

Learning Objectives

Chapter 34

In this chapter you will

- Learn the theory of liquidity preference as a short-run theory of the interest rate
- Analyse how monetary policy affects interest rates and aggregate demand
- Analyse how fiscal policy affects interest rates and aggregate demand
- Discuss the debate over whether policy makers should try to stabilize the economy
- Consider the suggestion that monetary policy can be set by rule
- Cover the effect of automatic stabilisers in balancing the economy

You should be able to

- State the theory of liquidity preference
- Outline the determination of equilibrium in the money market
- Show what an increase in the money supply does to the interest rate in the short run
- Illustrate what an increase in the money supply does to aggregate demand
- Explain how fiscal policy affects aggregate demand
- Explain crowding out
- Outline the case for and against an active stabilisation policy
- Calculate the nominal interest rate using the Taylor rule
- Outline how automatic stabilisers stimulate the economy
- Describe the lags in fiscal and monetary policy