

Answers to Questions from Chapter 16

2. A tariff is a tax on the consumption of imports. The demand for domestic goods, and thus the level of aggregate demand, will be higher for any level of the exchange rate. This is depicted in Figure 16.1 as a rightward shift in the output market schedule from DD to $D'D'$. If the tariff is temporary, this is the only effect, and output will rise even though the domestic currency appreciates as the economy moves from Points 0 to 1. If the tariff is permanent, however, the long-run expected exchange rate falls, so the asset market schedule shifts to $A'A'$. The appreciation of the domestic currency is greater in this later case. If output is initially at full employment, then there is no change in output due to a permanent tariff.

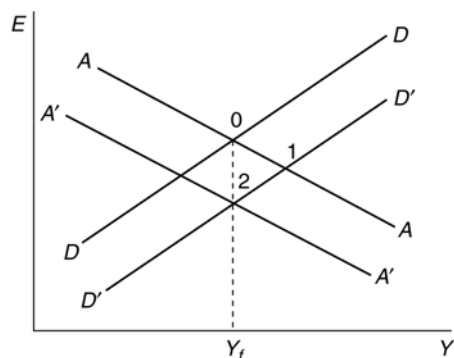


Figure 16.1

3. A temporary fiscal policy shift affects employment and output, even if the government maintains a balanced budget. An intuitive explanation for this relies upon the different propensities to consume of the government and of taxpayers. If the government spends \$1 more and finances this spending by taxing the public \$1 more, aggregate demand will have risen because the government spends the entire \$1, while the public reduces its spending by less than \$1 (i.e., $\$1 \times \text{mpc}$ —where the marginal propensity to consume is less than one). (Of course, domestic currency appreciation still prevents permanent fiscal expansions from affecting output in our model.)

5. Figure 16.2 can be used to show that any permanent fiscal expansion worsens the current account. In this diagram, the schedule XX represents combinations of the exchange rate and income for which the current account is in balance. Points above and to the left of XX represent current account surplus, and points below and to the right represent current account deficit. A permanent fiscal expansion shifts the DD curve to $D'D'$ and, because of the effect on the long-run exchange rate, the AA curve shifts to $A'A'$. The equilibrium point moves from 0, where the current account is in balance, to 1, where there is a current account deficit.

If, instead, there was a temporary fiscal expansion of the same size, the AA curve would not shift and the new equilibrium would be at Point 2 where there is a current account deficit, although it is smaller than the current account deficit at Point 1. Thus, a temporary increase in government spending causes the current account to decline by less than a permanent increase because there is no change in the long-run expected exchange rate with a temporary policy and thus the AA curve does not shift.

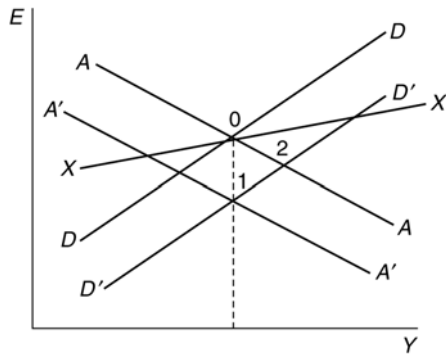


Figure 16.2

13. Suppose output is initially at full employment. A permanent change in fiscal policy will cause both the AA and DD curves to shift such that there is no effect on output. Now consider the case where the economy is not initially at full employment. A permanent change in fiscal policy shifts the AA curve because of its effect on the long-run exchange rate and shifts the DD curve because of its effect on expenditures. There is no reason, however, for output to remain constant in this case since its initial value is not equal to its long-run level, and thus an argument like the one in the text that shows the neutrality of permanent fiscal policy on output does not carry through.

In fact, we might expect that an economy that begins in a recession (below Y^f) would be stimulated back towards Y^f by a positive permanent fiscal shock. If Y does rise permanently, we would expect a permanent drop in the price level (since M is constant and $L(R, Y)$ would increase). This fall in P in the long run would shift AA and DD both out.

We could also consider the fact that in the case where we begin at full employment and there is no impact on Y , AA was shifting back due to the real appreciation necessitated by the increase in demand for home products (as a result of the increase in G). If there is a permanent increase in Y , there has also been a relative supply increase which can offset the relative demand increase and weaken the need for a real appreciation. Because of this, AA would shift back by less. We do not know the exact effect without knowing how far the lines originally move (the size of the shock), but we do know that without the restriction that Y is unchanged in the long run, the argument in the text collapses, and we can have both short run and long run effects on Y .

16. It is difficult to see how government spending can rise permanently without increasing taxes or how taxes can be cut permanently without cutting spending. Thus, a truly permanent fiscal expansion is difficult to envision. The one possible scenario is if the government realized it was on a path to permanent surpluses and it could cut taxes without risking long-run imbalances. Because rational agents are aware the government has a long-run budget constraint, they may assume that *any* fiscal policy is actually temporary. This would mean that a “permanent” policy would look just like a temporary one.