Class Outlines
September 25 and 27 2001

September 25, 2001

I. Review.

II. An example.

a. The Federal budget.
   i. If T>G then the government is said to be running a *budget surplus*.
   ii. If T<G then the government is said to be running a *budget deficit*.
   iii. The sum of all budget deficits is also known as the *national debt*.

b. To eliminate a deficit, the federal government must either increase taxes or decrease government spending. Such a policy is known as contractionary fiscal policy.
   i. From our IS/LM analysis, contractionary fiscal policy leads to a decline in the IS curve. This result is a decline in equilibrium output and a decline in interest rates.

c. A decline in output goes against one of our initial goals for the economy (high output. We must be careful here since we will see policies that attempt to promote high output can have negative consequences on the economy. We will come back to this point). To increase output in response to contractionary fiscal policy, we can use expansionary monetary policy. Such a policy shifts the LM curve to the right. If properly done, we can increase output to its initial level. The interest rate will fall in response.

III. Dynamics

a. We have assumed that we are always on the IS or LM curve. Following an increase in government spending, for example, we assume that we immediately move to a new IS curve. The following describes a more likely scenario.
   i. If the money supply changes, interest rates will immediately change since financial markets are very efficient (look at how quickly markets react to news on Wall Street). Thus we are always on the LM curve.
   ii. Output is less likely to increase or decrease immediately following a policy change for some of the reasons described in

chapter 3 (e.g. bureaucracy associated with a tax cut). Thus, it takes time to move from one IS curve to another.

b. An example.
    i. Suppose we cut taxes. Because this does not directly affect interest rates, there is no immediate effect on interest rates. Only over time does income increase as the affects of the tax cut are finally felt. Thus over time, we move up the LM curve to our new equilibrium (and to our new IS curve). (Note, we are always on the LM curve, since as income increases, money demand increases, and we immediately get a higher interest rate. This again occurs because financial markets are very efficient). Thus over time, we get a higher level of output and higher interest rates.
    ii. An example illustrating how the dynamics work when the money supply is altered can be found in chapter 5.

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I. EXAM # 1