MACROECONOMIC DISTURBANCE

Consider the six possible parametric changes listed below. Match each of the six changes in this column (marked by four solid bullets and two hollow ones) with the appropriate bullet in the second column.

A waxing of the “animal spirits” . . . . . . ●

A waning of the “animal spirits” . . . . . . ●

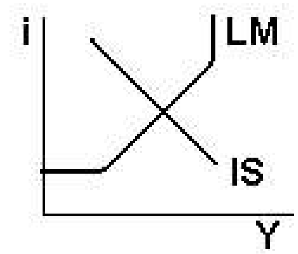
An increase in liquidity preferences . . . . ●

A decreased in liquidity preference . . . . ●

An increased in saving propensities . . . . ❍

A decreased in saving propensities . . . . ❍

ASSOCIATED MOVEMENT OF IS OR LM



● shifts LM to the right. Shift it back with.... ●

● shifts LM to the left. Shift it back with.... ●

● shifts IS to the right. Shift it back with.... ●

● shifts IS to the left. Shift it back with.... ●

CORRECTIVE POLICY ACTION

In some instances, you may choose as many as two policy options. Choosing two is to be interpreted as using one of the policies *or* the other.

● an increase in government spending.

● an increase in taxes.

● a decrease in government spending.

● a decrease in taxes.

● an increase in the money supply.

● a decrease in the money supply.

NOTES:

1. The first four macroeconomic disturbances (each marked with a solid bullet) are characteristic of a capitalist economy, according to Keynes. The last two disturbances, he thought, are very unlikely to occur (and are thus marked with hollow bullets). Query: What would Hayek say about a “disturbance” in the form of an increase in saving propensities?

2. Notice that you should use a fiscal policy tool to counter a real-sector disturbance. You should use monetary policy to counter a monetary-sector disturbance. If you try to use monetary policy to fix a real problem (or fiscal policy to fix a monetary problem), you can counter only one movement (in Y *or* in i); your policy will exacerbate the movement in the other magnitude.

3. Decreasing taxes has the same effect as increasing government spending–except that the (equi-potent) tax cut would have to be a little bigger than the alternative government-spending increase. Rather than use taxes and government spending as *alternative* policy tools, you can use them *together*–so as not to get the budget out of balance. Increasing *both* government spending and taxes by the *same* amount shifts the IS curve to the right by *that same* amount. Can you prove it?