

CHAPTER

16

Achieving Economic Stability

Economics & You



One of our nation's most important goals is to create an economic environment favorable to growth and stability. In **Chapter 16**, you will learn about the policies and factors that influence our economic stability. To learn about theories for controlling economic cycles, view the Chapter 23 video lesson:

Economic Growth and Stability

ECONOMICS
Online



Chapter Overview Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on **Chapter 16—Chapter Overviews** to preview chapter information.

← **CLICK HERE**

The mental and social health of society is an important concern for economists.

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The Cost of Economic Instability

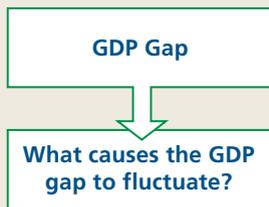
Study Guide

Main Idea

Economic instability leads to social as well as economic problems.

Reading Strategy

Graphic Organizer As you read the section, use a graphic organizer similar to the one below to describe the GDP gap.



Key Terms

stagflation, GDP gap, misery (discomfort) index

Objectives

After studying this section, you will be able to:

1. **Explain** the economic costs of instability.
2. **Describe** the social costs of instability.

Applying Economic Concepts

Misery Index Do you know someone who has suffered from the problems associated with unemployment and inflation at the same time? Many people do, which is why economists have invented a measure called the *misery index*. Read to find out how the misery index got its name.

Cover Story

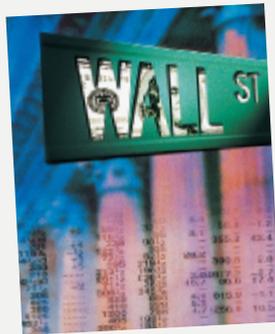
Labor Woes to Linger

NEW YORK—By most lights the economy has recovered smartly from this spring's downturn, but every bit of good news that crosses the wire these days is probably met with a resounding "So what?" from the 9 million Americans without jobs.

Unfortunately, despite the pickup in economic growth, those who are unemployed aren't going to see many new jobs any time soon, according to many economists.

In most recoveries, such growth spurs job creation. But it doesn't just happen overnight, since companies first must become confident of the recovery, then take time to seek and interview job applicants.

—CNN/Money, August 29, 2003



The stock market recovery has not led to more jobs.

Recession, high unemployment, and inflation are forms of economic instability that hinder long-term economic growth. Sometimes the economy experiences these problems separately, and sometimes they occur at the same time. In the early 1970s, for example, the economy experienced **stagflation**—a period of stagnant growth combined with inflation.

Even when the economy is relatively healthy, or when there is a hint of problems on the horizon, as you just saw in the cover story, we still worry about inflation—and even our worries have real consequences. These fears are not unfounded, because economic instability carries an enormous cost—one that can be measured in human as well as economic terms.

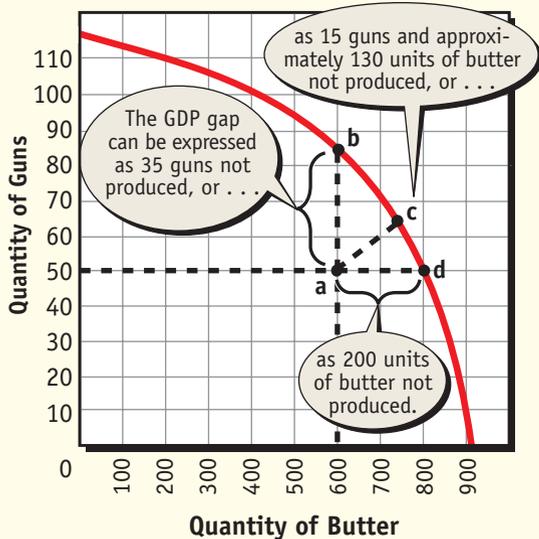
The Economic Costs



On one level, unemployment and inflation are simply numbers that are collected, reported in the press, or plotted on a graph. At another level, they represent enormous economic failures that waste the resources of the nation and its people.

Figure 16.1

The GDP Gap and the Production Possibilities Frontier



Using Graphs The GDP gap is the difference between the actual production at point **a** and the potential production as indicated by points **b**, **c**, or **d**. **What happens to production when some resources are idle or are not employed efficiently?**

The GDP Gap

One measure of the cost of stagnation is the **GDP gap**—the difference between the actual GDP and the potential GDP that could be produced if all resources were fully employed. In other words, the gap is a type of opportunity cost—a measure of output not produced because of unemployed resources.

The GDP gap, illustrated in **Figure 16.1**, shows the production possibilities curve in the classic guns-versus-butter example. The output not produced because of idle resources can be measured in either guns, butter, or a combination of the two items.

In a more dynamic sense, business cycles or fluctuations cause the size of this gap to vary over time. The scale of GDP is such that if GDP declines even a fraction of a percentage point, the amount of lost production and income can be enormous.

In 2003, for example, the GDP of the United States economy was approximately \$10.8 trillion. If a \$10.8 trillion economy declines just one-fourth of one percentage point, \$27 billion of production would be lost. This amount is more than the federal government spent on agriculture or general science, space, and technology during the entire 2003 fiscal budget year.

Described in other terms, this amount would be equal to 900,000 workers losing jobs that paid \$30,000 each for an entire year. In practice, the effects of a decline in GDP generally are spread out over a large area rather than being concentrated in just one spot, but they are still enormous by any measure.

The Misery Index

The **misery index**, sometimes called the **discomfort index**, is the sum of the monthly inflation and unemployment rates. **Figure 16.2** shows the misery index for a period beginning in 1965.

Although it is not an official government statistic, the misery index is a comprehensive measure of consumer suffering during periods of high inflation and unemployment. The index is relevant only over long periods because of the wide month-to-month swings in some of the numbers.

Uncertainty

When the economy is unstable, a great deal of uncertainty exists. A worker may not buy something because of concern over his or her job. This uncertainty translates into purchases that are not made, causing some unemployment to rise and jobs to be lost.

The worker is not the only one the uncertainty affects. For example, the owner of a business producing at capacity may decide against an expansion although new orders are arriving daily. Instead, the producer may try to raise prices, which increases inflation.

The Social Costs



The cost of instability can be measured in dollars rather easily, but it is harder to measure in terms of human suffering. In human terms, the costs are almost beyond comprehension. Because of these social costs, everyone agrees that stability must be achieved. Economists are interested not only in society's production, but in its mental and social health as well.

Wasted Resources

Human suffering during periods of instability goes beyond not having more goods and services that raise the standard of living. The labor resource is wasted, with people wanting work but not being able to find it. When this happens, the economy

fails to satisfy the basic human need to be a useful and productive member of society. This labor situation is particularly acute in inner cities where unemployment rates run high among minority groups.

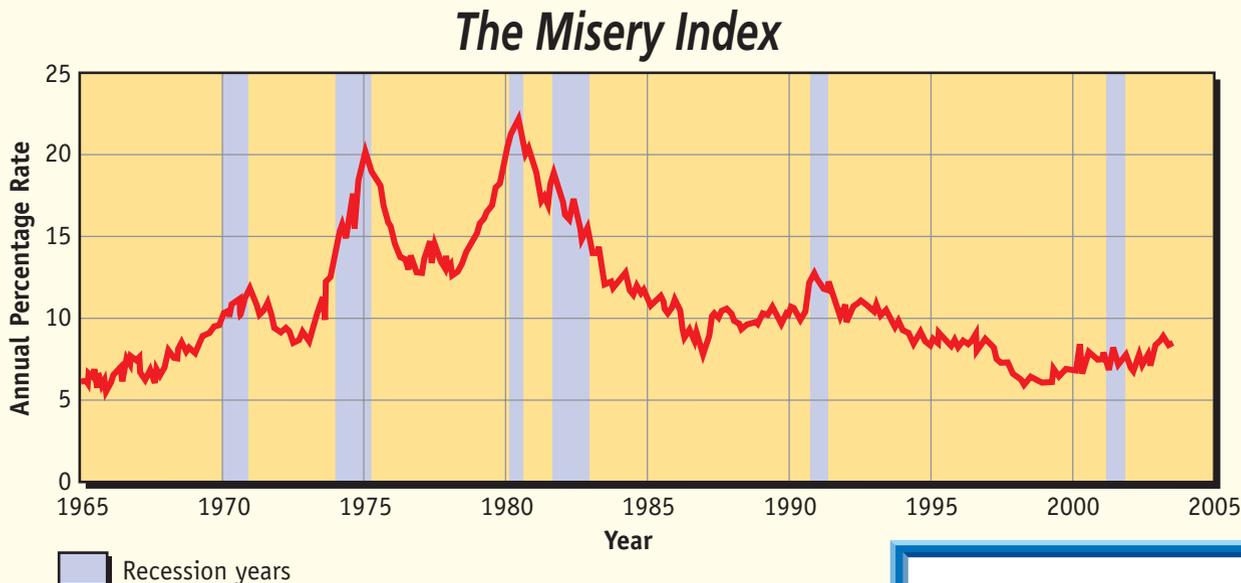
Wasted resources are not limited to just human resources. Idle factories waiting to be utilized are another wasted resource. Natural resources may also lie unused or go to waste.

Political Instability

Politicians also suffer from the consequences of economic instability. When times are hard, voters are dissatisfied, and incumbents are often thrown out of office. For example, most experts agree that Bill Clinton's victory over President George Bush in 1992 was due in part to the 1991 recession.

ECONOMICS AT A GLANCE

Figure 16.2



Source: Bureau of Economic Analysis, United States Department of Commerce

Using Graphs The misery index is the sum of the monthly inflation and unemployment rates. **When did the misery index reach its highest point?**



Visit epp.glencoe.com and click on *Textbook Updates—Chapter 16* for an update of the data.

[CLICK HERE](#)

Economics and Society

If too much economic instability exists, as during the Great Depression of the 1930s, voters are often willing to vote for radical change. As a result, economic stability adds to the political stability of our nation.

Crime and Family Values

High crime rates, too few economic and social opportunities for minorities, the loss of individual freedoms, and the lack of economic stability for many Americans are all grounds for concern. Many people believe that some of these social ills cannot be cured without the help of a strong and stable economy.

When the economy is healthy, the citizens of a society can more easily deal with its social problems. People have jobs and can provide for themselves and their families. Communities can take advantage of higher tax collections, which can be used to increase police protection and other municipal services. Companies are more willing to hire disadvantaged persons and provide on-the-job training.



Family Values A vibrant economy means that people will be more certain of their ability to provide for themselves and their families. *What are some benefits of a healthy economy?*

A healthy economy means that people will be more certain of their ability to provide for themselves and their families. When people can do this, they are more positive about the future in general.

Section 1 Assessment

Checking for Understanding

- 1. Main Idea** Using your notes from the graphic organizer activity on page 437, explain what the GDP gap measures.
- 2. Key Terms** Define stagflation, GDP gap, misery (discomfort) index.
- 3. Explain** how economists measure the economic cost of instability.
- 4. Describe** the social cost of instability.

Applying Economic Concepts

- 5. Misery Index** How might the psychological strains that many people feel in difficult

economic times help prolong an economic downturn? Provide at least one example with your answer.

Critical Thinking

- 6. Making Generalizations** If the GDP gap in a given year rose dramatically, what do you think would happen to unemployment and inflation?
- 7. Making Comparisons** How does stagflation differ from the traditional business cycle?



Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2*.

STUDY AND WRITING

Skill

Applying the Writing Process

Researching and writing allows you to organize your ideas in a logical manner. The writing process involves using skills you have already learned, such as taking notes, outlining, and synthesizing information.

Learning the Skill

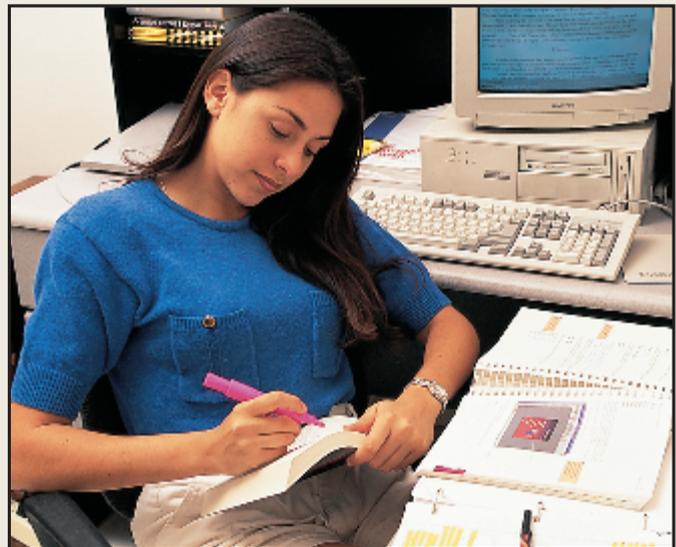
Use the following guidelines to help you apply the writing process.

- Select an interesting topic. As you identify possible topics, focus on resources that would be available. Do preliminary research to determine whether your topic is too broad or too narrow.
- Write a thesis statement that defines what you want to prove, discover, or illustrate in your writing. This will be the focus of your entire paper.
- Prepare and do research on your topic. First formulate a list of main idea questions; then do research to answer those questions. Prepare note cards on each main-idea question, listing the source information.
- Organize your information by building an outline or another kind of organizer. Then follow your outline or organizer in writing a rough draft of your report.
- A report should have three main parts: the introduction, the body, and the conclusion. The introduction briefly presents the topic and gives your topic statement. In the body, follow your outline to develop the important ideas in your argument. The conclusion summarizes and restates your findings.
- Each paragraph should express one main idea in a topic sentence. Additional sentences support or explain the main idea by using details and facts.
- Revise the draft into a final report. Wait for a day, then reread and revise it.

Practicing the Skill

Suppose you are writing a report on the role political turmoil plays in economic instability. Answer the following questions about the writing process.

1. How could you narrow this topic?
2. Write a thesis statement.
3. What are three main ideas?
4. What are three possible sources of information?



A systematic approach facilitates the writing process.

Application Activity

Use research resources in your library to find information on political instability during the Great Depression. Write a short report on the topic.



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Macroeconomic Equilibrium

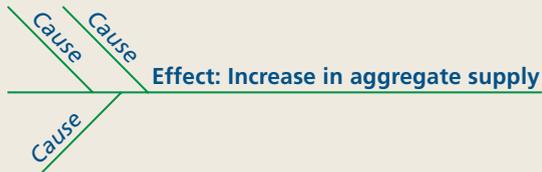
Study Guide

Main Idea

Aggregate *supply* is the total quantity of goods and services produced at different price levels. Aggregate *demand* is the total quantity purchased at different price levels.

Reading Strategy

Graphic Organizer 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 leading to an increase in aggregate supply.



Key Terms

aggregate supply, aggregate supply curve, aggregate demand, aggregate demand curve, macroeconomic equilibrium

Objectives

After studying this section, you will be able to:

1. **Explain** the concept of aggregate supply.
2. **Describe** the importance of aggregate demand.
3. **Examine** the nature of macroeconomic equilibrium.

Applying Economic Concepts

Equilibrium Have you ever experienced one of those rare moments when you feel completely satisfied and do not want to change anything that you are doing? This is called a state of *equilibrium*. Read to find out how the economy, too, reaches a state of equilibrium occasionally.

Cover Story

Report Sees Economy Recovering

WASHINGTON (Reuters) - Conditions in the U.S. economy are improving and favor a recovery by the start of next year, a congressional report released Tuesday said.

"Currently, several forces making for a near-term slow-down have reversed themselves or are on the wane and moving in the right direction," the report said. "At this time, therefore, the odds appear to favor a recovery in the near-term."

The study, entitled "Assessment of the Current Economic Environment", was put together by the Joint Economic Committee of the U.S. Congress.

But the study warns that there are still risks in the economy and encourages policy makers to continue to take the necessary actions to get the economy back on track.



Economy improving

—Excite News (online), July 3, 2001

From a historical perspective, sustained strong economic growth is relatively rare. We would like to see this prevail more often, but something always seems to happen to prevent it. As a result, economists study markets in an attempt to find out how they work, and how they can be made to work even better.

Aggregate Supply

 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 the concepts of supply and demand in much the same way.

One approach is to study **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 production took place within a country's borders, then aggregate supply would be the same as GDP.

The Aggregate Supply Curve

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

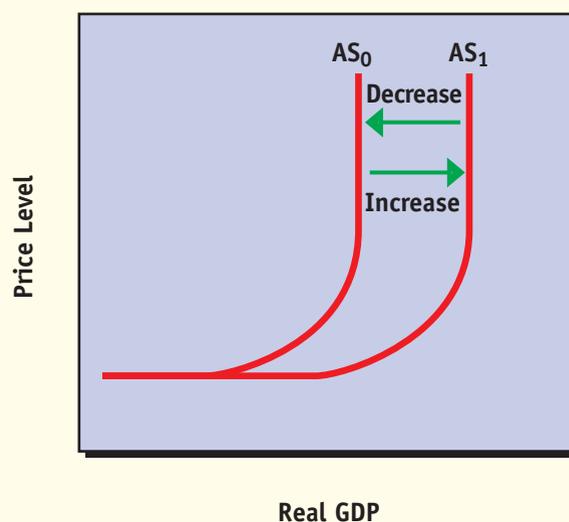
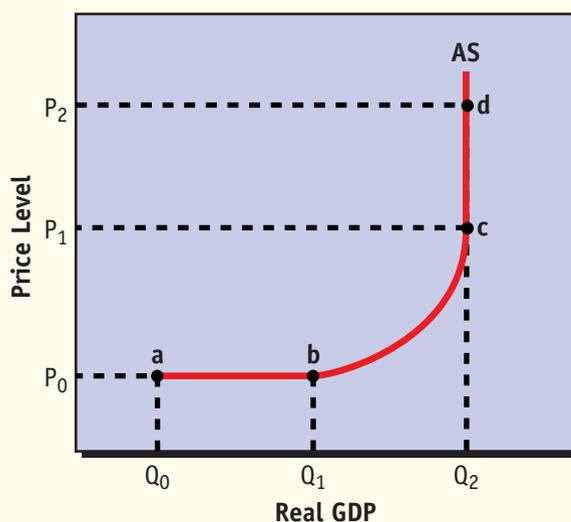
Figure 16.3 shows how an aggregate supply curve, **AS**, for the whole economy might look. It is shown as upward sloping, but with a horizontal as well as vertical range. The horizontal range represents various levels of output that coexist with large amounts of unemployed resources. If the economy is producing at point **a**, for example, output could be expanded to point **b** by putting some unemployed resources to work, without causing any change in the general price level.

However, any expansion of real GDP beyond point **b**, which has an output of Q_1 , is not possible without some increase in the price level. By the time the economy has reached point **c**, the price level has risen to P_1 because firms have been competing for increasingly scarce resources. Q_2 is the level of output where all resources are fully employed, because firms merely drive up prices if they try to expand production beyond point **c**.

The aggregate supply curve, like the supply curve of the individual firm, can increase or decrease. Most of the increases in aggregate supply are tied to the cost of production for the individual firm. If the cost goes down for some or all firms, aggregate supply increases, which shows as a shift to the right.

Factors that tend to increase the cost of production for an individual firm tend to decrease aggregate supply. These factors include higher prices for foreign oil, higher interest rates, and lower labor productivity. Any increase in cost that causes firms to offer fewer goods and services for

The Aggregate Supply Curve



Using Graphs The aggregate supply curve shows the amount of real GDP that could be produced at various price levels. An increase in aggregate supply comes about when production costs for all the individual producers fall. **What causes a decrease in aggregate supply?**

sale at each and every price would shift the aggregate supply curve to the left.

Aggregate Demand

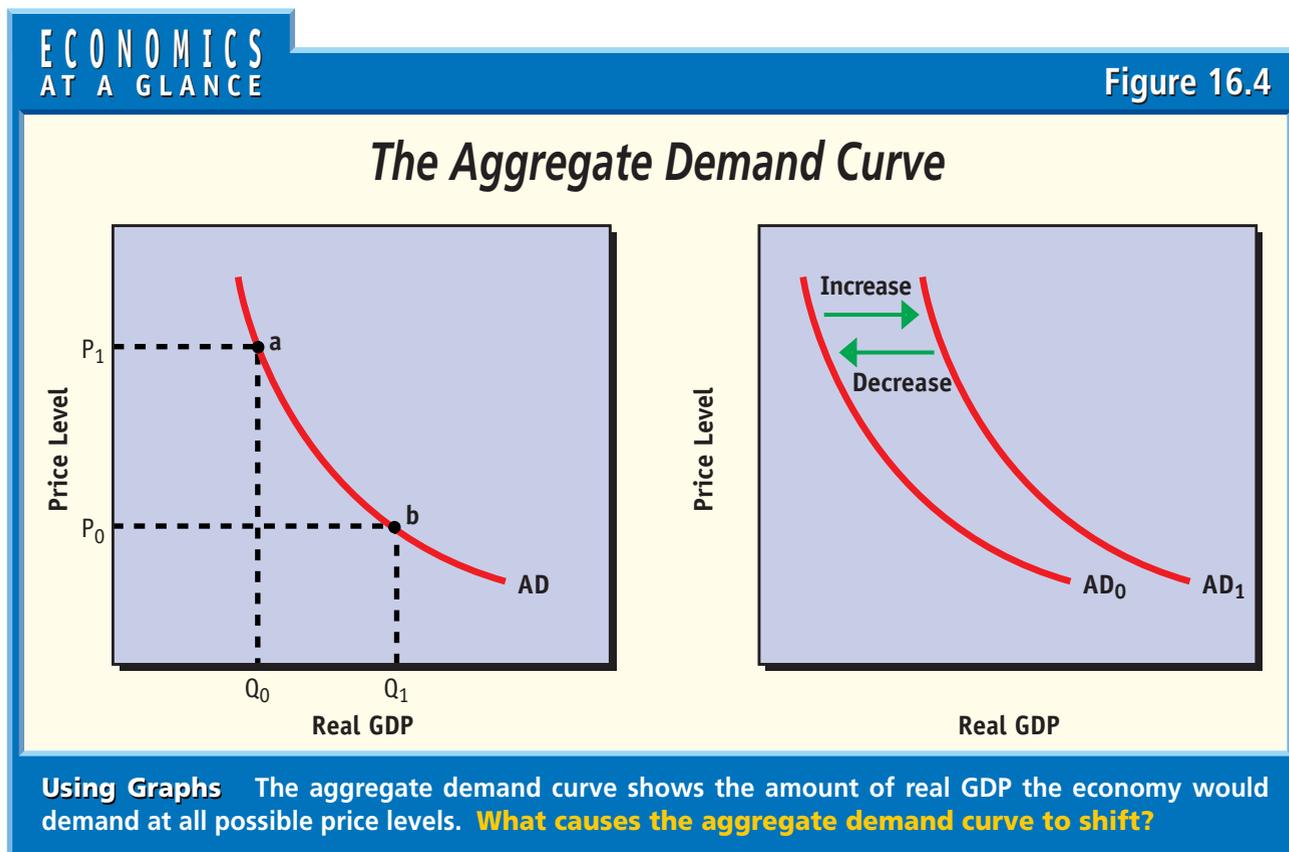
 **Aggregate demand** is the total quantity of goods and services demanded at different price levels. It is like aggregate supply in that it is a summary measure of all demand in the economy; it can be represented in the form of a graph; and it can either increase or decrease over time.

The Aggregate Demand Curve

Figure 16.4 illustrates the **aggregate demand curve**, a graph showing the quantity of real GDP that would be purchased at each possible price level in the economy. This curve, labeled **AD**, represents the sum of consumer, business, and government demands at various price levels. It slopes downward and to the right like the demand curve for individuals, but for entirely different reasons.

The primary reason for the negative slope is the underlying assumption that the economy can have only one money supply at a time. The size of this supply is fixed and has a different purchasing power at every possible price level. When prices are very high, a given money supply will purchase a limited amount of output, such as that represented by point **a**. When prices are much lower, everyone will be able to buy relatively more GDP, putting output purchased at point **b**. If the price level dropped further, even more GDP could be purchased, which is why the curve tends to slope downward and to the right.

The aggregate demand curve, like the aggregate supply curve, can increase or decrease depending on certain conditions. One factor that affects the aggregate demand curve is a change in the amount of money that people save. If consumers collectively save less and spend more, the increase in consumer spending would increase aggregate demand, shifting the aggregate demand curve to the right.



A decrease in aggregate demand can be caused by the same factors behaving in an opposite fashion. For example, an increase in saving—leaving consumers less money to spend—will cause the aggregate demand curve to 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.

Macroeconomic Equilibrium

 **Macroeconomic equilibrium** is the level of real GDP consistent with a given price level, as determined by the intersection of the aggregate supply and demand curves. This equilibrium is shown in **Figure 16.5** where **Q** is the level of real GDP that is consistent with the price level **P**. This is a static equilibrium because it represents a situation at a particular point in time.

If the economy is growing, the price level may or may not change, depending on changes in productivity and the money supply. 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.

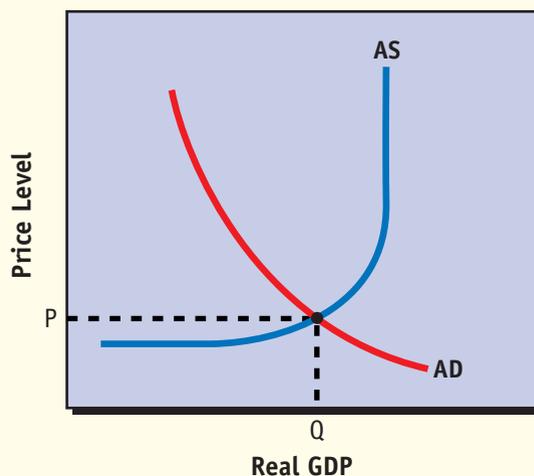
Aggregate supply and demand curves are useful concepts, providing a framework for analyzing equilibrium, economic growth, and price stability. They can be used to give an idea of the way and direction

that things will change, but they do not yield exact predictions. Even so, they are becoming increasingly important when analyzing macroeconomic issues.

ECONOMICS AT A GLANCE

Figure 16.5

Macroeconomic Equilibrium



Using Graphs The economy is at equilibrium when the quantity of real GDP demanded is equal to the real GDP supplied at a given price level. **What happens to the price level when output increases?**

Section 2 Assessment

Checking for Understanding

- 1. Main Idea** What factors might cause aggregate demand to increase?
- 2. Key Terms** Define aggregate supply, aggregate supply curve, aggregate demand, aggregate demand curve, macroeconomic equilibrium.
- 3. Describe** the concept of aggregate supply.
- 4. Explain** the importance of aggregate demand.
- 5. Describe** the nature of macroeconomic equilibrium.

Applying Economic Concepts

- 6. Equilibrium** Define macroeconomic equilibrium, then discuss how a decrease in business investments would affect the macroeconomic equilibrium.

Critical Thinking

- 7. Analyzing Information** What kind of effect would higher taxes have on aggregate supply? Explain your reasoning.



Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2*.

Profiles IN Economics

From Rags to Riches

Rags to riches. The expression is cliché, but it captures the imaginations of millions of Americans who dream of success in the country's free market economy. They find inspiration in the stories of individuals who started what would some day become giant global corporations—individuals, perhaps, not unlike themselves.

E.I. DU PONT

The DuPont Company is a multi-billion dollar enterprise, one of the largest corporations in the world. It has about 125 plants in the United States and elsewhere, manufacturing more than 40,000 distinct products. Most are chemical products—anything from polyester to pesticides to camera film. In addition, DuPont controls many subsidiaries, including Conoco, the petroleum giant.

DuPont's official name is E.I. DuPont de Numours & Company, a tribute to Èleuthère Irénée du Pont (1771–1834), its founder. At 17, du Pont was a worker at the French royal gunpowder works. At 29, he and his family were forced by the revolution to come to the United States. Noting

the poor quality of American gunpowder, he thought he could succeed by making one of higher quality. In 1802, he constructed a small powder works on Brandywine Creek near Wilmington, Delaware. From these humble beginnings, the DuPont giant grew.

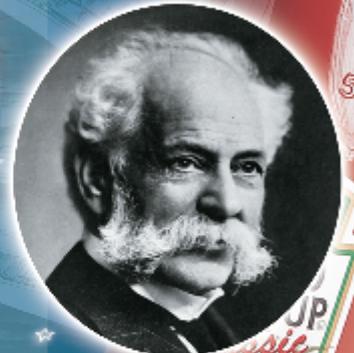
HENRY JOHN HEINZ

The J. Heinz Company markets 5,000 varieties of food in 200 countries. The company is named for its founder, Henry John Heinz. Heinz was born in Pittsburgh in 1844. He started his selling career at age 12, hawking produce from his family's garden. At 25, he sold his mother's grated horseradish. He called it "pure and superior," and sold it in clear glass jars to prove his claim. The company went bankrupt after a few years, but Heinz persevered.

HEINZ



DU PONT



He started a food company, selling ketchup, pickles, jams, jellies and condiments. Clever marketing ("It's not so much what you say," said Heinz, "but how, when and where.") and aggressive sales were key to company growth. By 1896, when Heinz was 52, his company had made him a millionaire. Its growth since then has been even more impressive.

Examining the Profile

- 1. Making Comparisons** How are the individuals profiled alike? How are they different?
- 2. Synthesizing Information** Explain why you think the companies du Pont and Heinz founded are typical or atypical.

Stabilization Policies

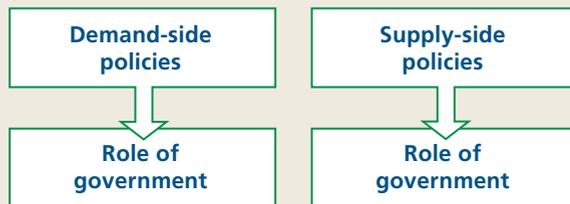
Study Guide

Main Idea

Government can promote economic growth through demand-side and supply-side policies.

Reading Strategy

Graphic Organizer 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.



Key Terms

fiscal policy, Keynesian economics, multiplier, accelerator, automatic stabilizer, unemployment insurance, supply-side economics, Laffer curve, monetarism, wage-price controls

Objectives

After studying this section, you will be able to:

1. **Explain** the operations and impact of fiscal policy.
2. **Distinguish** between supply-side economics and fiscal policy.
3. **State** the basic assumptions of monetary policy.

Applying Economic Concepts

Automatic Stabilizers You may know someone who collects unemployment insurance, Social Security, or Medicare. Read to find out why these programs are some of the key fiscal policy measures used today.

Cover Story

Hard to Find the Funny Side of Gridlock

Even by the high standards of acrimony common in Washington, the legislative agenda has fallen prey to particularly bitter wrangling over the government's big budget surpluses—projected at \$3,000 billion over the next 10 years.

Both Republican and Democratic leaders are under pressure from rank-and-file members to avoid compromises this year.

Many candidates for Congress and the presidency would prefer to run on party-defining issues, unclouded by messy compromises or cross-over votes. As a result, Democrats and Republicans have been unable—or are unwilling—to reach agreement on many routine bills.



Congress in session

—The Financial Times, August 6, 1999

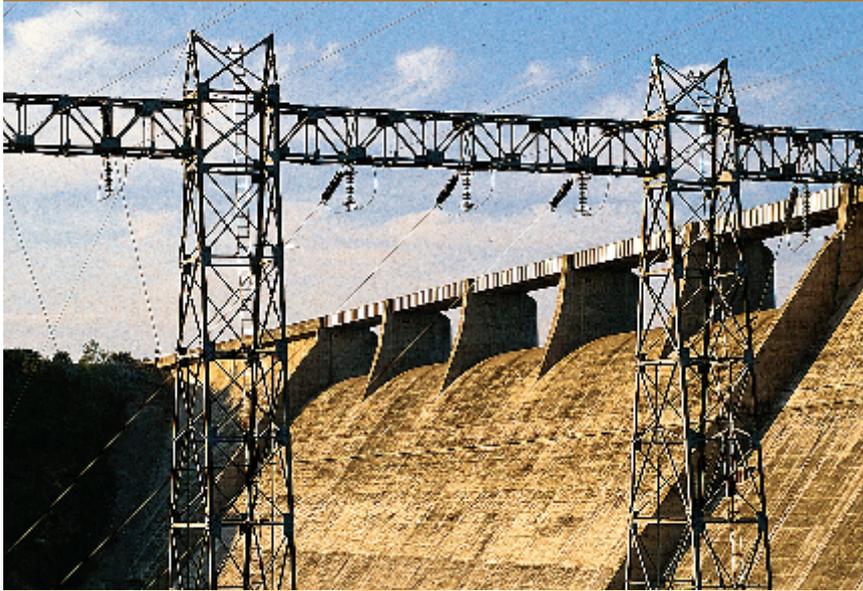
Economic growth, full employment, and price stability are three of the seven major economic goals of the American people. In order to reach these goals, sound economic policies must be designed and implemented.

Economic stability can be achieved in several ways. Some people favor policies that stimulate aggregate demand, while others favor ones that stimulate aggregate supply. While these two approaches have their supporters, Congressional gridlock, as we just saw in the cover story, makes them increasingly more difficult to implement. As a result, a third approach that favors monetary policy has filled the void.

Demand-Side Policies

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

Keynesian Economics



The Role of Government

According to Keynesian economics, economic activity will be stimulated if the federal government invests in projects such as hydroelectric plants. *What is the role of government deficits according to Keynesian theory?*

Fiscal policies are derived from **Keynesian economics**, a set of actions 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.

The Keynesian Framework

Keynes provided the basic framework with 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. Spending by the consumer sector (C), stated Keynes, was the most stable of all. Ruling out F, G, and C, it then appeared that the business, or investment, sector (I) was to blame for the instability.

In Keynes's theory, investment sector spending 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**, and 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, so if investment spending goes down by \$50 billion, the decline in overall spending could reach \$100 billion.

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, it causes 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.

The 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 and undertake its own spending to offset the decline in spending by businesses. Or, it could 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. Thus, the \$50 billion that business does not spend would be replaced by the \$50 billion the government spends. Thus, the overall sum of $C + I + G + F$ would remain unchanged.

Or, instead of spending the \$50 billion, the government could reduce tax rates by that amount and give investors and consumers more purchasing power. If the \$50 billion not collected in taxes were spent, the initial decline in investment spending would be offset, and the sum for $C + I + G + F$ again would remain the same.

Either way, the government would run the risk of a growing 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.

Automatic Stabilizers

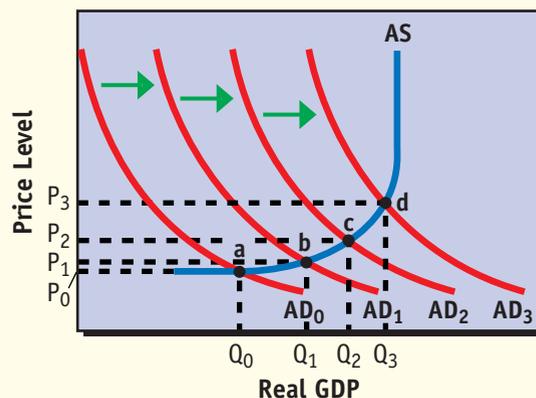
Another key component of fiscal policy is the role of **automatic stabilizers**, programs that automatically trigger benefits if changes in the economy

STANDARD & POOR'S

INFOBYTE

The Employment Report The Employment Report, released monthly by the Bureau of Labor Statistics, provides the unemployment rate, number of nonfarm payrolls, average workweek, and average hourly earnings figures. It is the broadest and most timely indicator of economic activity.

Fiscal Policy and the Aggregate Demand Curve



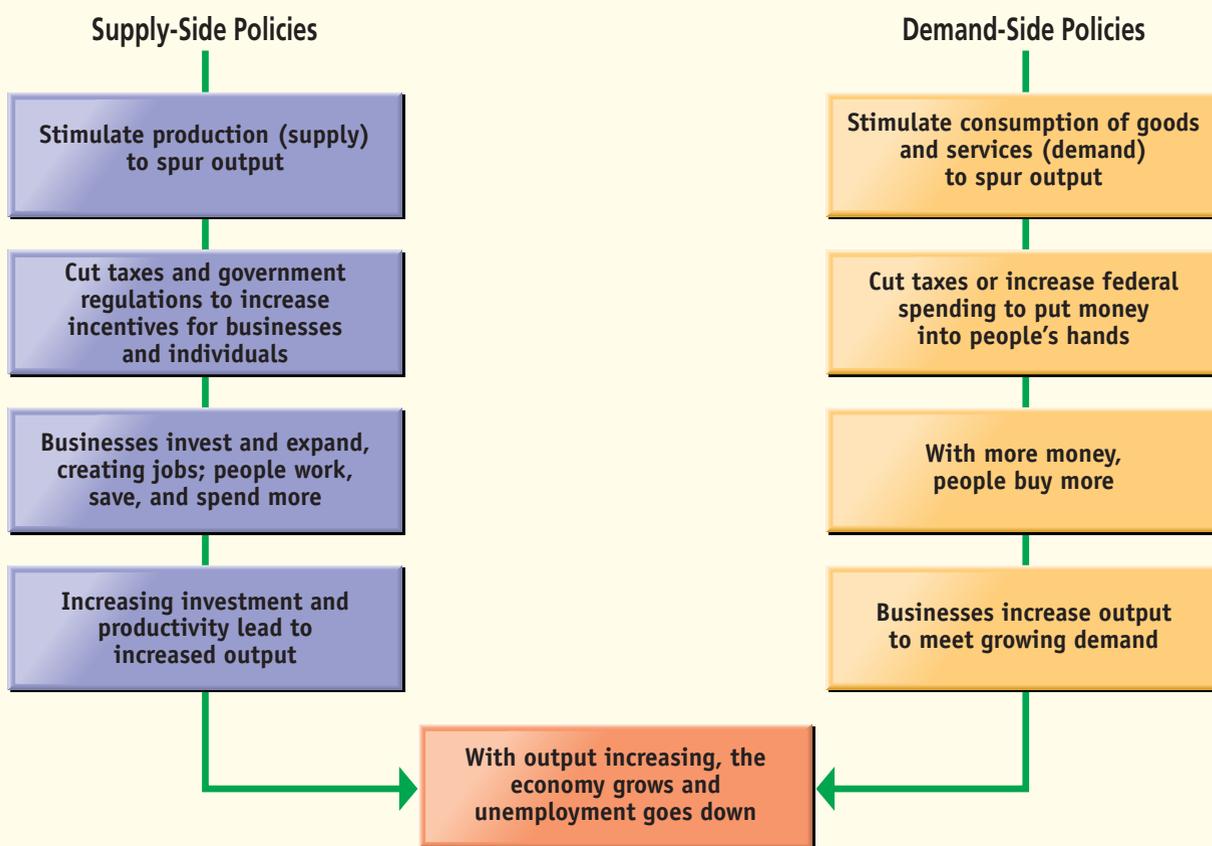
Using Graphs Fiscal policies are designed to increase aggregate demand. Successive increases in aggregate demand—or moving the economy from **a** to **d**—put increasing pressure on the price level as the unemployed resources in the economy find employment. **Which point on the graph represents the lowest aggregate demand?**

threaten income. Three important stabilizers are unemployment insurance, federal entitlement programs, and the progressive income tax.

Unemployment insurance is insurance that workers who lose their jobs through no fault of their own can collect for a limited amount of time. Unemployment insurance cannot be collected by people who are fired because of misconduct or who quit their jobs without good reason.

Federal entitlement programs and many social welfare programs designed to provide minimum health, nutritional, and income levels for selected groups of people also work as automatic stabilizers. They include federal programs such as welfare, government pensions, medicare, medicaid, and Social Security. The availability of these programs is a guarantee that economic instability or some other factor will not cause demand to fall below a certain level for selected individuals.

Supply-Side and Demand-Side Economics



Making Comparisons Supply-side policies and demand-side policies have the same goal: continuous and stable economic growth without price inflation. **How does the role of government differ under supply-side and demand-side policies?**

The progressive income tax is the third automatic stabilizer. 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

The impact of fiscal policies can be illustrated with the aggregate demand curve **AD**. **Figure 16.6**

shows a single aggregate supply curve and several aggregate demand curves. When aggregate demand is very low, as during the Great Depression or other periods of severe economic downturn, the economy would be at point **a**, where **AD₀** intersects **AS**. Increases in government spending—public works projects, transfer payments, or even tax reductions—could be used to increase aggregate demand to **AD₁**. Because many resources are not employed, the movement of the economy from **a** to **b** causes very little price inflation.

Further attempts to increase aggregate demand to AD_2 and AD_3 produce successively less output with increasingly higher price levels. Eventually, all attempts the government sector makes to increase aggregate demand only increase the price level without increasing the production of real GDP.

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 has been generally unable to bring its spending under control, even when it ran enormous budget deficits in the 1980s.

As a result, the most effective counter-cyclical fiscal policies used today are the automatic stabilizers. The advantage of the stabilizers is that spending

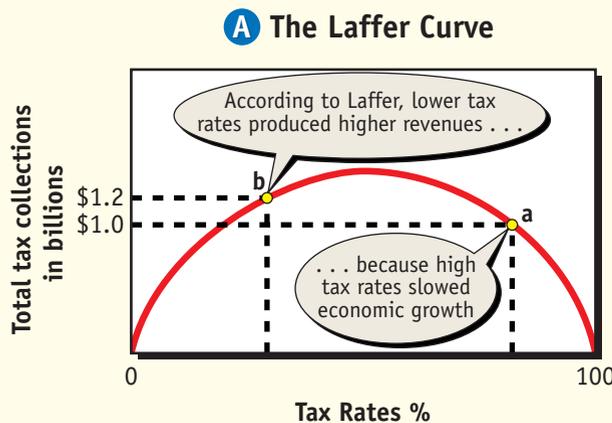
approval or tax reduction is not needed when the economy enters a recession, or when people lose jobs and need unemployment insurance coverage.

Supply-Side Policies

 **Supply-side economics** are policies designed to stimulate output and lower unemployment by increasing production rather than 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 Reagan's administration.

The differences between supply-side economics and demand-side economics are smaller than most people realize. Both policies, which are summarized in **Figure 16.7**, have the same goal—that of increasing production and decreasing unemployment without increasing inflation.

The Laffer Curve



B Tax Receipts

	Real Individual Tax Receipts	Real Corporate Tax Receipts
1981	\$362,379	\$77,487
1982	355,303	58,720
1983	331,351	42,456
1984	327,929	62,520
1985	354,376	64,969
1986	360,123	65,163
1987	392,557	83,926
1988	386,122	90,961
1989	410,774	95,199

Sequencing Information Proponents used the Laffer curve to argue that lower tax rates would generate higher economic growth as well as higher tax collections. In retrospect, lower tax rates generated lower tax receipts. After adjusting for inflation, federal tax revenues declined after taxes were reduced in 1981. **What happened to tax revenues after taxes were raised in 1986?**

Smaller Role for Government

A key issue for supply-siders is that of reducing government's role in the economy. One way to do this is to reduce the number of federal agencies. Another way to make government's role smaller is through deregulation—removing established regulations with which industries must comply.

Deregulation is a major objective of supply-siders and is favored by some demand-siders as well. Under the administration of President Jimmy Carter, major steps were taken to deregulate the energy, airline, and trucking industries. The Reagan administration continued deregulation efforts in the savings and loan industry, hoping to bring about more competition.

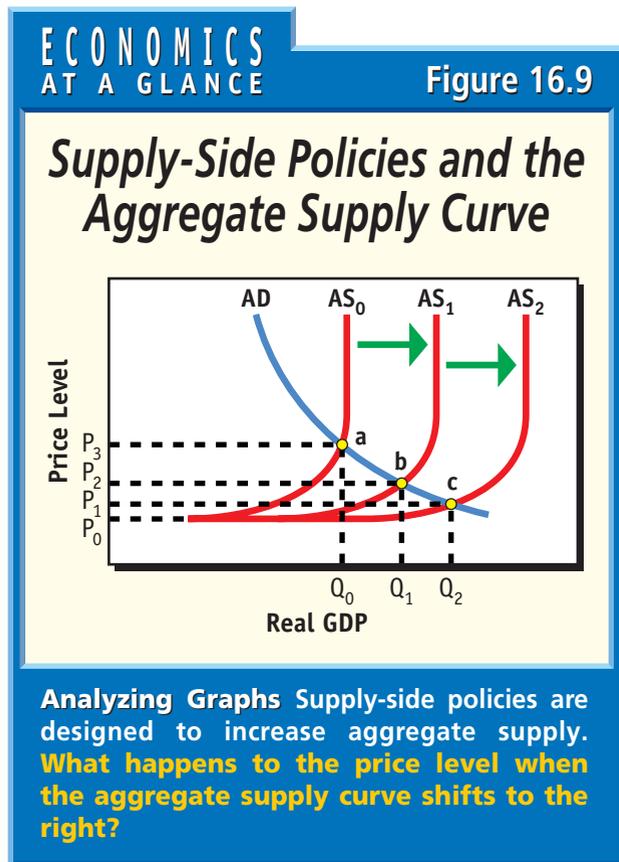
Lower Federal Taxes

Another target of supply-siders is the federal tax burden on individuals and businesses. They

believe that if taxes are too high, people will not want to work, and businesses will produce less. Lower tax rates, they argue, allow individuals and businesses 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 would also gain as total tax collections go up because of the extra activity.

In the 1980s, somewhat optimistic supply-siders even argued that lower tax rates would stimulate the economy so much that eventually even more taxes could be collected than before. This was formalized in the **Laffer curve**—a hypothetical relationship between federal tax rates and tax revenues—shown in **Panel A** of **Figure 16.8**. This proposition was the basis for President Reagan's 1981 tax cut, which reduced income taxes 25 percent over a three-year period.

As it turned out, either the interpretation or the assumptions of the Laffer curve were invalid, as the increased revenue collections never materialized. As **Panel B** in **Figure 16.8** shows, after adjusting for inflation, both individual income tax receipts and corporate tax receipts were lower in 1986 than they were in 1981. Because tax collections never went up, the federal budget showed a deficit instead. In fact, real tax collections did not surpass their 1981 levels until after the 1986 tax revisions took effect in 1987.



Supply-Side Policies and Aggregate Supply

The impact of supply-side policies can be illustrated in terms of the aggregate supply and demand curves shown in **Figure 16.9**. When aggregate supply is very low, the economy would be at point **a**, where **AS₀** intersects **AD**. If supply-side policies were successfully instituted, the aggregate supply curve would shift to **AS₁**, moving the point of macroeconomic equilibrium to **b**. Without any corresponding change in aggregate demand, real output would grow, and the price level would come down.

Further attempts to increase aggregate supply to move the economy to **c** has even less impact on the price level. If the aggregate supply curve does have a horizontal range then the price level could never be reduced below **P₀**.



STABILIZING EFFORTS IN AFRICA

Beginning in the 1970s, droughts, growing populations, lack of capital, and falling world prices for their exports weakened many African economies.

Relying on foreign help to remedy these problems, African countries south of the Sahara took on \$130 billion worth of debt by the 1980s. African

leaders increasingly realized that they would have to find answers to Africa's problems without much outside help. To break their reliance on foreign countries, some African nations formed regional associations to promote trade and economic cooperation. Governments that had once adopted socialist policies increasingly encouraged free enterprise.

Critical Thinking

1. **Analyzing Information** What policies helped create the large debt?
2. **Analyzing Information** Why did many African nations form regional associations?

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 the concepts of aggregate supply and aggregate demand are largely conceptual, making it difficult to predict, based on the shapes of the two curves, the exact consequence of any particular supply-side policy.

In the case of the Laffer curve, total tax collections, when adjusted for inflation, actually declined after the 1981 tax reductions were implemented. The result was that one of the main foundations of the supply-side school was found to be invalid. Even so, policies that promote productivity, reduce unnecessary paperwork, or otherwise allow the economy to grow to its maximum potential are certainly worthwhile. Almost everyone, including demand-siders, favors these policies.

Finally, supply-side economic policies are designed more to promote economic growth rather than to remedy economic instability. No matter how fast or slow the economy grows, it seems to have a tendency to fluctuate around its trend line. Supply-side policies during the Reagan presidency tended to weaken the automatic stabilizers by making the federal tax structure less progressive and by reducing many of the "safety net" programs.

Monetary Policies



Both demand-side economics and supply-side economics are concerned with stimulating production and employment. Neither policy assigns much importance to the money supply. A doctrine called **monetarism**, however, places primary importance on the role of money and its growth.

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

Interest Rates and Inflation

In the short run, expansionist monetary policy can lower interest rates. This action would reduce the cost of consumer and business borrowing and shift the aggregate supply curve to the right. Real GDP would tend to increase, but so would the possibility of future inflation. The money supply can grow over time, but how fast should the money supply be allowed to grow?

Most monetarists believe that inflation can be controlled if the money supply is allowed to grow at a slow but steady rate. The rates of growth of real GDP and productivity would determine the

rate at which the money supply grows. For example, if the rate of growth of real GDP were 3 percent, and that of productivity 1 percent, the money supply would 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 those tried earlier. In the early 1970s, for example, President Richard Nixon tried 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. The economy ultimately proved the economists correct: the controls did little to stop inflation.

Monetary Policy and Unemployment

Monetarists argue that attempts to cut unemployment by expanding the money supply provide only temporary relief. They argue that excessive rates of monetary growth eventually drive up prices and interest rates.

When rates eventually do go up, the cost of borrowing for businesses increases, which shifts the aggregate supply curve to the left. The larger money supply also shifts the aggregate demand curve to the right. The result is that real GDP would fall back to its original level—but at a different and much higher price level. The final result would appear as if the aggregate supply and demand curves shifted up together.

An overly expansionist monetary policy, then, will only cause long-term inflation. Monetary policy is not a long-term cure for unemployment.

CYBERNOMICS SPOTLIGHT

Deregulation and New Growth

The deregulation of the telecommunications industry and the breakup of AT&T have helped turn the telephone into an important component of the economy. The telephone is responsible for helping Sioux Falls, South Dakota, and Omaha, Nebraska, become major centers for the credit-card processing and telemarketing industries.

Section 3 Assessment

Checking for Understanding

- 1. Main Idea** Compare the views of supply-side economists and demand-side economists regarding the role of government in the economy.
- 2. Key Terms** Define fiscal policy, Keynesian economics, multiplier, accelerator, automatic stabilizer, unemployment insurance, supply-side economics, Laffer curve, monetarism, wage-price controls.
- 3. Describe** the objectives of demand-side policies.
- 4. Identify** the main assumptions of supply-side policies.
- 5. Explain** how monetary policy could be destabilizing.

Applying Economic Concepts

- 6. Automatic Stabilizers** Fiscal policy is one of the tools designed to stabilize the economy. First, define fiscal policy in your own words. Then, explain its role in shifting the aggregate demand curve.

Critical Thinking

- 7. Making Comparisons** How do demand-side policies and supply-side policies differ from one another?
- 8. Analyzing Information** According to monetarists, how do fluctuations in the money supply affect the economy?



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BusinessWeek

Newsclip

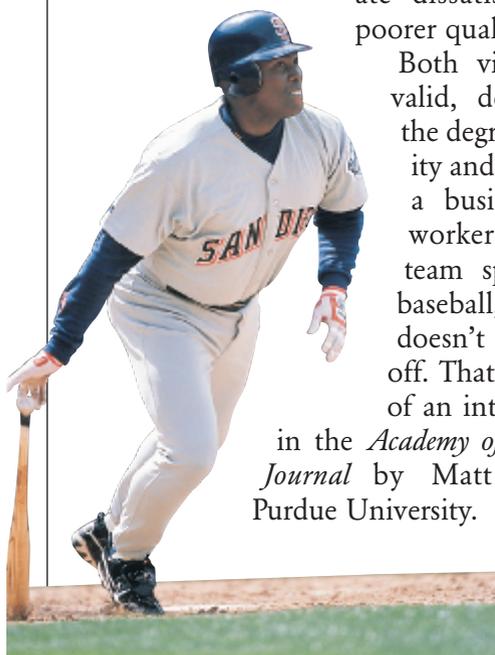
Wages are determined basically the same way other prices are—by demand and supply. People work and earn money. The amount they earn usually depends on the value of their labor. Those who possess a unique skill or ability may receive very high wages.

Unequal Pay Strikes Out

Economists and psychologists who have studied the impact of pay differentials on corporate performance seem to be of two minds on the subject. Some experts argue that unequal pay is beneficial—inspiring greater individual effort and productivity. Others claim that large pay differences often generate dissatisfaction and poorer quality work.

Both views may be valid, depending on the degree of inequality and the nature of a business and its workers. But in a team sport such as baseball, unequal pay doesn't seem to pay off. That's the finding of an intriguing study

in the *Academy of Management Journal* by Matt Bloom of Purdue University.



Using two measures of pay dispersion, Bloom analyzed how they affected both individual player performance and final team standings for 29 teams from 1985 to 1993. Adjusting for such factors as past performance, age, experience, and pay levels, he found that unequal pay distributions translated into poorer stats for lower-paid players on a number of performance measures—and into lower standings for their teams.

The proof of the pudding: Bloom notes that three of [1998's] division winners, the New York Yankees, the San Diego Padres, and the Cleveland Indians, each had one of the smallest pay spreads in their respective leagues.

Successful teams like the San Diego Padres and Cleveland Indians tend to have relatively smaller pay spreads.



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Examining the Newsclip

- 1. Synthesizing Information** What are the two theories presented in the article regarding large pay differentials?
- 2. Finding the Main Idea** Which theory does the Bloom theory support?
- 3. Drawing Conclusions** In your opinion, are the study's findings valid? Explain your reasoning.

Economics and Politics

Study Guide

Main Idea

Monetary policy is becoming more important because discretionary fiscal policy is difficult to implement.

Reading Strategy

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



Key Term

Council of Economic Advisers

Objectives

After studying this section, you will be able to:

1. **Explain** why monetary policy sometimes conflicts with other economic policies.
2. **Recognize** that economists have differing views.
3. **Understand** the way that politics and economics interact.

Applying Economic Concepts

Diversity of Opinion Well-meaning friends often disagree over how something should be done. Read to find out why the same thing happens to economists.

Cover Story

Slew of New Issues Await Congress

WASHINGTON—Members of Congress return to work this week in a city still shaken by last week's terrorist attacks [on the World Trade Center].

Priorities that once commanded Congress' attention—prescription drugs, a new farm bill and health-care reform—have been squeezed aside by a pending military confrontation overseas, the financial crisis of U.S. airlines and a desire to provide sustenance to the nation's ailing economy.

The sharply partisan tones of appropriations season in Washington have been replaced by bipartisanship unknown in recent history.

Lawmakers already are working out the details of an economic assistance package for the airline industry. Defense budgets are expected to grow. And intelligence-gathering agencies seem destined for a big boost in funding.

—Omaha World-Herald, September 20, 2001



Defense spending may increase

As we look at the economic history of the United States, it is clear that times are better now than at any time in our past. 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 political events such as the one mentioned in the cover story can temporarily interrupt the economy, but democratic 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 improves our economic health, and in a way that benefits everyone.

The Changing Nature of Economic Policy

As you know, fiscal policy is the federal government's attempt to stabilize the economy through taxing and government spending. Fiscal policy involves planning a budget that has either surpluses or deficits that are intended to maintain a steady level of total spending in the economy.

Fiscal policy can be either *discretionary*, *passive*, or *structural*. Discretionary fiscal policy is policy that someone must *choose* to implement. It requires an action by either the Congress and the president, or by an agency of government, to take effect. Passive fiscal policy does not require new or special action to go into effect. It reacts automatically when the economy changes. Structural fiscal policy includes plans and programs put in operation to strengthen the economy in the long run.

The Decline of Discretionary Fiscal Policy

Discretionary fiscal policy is used less today for several reasons. The first is the “recognition lag.” This lag is the time between the beginning of a recession or a period of inflation and the awareness that it is actually happening. Most people do not believe that a recession is imminent until it actually occurs. Meanwhile, the economic problem may grow more severe than it would have if the situation had been recognized and dealt with sooner.

This recognition lag is often followed by an “implementation lag,” which is the amount of time it takes to do something once the problem is identified. For example, 2001 was nearly over before it was realized that a recession had actually taken place. Meanwhile, President Bush was pushing for a 10-year, \$1.35 billion tax cut that was designed to reduce a growing federal budget surplus. The surplus never occurred, however, because federal tax revenues fell sharply when nearly 2 million jobs were lost and corporate profits fell. Instead of a budget surplus, the country had record federal deficits instead.

The third reason for the decline of discretionary fiscal policy is the relatively short duration of recessions, which now average about eight months. When a recession is this short, it is almost easier to wait for it to end rather than enact any programs to stimulate GDP.

The fourth reason contributing to the decline of fiscal policy is the gridlock that has characterized our government since the 1990s. In both 1995 and 1996, Congress shut the federal government down when the parties could not agree on the federal budget. When Republicans and Democrats deadlocked in 1999 over a \$792 billion

tax cut proposal, the federal government could not use fiscal policy to shape the economy.

Fifth, Congress imposed budget caps designed to limit federal government spending. The caps gave Congress little leeway to pursue discretionary policies. As a result, some spending for agriculture, military operations in Kosovo, and even routine expenditures such as those required to carry out the 2000 census, were classified as “emergency expenditures” to get around the budget caps.

Of course, discretionary fiscal policies are still possible, but it takes an event like the one discussed in the cover story to spur Congress to action. For all these reasons, discretionary fiscal policies are losing ground to passive fiscal policies.

The Importance of Passive Fiscal Policies

Despite the declining use of discretionary fiscal policies, several passive fiscal programs contribute to the stability of the American economy.

All of the automatic stabilizers—unemployment insurance, social security, and other programs dis-

Careers

Credit Manager

Credit managers decide whether to extend credit to clients—either companies or individuals.

The Work

Credit managers' duties include analyzing financial reports submitted by client companies and reviewing credit agency reports on their promptness in paying bills. Credit managers also draw up credit policies to be met by individuals applying for credit. They set up office procedures and oversee other employees in the credit department.

Qualifications

To succeed in their work, credit managers must be able to analyze detailed information, draw conclusions, and speak and write effectively. A degree in business administration is a must.



cussed on page 449—protect consumers and the economy if economic conditions worsen. Other programs, such as the progressive individual income tax, discussed on page 450, provide the same relief.

For example, if the economy slows down, workers earn less and drop into lower tax brackets, which helps offset their lost income. On the other hand, if the economy accelerates, as it did in the late 1990s, workers earn more and move into higher tax brackets. The higher tax brackets help put a break on over-expansion, and generate substantial tax revenues in the process. These surpluses can then be used to repay money that was previously borrowed—as the Democrats suggested in 1999. Or, they can be returned to the American people in the form of lower taxes—as the Republicans preferred to do.

Structural Fiscal Policies

Structural fiscal policies are policies designed to strengthen the economy in the long run. They are not designed to deal with temporary problems such as recession and unemployment.

One example of a structural program is the national health-care program President Clinton proposed in the early 1990s. Another is the 1997 welfare overhaul that replaced the Aid to Families with Dependent Children (AFDC) with the Temporary Assistance for Needy Families (TANF). Proposals to strengthen the banking system with better inspection and insurance even come under this heading. A further example is President Bush's \$1.35 billion tax cut that passed in mid-2001.

Did you know?

Private Property Early Americans believed so strongly in the right to private property that they incorporated this right into law. The first Congress proposed the Fifth Amendment, which was ratified in 1791. The amendment states that private property shall not be taken for public use without just compensation. The Fourteenth Amendment prevents any state from depriving people of their property without due process of law.

Finally, because structural policies are designed to deal with long-term problems, they do not need short-term attention once they are put in place.

The Dominance of Monetary Policy

The declining use of discretionary fiscal policy left a void filled by the Federal Reserve System (Fed), which conducts monetary policy. The abandonment of discretionary fiscal policy also means that monetary and fiscal policies are less likely to clash—although monetary policy is still subject to criticism by political leaders.

Such a situation occurred during the 1992 presidential election campaign. Because of the threat of inflation, the Fed was pursuing a tighter monetary policy than President Bush wanted. The high interest rates caused by the Fed's policy also contributed to the length of the 1991 recession. Eventually, the high interest rates and the recession during the election year—along with President Bush's broken promise not to raise taxes—paved the way for Bill Clinton's narrow election victory.

Of course, the Fed is not above criticism. For example, the Fed's efforts to prevent inflation by raising interest rates several times in 2000 may have caused the 2001 slowdown. The Fed then reversed itself and lowered interest rates eleven times in a row in 2001 to stimulate growth. Even so, Congress has not been willing to make the Fed less independent. Most members of Congress continue to believe that the power to create money should remain with an independent agency rather than with elected officials.

Why Economists Differ

 Choosing which economic policies will work best is difficult. The proposals economists offer often seem contradictory, which adds to the difficulty. These differences, however, are smaller than most people realize.

Different Criteria

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. If you were to survey all economists on the best way to deal with a specific problem, their recommendations would be much more consistent.

Different Eras

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

The Monetarist Point of View

The monetarist point of view emerged in the 1960s and 1970s when inflation soared. Because demand-side economic policies were not designed to deal with inflation, new solutions were needed. The problem with the monetarist view, however, was that it offered long-term solutions but little short-term relief.

Supply-Side Policies

Supply-side policies eventually grew out of frustration with stagflation and the failure of demand-siders and monetarists to address this issue. Again, changing times led to changing problems, and so something new and different seemed to be needed.

For the most part, economists do not normally define their positions as being purely demand-side, supply-side, or monetarist. Many demand-siders are monetarists when it comes to controlling inflation. Many monetarists are supply-siders when it comes to agreeing on the potential burden of the tax structure. Most economists take a middle road that incorporates many points of view.

As long as society keeps changing, new problems will continue to arise. From each new set of problems, new theories—and advocates for those theories—are bound to emerge.

Economic Policy

Hang In There!



Difference of Opinion Although economists do not come to blow like the ones in this cartoon, they often do not agree on economic policies. **Why do economists differ in their policies?**

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 best described as “economic politics.” Today, politicians are concerned with the economic consequences of what they do. Most of the major debates in Congress, for example, are over spending, taxes, or other budgetary matters.

Council of Economic Advisers

Generally, economists and politicians work together fairly closely. The president relies on a

Council of Economic Advisers, a three-member group that reports on economic developments and proposes strategies. The economists basically 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. To illustrate, 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.

Increased Understanding and Awareness

Despite disagreeing on some points, economists have had considerable success in 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 in the tasks of economic analysis and explanation.

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. They can, however, devise policies to stimulate growth, help disadvantaged groups when unemployment rises or inflation strikes, and generally make the American economy more successful.

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ECONOMICS
Online



Student Web Activity Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on **Chapter 16—Student Web Activities** for an activity on the Council of Economic Advisers.

Section 4 Assessment

Checking for Understanding

- 1. Main Idea** Using your notes from the graphic organizer activity on page 456, explain the difference between automatic and discretionary fiscal policy. List examples of each in your answer.
- 2. Key Term** Define Council of Economic Advisers.
- 3. Describe** monetary policy and its goals. Then explain how monetary policy can sometimes conflict with economic policy.
- 4. List** several reasons economists differ over policies and issues.
- 5. Explain** what “economic politics” means in your own words.

Applying Economic Concepts

- 6. Diversity of Opinion** Why do monetary and fiscal policies often operate at cross-purposes? What impact does this conflict have on the economy?

Critical Thinking

- 7. Making Inferences** Suppose that, in an election year, Congress passes a massive tax cut even though inflation is at 9 percent. What actions might the Fed take in response during such economic times?
- 8. Analyzing Information** Why might monetary and fiscal policy be at odds during an election year?



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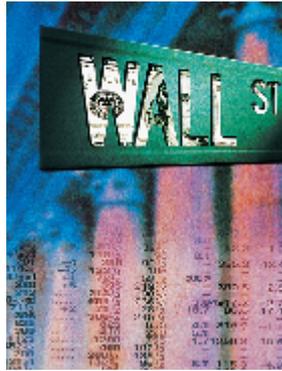
Chapter 16 Summary

Section 1

The Cost of Economic Instability

(pages 437–440)

- Low economic growth and economic instability in the form of inflation and high unemployment rates have both economic and social costs.
- The economic costs can be measured with the **miser index** or the **GDP gap**.
- The social costs include unemployment, wasted resources, potential political instability, increased crime, and damage to family financial security.
- Strong economic growth is more than an economic ideal. It is one of the foundations of a healthy society.



Section 2

Macroeconomic Equilibrium

(pages 442–445)

- **Macroeconomic equilibrium** is similar to equilibrium in individual markets. It can be analyzed with the help of **aggregate supply curves** and **aggregate demand curves**.
- Most of the factors that influence the individual supply and demand curves also affect the aggregate curves. They shift to the right to represent an increase, and to the left to represent a decrease.
- The intersection of aggregate supply and aggregate demand determines **macroeconomic equilibrium**. This equilibrium is defined in terms of a certain amount of real GDP being produced at a specific price level.

Section 3

Stabilization Policies (pages 447–454)

- Demand-side policies, or **fiscal policies**, are policies designed to affect the aggregate demand curve through federal spending and taxing decisions. Fiscal policies are derived from **Keynesian economics**, which assigns the government a key role in offsetting fluctuating spending by the business sector.
- **Automatic stabilizers** are an important part of demand-side economics.
- Supply-side economics recommends a smaller role for governments and a lower federal tax structure.
- The outcome of monetary policy is a change in the size of the money supply that, in turn, affects the cost and availability of credit.
- The short-run impact of monetary policy is on interest rates. The long-run impact is on the rate of inflation.



Section 4

Economics and Politics (pages 456–460)

- Discretionary policy is increasingly difficult to execute due to recognition lags, implementation lags, Congressional gridlock, the brevity of recessions, and conservative budget caps.
- Passive fiscal policy in the form of automatic stabilizers still provides much stability, but monetary policy has filled the void and has become dominant.
- The fields of economics and politics are closely intertwined. The president has a **Council of Economic Advisers** but, for political reasons, may not always be able to follow the Council's advice.

Chapter 16 Assessment and Activities

ECONOMICS Online



Self-Check Quiz Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on **Chapter 16—Self-Check Quizzes** to prepare for the chapter test.



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Identifying Key Terms

Classify each of the terms below into one of the following categories:

- supply-side policies
 - demand-side policies
 - monetary policies
1. aggregate demand curve
 2. aggregate supply curve
 3. automatic stabilizer
 4. multiplier
 5. deregulation
 6. entitlements
 7. fiscal policy
 8. Keynesian economics
 9. Laffer curve
 10. wage-price controls

Reviewing the Facts

Section 1 (pages 437–440)

1. **List** two measures used to describe the problems of growth and economic instability.
2. **Name** some of the social costs of instability.

Section 2 (pages 442–445)

3. **Describe** the difference between the supply curve of a firm and the aggregate supply curve.

4. **Identify** the factors that would cause the aggregate demand curve to increase.
5. **Discuss** what is meant by macroeconomic equilibrium.

Section 3 (pages 447–454)

6. **Identify** the major tools of fiscal policy.
7. **List** the main assumptions of supply-siders.
8. **Describe** the short-term and long-term impacts of monetary policy.

Section 4 (pages 456–460)

9. **Explain** why discretionary fiscal policy is so difficult to use.
10. **Explain** why new problems will arise in the economy, even as old ones are solved.
11. **State** an example of how politics sometimes overrides sound economic policies.

Thinking Critically

1. **Drawing Conclusions** Why is the misery index a more personal measure of the social costs of instability than other concepts, such as the GDP gap?
2. **Making Comparisons** How do aggregate supply and demand differ from simple supply and demand? Use a chart similar to the one below to answer the question.

	Description
Demand	
Aggregate Demand	
Supply	
Aggregate Supply	

Chapter 16 Assessment and Activities

- 3. Making Comparisons** Analyze 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.

Applying Economic Concepts

- 1. Automatic Stabilizers** What automatic stabilizers have benefited you or your family in the recent past? Could you have managed without them?
- 2. Multiplier** Provide an example of how a \$100,000 expenditure in your community would have a magnified effect as described by the multiplier.
- 3. Diversity of Opinion** 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? Provide reasons to support your choice.
- 4. Monetary Policy** The Federal Reserve System conducts monetary policy. At one time or another, most presidents have complained about the independence of the Fed. Do you think this independence should be maintained, or that elected officials should have more control over monetary policy? Support your answer.

Math Practice

According to Keynesian economics, what action should government take if business investment fell by \$20 billion? Show your findings using the output-expenditure model:

$$\text{GDP} = C + I + G + F$$

Thinking Like an Economist

Both demand-side and supply-side policies are designed to ensure stable economic growth. The approaches differ, however, on what should be done to achieve this goal. Assume that real GDP growth was negative during the last quarter. Make a two-column chart. In the left column, list the policies that demand-side economists would follow to help the economy. Place the supply-side solution in the right column. How do they differ?

Technology Skill

Using the Internet Log on to the Internet. Then, using a search engine, type in the following key words:

- John Maynard Keynes
- Unemployment
- Stabilization policies
- Inflation
- Fiscal policy

Print out (or download) any articles or reports on these topics. Using the information you retrieved, prepare a two-paragraph report on each topic listed above—defining the terms and summarizing their significance to economic security. Add a list of Web sites and bibliography entries at the end of your report.

Building Skills

Applying the Writing Process Go to a library to look up advertisements for airfares from 19 years ago. Find out what the current airfares are when traveling to the same locations. Write an essay that explains the effect these price changes may have had on consumers. What might they have to do with the deregulation of the airline industry?



Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2*.