# Chapter 33
# Fiscal and Monetary Policy Debates

## 33.1 Fiscal Policy Versus Monetary Policy

1) List and briefly explain the steps in the transmission of monetary policy. What factors enable monetary policy to have a more powerful effect on real GDP?

Answer: There are two steps. Step one is a change in the money supply, which then changes the interest rate. Step two is the change in the interest rate, which then changes investment and aggregate demand. The change in the money supply will have a powerful effect on real GDP if it creates a large change in the interest rate and if the change in the interest rate creates a large change in investment. This outcome will occur if the demand for money is relatively insensitive to the interest rate and if investment is sensitive to the interest rate.

*Topic: Monetary policy transmission*
*Skill: Level 2: Using definitions*
*Objective: Checkpoint 33.1*
*Author: AA*

2) Is monetary policy more powerful or less powerful if the demand for money is less responsive to the interest rate? Why?

Answer: Monetary policy will be stronger if the demand for money is less responsive to the interest rate. If the demand for money is less responsive to the interest rate, any given change in the money supply will lead to a larger change in the interest rate in order to restore equality between the quantity of money demanded and the quantity supplied. The larger the change in the interest rate, the larger the effect on investment and real GDP.

*Topic: Strength of monetary policy*
*Skill: Level 3: Using models*
*Objective: Checkpoint 33.1*
*Author: NAU*

3) Discuss the factors that determine the power of monetary policy.

Answer: The size of the effect of an increase in the money supply on aggregate demand depends upon how sensitive the demand for money is to the interest rate and how sensitive investment is to the interest rate.

If the demand for money is very sensitive to the interest rate, so that the demand for money curve is nearly horizontal, than an increase in the supply of money leads to a very small fall in the interest rate. In this case, monetary policy is weak. However, if the demand for money is insensitive to the interest rate, so that the demand for money curve is nearly vertical, then an increase in the supply of money leads to a large fall in the interest rate. In this case, monetary policy is powerful.

If investment is very sensitive to the interest rate, so that the investment demand curve is nearly horizontal, then any change in the interest rate leads to a large change in investment. In this case, monetary policy is powerful. If investment is insensitive to the interest rate, so that the investment demand curve is nearly vertical, then any change in the interest rate leads to a small change in investment. In this case, monetary policy is weak.

*Topic: Strength of monetary policy*
*Skill: Level 3: Using models*
*Objective: Checkpoint 33.1*
*Author: CT*

4) What two conditions mean that monetary policy has no effect on aggregate demand? Briefly explain each.

Answer: If the demand for money has infinite sensitivity to the interest rate or if investment demand has zero sensitivity to the interest rate, then monetary policy has no effect on aggregate demand. The case in which the demand for money has infinite sensitivity to the interest rate is called the "liquidity trap." In this situation, the demand for money curve is horizontal and so a change in the quantity of money has no effect on the interest rate. The case in which investment has zero sensitivity to the interest rate means that whatever the change in the interest rate, investment does not change and so there is no effect on aggregate demand.

*Topic: Strength of monetary policy*
*Skill: Level 3: Using models*
*Objective: Checkpoint 33.1*
*Author: WM*

5) How does the expenditure multiplier affect the strength of monetary policy?

Answer: Monetary policy works by changing the money supply, which changes the interest rate, which changes investment, which changes aggregate demand, which changes real GDP. The change in aggregate demand that results from a change in investment is determined by the expenditure multiplier, so the expenditure multiplier plays a role in determining the strength of monetary policy.

*Topic: Strength of monetary policy*
*Skill: Level 5: Critical thinking*
*Objective: Checkpoint 33.1*
*Author: NAU*

6) List and briefly explain the steps in the transmission of the fiscal policy

Answer: There are three steps. Step 1 is a change in government expenditure or tax rate, which leads to a multiplied change in aggregate demand. Step 2 is the change in real GDP, which then changes the demand for money and which, in turn, changes the interest rate. Step 3 is the effect the change in the interest rate has on investment and aggregate expenditure, which offsets the effects of the initial change in government purchases.

*Topic: Fiscal policy transmission*
*Skill: Level 2: Using definitions*
*Objective: Checkpoint 33.1*
*Author: AA*

7) What is crowding out and how does it affect the strength of fiscal policy?

Answer: Crowding out is the reduction in private spending that results from fiscal policy. For instance, an increase in government expenditure increases the interest rate and thereby decreases investment. The larger the amount of crowding out, the weaker is fiscal policy.

*Topic: Strength of fiscal policy*
*Skill: Level 2: Using definitions*
*Objective: Checkpoint 33.1*
*Author: CT*

8) "The larger the crowding-out effect, the stronger is fiscal policy." Is the previous statement correct or incorrect?

Answer: The statement is incorrect. The stronger the crowding-out effect, the *weaker* is fiscal policy.

*Topic: Strength of fiscal policy*
*Skill: Level 2: Using definitions*
*Objective: Checkpoint 33.1*
*Author: AA*

9) Define the liquidity trap. Discuss the impact of the liquidity trap on the effectiveness of monetary and fiscal policy.

Answer: A liquidity trap occurs when the interest rate is at a level so that people are willing to hold any quantity of money. In this case, the demand for money curve is horizontal. A change in the supply of money has no effect on the interest rate and so monetary policy has no effect. However, a change in government spending leaves the interest rate unchanged, so there is no crowding out. As a result, fiscal policy is extremely powerful.

*Topic: Liquidity trap*
*Skill: Level 2: Using definitions*
*Objective: Checkpoint 33.1*
*Author: CT*

10) Is monetary policy or fiscal policy more powerful if there is a liquidity trap? Explain your answer.

Answer: Fiscal policy is extremely powerful in a liquidity trap whereas monetary policy has no effect at all. A liquidity trap occurs when the interest rate is at a level such that people are willing to hold any quantity of money. In this case, the demand for money curve is horizontal. As a result, a change in government spending leaves the interest rate unchanged, so there is no crowding out and hence fiscal policy enjoys the full multiplier effect on aggregate demand. Monetary policy, however, has no effect on aggregate demand because changes in the supply of money do not change the interest rate. Because monetary policy cannot change the interest rate, investment is unchanged, and so aggregate demand is unchanged.

*Topic: Liquidity trap*
*Skill: Level 2: Using definitions*
*Objective: Checkpoint 33.1*
*Author: DMC*

11) "The conditions that make fiscal policy strong are the same ones that make monetary policy weak." Is the previous statement correct or incorrect? State what conditions make fiscal policy strong and tell what conditions make monetary policy weak.

Answer: The statement is correct. Fiscal policy is strong and monetary policy is weak when the demand for money is very sensitive to the interest rate and when investment is very insensitive to the interest rate.

*Topic: Strength of fiscal policy versus monetary policy*
*Skill: Level 2: Using definitions*
*Objective: Checkpoint 33.1*
*Author: NAU*