Monetary and Fiscal Policy

Part A

Tools of Monetary and Fiscal Policy

Both monetary and fiscal policy can be used to influence the inflation rate and real output. Indicate what effect each specific policy has on inflation and real output in the short run (nine to 18 months).

Figure 43.1

Monetary Policy	Inflation	Real Output
1. (A) Buy government securities		
(B) Sell government securities		
2. (A) Decrease the discount rate		
(B) Increase the discount rate		
3. (A) Decrease reserve requirement		
(B) Increase reserve requirement		

Fiscal Policy	Inflation	Real Output
4. (A) Increase government spending		
(B) Decrease government spending		
5. (A) Increase taxes		
(B) Decrease taxes		

Part B

Lags in Policy Making

As the economic situation changes, policy makers must decide when to take action and which policy action to take. Then they must implement the policy. The economy then responds to the policy. The amount of time it takes policy makers to recognize and take action is called the *inside lag.* The amount of time it takes the economy to respond to the policy changes is called the *outside* or *impact lag.* The inside lag is estimated to be short for monetary policy but long for fiscal policy. The inside lag is long for fiscal policy because the legislative branch must come to agreement about the appropriate action. The outside lag, however, is long and variable for monetary policy but very short for fiscal policy.

6. Explain why the inside lag can be short for monetary policy but the outside lag is long and variable.

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