LECTURE 13
IS-LM | MONETARY & FISCAL POLICY

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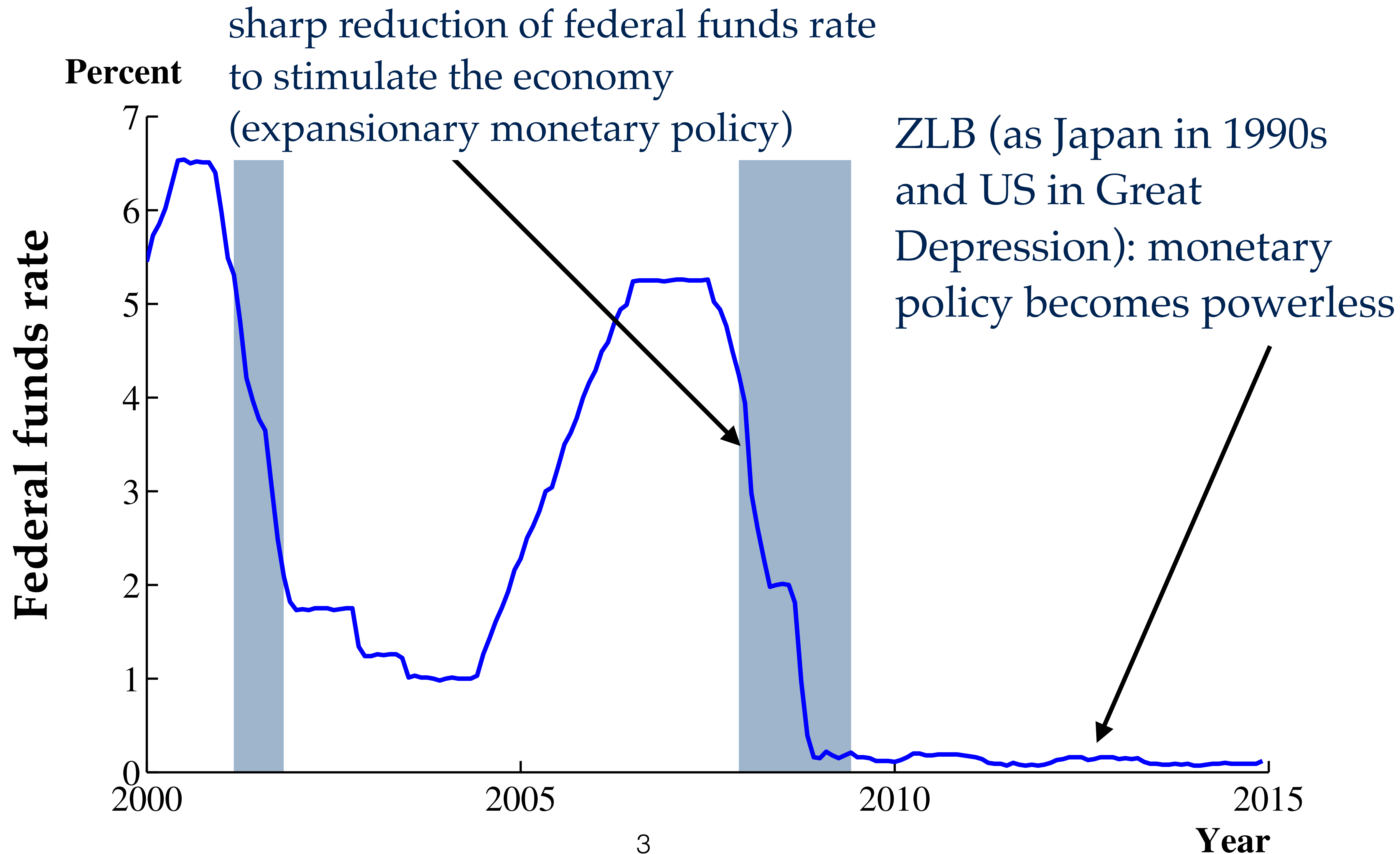
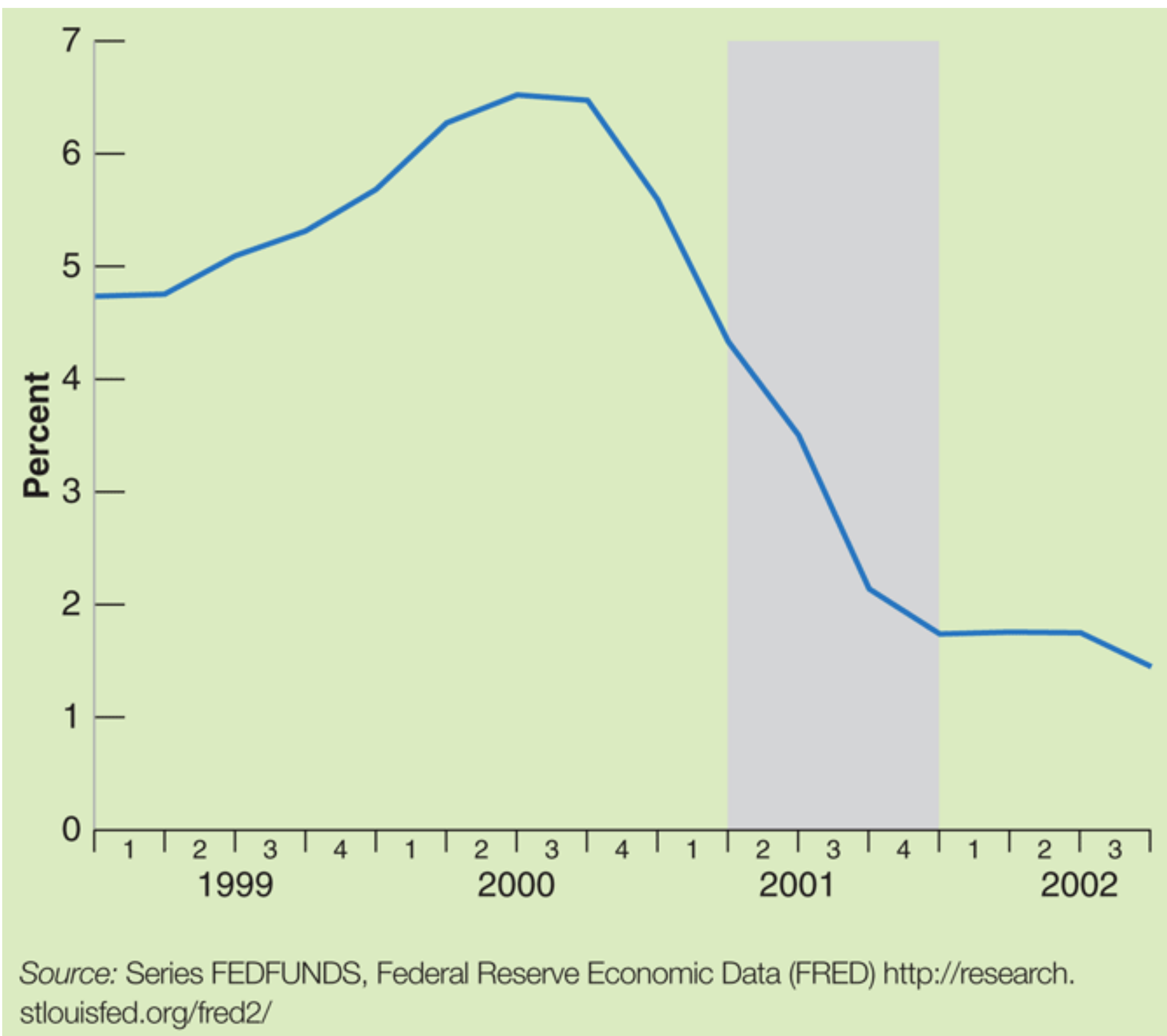
MANDATE OF THE US GOVERNMENT

- Employment Act of 1946 + Full Employment Act of 1978
- key objective: policy must foster "price stability" and bring the economy to "full employment"
  - inflation about 2% and unemployment about 3% – 4%
- Federal Reserve System: through monetary policy (federal funds rate)
  - most recent Fed announcement: https://www.federalreserve.gov/newsevents/pressreleases/monetary20180926a.htm
- federal government: through fiscal policy
  - public spending, public employment, taxes, transfers

US MONETARY POLICY DURING GREAT RECESSION, 2007–2009

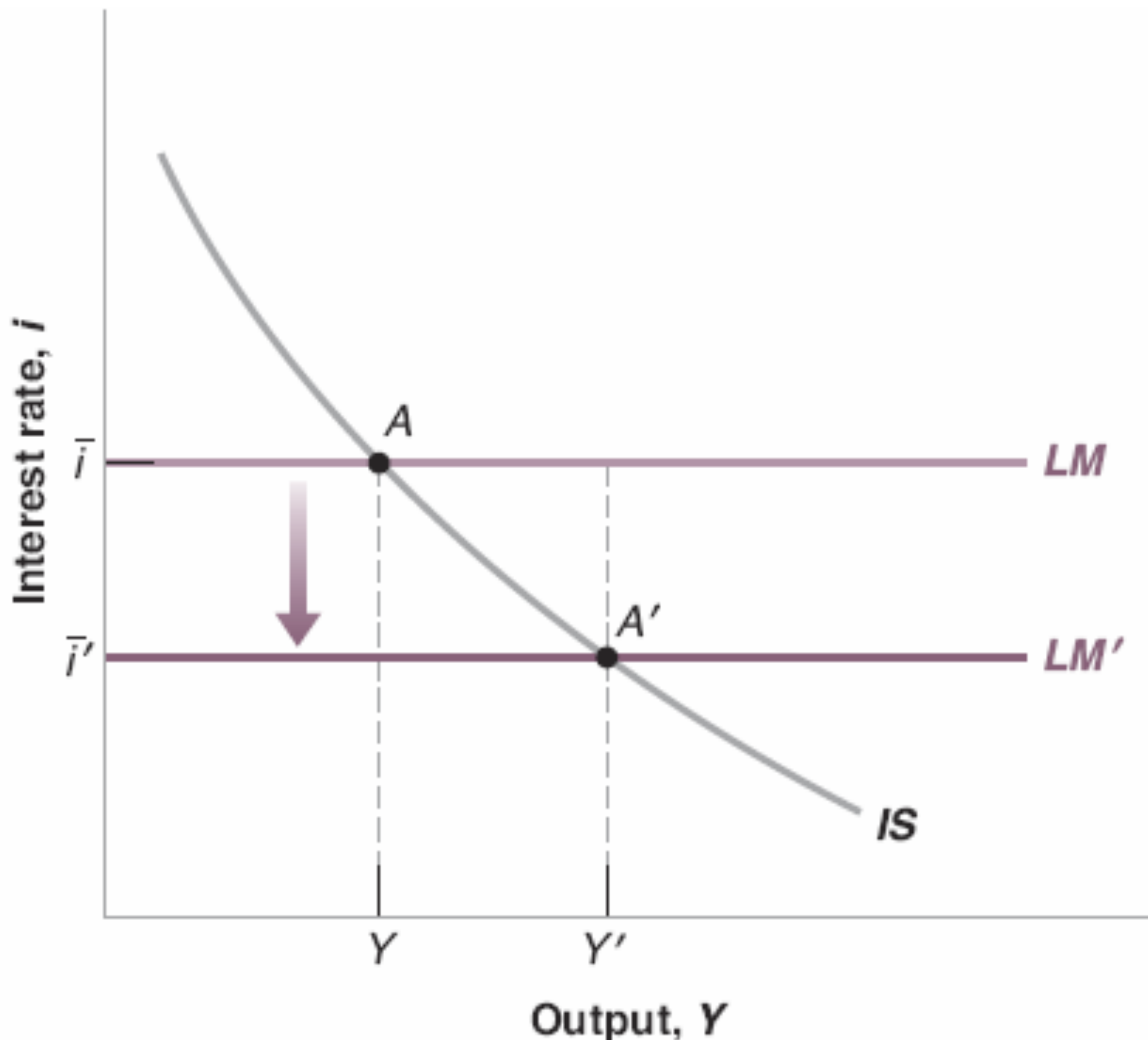


ANOTHER EXAMPLE: 2001 RECESSION



- strong response of monetary policy to the recession
- the Fed cut the federal funds rate from 6.5% to 2%
- the goal of this expansionary monetary policy was to stimulate the economy

EXPANSIONARY MONETARY POLICY IN IS-LM MODEL



- the reduction in interest rate is implemented by increasing the money supply through OMO
- the LM curve shifts down
- equilibrium output rises (so consumption and investment also rise)
- this monetary policy is expansionary

US FISCAL POLICY DURING GREAT RECESSION, 2007–2009

- American Recovery and Reinvestment Act of 2009
  - spending: $780 billion
  - increase in the duration of unemployment benefits from 26 weeks to 99 weeks
  - increase in the generosity of other welfare programs, such as the Supplemental Nutrition Assistance Program (food stamps)
  - spending on infrastructure projects

BUDGET DEFICIT (% GDP) DURING GREAT RECESSION, 2007–2009

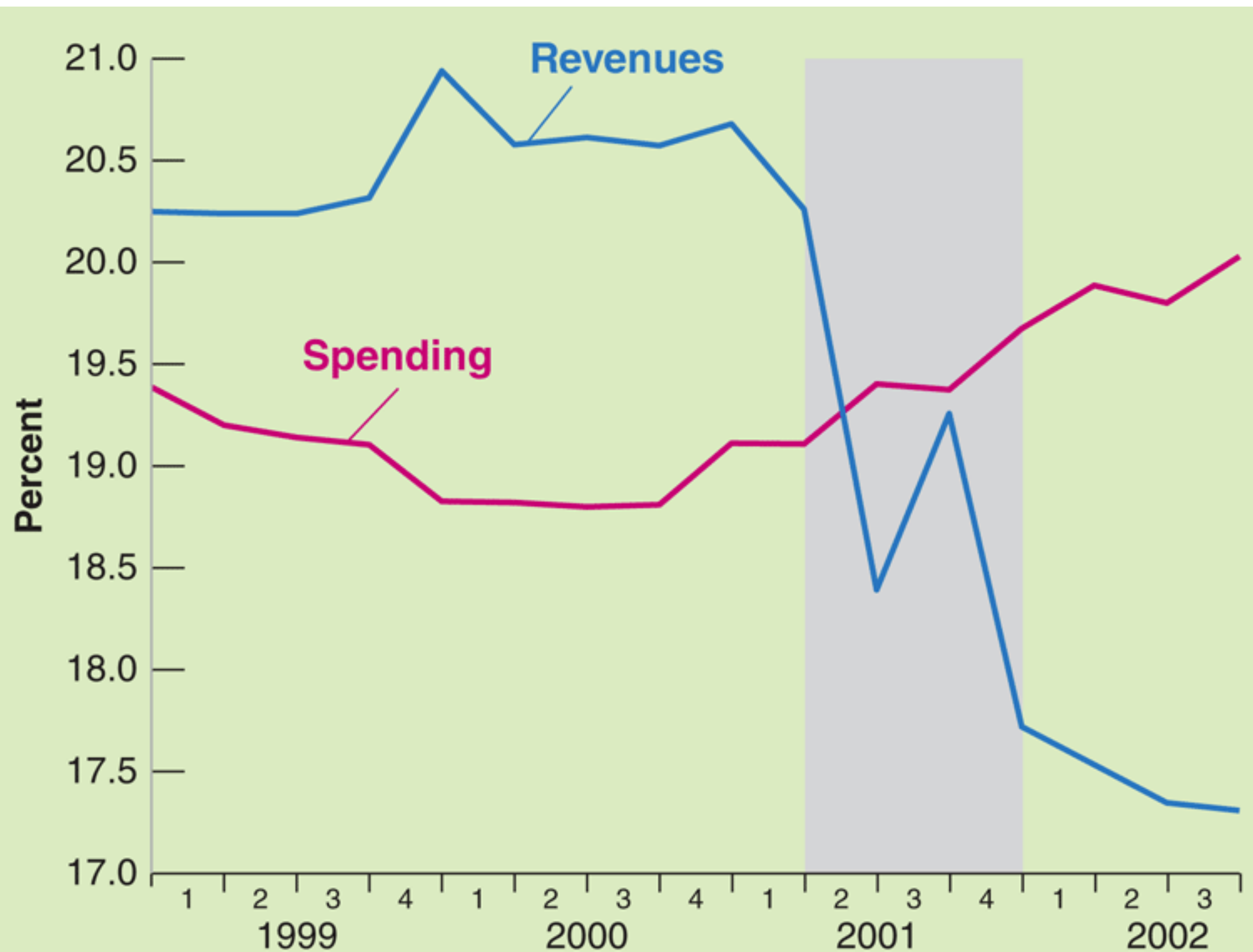
Percent

4
2
0
−2
−4
−6
−8
−10
−12

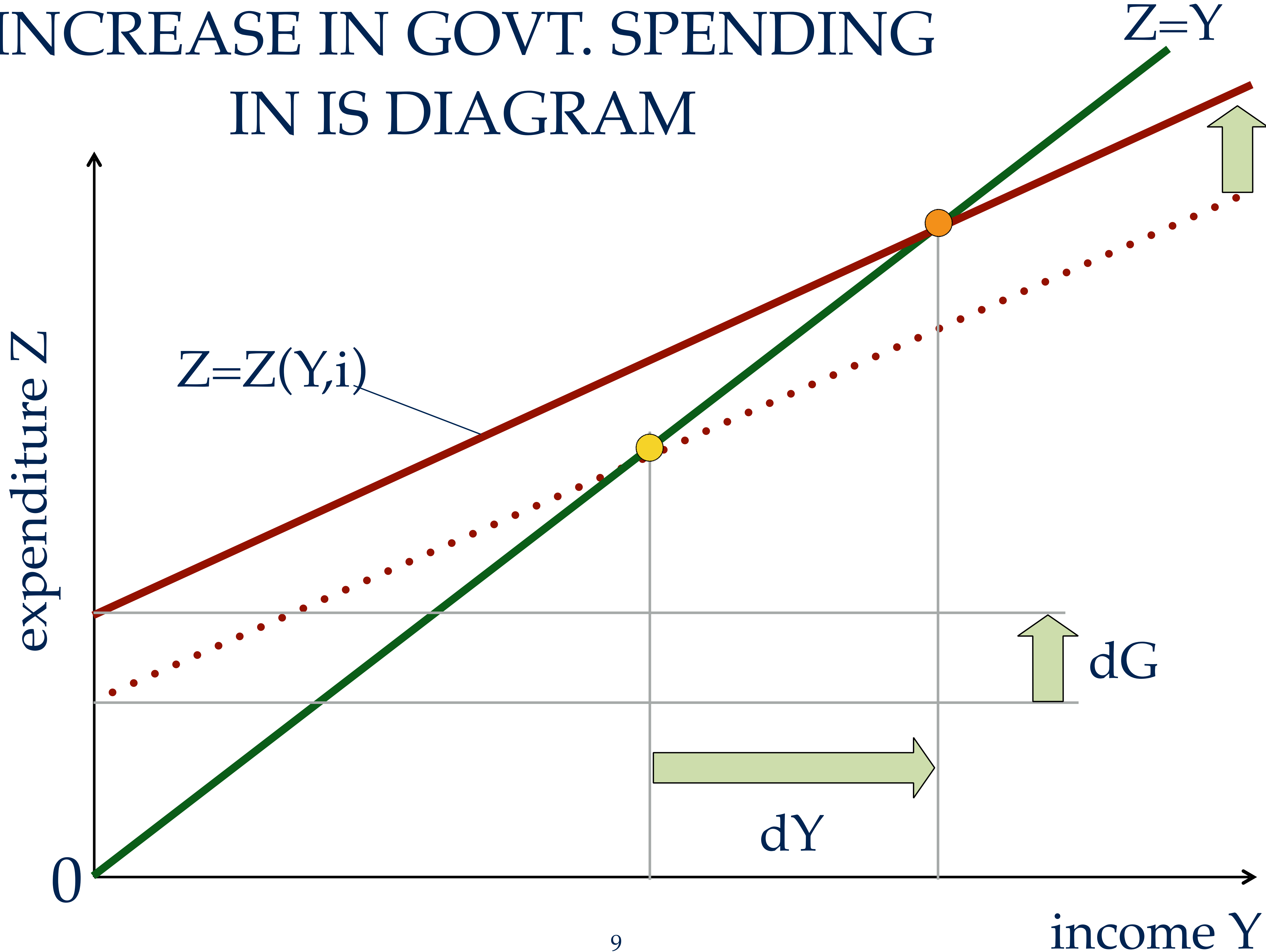
less revenue (lower taxes, less activity) and more spending

1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010

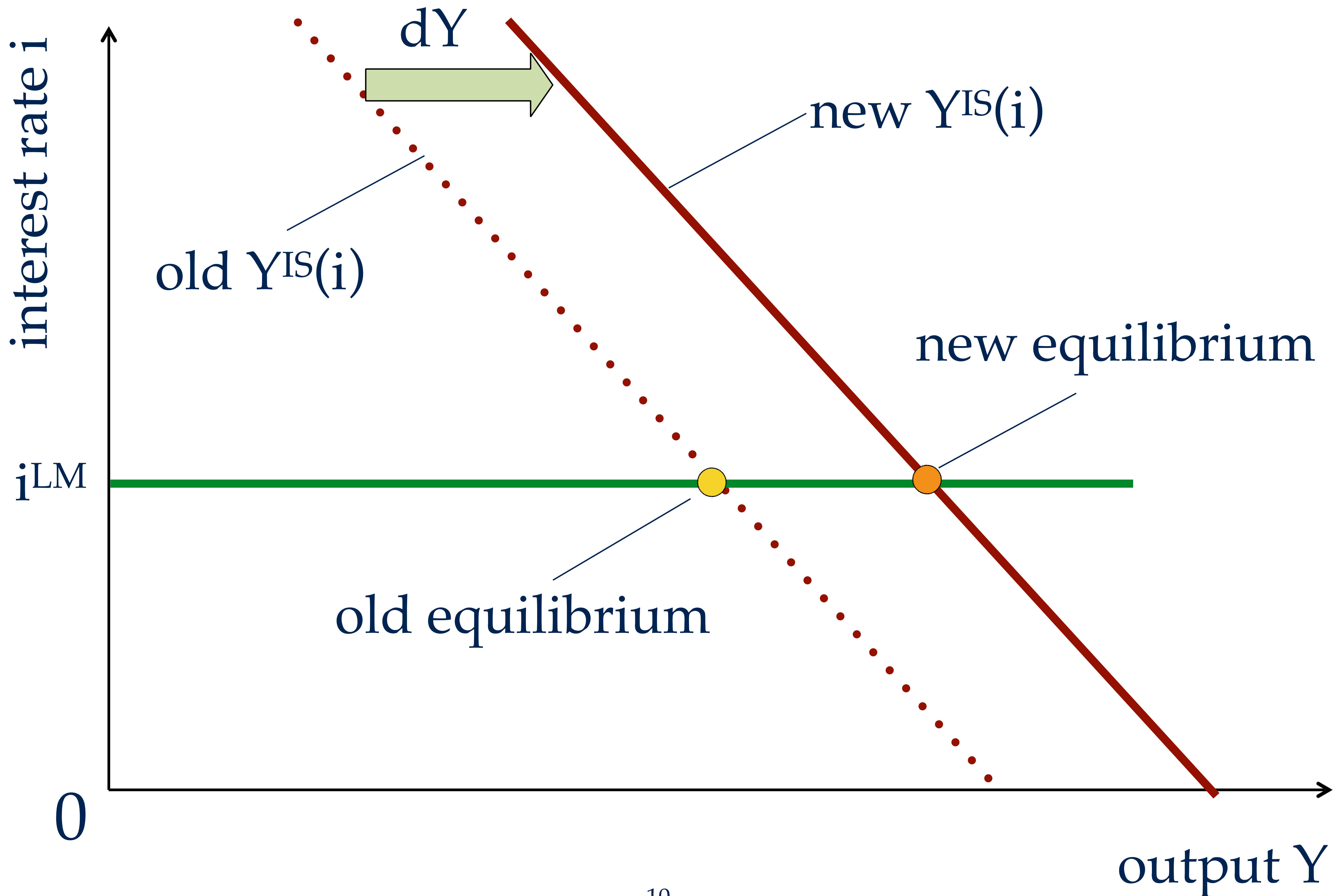
ANOTHER EXAMPLE: 2001 RECESSION



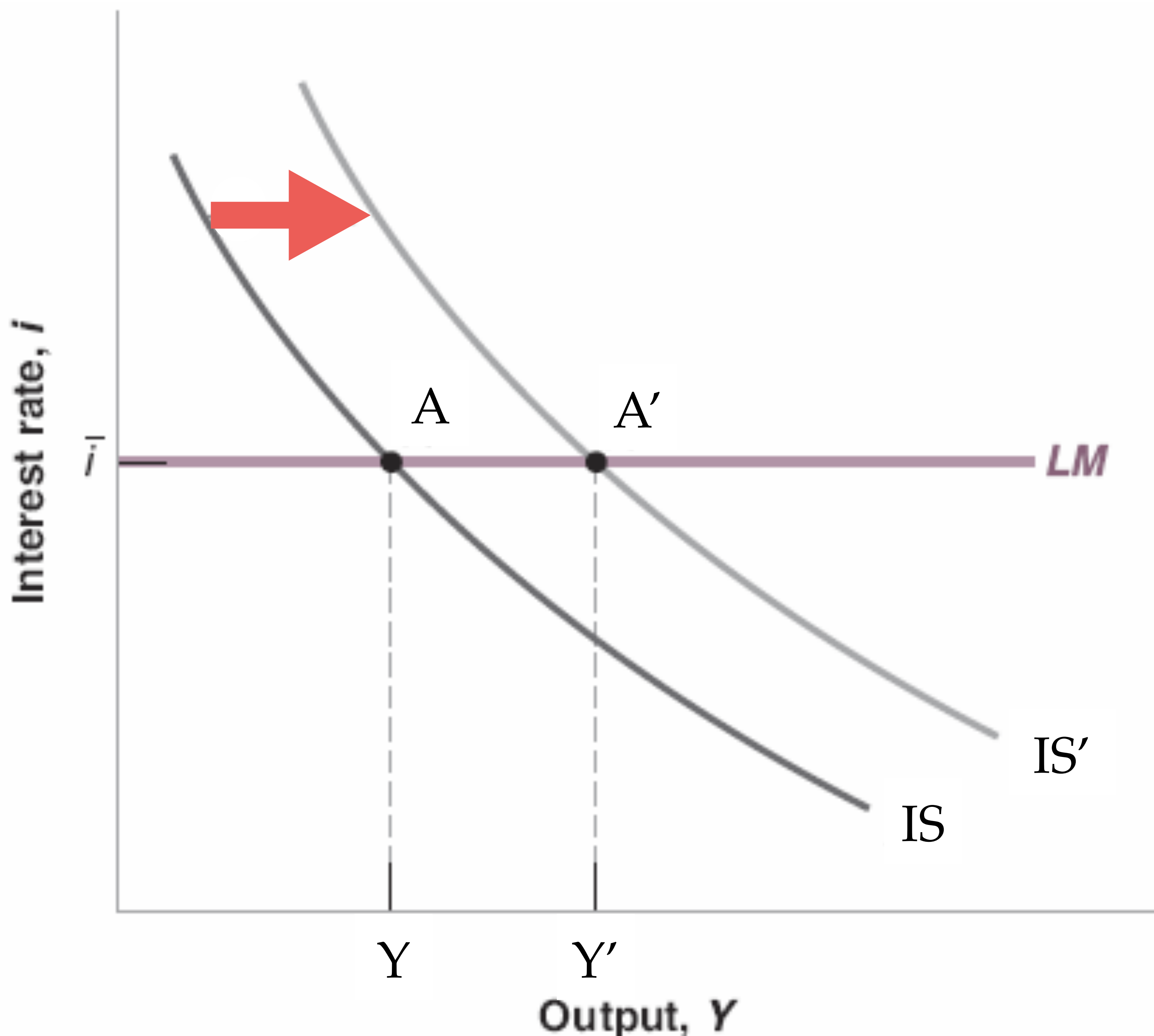
- taxes were cut in 2001 and 2002
- government spending increased in 2001 and 2002 (partly in response to 09/11/2001)
- in 2002: the government ran a budget deficit


INCREASE IN GOVT. SPENDING
IN IS DIAGRAM
Z=Y
Z=Z(Y,i)
expenditure Z
dG
dY
0
income Y

INCREASE IN GOVT. SPENDING IN IS-LM DIAGRAM

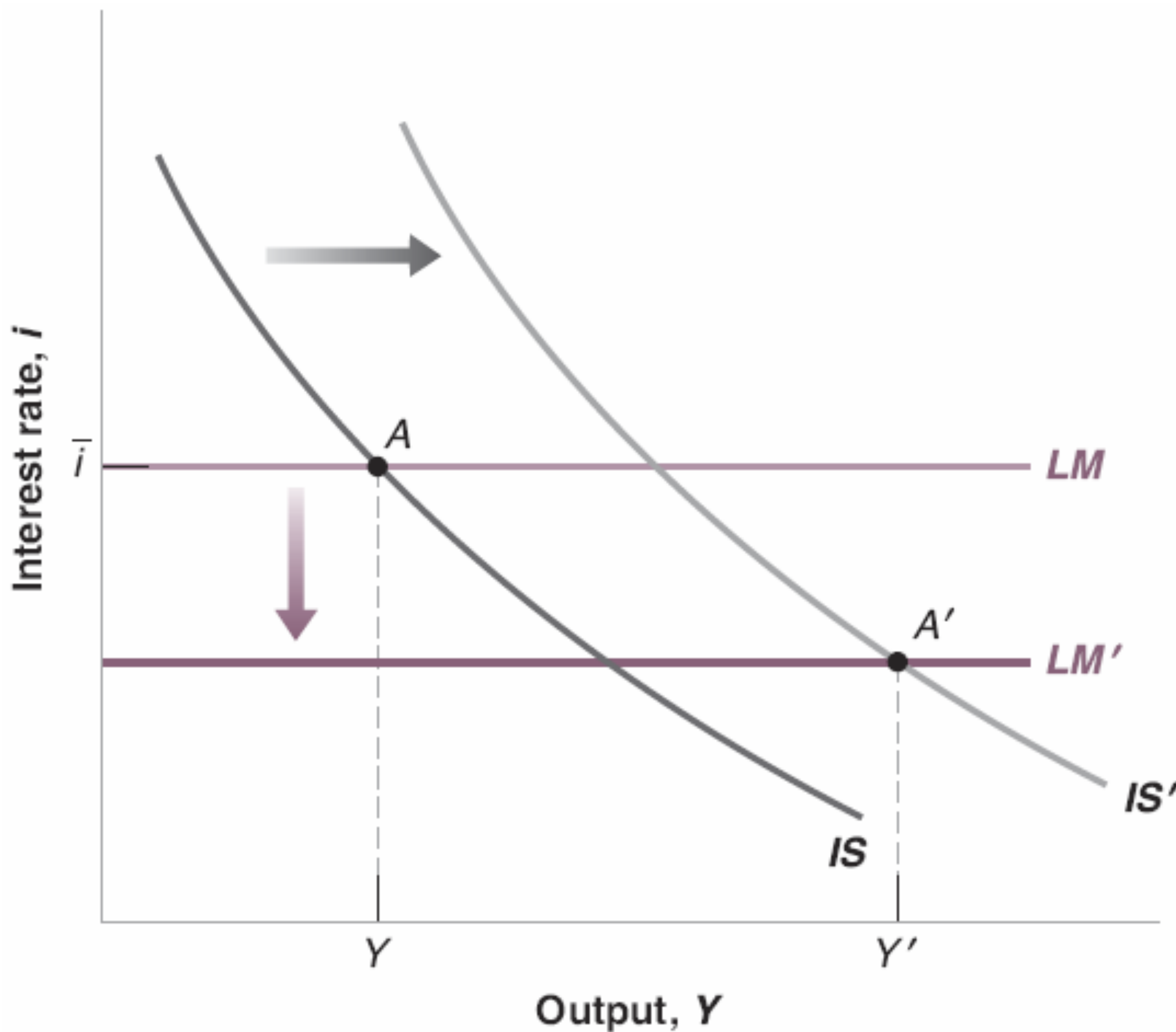


EXPANSIONARY FISCAL POLICY IN IS-LM DIAGRAM



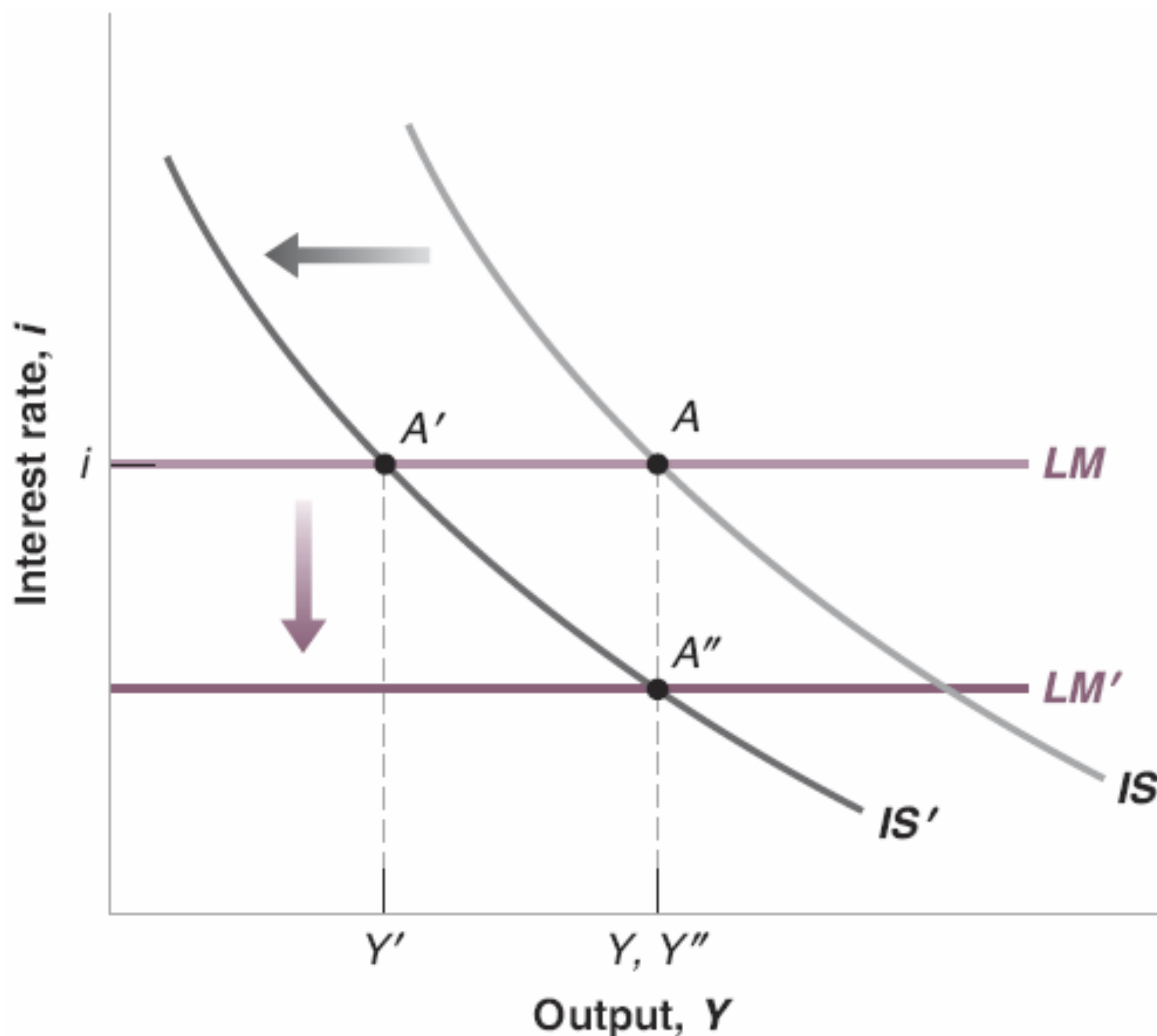
- lower T or higher G raise autonomous spending
- such increase in G – T leads to a higher budget deficit
- the IS curve shifts rightward
- equilibrium output increases (so consumption and investment also rise)
- this fiscal policy is expansionary

POLICY MIX: MONETARY & FISCAL EXPANSIONS



- monetary expansion: shifts the LM curve down
- fiscal expansion: shifts the IS curve to the right
- the combination of these expansionary policies leads to higher output, consumption, and investment

HOW TO REDUCE GOVERNMENT DEFICIT WITHOUT CAUSING A RECESSION?



- first step: raise T and/or lower G to reduce the government budget deficit (as G–T is lower)
- second step: combine the fiscal policy with a monetary expansion to maintain output at the same level
- the policy mix keeps output at the same level but reduces the government budget deficit!