.