Resumen en español

Spotlight VIDEOS

CHAPTER 15

Economic Stabilization Policies

Why It Matters

Do you remember Hurricane Katrina or the invasion of Iraq and the subsequent war? How did these events—along with growing demand—affect gasoline prices? Did the higher gasoline prices change the spending habits of you and your friends? How and why? Conduct a simple survey of your friends and family to find out how higher prices impacted their lives. Present the survey to your class. Read Chapter 15 to learn what the government might do to stabilize the economy.

The BIG Idea

Governments strive for a balance between the costs and benefits of their economic policies to promote economic stability and growth.

A busy lunch hour at Times Square in New York City indicates a stable, growing economy.

Economics ONLINE **Chapter Overview** Visit the *Economics: Principles and Practices* Web site at glencoe.com and click on *Chapter 15—Chapter Overviews* to preview chapter information.

Jon Arnold Images/SuperStock

SECTION 1

Macroeconomic Equilibrium

GUIDE TO READING

Section Preview

In this section, you will learn that macroeconomic equilibrium takes place at the intersection of aggregate demand and aggregate supply.

Content Vocabulary

- macroeconomics *(p. 413)*
- equilibrium price *(p. 414)*
- aggregate supply *(p. 414)*
- aggregate supply curve *(p. 414)*
- aggregate demand *(p. 415)*
- aggregate demand curve *(p. 415)*
- macroeconomic equilibrium *(p. 416)*

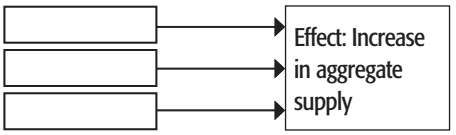
Academic Vocabulary

- framework *(p. 416)*
- unduly *(p. 417)*

Reading Strategy

Listing As you read the section, complete a graphic organizer similar to the one below by listing at least three factors that could lower production costs and lead to an increase in aggregate supply.

Interactive Graphic Organizer



ISSUES IN THE NEWS

–BusinessWeek

This Porridge Looks a Little Too Warm

Goldilocks lives. The economic scenario, that is. Those who believe in her think the economy this year will be not too hot, not too cold, but just right. Currently, it's the view most widely held by economists, investors, and Wall Street pros. So, the tale goes, after the unusually warm winter heated up the economy in the first quarter, growth will cool down to a pace of about 3%. . . .

[T]wo things are happening right now that are affecting both manufacturing and the economy. One, businesses are rushing to expand their operations in the face of strong demand and insufficient production capacity. And two, because factory output is growing . . . manufacturing operating rates have risen sharply during the past year. The only way to know for sure . . . is to watch the economy and the data. ■

"Not too hot, not too cold, but just right." According to the news story above, the concept of equilibrium seems to be alive and well. In literature as well as in life, we seem to like things best when they can achieve a reasonable balance. The economy is no exception.

When we deal with **macroeconomics**, the part of economics concerned with the economy as a whole and decision making by large units, we also seek a balance. To do so, we can use a set of "tools" already familiar to us—supply and demand—to find out just where the balance is.

macroeconomics part of economics that deals with the economy as a whole *(also see page 197)*

David Grossman/The Image Works

equilibrium price price where quantity supplied equals quantity demanded *(also see page 149)*

aggregate supply the total value of all goods and services that all firms would produce in a specific period of time at various price levels

aggregate supply curve hypothetical curve showing different levels of real GDP that would be produced at various price levels

Aggregate Supply and Demand

MAIN Idea Aggregate supply and demand help us study supply and demand for the economy as a whole.

Economics and You In your English classes, you might study a part of a novel in depth to understand the whole book better. Read on to learn about a similar approach in economics.

When we study markets, we often use the tools of supply and demand to show how the **equilibrium price** and quantity of output are determined. When we study the economy as a whole, we can use these tools in much the same way.

Aggregate Supply

You learned in Chapter 5 that supply is the amount of a particular product offered for sale at all possible prices. When it comes to the economy as a whole, economists like to look at **aggregate supply**, the total value of goods and services that all firms would produce in a specific period of time at various price levels. If the period was exactly one year, and if all production took place within a country's borders, then aggregate supply would be the same as GDP.

The concept of aggregate supply assumes that the money supply is fixed and that a given price level prevails. If prices should change, however, then individual firms would respond by adjusting their output to produce a slightly different level of GDP. If it were somehow possible to keep adjusting the price level to observe how total output changed, we could then construct an **aggregate supply curve**, which shows the amount of real GDP that would be produced at various price levels.

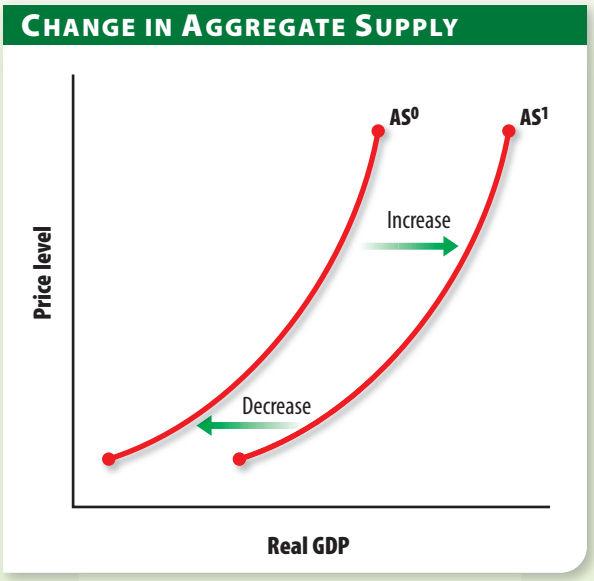
Figure 15.1 shows how an aggregate supply curve for the whole economy might look. Like the supply curve of an individual firm or the market supply curve, it is shown as upward sloping as you move from left to right. To distinguish the aggregate supply curve from other supply curves, it is labeled **AS.**

In Figure 15.1, note that the vertical axis of the graph is labeled 'Price level' rather than just 'Price', as you have seen in earlier chapters. The price level includes the price of everything produced in the economy. In contrast, the word *price* would indicate the cost of only a single good or service. Economists often use an aggregate measure like the price level rather than a single price. Aggregate measures help them better explain changes in the economy.

Figure 15.1 ▶ The Aggregate Supply Curve

▶ The aggregate supply curve shows the amount of real GDP that would be produced at various price levels. An increase in aggregate supply occurs when production costs decrease for all individual producers. When economists use 2 curves to show changes in aggregate supply, they label the first curve **AS⁰** and the second **AS¹**.

Economic Analysis ***What causes a decrease in aggregate supply?***



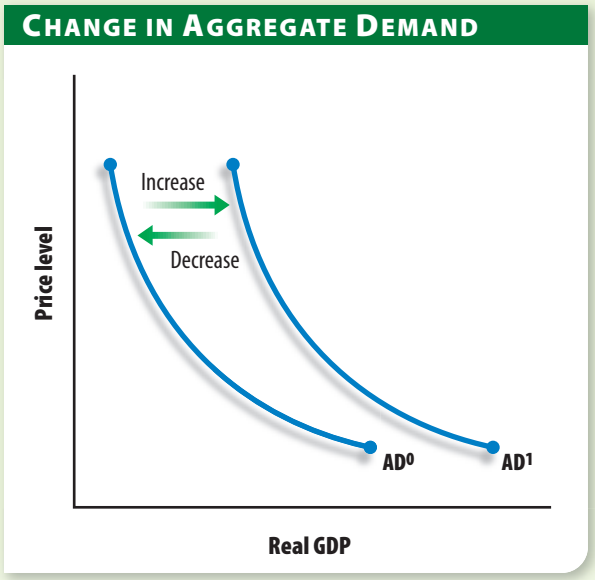
Graphs In Motion

See StudentWorks™ Plus or glencoe.com.

Figure 15.2 ▶ The Aggregate Demand Curve

Graphs In Motion

See StudentWorks™ Plus or glencoe.com.



▶ The aggregate demand curve shows the amount of real GDP the economy would demand at all possible price levels. Aggregate demand, like aggregate supply, can either increase or decrease. When economists use two curves to show changes in aggregate demand, they label the first curve **AD⁰** and the second **AD¹**.

Economic Analysis ***What causes the aggregate demand curve to shift?***

Finally, note that the horizontal axis is labeled 'Real GDP'. This is because we want to know the value of all goods and services produced, not just the output of a single product. While there are some other differences between the supply curve of a single product and aggregate supply, the two curves are otherwise fairly similar.

Changes in Aggregate Supply

Aggregate supply, like the supply of an individual firm, can increase or decrease. Many increases in aggregate supply are tied to the cost of production for an individual firm. For example, if the price of energy should suddenly go down, most if not all firms will be able to produce a little more output, and real GDP will go up. Since this increase in output would happen at all price levels, the increase shows as a shift of the original aggregate supply curve **AS⁰** to the right, and the new aggregate supply curve **AS¹.**

Factors that increase the cost of production for individual firms tend to decrease aggregate supply. These factors include higher oil prices, higher interest rates, and lower labor productivity. Any increase in cost that causes individual firms to offer fewer goods and services for sale at each and every price would shift the aggregate supply curve to the left.

Aggregate Demand

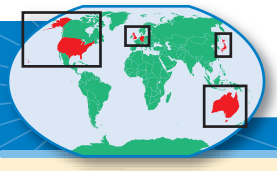
In Chapter 4 you learned that demand is the desire, ability, and willingness to purchase a product. If it were possible to add up everyone's demand for every good and service in the economy, we would have a measure of aggregate, or total, demand. Accordingly, economists call this concept **aggregate demand,** the total value of all goods and services demanded at different price levels. Aggregate demand is labeled **AD** to keep it separate from other demand curves. It is a summary measure of all demand in the economy. Like aggregate supply, it can be represented as a graph, and it can either increase or decrease.

The **aggregate demand curve** appears in **Figure 15.2** and shows the amount of total output, measured in terms of real GDP, that would be purchased at every possible price level. This curve is labeled **AD** and represents the sum of all consumer, business, government, and net foreign demands

aggregate demand the total value of goods and services demanded at all different price levels

aggregate demand curve hypothetical curve showing different levels of real GDP that would be purchased at various price levels

The Global Economy & YOU

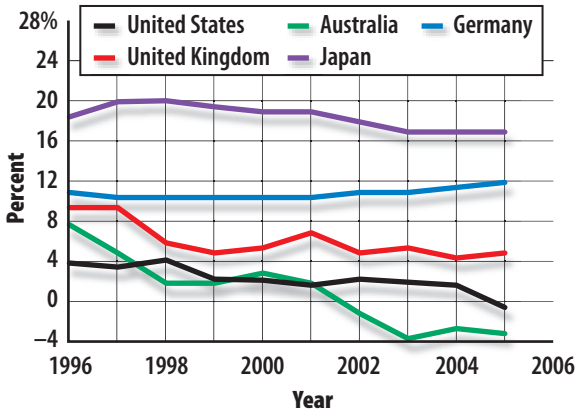


Banking on the Future

When consumers save less and spend more, the aggregate demand curve shifts to the right. This has been the case recently in the United States, where seemingly tireless consumers shop online, in the mall, and at every stop in between. In a country where the minimum wage is $5.15 per hour—compared to Mexico's $4.36 per day—one would think Americans could afford to sock away substantial savings. Instead, we are spending our money at an astonishing rate.

Why are Americans not saving more? Given the dismal outlook for Social Security, shaky pension plans, and rising interest rates, they should be more concerned than ever about their economic future. Despite these issues, the U.S. personal savings rate dipped lower in 2005 than it has since 1933, during the Great Depression. That year it reached negative 0.4 percent.

PERSONAL SAVINGS RATE



Source: St. Louis Federal Reserve

Compared with personal savings rates from around the globe, those of Americans are well below the international average.

macroeconomic equilibrium level of real GDP consistent with a given price level and marked by the intersection of aggregate supply and aggregate demand

at various price levels. It slopes downward and to the right like the individual and the market demand curves.

Changes in Aggregate Demand

Aggregate demand can increase or decrease depending on certain factors. For example, if consumers decide to spend more and save less, the increase in consumer spending also increases aggregate demand, shifting the original aggregate demand curve $\mathbf{AD^0}$ to the right to form the new aggregate demand curve $\mathbf{AD^1}$.

A decrease in aggregate demand can occur if the same factors act in an opposite manner. If people were to save more and spend less, the aggregate demand curve would shift to the left. Higher taxes and lower transfer payments could also reduce aggregate spending. Such decisions shift the aggregate demand curve to the left because all sectors of the economy collectively buy less GDP at all price levels.

✓Reading Check **Comparing** How do AS and AD compare to individual supply and demand?

Macroeconomic Equilibrium

MAIN Idea Macroeconomic equilibrium is reached when the level of real GDP is consistent with a given price level.

Economics and You You learned earlier about the equilibrium price. Read on to learn how this concept applies to the economy as a whole.

Aggregate supply and demand curves are useful concepts because they provide a **framework** to help us analyze the impact of economic policy proposals on economic growth and price stability. They also can give us an idea of the way and direction in which things will change. They do not provide us with exact predictions, however. Even so, they are useful when we analyze macroeconomic issues.

Macroeconomic equilibrium, for example, is the point at which the level of real GDP is consistent with a given price level. It is determined by the intersection of the aggregate supply and demand curves.

This equilibrium is shown in **Figure 15.3.** In this figure, quantity **Q** is the level of real GDP that is consistent with price level **P,** or where the aggregate supply curve **AS** and the aggregate demand curve **AD** intersect. This equilibrium represents a specific situation at a particular point in time and could change if either **AS** or **AD** changes.

For example, if a new government policy caused the aggregate demand curve **AD** to shift to the right, the new equilibrium would take place at a higher level of real GDP and a higher price level. This is one of the dilemmas facing economic policy makers—how to make real GDP grow without **unduly** increasing the price level and thereby the rate of inflation.

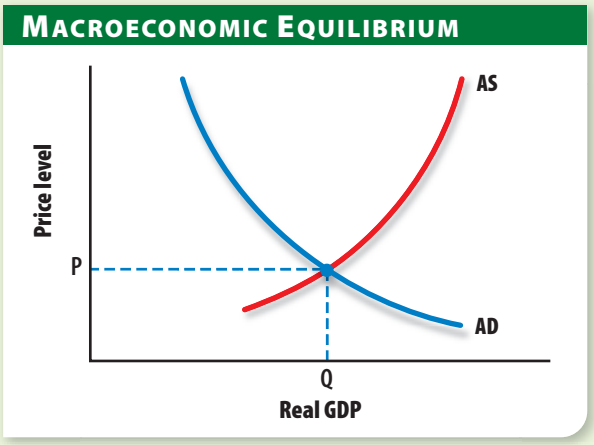
As you will see in the next section, we can use aggregate supply and demand to analyze the impact of fiscal and monetary policies, two of the major ways of affecting the level of output and real GDP.

Reading Check **Explaining** How does the macroeconomic equilibrium work? How is it used?

Figure 15.3 ▶ The Economy in Equilibrium

▶ The economy is at equilibrium when the quantity of real GDP demanded is equal to the real GDP supplied.

Economic Analysis ***What happens to the price level when output increases?***



SECTION 1

Review

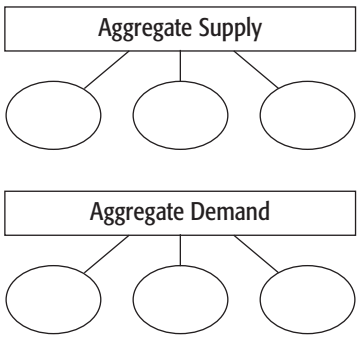
Vocabulary

1. **Explain** the significance of macroeconomics, equilibrium price, aggregate supply, aggregate supply curve, aggregate demand, aggregate demand curve, and macroeconomic equilibrium.

Main Ideas

2. **Identifying** Use a graphic organizer like the one below to identify the factors that might cause aggregate supply to increase and aggregate demand to decrease.

Interactive Graphic Organizer



3. **Explaining** Why is macroeconomic equilibrium important?

Critical Thinking

4. **The BIG Idea** How do aggregate supply and aggregate demand help economic policy makers?
5. **Drawing Conclusions** How is it possible for an economy to grow without a general increase in price levels?
6. **Analyzing Information** What kind of effect would higher taxes have on aggregate supply? Explain.
7. **Analyzing Visuals** Look at Figure 15.3 on this page. What would happen to the price level if AD decreased?

Applying Economics

8. **Aggregate Supply and Demand** Search your local newspaper for articles relating to the impact of changing gasoline prices. Summarize the articles and answer the following question: "How do changing gasoline prices impact AS and AD?" Explain your answer.

BusinessWeek NEWSCLIP

Aggregate demand and aggregate supply are becoming global concepts. When demand for a product drops in one country, producers often look for markets in other countries to take up the slack. Asian automakers did just that when demand for Japanese cars decreased in Japan.

Asia's Automakers Think Globally

The global market may be becoming increasingly competitive, but Japan's and Korea's top automakers are hitting new production records and expanding outside their domestic markets at a rapid pace. Faced with stagnant demand in their home countries and a need to reduce foreign exchange risks, the big automakers in both countries are rapidly expanding production overseas and shearing off market shares from the foreign incumbents.

So far, the big three Japanese companies—Toyota Motor Corp., Honda Motor Co. Ltd., and Nissan Motor Co. Ltd.—are enjoying successes as their tight controls on costs and mostly competitive product lineups enable them to take market share from overseas rivals. . . .

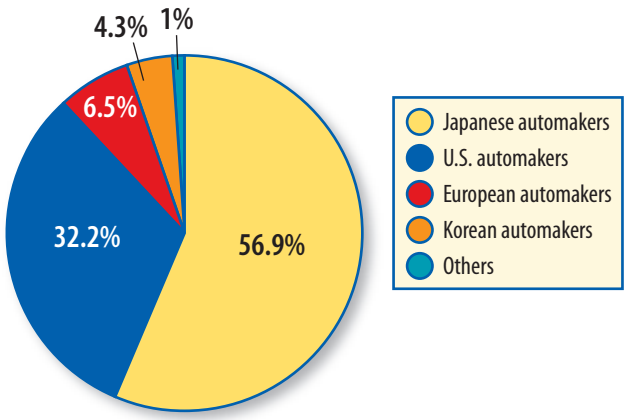
Over the past decade, Japanese automakers have been setting up and expanding production facilities overseas. . . . In comparison, Hyundai and its subsidiary Kia are late starters in their localization plans in the U.S. and Europe. But . . . all five automakers' prospects for further expansion in North America look promising. In the current high gasoline price environment, their product mixes look to be in tune with customer shifts, with more fuel-efficient cars becoming popular. . . .

Success in the U.S. carries some risks. . . . The impact of a sudden change in purchasing habits by American auto buyers on these companies' earnings and cash flow could be amplified because of this heavy dependence. . . .

The Japanese domestic market remains flat, however. Although the economy is recovering, weak demand is unlikely to be reversed. With a rapidly aging population, long-term growth prospects in Japan are very limited.

—Reprinted from *BusinessWeek*

World Automobile Sales



Source: Autodata Corp.

Examining the Newsclip

1. **Determining Cause and Effect** According to the article, what is causing demand for Japanese and other Asian autos to increase in the United States?
2. **Analyzing** Why is demand for Japanese cars decreasing in Japan?

SECTION 2

Stabilization Policies

GUIDE TO READING

Section Preview

In this section, you will learn how government can promote economic growth through economic policies.

Content Vocabulary

- Medicare *(p. 419)*
- fiscal policy *(p. 420)*
- Keynesian economics *(p. 420)*
- multiplier *(p. 420)*
- accelerator *(p. 420)*
- automatic stabilizer *(p. 422)*
- entitlements *(p. 422)*
- unemployment insurance *(p. 422)*
- supply-side policies *(p. 423)*
- deregulation *(p. 424)*
- monetarism *(p. 426)*
- wage-price controls *(p. 427)*

Academic Vocabulary

- unstable *(p. 420)*
- explicit *(p. 427)*

Reading Strategy

Describing As you read the section, complete graphic organizers similar to the ones below by describing the role of government under demand-side and supply-side policies.

Interactive Graphic Organizer

Demand-side policies	Supply-side policies
↓	↓

ISSUES IN THE NEWS

—www.cato.org

Time for "Wise and Frugal"

Federal spending has increased 45 percent in the past five years; the government has run deficits in thirty-three of the past thirty-seven years; the costs of programs for the elderly are set to balloon and impose huge burdens on coming generations of young workers.

Clearly, policymakers are failing to run a "wise and frugal government," as Thomas Jefferson advised in his first inaugural address. A key problem is that federal budget rules stack the deck in favor of continual program expansion. The costly Medicare drug bill and the explosion in pork spending illustrate how a lack of structural controls leads to an undisciplined scramble to spend, spend, spend. ■

Whenever the government spends money on **Medicare**, the federal program that provides health-care expenditures for the elderly, it shifts the aggregate demand curve to the right. As you read in the news story above, it costs the government more money—and it puts an upward pressure on the price level.

Medicare expenditures are important to those who benefit from them, since economic security is one of the seven major economic goals. Still, policy makers must often choose among a number of competing economic policies. Finding the proper balance between them is an important part of stabilization policy.

Medicare federal health-care program for senior citizens, regardless of income *(also see page 235)*

Mark Reinstein/Jupiter Images

fiscal policy
use of government spending and revenue collection measures to influence the economy

Keynesian economics
government spending and taxation policies suggested by John Maynard Keynes to stimulate the economy

multiplier
magnified change in overall spending caused by a change in investment spending

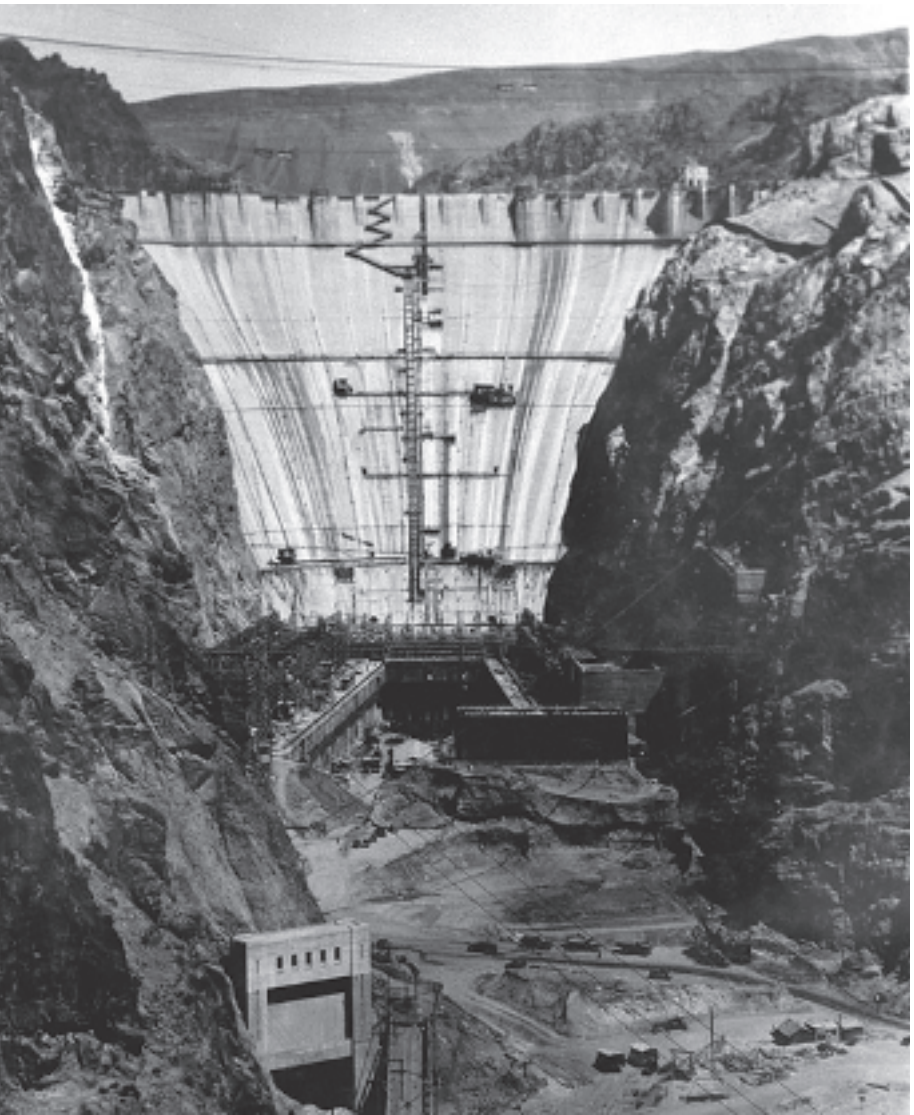
Demand-Side Policies

MAIN Idea Demand-side policies are designed to affect total demand through taxing, government spending, and automatic stabilizers.

Economics and You You learned earlier that government implements policies to help people. Read on to learn how it uses policies to affect the economy.

Demand-side policies are designed to increase or decrease total demand in the economy. These policies try to shift the aggregate demand curve to the right or the left. One approach to changing demand is known as **fiscal policy**—the federal government's attempt to influence or stabilize the economy through taxing and government spending.

Government Spending During the Great Depression, the government funded public works, such as the construction of Hoover Dam shown below, to stabilize the economy. ***Which economist made fiscal policy popular?***



US Dept. of the Interior Bureau of Reclamation/Lower Colorado Region

Fiscal policies are derived from **Keynesian economics,** an economic policy approach designed to lower unemployment by stimulating aggregate demand. John Maynard Keynes put forth these theories in 1936, and they dominated the thinking of economists until the 1970s.

Keynesian Economics

Keynes provided the basic framework by using the output-expenditure model, GDP = C + I + G + F. According to this model, any change in GDP on the left side of the equation could be traced to changes on the right side of the equation. The question was: which of the four components caused the instability?

According to Keynes, the net impact of the foreign sector (F) was so small that it could be ignored. The government sector (G) was not the problem either, because its expenditures were normally stable over time. According to Keynes, spending by the consumer sector (C), was the most stable of all. It appeared that the business, or investment, sector (I) was to blame for the instability.

In Keynes's theory, spending by the investment sector was not only **unstable** but had a magnified effect on other spending. If investment spending declined by $50 billion, for example, many workers would lose their jobs. These workers in turn would spend less and pay fewer taxes. Soon, the amount of spending by all sectors in the economy would be down by more than the initial decline in investment.

This effect is called the **multiplier.** It says that a change in investment spending will have a magnified effect on total spending. The multiplier is believed to be about 2 in today's economy. Thus, if investment spending goes down by $50 billion, the decline in overall spending could reach $100 billion. The multiplier also works in the other direction. An increase in spending by $50 billion would increase overall spending by twice that amount.

Public Works The federal government continues to fund large-scale public works projects, such as the Hyperion water treatment facility in Los Angeles. ***How does public spending offest the loss of business spending?***

Conditions are likely to be made even worse by the **accelerator**—the change in investment spending caused by a change in total spending. After a decline in overall spending begins, investors tend to become cautious, causing investment spending to be reduced even further. Before long, the economy is trapped in a downward spiral. The combined multiplier-accelerator effect is important because it contributes to the instability of GDP.

accelerator change in investment spending caused by a change in overall spending

Role of Government

Keynes argued that only the government was big enough to step in and offset changes in investment-sector spending. The government could take a direct role in the economy and undertake its own spending to offset the decline in spending by businesses. The government could also play an indirect role by lowering taxes and enacting other measures to encourage businesses and consumers to spend more.

Suppose the government wanted to take direct steps quickly to offset a $50 billion decline in business spending. To do this, it could spend $10 billion to build a dam, give $20 billion in grants to cities to fix up poor neighborhoods, and spend another $20 billion in other ways. By adding up individual programs, government spending would replace the $50 billion that businesses do not spend. Thus, the overall sum of C + I + G + F would remain unchanged.

Instead of spending the $50 billion, the government could affect the economy indirectly by reducing tax rates to give investors and consumers more purchasing power. If they spent the $50 billion not collected in taxes, investors and consumers would offset the initial decline in investment spending. Again, there would be no change in the sum of C + I + G + F.

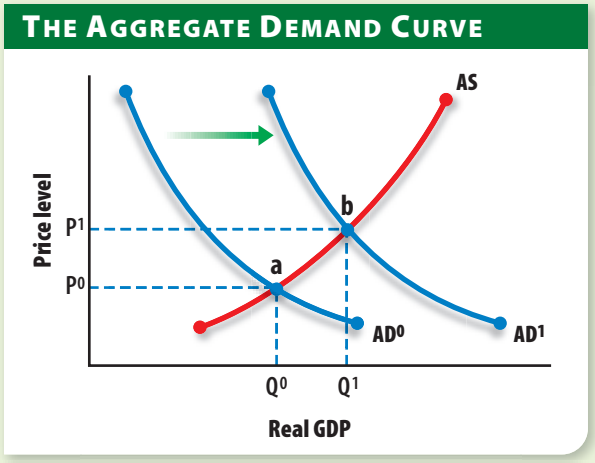
Either way, the government would run the risk of a short-term federal deficit. In Keynes's view, the deficit was unfortunate but necessary to stop further declines in economic activity. When the economy recovered, tax collections would rise, the government would run a surplus, and the debt could be paid back. The justification for *temporary* federal deficits was one of the lasting contributions of Keynesian economics and a major departure from the economic thinking of the time.

Tom Carroll/IndexStock

Figure 15.4 ▶ Fiscal Policy and Aggregate Demand

▶ Fiscal policies are designed to affect aggregate demand. Increases in government spending or tax reductions increase aggregate demand. As a result, the economy moves from **a** to **b.**

Economic Analysis ***Which point on the graph represents the lowest aggregate demand?***



automatic stabilizer program that automatically provides benefits to offset a change in people's incomes

entitlement broad social program that uses established eligibility requirements to provide health, nutritional, or income supplements to individuals *(also see page 283)*

unemployment insurance government program providing payments to unemployed workers

Automatic Stabilizers

Another key component of fiscal policy is the role of **automatic stabilizers,** programs that automatically trigger benefits if changes in the economy threaten income. The benefits are automatic because they were approved in prior legislation.

Most **entitlements**—broad social programs that use established eligibility requirements to provide health, nutritional, or income supplements—function as automatic stabilizers. These progams provide some financial assistance to people who lose a job, are injured on the job and receive medical benefits, or are forced to retire because of age or health.

One such entitlement program is **unemployment insurance**—insurance that workers who lose their jobs through no fault of their own can collect from individual states for a limited amount of time. This insurance cannot be collected by people who are fired because of misconduct or who quit their jobs without good reason.

Another important automatic stabilizer is the progressive income tax. For example, if someone loses his or her job or ends up working fewer hours because of cutbacks, that person will earn less. If the reduction in income is significant, that person is likely to fall into a lower tax bracket, which cushions the decline in income.

Fiscal Policy and Aggregate Demand

We can illustrate the impact of such fiscal policies with the aggregate demand curve **AD**. **Figure 15.4** shows a single aggregate supply curve and two aggregate demand curves. When aggregate demand is weak, the economy would be at point **a,** where **AD⁰** intersects **AS.** Increases in government spending or tax reductions could shift aggregate demand to **AD¹** and move the economy to point **b,** where both real GDP and the price level are higher.

Because aggregate demand basically is the sum of C + I + G + F, it makes little difference which sector provides the stimulus. As long as government policies cause the spending of one sector to expand, AD will shift to the right.

Limitations of Fiscal Policy

Keynes envisioned the role of government spending as a counterbalance to changes in investment spending. Ideally, the government would increase its spending to offset declines in business spending, and conversely government would decrease spending whenever business spending recovered. In practice, however, the federal government generally has not been able to limit or reduce spending.

As a result, the most effective fiscal policies to counter business cycles are the automatic stabilizers. The advantage of the stabilizers is the speed at which they can be implemented because the legislation is already approved.

✓**Reading Check** **Analyzing** Why are Keynes's ideas important in the study of economics?

Supply-Side Policies

MAIN Idea Supply-side economics focuses on policies that increase production through less government and lower taxes.

Economics and You If you and your family had to pay less in taxes, would you spend or save the extra money? Read on to find out what supply-siders think.

Supply-side policies are policies designed to stimulate output and lower unemployment by increasing production rather than by stimulating demand. The supply-side view gained support in the late 1970s because demand-side policies did not seem to be controlling the nation's growing unemployment and inflation. In the 1980s, supply-side policies became the hallmark of President Ronald Reagan's administration.

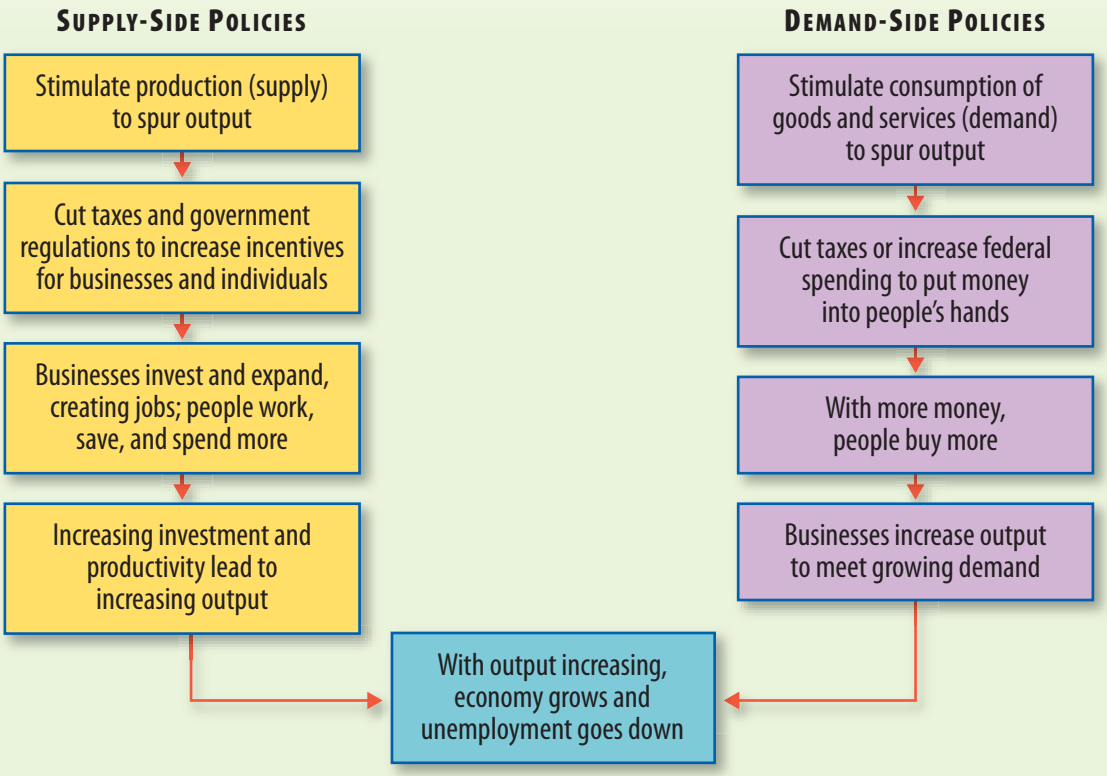
The differences between supply-side policies and demand-side policies are smaller than most people realize. Both policies, which are summarized in **Figure 15.5,** have the same goal: increasing production and decreasing unemployment without increasing inflation.

supply-side policies economic policies designed to stimulate the economy by increasing production

Smaller Role for Government

A key goal for supply-siders is reducing government's role in the economy. One way to do this is to reduce the number of federal agencies. Another way is to spend less at the federal level. Yet another way is to lessen the government's role by relaxing

Figure 15.5 ▶ Comparing Supply-Side and Demand-Side Policies



▶ Supply-side policies and demand-side policies have the same goal: continuous and stable economic growth without price inflation.

Economic Analysis ***How does the role of the government differ under supply-side and demand-side policies?***

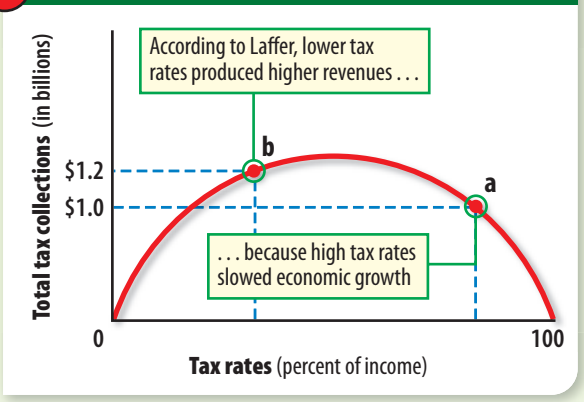
Charts In MOtion
See StudentWorks™ Plus or glencoe.com.

Figure 15.6 ▶ Tax Rates and Tax Receipts

▶ The Laffer curve is a hypothetical relationship between federal income tax rates and tax revenues. Panel A illustrates the argument that lower individual income tax rates would generate higher tax collections, as shown in the movement from **a** to **b.** Panel B shows that federal tax revenues declined after individual income tax rates were reduced in 2001.

Economic Analysis ***How does personal income in 2000 and 2005 compare to individual income tax receipts during the same years?***

A THE LAFFER CURVE



B TAX RECEIPTS

Year	Personal income (in billions)	Individual income tax receipts (in billions)
2000	$8,430	$1,004
2001	8,724	994
2002	8,882	858
2003	9,164	794
2004	9,731	809
2005	10,239	927

Source: *Economic Report of the President*

deregulation relaxation or removal of government regulations on business activities

or removing government regulations that restrict the activities of firms in certain industries—a process called **deregulation**.

Deregulation is a major objective of supply-siders. The policy has been popular among politicians ever since President Reagan deregulated the savings and loan industry in the 1980s. Since then, the American economy has seen a flood of deregulation ranging from airlines and banking to telecommunications and interstate trucking.

Lower Federal Taxes

Supply-siders also target the federal tax burden on individuals and businesses. They believe that if taxes are too high, people will not want to work as much, and businesses will therefore produce less. Lower tax rates, they argue, allow individuals to keep more of the money they earn, which encourages them to work harder. This would give workers more money to spend in the long run. Government revenues would also increase, as additional business activity leads to greater production, resulting in greater tax collections.

During the 1980s, somewhat optimistic supply-siders argued that lower individual income tax rates would stimulate the economy so much that the government could collect even more taxes than before. This idea of increased tax revenue was formalized in the Laffer curve—a hypothetical relationship between federal income tax rates and tax revenues.

The Laffer curve shown in **Panel A** of **Figure 15.6** illustrates the expected gain in tax revenues when taxes were reduced from point **a** to point **b.** This proposition was the basis for President Reagan's 1981 tax cut, which reduced the tax rates for individual income taxes 25 percent over a three-year period. The Laffer curve was popular at the time because it gave people a seemingly sound reason to have lower marginal tax brackets.

When President George W. Bush was elected in 2000, he also made individual income tax cuts one of his highest priorities. The first round of his proposed tax cuts was passed in 2001, and several extensions followed in subsequent years.

However, as **Panel B** in Figure 15.6 shows, individual income tax receipts generally declined from 2000 to 2004, even though personal income rose in each of those years. Unfortunately, the increased tax revenue collections predicted by the Laffer curve never materialized, although it is highly likely that the increase in personal income worked to stimulate economic growth.

Impact of Supply-Side Policies

The aggregate supply and demand curves can illustrate the impact of supply-side policies. As **Figure 15.7** shows, when aggregate supply is low, the economy is at point **a.** This is the point where the original aggregate demand curve **AS⁰** intersects with the aggregate demand curve **AD.**

If supply-side policies were successful, more would be produced at every price level. The aggregate supply curve would then shift to **AS¹,** and the point of macroeconomic equilibrium would move to **b.** As long as there was no corresponding change in aggregate demand, real output would grow, and the price level would come down.

Limitations of Supply-Side Policies

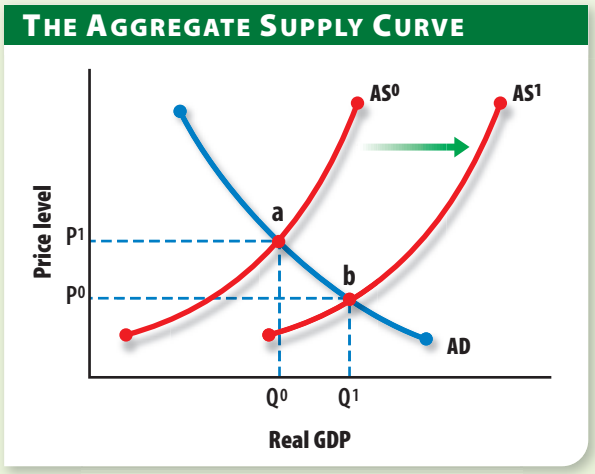
One limitation of supply-side policies is a lack of enough experience with them to know how they affect the economy. Even aggregate supply and aggregate demand are largely conceptual, making it difficult to predict the exact consequence of any particular supply-side policy.

In the case of the Laffer curve, total personal income tax collections, when adjusted for inflation, actually declined after the implementation of President Reagan's 1981 tax reductions. They declined again after the Bush tax cuts of 2001. The result was that one of the main foundations of the supply-side school—that tax cuts would lead to higher tax revenues—proved to be false. Even so, policies that promote productivity, reduce unnecessary paperwork, or otherwise stimulate the economy to grow to its maximum potential are certainly worthwhile. Almost everyone, including demand-siders, favors these policies.

Finally, we should note that supply-side economic policies are designed to promote economic growth rather than to remedy economic instability. Many economists believe that supply-side policies during both the Reagan and the Bush presidencies weakened the automatic stabilizers by making the federal tax structure less progressive and by reducing many "safety net" programs. Both actions may have stimulated growth. However, neither was designed to add to short-term economic stability.

✓Reading Check **Interpreting** What are the main goals of supply-side economists?

Figure 15.7 ▶ **Supply-Side Policies and Aggregate Supply**



▶ Supply-side policies are designed to increase aggregate supply through decreased government spending and involvement as well as lower taxes.

Economic Analysis ***What happens to the price level when the aggregate supply curve shifts to the right?***

Money Supply and Interest Rates
When the Fed decreases interest rates, more money becomes available to grow the economy. ***What is the short-run impact of lower interest rates?***

Monetary Policies

MAIN Idea Monetarist policies seek steady economic growth by controlling the money supply.

Economics and You Neither demand-siders nor supply-siders consider the money supply. Read on to learn why monetarists disagree with both.

Both demand-side policies and supply-side policies are concerned with stimulating production and employment. Neither assigns much importance to the money supply. An approach called **monetarism**, however, places primary importance on the role of money in the economy.

monetarism school of thought stressing the importance of stable monetary growth to control inflation and stimulate long-term economic growth

Monetarists believe that fluctuations in the money supply can be a destabilizing element that leads to unemployment and inflation. Therefore, they favor policies that lead to stable, long-term monetary growth at levels low enough to control inflation.

Skills Handbook
*See page **R52** to learn about **Sequencing Events.***

Short-Run Impacts

A monetary policy in which the money supply is tightened is called a contractionary monetary policy. In the short run, this policy can raise interest rates. Higher interest rates might be desirable if the economy is growing too fast and prices are rising. The higher interest rates would slow consumer and business borrowing, leading to a decrease in aggregate demand. As a result, the aggregate demand curve would shift to the left, lowering both the price level and real GDP.

If the economy is growing too slowly, an expansionary policy can increase the money supply and lower interest rates. This would reduce the cost of consumer and business borrowing and increase aggregate demand. The aggregate demand curve would then shift to the right, causing real GDP and the price level to increase.

In the short run, monetary policy affects interest rates. Changes in the level of interest rates can have a significant impact on the demand for real GDP. In the longer run, however, monetary policy can have very different results.

Long Run Impacts

Expansionary monetary policy, with a larger money supply, can lower interest rates. At the same time, it could also increase the possibility of future inflation, as past events have shown. During the Revolutionary War, so much money was printed that prices rose dramatically, and the Continental dollar soon became worthless. Prices also increased significantly during the Civil War when too many greenbacks were printed. Finally, excessive monetary growth allowed by the Fed to help the government finance the Vietnam War resulted in the inflation of the 1970s.

The money supply can grow over time, but how fast should it be allowed to grow? According to the monetarists, it should grow at a slow but steady rate. Specifically, the rates of growth of real GDP and productivity would determine the rate at which the money supply grows.

For example, with real GDP growing by 3 percent and productivity growing by 1 percent, the money supply could be allowed

to grow at about 4 percent without causing inflation. At this rate, there would be just enough extra money each year to buy the additional goods and services the economy produces.

This approach to inflation control is in sharp contrast to approaches that other administrations tried earlier. In the early 1970s, for example, President Richard Nixon attempted to stop inflation by imposing **wage-price controls**—regulations that make it illegal for businesses to give workers raises or to raise prices without the **explicit** permission of the government. Most monetarists at the time said the controls would not work. Events soon proved them correct, as prices rose despite the legislated controls.

wage-price controls policies and regulations making it illegal for firms to give raises or raise prices without government permission

Use of Monetary Policy

Economists have discovered that timing can be difficult when it comes to implementing monetary policy. An expansionary monetary policy may affect the economy right away—or several years later. The same thing is true for a contractionary monetary policy. In either case, the desired changes may happen immediately or only after a lag. For this reason, monetarists argue that changes in the money supply should be gradual so that they do not destabilize the economy.

Because of these lags, monetary policy does not seem to be very effective in reducing short-term unemployment. For example, when the Fed aggressively lowered interest rates in 2001 to move the economy out of the recession, it took several years for the unemployment rate to come down. In the end, most monetarists argue that monetary policy can be used to maintain long-term price stability. However, it must be used with caution because its short-run impacts are uncertain.

✓Reading Check **Summarizing** What problems are associated with expansionist monetary policy?

SECTION 2

Review

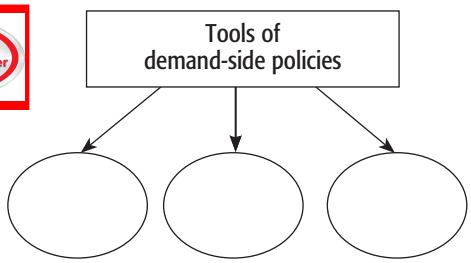
Vocabulary

1. **Explain** the significance of Medicare, fiscal policy, Keynesian economics, multiplier, accelerator, automatic stabilizer, entitlements, unemployment insurance, supply-side policies, deregulation, monetarism, and wage-price controls.

Main Ideas

2. **Listing** What are the assumptions of supply-siders?
3. **Explaining** What problems exist for monetary policy?
4. **Identifying** Use a graphic organizer like the one below to identify the tools of demand-side policies.

Interactive Graphic Organizer



Critical Thinking

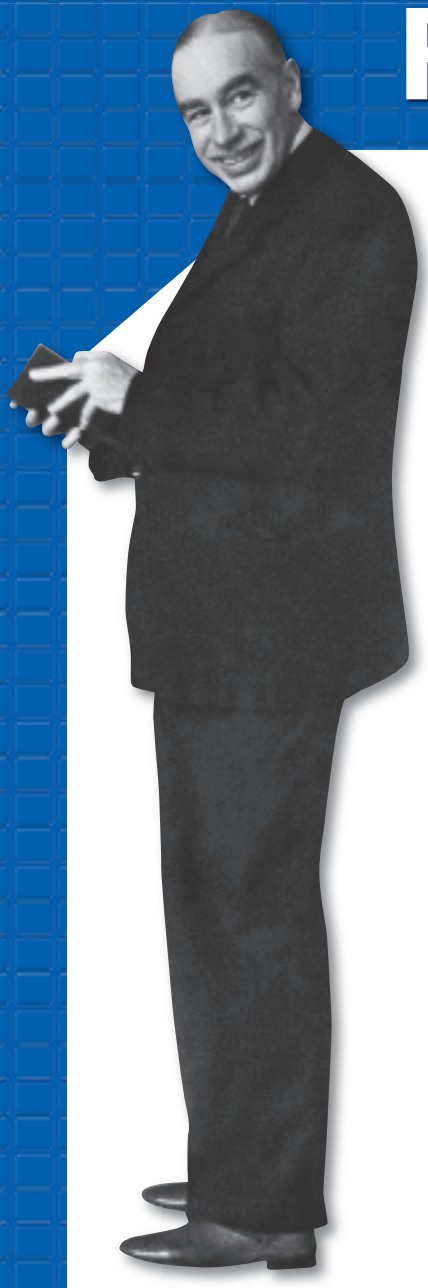
5. **The BIG Idea** How do supply-side economists and demand-side economists differ with regard to the role of government in the economy?
6. **Drawing Conclusions** Do you agree with the opinion that fiscal policy is ineffective? Explain your reasons for agreeing or disagreeing.
7. **Analyzing Information** According to monetarists, how do fluctuations in the money supply affect the economy?
8. **Analyzing Visuals** Look at the photo on page 420. How does it reflect the views of John Maynard Keynes on the role of government in the economy?

Applying Economics

9. **Deregulation** Identify an industry in your state that has been or is being deregulated. Why did legislators make the decision to deregulate the industry? Did deregulation have the expected benefits? Were there any unanticipated costs? Explain.

ECONOMIST

Profiles in Economics



John Maynard Keynes is widely regarded as the most influential economist of the twentieth century. His theories led the U.S. government to take an active role in preventing economic instability that could lead to widespread joblessness.

John Maynard Keynes (1883–1946)

- his "Keynesian economics" caused governments to implement fiscal policy
- instrumental in the planning of the World Bank

The Long Run

During the Great Depression of the 1930s, government leaders desperately sought solutions to widespread unemployment and poverty. Yet they remained reluctant to "unbalance" the budget by using federal money to help the nation's people directly. Instead, they believed that laissez-faire policies would allow the market to correct itself in the long run.

Enter Keynes

A brilliant intellectual, John Maynard Keynes established a reputation for straight talking and insightful critique early in his career. He served as an adviser to the British Treasury and as a British representative at the World War I peace conference at Versailles. He correctly predicted that the high reparations imposed on Germany after World War I would lead to another war.

As an economist, Keynes was not impressed with perfectly balanced budgets. In fact, he considered balanced budgets—when that meant government inaction—to be disastrous if a nation's consumer and business sectors had no money to spend or invest to create jobs. In his masterpiece, *The General Theory of Employment, Interest, and Money* (1936), Keynes argued that governments should spend money—and even take on debt—to help correct an economic recession or depression. They should then save money during an overly successful period to prevent inflation.

To Keynes, it did not help anyone to wait for the long run because "in the long run we are all dead." His theories were revolutionary, and they provided much needed insight into the workings of a depression-era economy. Soon, the label *Keynesian economics* stood for any government spending or taxing policies designed to stimulate the private sector.

Examining the Profile

1. **Analyzing Information** Why were government leaders reluctant to help people during the Great Depression?
2. **Summarizing Information** What is the basic premise of Keynesian economics?

SECTION 3

Economics and Politics

GUIDE TO READING

Section Preview

In this section, you will learn that economic policies change as time and circumstances change.

Content Vocabulary

- monetary policy *(p. 431)*
- baby boomers *(p. 432)*
- Council of Economic Advisers *(p. 433)*

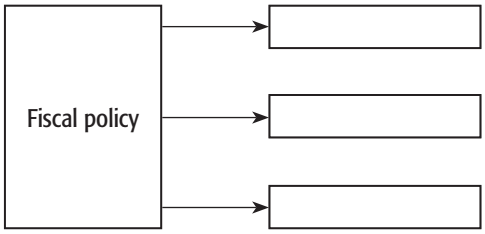
Academic Vocabulary

- ideology *(p. 431)*
- advocates *(p. 433)*

Reading Strategy

Identifying As you read the section, complete a graphic organizer similar to the one below by identifying the different kinds of fiscal policy.

Interactive Graphic Organizer



ISSUES IN THE NEWS

–TIME

Enthusiastic Capitalism

American culture is today, as ever, uniquely suited for growth, innovation, and advancement.

The most obvious bedrock of success is entrepreneurial spirit. The U.S. has the most risk-taking, most laissez-faire, least regulated economy in the advanced Western world. America is heartily disdained by its coddled and controlled European cousins for its cowboy capitalism. But it is precisely America's tolerance for creative destruction—industries failing, others rising, workers changing jobs and cities and skills with an [enthusiasm] and [casualness] that Europeans find astonishing—that keeps its economy churning and advancing. . . . The mistake of the Soviets, Japanese, and so many others was to assume that creativity could be achieved with enough government planning and funding. . . . ■

As we look at the economic history of the United States, it is clear that times are better than ever. Inflation is largely under control, and the economy is larger and more productive than ever. Recessions still occur, of course, but business cycles have generally turned into fluctuations, and economic expansions are longer than ever.

Major domestic or even international events can temporarily interrupt the economy, but capitalistic market economies have a remarkable ability to cope with adversity. If anything, the task before us is to manage our prosperity in a way that both improves our economic health and benefits everyone.

Lon C. Diehl/PhotoEdit

Changing Nature of Economic Policy

MAIN Idea The government can influence the economy with discretionary, passive, or structural fiscal policies.

Economics and You Today, major recessions are rare in the United States. Read on to learn how this has affected government policies.

Fiscal policies are government attempts to influence the economy through taxing and spending actions. This may involve ways to speed up the economy with tax cuts or with additional federal spending. It may also include government efforts to slow the economy down by either increasing taxes or reducing spending.

Types of Fiscal Policy

Several different kinds of spending and taxing policies exist. These fiscal policies can be either discretionary, passive, or structural.

Discretionary fiscal policy is policy that someone must choose to implement. It requires an action by Congress, the president, or an agency of government to take effect. One example is a federal expenditure to build a highway or renovate a downtown area in order to offset a decline in business spending. As you read in Chapter 10, about one-third of all federal spending is discretionary rather than mandatory.

Passive fiscal policies do not require new or special action to go into effect. Instead, the policies react automatically when the economy changes. Examples of passive fiscal policies include unemployment insurance and Social Security benefits. In fact, most of the automatic stabilizers you learned about earlier are examples of passive fiscal policies.

Finally, *structural* fiscal policies are policies designed to strengthen the economy over a longer period of time. Examples include reforms of popular programs such as Social Security and welfare in order to make the programs financially secure and more effective in the long run. Most of the supply-side policies, which advocate a smaller role for government and lower taxes, are structural fiscal policies.

Decline of Discretionary Fiscal Policy

At one time, discretionary fiscal policies were the most popular economic policies. In the 1940s, massive government spending for World War II helped pull the economy out of the Great Depression. Both President Kennedy, in the early 1960s, and later President Reagan, in the early 1980s, used large tax cuts to get a sluggish economy moving again.

However, for several reasons discretionary fiscal policy is used less today. The first reason relates to the various lags that inevitably occur between recognizing that there is a problem and actually doing something about it. Suppose, for example, that the problem is a potential recession, and that the ideal remedy would be to spend $50 billion on roads and highways.

Policy makers first face a recognition lag because it normally takes several months to confirm that a recession is actually taking place. A legislative lag would follow because it may take a year or more for Congress to pass laws authorizing expenditures. This would be followed by an implementation lag because it often takes several more years to build the highways

Did You Know?

Early Practitioner While John Maynard Keynes was widely credited as the first person to advocate fiscal policy to stimulate the economy in the mid-1930s, President Franklin D. Roosevelt preceded him by several years. When Roosevelt took office on March 4, 1933, the U.S. economy was suffering from its worst depression. With little economic theory to guide him, Roosevelt introduced 15 new bills during his first 100 days in office, some of which poured billions of dollars into state-run welfare and public-works programs. Roosevelt's aggressive use of discretionary fiscal policy was instrumental in helping the economy out of the Great Depression.

and pump the money into the economy. In the end, the recession—which historically lasts for less than a year—will be over by the time the spending begins to stimulate the economy.

The second reason for the decline of discretionary fiscal policy is the gridlock that can occur when the political parties in Congress oppose each other's views on the budget. In both 1995 and 1996, for example, Congress shut down the federal government when Republicans and Democrats could not agree on the federal budget.

Ideology is the third reason. President Bush's tax cuts, for example, were based on the belief the American economy needed a structural change. As a result, in 2001 Bush proposed tax cuts that would extend to the year 2010 and beyond. Thus, the preference for structural policies has displaced the use of discretionary ones.

Rise of Monetary Policy

The declining use of discretionary fiscal policy left a void filled by the Federal Reserve System, which has the responsibility for conducting monetary policy. As you learned earlier, **monetary policy** involves changing the amount and availability of credit in order to influence interest rates.

Such a situation occurred during the recession of 2001. That recession was so mild and so short—lasting about eight months—that policymakers altogether ignored discretionary fiscal policy. In addition, Congress was preoccupied with a response to the terrorist attacks on September 11.

On the other hand, the Fed was actively lowering the discount rate on an almost monthly basis in order to stimulate the economy. The policy worked, and the Fed took much of the credit for the short duration and mild impact of the recession.

Of course, even the Fed is not above criticism. For example, the Fed's efforts to prevent inflation by raising interest rates in 2000 may have contributed to the 2001 slowdown. Even so, most members of Congress believe that the power to create money and to manage the money supply should remain with an independent agency rather than with elected officials.

✓Reading Check **Summarizing** Why is discretionary fiscal policy used less and less frequently?

monetary policy actions by the Federal Reserve System to expand or contract the money supply in order to affect the cost and availability of credit *(also see page 400)*

CAREERS

Credit Manager

The Work

* Manage the preparation of financial reports
* Oversee a firm's granting of credit by establishing credit-rating criteria, determining credit ceilings, and monitoring the collections of past-due accounts
* Solicit business, authorize loans, and direct the investment of funds

Qualifications

* Ability to analyze detailed information and draw conclusions
* Excellent communication skills to explain complex financial data
* Expertise on government appropriations, budgeting, tax laws, and regulations
* Knowledge about global trade, changes in federal and state laws, and new financial instruments
* Bachelor's degree in business, finance, accounting, or a related field, with many positions requiring a master's degree in business administration, economics, finance, or risk management

Earnings

* Median annual earnings: $81,880

Job Growth Outlook

* Average

Source: *Occupational Outlook Handbook,* 2006–2007 Edition

Differing Opinions
Economists have different ideas about economic policies, although they don't come to blows as in the cartoon. ***Why do economists differ?***

baby boomers people born in the United States during the historically high birthrate years from 1946 to 1964

Economics and Politics Today

MAIN Idea Current conditions shape the views of economists and policy makers.

Economics and You Have you ever perceived an issue to be a certain way and then found out later that it was completely different? Read on to learn why economists' views change as well.

Skills Handbook
*See page **R41** to learn about **Evaluating Information.***

Choosing which economic policies will work best is difficult. When economists offer proposals that sometimes seem contradictory, it makes choosing even more difficult. These differences of opinions among economists, however, are smaller than most people realize.

Economic Politics

In the 1800s, the science of economics was known as "political economics." After a while, economists broke away from the political theorists and tried to establish economics as a science in its own right.

In recent years, the two fields have merged again. This time, however, they have done so in a way better described as "economic politics." Today, politicians are concerned largely with the economic consequences of what they do. Most of the major debates in Congress are over spending, taxes, and other budgetary matters.

Why Economists Differ

Economists who choose one policy over another normally do so because they think that some problems are more critical than others. For example, one economist might think that unemployment is the crucial issue, while another believes that inflation is. Yet if we surveyed all economists on the best way to deal with one specific problem, their recommendations would be much more consistent.

Another reason economists differ is that most economic theories are a product of the times. The unemployment and other problems that occurred during the Great Depression influenced a generation of demand-side economists. Because the government sector was so small during the 1930s, supply-side policies designed to make government's role even smaller probably would not have helped much then.

Later, from the 1960s through 1980s, the monetarists gained influence because of the slow decline of discretionary fiscal policy. Then, by the 1980s, the ideological rejection of "big government" created a generation of supply-siders who thought that the key to economic growth was a smaller government.

By 2010 and beyond, the large population of retired **baby boomers**, who were born between 1946 and 1964, will have its own unique problems. The problems facing this group may well prompt another generation of economists to focus on a whole new set of issues. In the end, then, the views of economists are very much affected by the problems of the current moment.

Council of Economic Advisers

Generally, economists and politicians work together fairly closely. To help keep track of the economy, the president has a

Council of Economic Advisers, a three-member group that reports on economic developments and proposes strategies. The economists are the advisers, while the politicians direct or implement the policies. In its role as "the president's intelligence arm in the war against the business cycle," the council gathers information and makes recommendations.

The president listens to the economists' advice but may not be willing or able to follow it. For example, if the president **advocates** a balanced budget, the economic advisers may recommend raising taxes to achieve this goal. If one of the president's campaign pledges was not to raise taxes, however, the president might reject the advisers' suggestion and let a deficit develop.

Increased Public Understanding

Despite disagreeing on some points, economists have had considerable success with the description, analysis, and explanation of economic activity. They have developed many statistical measures of the economy's performance. Economists also have constructed models that are helpful with economic analysis and explanation. All of these tools are necessary if we are to understand the opportunity costs of the trade-offs we must make when we select one policy over another.

In the process, economists have helped the American people become more aware of the workings of the economy. This awareness has benefited everyone, from the student just starting out to the politician who must answer to the voters.

Today economists know enough about the economy to prevent a depression like the one in the 1930s. It is doubtful that economists know enough—or can persuade others that they know enough—to avoid minor recessions. Even so, they can devise policies to stimulate growth, help disadvantaged groups when unemployment rises or inflation strikes, and generally make the American economy more successful.

Reading Check **Interpreting** What is the role of the Council of Economic Advisers?

Economics ONLINE

Student Web Activity Visit the *Economics: Principles and Practices* Web site at glencoe.com and click on *Chapter 15—Student Web Activities* for an activity on the Council of Economic Advisers.

Council of Economic Advisers three-member group that devises strategies and advises the president of the United States on economic matters

SECTION 3 Review

Vocabulary

1. **Explain** the significance of monetary policy, baby boomers, and Council of Economic Advisers.

Main Ideas

2. **Explaining** Why have structural fiscal policies replaced discretionary fiscal policies?
3. **Describing** What actions did the Fed take in response to the recession of 2001?
4. **Describing** Use a graphic organizer like the one below to describe the different types of fiscal policy.

Interactive Graphic Organizer

Types of Fiscal Policy		
Type	Description	Example
Discretionary		
Passive		
Structural		

Critical Thinking

5. **The BIG Idea** Why do economists have differing views over which policy is most effective in producing stability and economic growth?
6. **Drawing Conclusions** Why do some people blame the Fed for the recession of 2001?
7. **Analyzing Information** Why might monetary and fiscal policy conflict during an election year?
8. **Analyzing Visuals** Look at the cartoon on the previous page. Why do you think economists care so strongly about their views?

Applying Economics

9. **Fiscal and Monetary Policy** Suppose that Congress passes a massive tax cut during an election year even though inflation is very high. What actions might the Fed take in response? Explain your answer.

CASE STUDY

Best Buy Gets Better

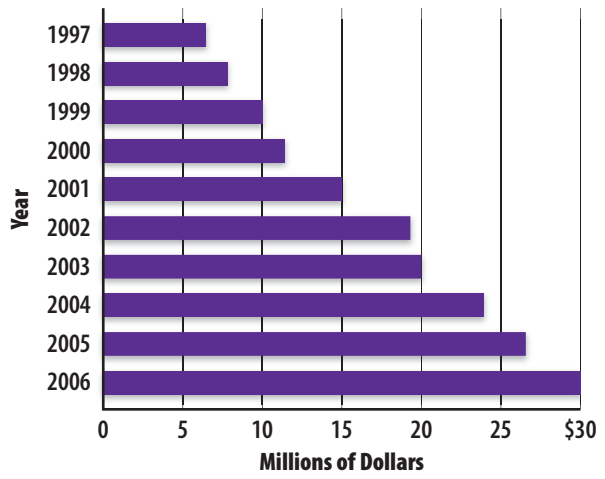
Too Big, Too Fast

In 1996 Best Buy found itself in a predicament. Despite astounding growth over a three-year period, the company had not changed the way it did business. As a result, its stock tumbled and profits dwindled. The company switched gears, opting for a smaller array of products, a new pricing strategy, and new store layouts.

Customer Focus

In addition, Best Buy turned to a business model called Customer Insight that determined the lifestyles of its most profitable customers. The five segments Best Buy identified include wealthy professionals desiring the best technology products, young males seeking the latest technology and accessories, fathers looking for technology to improve entertainment, mothers on the lookout for gadgets to enrich their children, and small-business owners who use technology to increase their profits. Best Buy began targeting these groups, increasing revenues from $7.8 million in 1997 to more than $30 million in 2006.

BEST BUY REVENUES, 1997–2006



Source: Best Buy annual reports

Geek Squad

Best Buy still faced strong competition from other technology retailers such as Circuit City. Enter, the Geek Squad. This army of 2,500 "agents" provides emergency services 24 hours a day, seven days a week, 525,600 minutes a year to fix computers, printers, and networks for individual customers and businesses alike. The ability to provide full technology service and support for the products sold in stores helped Best Buy win back customers and shareholders.

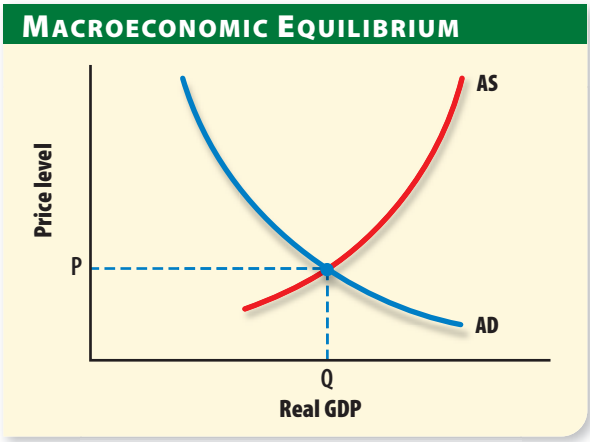
Analyzing the Impact

1. **Summarizing** What is Customer Insight, and how did it help change the way Best Buy does business?
2. **Drawing Conclusions** How did Best Buy differentiate itself from other technology retailers?

CHAPTER 15

Visual Summary

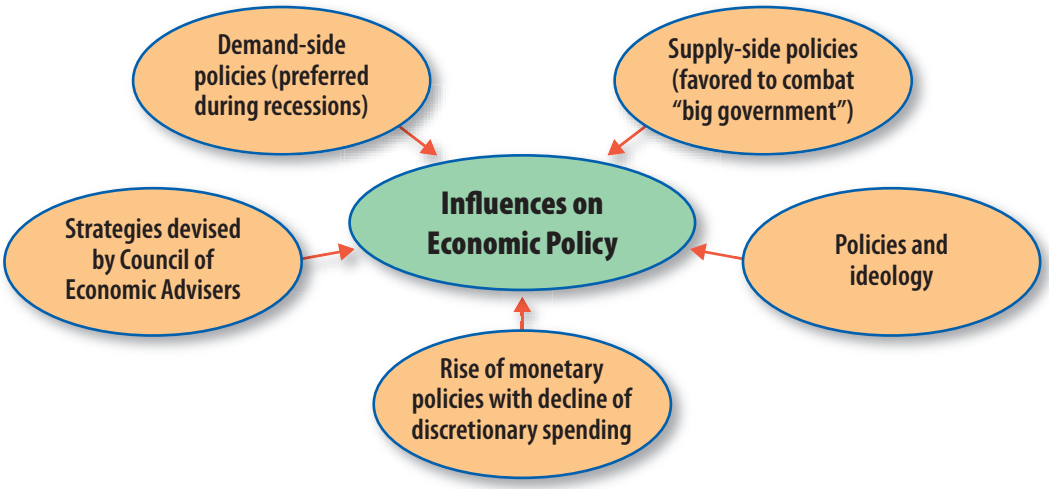
Aggregate Supply and Demand In order to understand the economy as a whole, we need to study aggregate supply and demand. The economy reaches macroeconomic equilibrium when aggregate supply and demand are equal at a given price level.



Stabilization Policies The government can pursue three different policies to stabilize and grow the economy.

Demand-Side Policies	Supply-Side Policies	Monetary Policies
• Stimulate consumption of goods and services (demand) • Introduced by John Maynard Keynes • Government's role is to offset changes in investment-sector spending • Includes automatic stabilizers	• Stimulate production of goods and services (supply) • Smaller role for government • Lower taxes • Difficult to predict results	• Focuses on money supply • Money supply to grow at a steady rate to match growth of real GDP and production • Difficult to time policy

Influences on Economic Policies Several factors influence economic policies.



CHAPTER 15

Assessment & Activities

Review Content Vocabulary

Use all of the terms below to write a paragraph about government policies to stabilize the economy.

1. aggregate supply
2. supply-side policies
3. fiscal policy
4. aggregate demand
5. monetarism
6. automatic stabilizer
7. deregulation
8. accelerator
9. macroeconomic equilibrium
10. monetary policy
11. wage-price controls
12. Keynesian economics

Review Academic Vocabulary

Use the words below to construct three sentences that summarize the goals of demand-side, supply-side, and monetarist economic policies.

13. unduly
14. framework
15. unstable
16. explicit
17. ideology
18. advocates

Review the Main Ideas

Section 1 *(pages 413–417)*

19. **Describe** the circumstances under which prices are consistent with a given level of real GDP.
20. **Explain** the difference between the supply curve of a firm and the aggregate supply curve.
21. **State** the major dilemma that faces economic policy makers.
22. **Identify** the factors influencing the increase or decrease of aggregate supply and aggregate demand by using a graphic organizer like the one below.

Aggregate Supply (AS) and Aggregate Demand (AD)	
Factors that increase AS	
Factors that decrease AS	
Factors that increase AD	
Factors that decrease AD	

Section 2 *(pages 419–427)*

23. **Identify** which component of GDP Keynes labeled as the cause of instability.
24. **Discuss** the effects of the multiplier and the accelerator.
25. **Describe** how monetarists determine the proper growth rate for the money supply.
26. **Explain** how supply-siders would reduce the government's role in the economy.

Section 3 *(pages 429–433)*

27. **Discuss** the difficulty of using discretionary fiscal policy.
28. **Explain** why new problems will arise in the economy, even as old ones are solved.
29. **State** an example of how politics sometimes overrides economic policies.
30. **Describe** how economists sometimes differ in their views about the economy.

Critical Thinking

31. **The BIG Idea** Why and how could monetary policy be destabilizing?
32. **Contrasting** How do aggregate supply and demand differ from simple supply and demand?
33. **Comparing** What are the limitations of demand-side, supply-side, and monetarist economic policies?

Economics ONLINE **Self-Check Quiz** Visit the *Economics: Principles and Practices* Web site at glencoe.com and click on *Chapter 15—Self-Check Quizzes* to prepare for the chapter test.

34. **Analyzing Information** How do the events of the 1980s and the early 2000s support or disprove the central supply-side position about the relationship between taxes, economic growth, and tax revenues? Provide examples in your answer.

35. **Drawing Conclusions** Why are the automatic stabilizers effective fiscal policies that counter business cycles?

36. **Contrasting** Compare the use of discretionary fiscal policy and monetary policy to offset the effects of a short recession. Which policy would you choose? Include reasons to support your choice.

Analyzing Visuals

37. **Synthesizing** Look at Figure 15.4 on page 422. Use what you have learned to explain what policies might make the demand curve shift. What effect does this have on aggregate supply?

Applying Economic Concepts

38. **Monetary Policy** At one time or another, some presidents have complained about the independence that the Fed enjoys when it conducts monetary policy. Do you think this independence is beneficial and should be maintained, or would you prefer that elected officials have more control over monetary policy? Support your answer.

39. **Fiscal Policy** Which fiscal policy do you think the government would use in each of the scenarios described in the table below? Explain your answers.

Scenario	Fiscal Policy	Explanation
Inflation is rising and real GDP is growing strongly		
GDP is down and the unemployment rate has increased by 10 percent		

Interpreting Cartoons

40. Look at the cartoon below. What is the topic of the cartoon? What point is the cartoonist making about the impact of tax cuts and the war in Iraq? How does the cartoonist illustrate this point?

Thinking Like an Economist

41. Like demand-side and supply-side policies, monetary policies are designed to promote stable economic growth. The three approaches differ on what should be done to achieve this goal. Assume that real GDP growth was negative during the last quarter. Using Figure 15.5 as an example, construct a similar chart listing the policies that monetarists would follow to help the economy.

Writing About Economics

42. **Expository Writing** Some economists favor policies that stimulate demand, while others favor those that stimulate the supply of goods and services. Still other economists prefer policies based on the growth of the money supply. With which group of economists do you agree? Write a two-page paper outlining the policies and the reason for your choice.