Fiscal policy, Monetary policy, and Inflation Worksheet

(Answer Key is at the end of this document)

News Article: Central banks will fail to tame inflation without better fiscal policy, study says (August 27, 2022)

Link:
https://www.reuters.com/markets/us/central-banks-will-fail-tame-inflation-without-better-fiscal-policy-study-says-2022-08-27/

Description: Students will read a short article about the interaction of fiscal and monetary policy. Specifically, a study presented at the Fed's Jackson Hole conference suggested that the Fed acting alone will be insufficient to control inflation unless (contractionary) fiscal policy measures are also implemented. Then, students will be asked to answer comprehension questions, as well as some questions related to the monetary and fiscal policy tools. They will also have to analyze the effects of contractionary policies on prices and GDP growth.

Resource Type: Fiscal policy in class or HW practice; Translate real world scenario into economic terms and analyze.

Assumptions: Students will need to be familiar with fiscal and monetary policy tools, and the process in which they affect prices.

Learning Objectives:

At the end of this worksheet, students will be able to:

1. *Distinguish between fiscal and monetary policy tools;*
2. *Distinguish between contractionary and expansionary monetary and fiscal policies;*
3. *Understand the concepts of inflation, stagnation, and stagflation;*
4. *Analyze the effect of a contractionary fiscal policy on consumer spending, firms' investment, aggregate demand, and ultimately, prices and real GDP growth;*
5. *Analyze the effect of a contractionary monetary policy on aggregate demand, and ultimately, prices and real GDP growth;*
6. *Apply the analysis from (4) and (5) above to evaluate the ability of a given policy to control inflation.*

Economics Vocabulary Used:

Fiscal policy, Monetary policy, Inflation, Monetary tightening, Contractionary/Expansionary fiscal/monetary policy, Interest rate

Foreshadowed Topics:

Growth, GDP, Stagnation, Stagflation, Aggregate demand

Suggested Excerpts:

“Governments around the world opened their coffers during the COVID-19 pandemic to prop up economies, but those efforts have helped push inflation rates to their highest levels in nearly half a century, raising the risk that rapid price growth will become entrenched.”
“Central banks are now raising interest rates, but the new study, presented on Saturday at the Kansas City Federal Reserve's Jackson Hole Economic Symposium argued that a central bank's inflation-fighting reputation is not decisive in such a scenario.”
“"If the monetary tightening is not supported by the expectation of appropriate fiscal adjustments, the deterioration of fiscal imbalances leads to even higher inflationary pressure," said Francesco Bianchi of Johns Hopkins University and Leonardo Melosi of the Chicago Fed. "As a result, a vicious circle of rising nominal interest rates, rising inflation, economic stagnation, and increasing debt would arise," the paper argued. "In this pathological situation, monetary tightening would actually spur higher inflation and would spark a pernicious fiscal stagflation."”
“The euro zone, which is also struggling with high inflation, is likely to follow a similar path, with its deficit hitting 3.8% this year…”
“The study argued that around half of the recent surge in U.S. inflation was due to fiscal policy…”
“While some central banks have been criticised for recognising the inflation problem too late, the study argued that even earlier rate hikes would have been futile.”
“"More hawkish (Fed) policy would have lowered inflation by only 1 percentage point at the cost of reducing output by around 3.4 percentage points," the authors said.”
“To control inflation, fiscal policy must work in tandem with monetary policy and reassure people that instead of inflating away debt, the government would raise taxes or cut expenditures.”

I. In-Class Discussion Questions:

Read this article, paying special attention to the fiscal and monetary policies discussed, as well as the conclusions of the study the article refers to. Then, answer the following questions.

1. What part of the increase in the inflation rate in the U.S. during the COVID-19 pandemic was caused by fiscal policy intervention based on the study discussed in the article?
    a. About 1%.
    b. About 3.8%.
    c. About 38%.
    d. About 50%.
2. The article states that "Central banks are now [in 2022] raising interest rates." What is the goal of this policy?
    a. Lower the rate at which prices are rising.
    b. Increase the rate at which prices are rising.
    c. Increase the rate at which people change jobs.
    d. Lower the rate at which people change jobs.
3. Increasing interest rates is one of the tools of which of the following policies?
    a. Expansionary fiscal policy
    b. Contractionary fiscal policy
    c. Expansionary monetary policy
    d. Contractionary monetary policy
4. The article refers to a study presented at the Kansas City Federal Reserve's Jackson Hole Economic Symposium. What does this study suggest about the increases in the interest rates Central banks have implemented in 2022?
    a. The policy will lead to higher consumer spending.
    b. The policy will not reduce inflation at all.
    c. The policy will be insufficient in controlling inflation.
    d. The policy will lead to an increase in aggregate demand.
5. Which of the following statements is most consistent with the study referenced in the article?
    a. A tightening monetary policy and no fiscal policy would eliminate the high inflation problem.
    b. If Central banks had increased interest rates earlier, the inflation problem would have been completely resolved by the time the study was presented.
    c. A monetary policy without a fiscal one would reduce inflation more than it would lower growth.

d. A combination of a fiscal and monetary policy is necessary to resolve the high inflation problem.

6. The article refers to the following concepts: inflation, stagflation, and stagnation. Connect each concept in Column A with its meaning in Column B.

Column A	**Column B**
Inflation	A prolonged period of decreasing, slow or no growth, and rising prices of goods and services
Stagnation	A period of rising prices of goods and services
Stagflation	A prolonged period of decreasing, slow or no growth

7. What fiscal policy tools do the article and the study it refers to mention?

a. Increase taxes.
b. Reduce spending.
c. All of the above.
d. None of the above.

8. Fill in the blanks. A *contractionary* fiscal policy involves _____ (increasing/decreasing) taxes and/or _____ (decreasing/increasing) expenditures. As a result, consumer spending and firms' investments are likely to _____ (decrease/increase). Aggregate demand (AD) _____ (decreases/increases), which is associated with a shift of the AD curve to the _____ (left/right). As a result, prices _____ (decrease/increase), (real) GDP growth _____ (decreases/increases), and employment _____ (decreases/increases).

Answer key:

Answers in **bold.**

1. What part of the increase in the inflation rate in the U.S. during the COVID-19 pandemic was caused by fiscal policy intervention based on the study discussed in the article?
    a. About 1%.
    b. About 3.8%.
    c. About 38%.
    d. About 50%.
2. The article states that "Central banks are now [in 2022] raising interest rates." What is the goal of this policy?
    a. Lower the rate at which prices are rising.
    b. Increase the rate at which prices are rising.
    c. Increase the rate at which people change jobs.
    d. Lower the rate at which people change jobs.
3. Increasing interest rates is one of the tools of which of the following policies?
    a. Expansionary fiscal policy
    b. Contractionary fiscal policy
    c. Expansionary monetary policy
    d. Contractionary monetary policy
4. The article refers to a study presented at the Kansas City Federal Reserve's Jackson Hole Economic Symposium. What does this study suggest about the increases in the interest rates Central banks have implemented in 2022?
    a. The policy will lead to higher consumer spending.
    b. The policy will not reduce inflation at all.
    c. The policy will be insufficient in controlling inflation.
    d. The policy will lead to an increase in aggregate demand.

    Answer: Answer C is correct. According to the article, higher interest rates would not be sufficient to reduce inflation as much as is necessary. A combination of monetary and fiscal policy might be required.
    Higher interest rates reduce consumer spending (which eliminates answer A). As a result, aggregate demand decreases (which eliminates answer D), which leads to lower real GDP growth and lower prices (which eliminates answer B which suggests that prices would not decrease at all).
5. Which of the following statements is most consistent with the study referenced in the article?

a. A tightening monetary policy and no fiscal policy would eliminate the high inflation problem.
b. If Central banks had increased interest rates earlier, the inflation problem would have been completely resolved by the time the study was presented.
c. A monetary policy without a fiscal one would reduce inflation more than it would lower growth.
d. A combination of a fiscal and monetary policy is necessary to resolve the high inflation problem.

6. The article refers to the following concepts: inflation, stagflation, and stagnation. Connect each concept in Column A with its meaning in Column B.

Column A	**Column B**
Inflation	A prolonged period of decreasing, slow or no growth, and rising prices of goods and services
Stagnation	A period of rising prices of goods and services
Stagflation	A prolonged period of decreasing, slow or no growth

Answer:
Inflation – a period of rising prices of goods and services.
Stagnation – a prolonged period of decreasing, slow or no growth.
Stagflation – a prolonged period of decreasing, slow or no growth, and rising prices of goods and services, i.e., stagnation accompanied by inflation.

7. What fiscal policy tools do the article and the study it refers to mention?
a. Increase taxes.
b. Reduce spending.
c. All of the above.
d. None of the above.

8. Fill in the blanks. A *contractionary* fiscal policy involves _____ (**increasing**/decreasing) taxes and/or _____ (**decreasing**/increasing) expenditures. As a result, consumer spending and firms' investments are likely to _____ (**decrease**/increase). Aggregate demand (AD) _____ (**decreases**/increases), which is associated with a shift of the AD curve to the _____ (**left**/right). As a result, prices _____ (**decrease**/increase), (real) GDP growth _____ (**decreases**/increases), and employment _____ (**decreases**/increases).

Answer: A *contractionary* fiscal policy involves increasing taxes and/or decreasing expenditures. As a result, consumer spending and firms' investments are likely to decrease. Aggregate demand (AD) decreases, which is associated with a shift of the AD curve to the left. As a result, prices decrease, (real) GDP growth decreases, and employment decreases.