The Penta-Fecta! (not a real term)

Step 1: draw the basic set-up of the graphs on the graph page. Use the neo-classical model for AS/AD. If you’re graphing expansionary policy, start with a recessionary gap. If you’re graphing contractionary policy, start with an inflationary gap.

Step 2: Fill in the blanks below with arrows to indicate changes.

Step 3: Draw the effects on the graph page (using a different color?!).

Step 4: Do a little dance because you’re now totally ready to dominate Economics!!!

Let’s start with expansionary Monetary Policy. Enjoy!

To counteract a recession, the Fed can \_\_\_\_\_ the reserve requirement, \_\_\_\_\_ the discount rate, and/or \_\_\_\_\_ bonds. That expansionary policy will \_\_\_\_\_ the excess reserves in banks. Therefore, the money supply will \_\_\_\_\_ causing nominal interest rates to \_\_\_\_\_. That change in interest rates leads to an \_\_\_\_\_ in gross investment, so AD shifts \_\_\_\_\_. The price level will therefore \_\_\_\_\_ and the real GDP will \_\_\_\_\_, making the unemployment rate \_\_\_\_\_. Now, because the nominal interest rate \_\_\_\_\_, either the demand for US$ will \_\_\_\_\_ or the supply of US$ will \_\_\_\_\_. This causes the price of US$ to \_\_\_\_\_, making US goods \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and foreign goods relatively \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, causing exports to \_\_\_\_\_ and imports to \_\_\_\_\_, which obviously means that the net exports \_\_\_\_\_. This reinforces the increase in AD already caused by the increase in gross investment! Monetary Policy has a **reinforcing** effect on net exports.

Moving on, here’s Contractionary Monetary Policy.

To counteract inflation, the Fed can \_\_\_\_\_ the reserve requirement, \_\_\_\_\_ the discount rate, and/or \_\_\_\_\_ bonds. That contractionary policy will \_\_\_\_\_ the excess reserves in banks. Therefore, the money supply will \_\_\_\_\_ causing nominal interest rates to \_\_\_\_\_. That change in interest rates leads to a \_\_\_\_\_ in gross investment, so AD shifts \_\_\_\_\_. The price level will therefore \_\_\_\_\_ and the real GDP will \_\_\_\_\_, making the unemployment rate \_\_\_\_\_. Now, because the nominal interest rate \_\_\_\_\_, either the demand for US$ will \_\_\_\_\_ or the supply of US$ will \_\_\_\_\_. This causes the price of US$ to \_\_\_\_\_, making US goods \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ and foreign goods relatively \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, causing exports to \_\_\_\_\_ and imports to \_\_\_\_\_, which means that the net exports \_\_\_\_\_. This reinforces the decrease in AD already caused by the decrease in gross investment! Monetary Policy has a **reinforcing** effect on net exports.

Next up: expansionary Fiscal Policy. Dummm dummmm duuuuummmmmm…

A possible side-effect of increased government spending and reduced taxes is a budget deficit which may lead to the crowding out of gross private investment AND net exports. When government spending \_\_\_\_\_ or taxes \_\_\_\_\_, then government must borrow in order to continue spending. This leads to an \_\_\_\_\_ in the demand for *all* loanable funds (or a \_\_\_\_\_ in the supply of *private* loanable funds). The change in loanable funds results in real interest rates \_\_\_\_\_. This change in real interest rates leads to \_\_\_\_\_ in gross investment. In addition, the increase in real interest rates causes the demand for US$ to \_\_\_\_\_ and/or the supply of US$ to \_\_\_\_\_ as investors seek higher returns in the US. This leads to the price of US$ \_\_\_\_\_, which leads to \_\_\_\_\_ exports and \_\_\_\_\_ imports, so the overall level of net exports \_\_\_\_\_. Because gross investment and net exports are direct components of AD, these decreases offset some of the increase in AD. Darn it!

Finally: Contractionary Fiscal Policy.

A possible side-effect of decreased government spending and increased taxes is a budget surplus which may lead to the crowding in of gross private investment AND net exports. When government spending \_\_\_\_\_ or taxes \_\_\_\_\_, then government develops a budget surplus. This leads to a \_\_\_\_\_ in the demand for *all* loanable funds (or a \_\_\_\_\_ in the supply of *private* loanable funds). The change in loanable funds results in real interest rates \_\_\_\_\_. This change in real interest rates leads to \_\_\_\_\_ in gross investment. In addition, the decrease in real interest rates causes the demand for US$ to \_\_\_\_\_ and/or the supply of US$ to \_\_\_\_\_ as investors seek higher returns abroad. This leads to the price of US$ \_\_\_\_\_, which leads to \_\_\_\_\_ exports and \_\_\_\_\_ imports, so the overall level of net exports \_\_\_\_\_. Because gross investment and net exports are direct components of AD, these increases offset some of the decrease in AD. Darn it!