

1. If the economy is operating in a recessionary period with high unemployment and low aggregate demand, illustrate and explain how:

- (i) monetary policy might be used to resolve this problem;
- (ii) fiscal policy might be used to resolve this problem.

Explain the differences and similarities in the final composition of GDP of the two approaches.

Ans.

i)

Monetary policy can be used by the government to increase the money supply in the economy by facilitating money and credit expansion, buying of T-bills. A good monetary policy will also help achieve price stability to keep inflation in check. By taking these steps, interest rate will come down and the LM curve will shift to the right. Point of IS-LM curve will also shift to the right.

At the same time, with reduced interest rates of borrowing, firms and households will likely invest more, which will boost the GDP and consequently the Aggregate Demand in the economy.

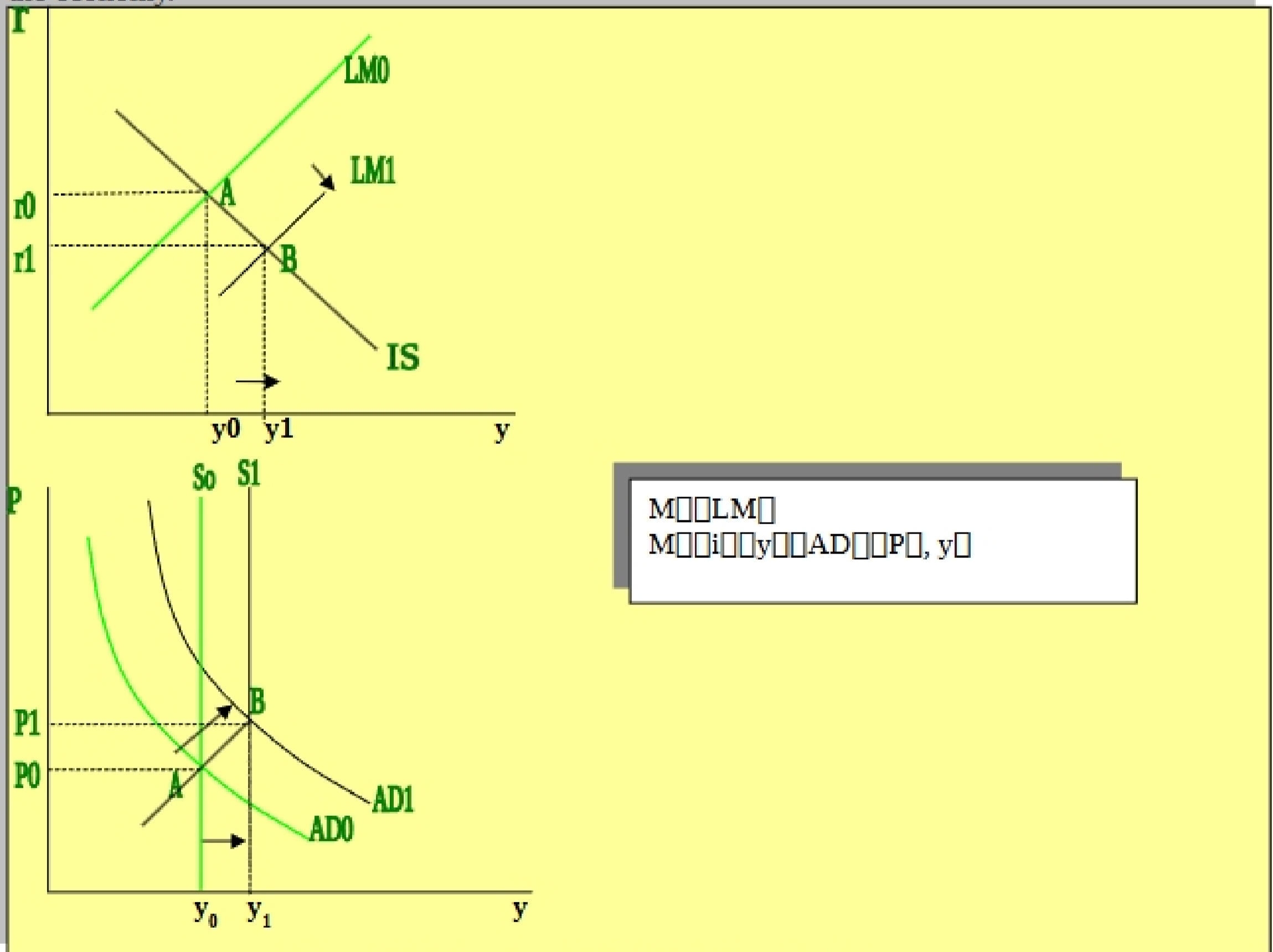


Figure 1: Monetary Policy Effects on GDP

$$y_d(\uparrow) = c + I(\uparrow) + g + NX$$

With the increased prices and Aggregate demand in the economy, level of employment is expected to increase because now employers are willing to pay higher to attract more employees (Assuming wage rigidity).

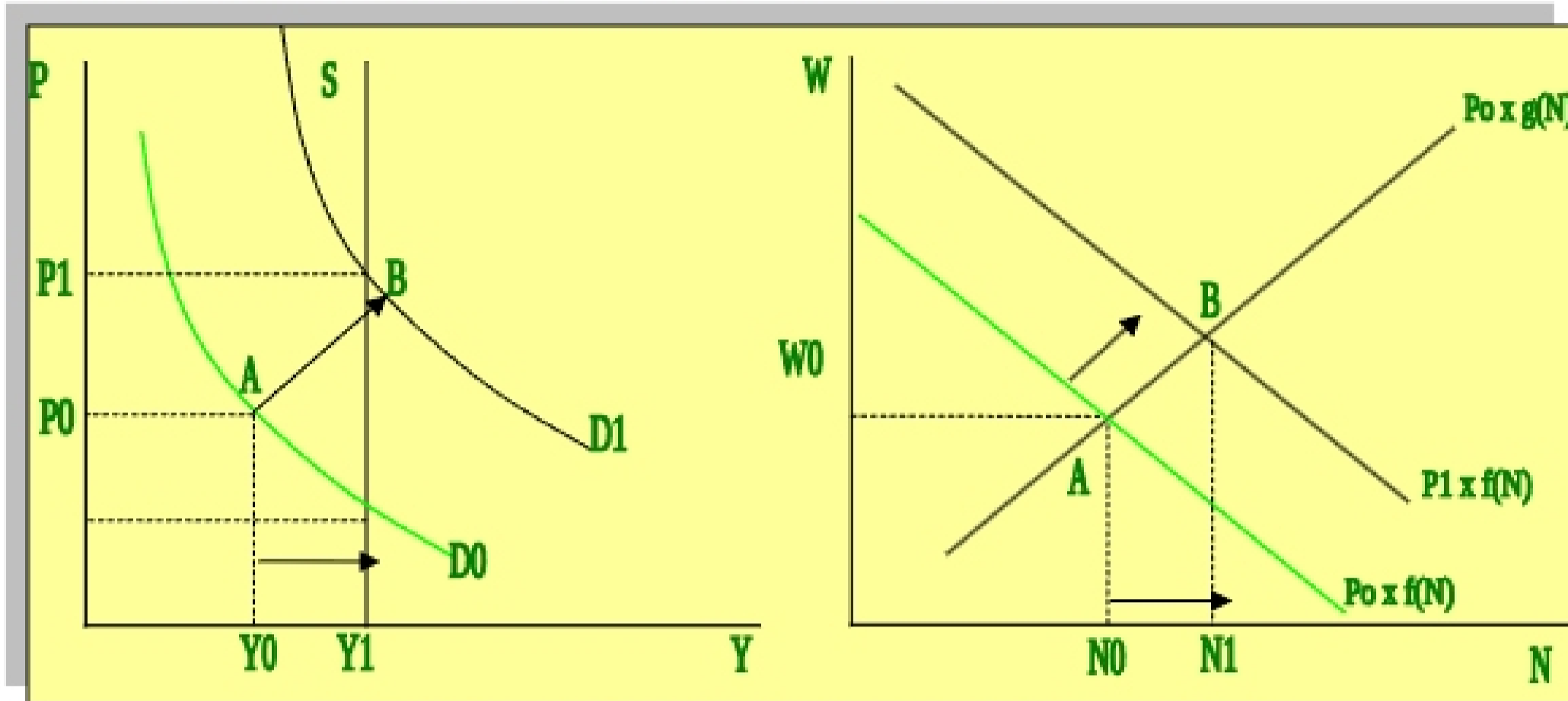


Figure 2: Monetary Policy Effects on employment

ii) Fiscal policy increases Aggregate demand in the economy by increasing Government expenditure (with excess capacity) or by decreasing marginal tax rate.

$$y_d(\uparrow) = c + I + g(\uparrow) + NX$$

With increased government expenditure, GDP increases and thus in IS-LM equilibrium, IS curves shifts to the right as a result.

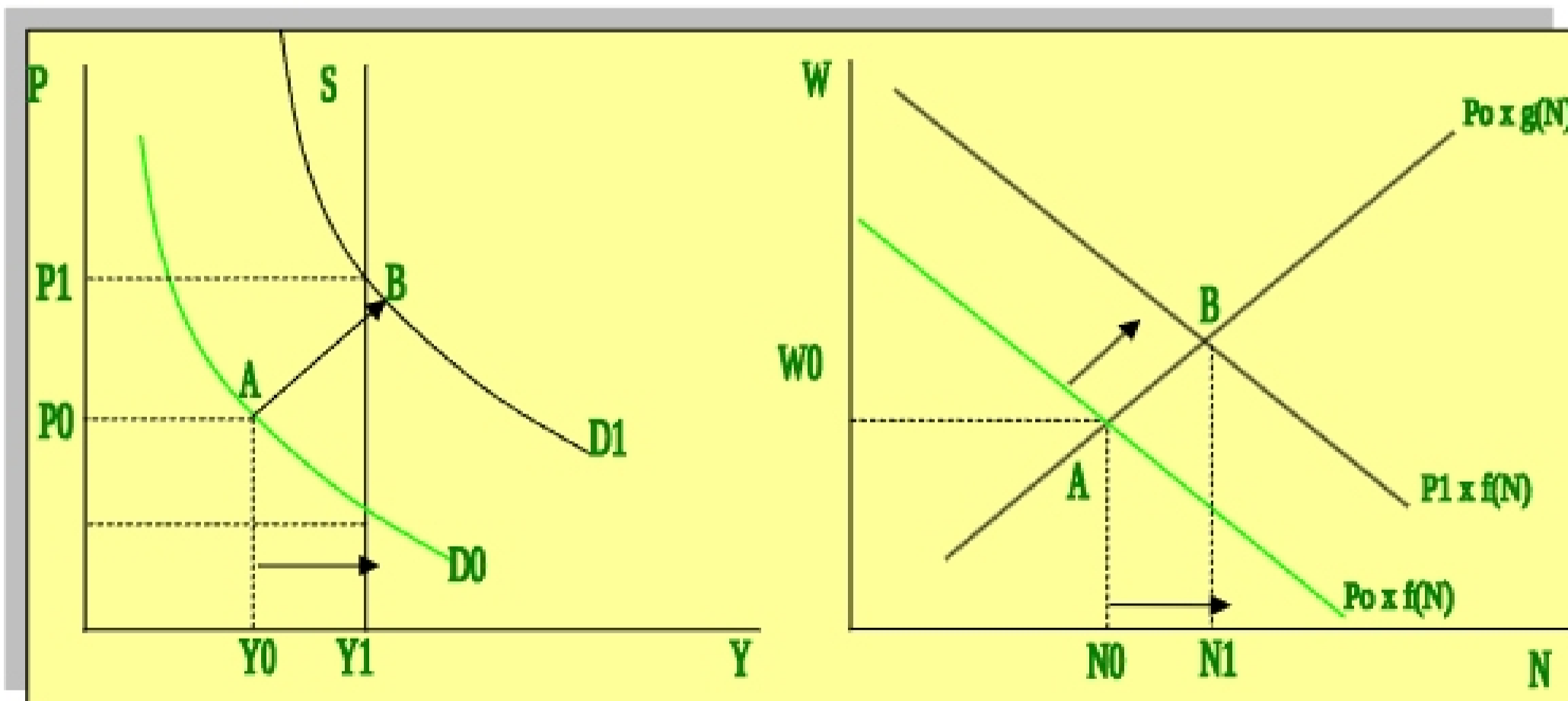
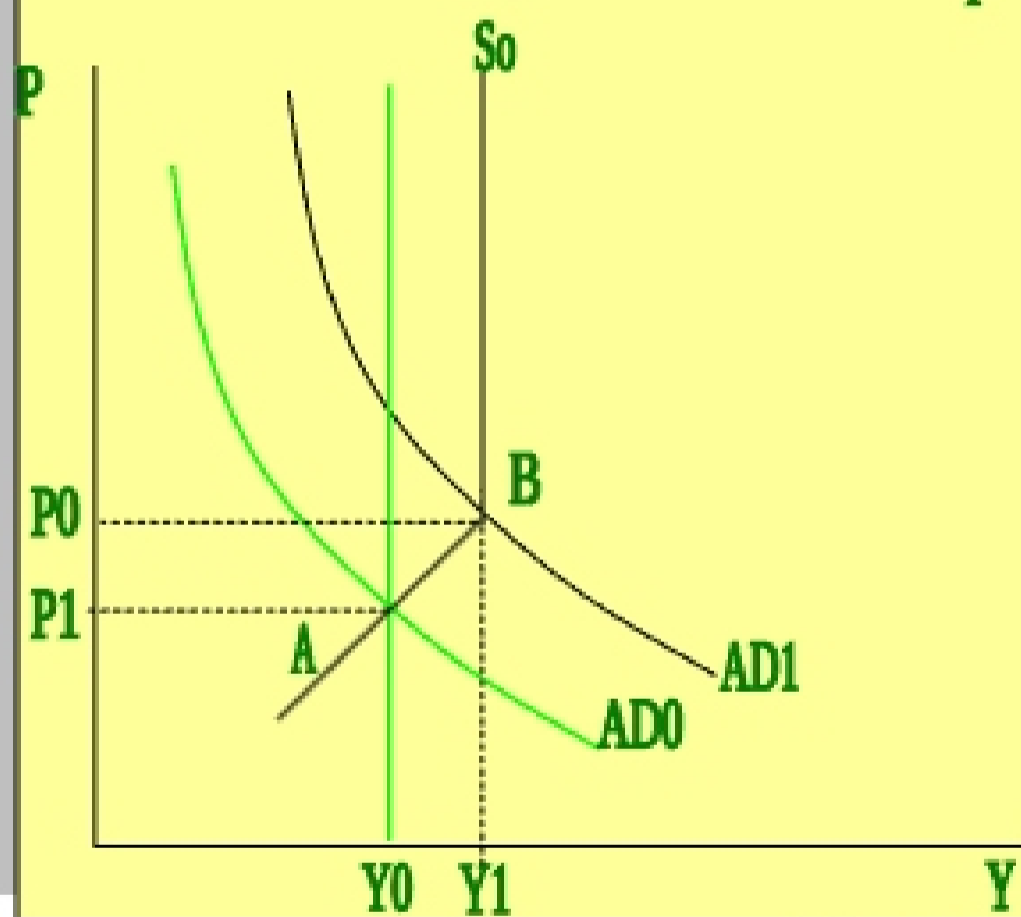
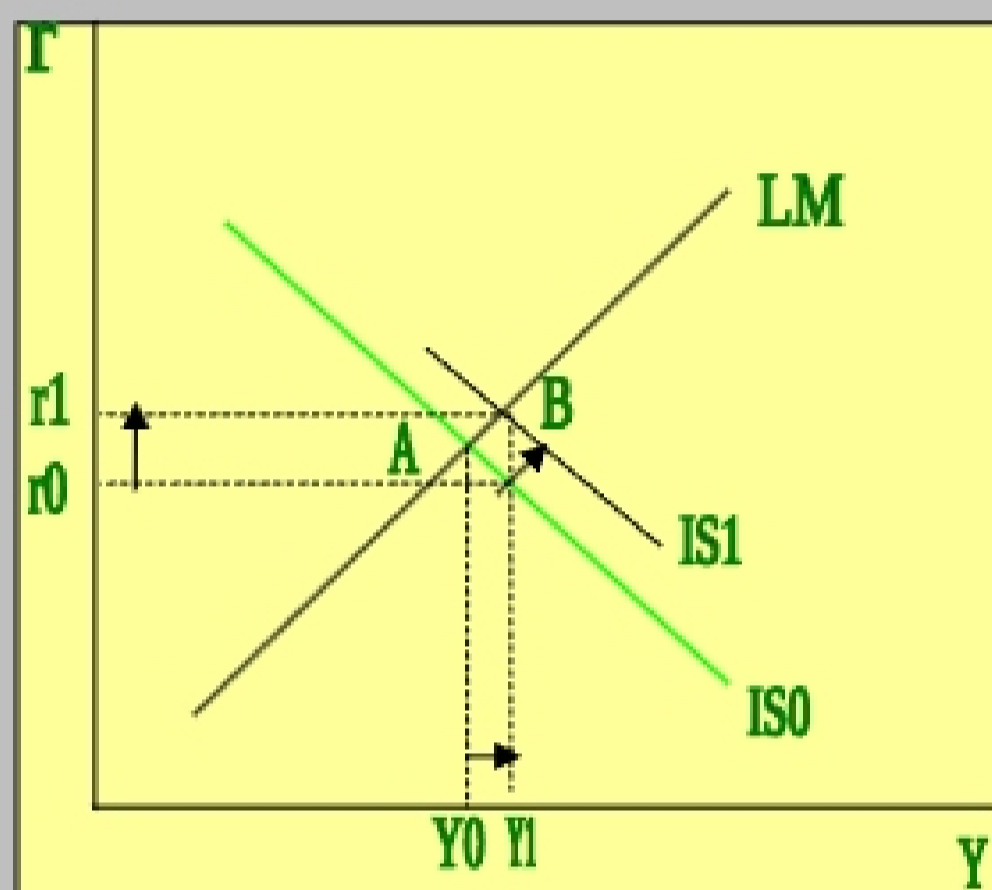


Figure 3: Fiscal Policy Effects on employment



$g \rightarrow AE \rightarrow IS$   
 $AD \rightarrow M, P, y$

Figure 4: Fiscal Policy Effects on GDP