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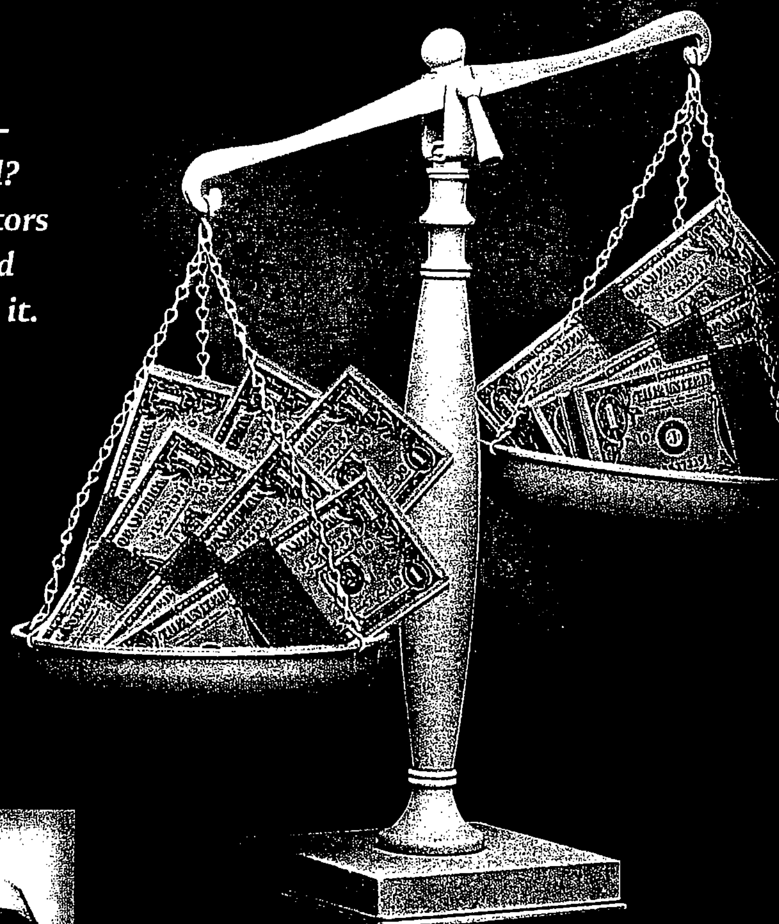
CHAPTER 17

Stabilizing the National Economy



Why It's Important

Why is it important for the economy to be balanced, or stabilized? This chapter will explain the factors that destabilize the economy, and what actions are taken to adjust it.

To learn more about unemployment and inflation, view the **Economics & You** *Chapter 23 video lesson:* **Economic Growth and Stability**

ECONOMICS *Online*

Chapter Overview Visit the *Economics Today and Tomorrow* Web site at ett.glencoe.com and click on ***Chapter 17—Chapter Overviews*** to preview chapter information.

SECTION 1

Unemployment and Inflation

Cover Story

***CNN/Money*, August 7, 2003**

Despite a recent wave of rosy reports on the U.S. economy and much optimism about the direction of growth, businesses still aren't hiring—and some economists worry the labor market slump, if it doesn't end soon, could nip the recovery in the bud.

Economic news Thursday from the Labor Department highlighted the promise and the danger for the job market. Weekly jobless claims stayed below a critical level for the third straight week, a sign things might be getting better.

Reader's Guide

Terms to Know

- stabilization policies
- unemployment rate
- full employment
- underground economy
- demand-pull inflation
- stagflation
- cost-push inflation

Reading Objectives

1. What are two problems the government faces in measuring unemployment?
2. What are the four kinds of unemployment?
3. How does demand-pull inflation differ from cost-push inflation?

When people are unemployed, they experience uncertainty. In the same way, unemployment in general causes uncertainty in the American economy. To keep the economy healthy and to make the future more predictable for planning, saving, and investing, the federal government uses monetary and fiscal policies. Together these are called **stabilization policies.** Unfortunately, neither policy is always successful in

<u>stabilization policies:</u> *attempts by the federal government to keep the economy healthy; includes monetary and fiscal policies*

ECONOMICS Online

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solving the complex problems of the economy. As you read this section, you'll learn that two of the biggest threats to a nation's economic stability are high unemployment and inflation.

Measuring Unemployment

Expert economists advise the President and Congress, but they often disagree about the causes and cures of the economic problems that periodically face the nation. One statistic they all look at, however, is the **unemployment rate**—the percentage of the civilian labor force that is without jobs but that is actively looking for work. See **Figure 17.1.**

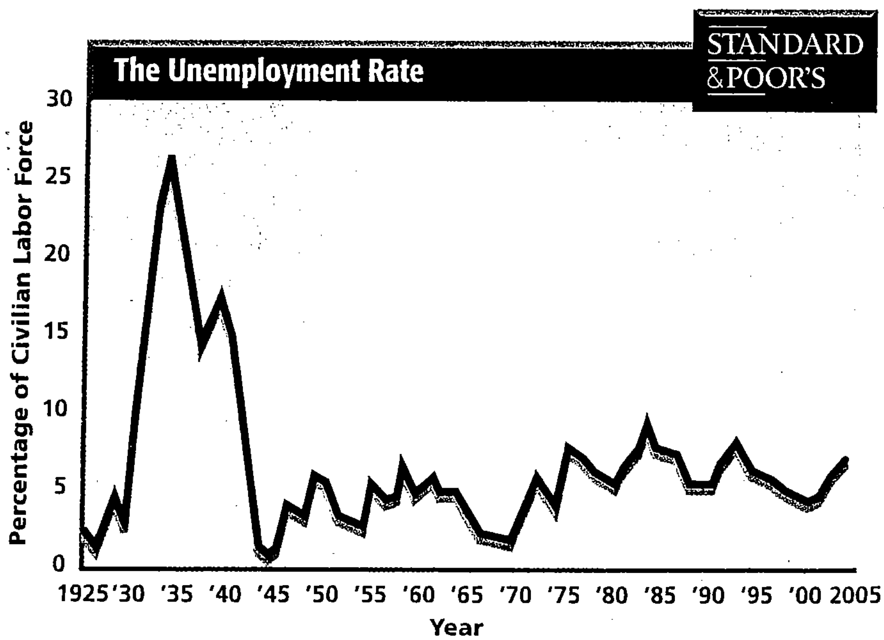
unemployment rate: *percentage of the civilian labor force that is unemployed but is actively looking for work*

High unemployment is usually a sign that all is not well with the economy. Moreover, the waste of human resources that unemployment causes is an extremely serious problem. As a result, maintaining a low unemployment rate is one of the major goals in stabilizing the economy.

FIGURE 17.1

Unemployment

Unemployment can reduce living standards, disrupt families, and reduce a person's feeling of self-respect. ***During which year shown did unemployment peak?***



Source: Standard & Poor's

ECONOMICS Online For an online update of this graph, visit ett.glencoe.com and click on ***Textbook Updates—Chapter 17.***

FIGURE 17.2 Types of Unemployment

Type	Definition	Characteristics
Cyclical	Unemployment associated with up or down fluctuations in the business cycle	Rises during recessions and depressions; falls during recoveries and booms
Structural	Unemployment caused by changes in the economy, such as technological advances or discoveries of natural resources	Can result when workers are replaced by computers or other machines or when cheaper natural resources are found elsewhere; often affects less skilled workers
Seasonal	Unemployment caused by changes in the seasons or weather	Affects construction workers, particularly in the Northeast and Midwest; also affects farmworkers needed only during certain months of the growing season
Frictional	Temporary unemployment between jobs because of firings, layoffs, voluntary searches for new jobs, or retraining	Always exists to some degree because of the time needed between jobs to find new work and the imperfect match between openings and applicants

Types of Unemployment Many types of unemployment exist. **Figure 17.2** describes these kinds of unemployment. Some people work in seasonal jobs or jobs that are sensitive to technological advances or to changes in the marketplace. As a result, not all unemployment can or should be eliminated. Moreover, economists disagree over what the level of full employment should be. Economists today generally have come to consider the economy at **full employment** when the unemployment rate is less than 5 percent.

full employment: condition of the economy when the unemployment rate is lower than a certain percentage established by economists' studies

It is important to remember that the unemployment rate is only an estimate. The unemployment rate does not include people who are unemployed and have stopped looking for work. Nor does it include people who work in family businesses without receiving pay.

Unemployment is difficult to measure accurately because government statisticians cannot possibly interview every person in and out of the labor force. Survey results are also imperfect because of the existence of the **underground economy.** The underground economy consists of people who do not follow federal and state laws with respect to reporting earnings. Examples might include tax avoiders, gamblers, and drug traffickers.

underground economy: transactions by people who do not follow federal and state laws with respect to reporting earnings

Global *Economy*

Unemployment

How do United States unemployment statistics compare to those of other industrialized nations?

U.S.	Japan	France	Germany
Unemployment Rate			
6.1%	5.4%	8.8%	8.4%
% of Average Wage Received in Benefits			
35%	48%	63%	44%
Length of Time Benefits Are Paid			
39 weeks	13 mo.	25 mo.	47 mo.

Source: *The World Factbook*, 2003

Inflation

A second major problem that may face any nation is inflation. The economy can usually adapt to gradually rising prices. If prices rise about 3 percent every year, for example, everyone comes to expect and understand that. Unpredictable inflation, however, has a destabilizing effect on the economy.

During periods of unpredictable high inflation, creditors raise interest rates to maintain the level of profits they had before inflation began to rise rapidly. This, in turn, may have a slowing effect on the economy's growth.

Inflation may also affect consumers' standard of living. Suppose you receive a 5 percent pay raise in a year in which inflation has risen 8 percent. Your real (adjusted for inflation) income has decreased. Inflation is a particularly serious problem for people who live on *fixed incomes,* such as those who are retired.

Not all economists agree on a single explanation of why inflation occurs. Two competing ideas have developed: the demand-pull theory (prices are *pulled* up by high demand) and the cost-push theory (prices are *pushed* up by high production costs and wages).

__demand-pull inflation:__ *theory that prices rise as the result of excessive business and consumer demand; demand increases faster than total supply, resulting in shortages that lead to higher prices*

Demand-Pull According to the theory of **demand-pull inflation,** prices rise as the result of excessive business and consumer demand. If economy-wide, or aggregate, demand increases faster than total supply, the resulting shortage will lead to the bidding up of prices.

Demand-pull inflation can occur for several reasons. If the Federal Reserve causes the money supply to grow too rapidly, individuals will spend the additional dollars on a limited supply of goods and services. This increased demand will cause prices to rise. Increases in government spending and in business investment can also increase overall demand. Aggregate demand can also increase if taxes are reduced or consumers begin saving less.

Cost-Push The demand-pull theory assumes that increased demand will increase output and reduce unemployment. Experience, however, has shown that rising prices and unemployment

ZIGGY

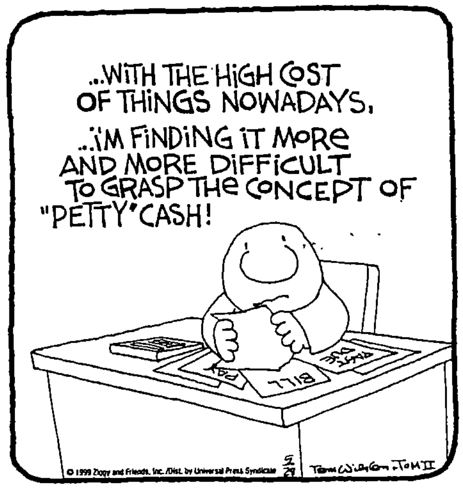


FIGURE 17.3

Effects of Inflation As Ziggy notes, inflation lowers the purchasing power of people, especially those on fixed incomes.

can occur at the same time. This combination of inflation and low economic activity is sometimes called **stagflation.**

According to some economists, stagflation is a result of cost-push inflation at work in the economy. The theory of **cost-push inflation** states that the wage demands of labor unions and the excessive profit motive of large corporations push up prices. When businesses have to pay higher wages, their costs increase. To maintain their profit level, businesses must raise the prices of the goods and services they produce.

During periods of cost-push inflation, unemployment can remain high. Prices are being adjusted for higher wages and profits—not because of increased aggregate demand. Without additional aggregate demand, producers have no reason to increase output by hiring new workers.

stagflation: *combination of inflation and low economic activity*

cost-push inflation: *theory that higher wages and profits push up prices*

Practice and **assess** key skills with ***Skillbuilder Interactive Workbook, Level 2.***

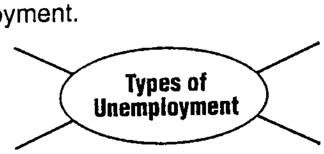
SECTION 1 Assessment

Understanding Key Terms

1. **Define** stabilization policies, unemployment rate, full employment, underground economy, demand-pull inflation, stagflation, cost-push inflation.

Reviewing Objectives

2. What are two problems the government faces in measuring unemployment?
3. **Graphic Organizer** Create a diagram like the one below to describe the four kinds of unemployment.



4. How does demand-pull inflation differ from cost-push inflation?

Applying Economic Concepts

5. **Inflation and Deflation** Name some factors that could cause the price of each of the following to go up or down: oil, medical care, orange juice, automobiles.

Critical Thinking Activity

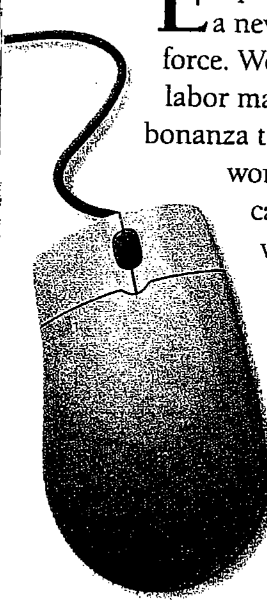
6. **Understanding Cause and Effect** Construct a table that identifies the causes of inflation. List four causes under demand-pull inflation in column 1 and three causes under cost-push inflation in column 2. *For help in constructing tables, see page xvii in the Economic Handbook.*

BusinessWeek

Spotlight on the Economy

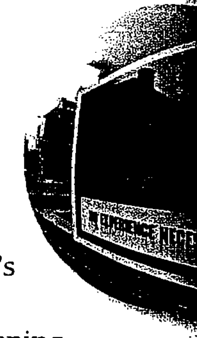
Your Next Job

<u>Check It Out!</u> In this chapter you learned about the four kinds of unemployment. In this article, read to learn how the United States job market looked at the end of the twentieth century.



Employers across the country are facing a newly emboldened American work force. We're living through the tightest U.S. labor market in three decades—a hiring bonanza that is transforming the nature of work. The current hypergrowth in jobs can't last forever; fast-food restaurants won't be paying signing bonuses during the next recession. But the most remarkable changes in the workplace—and our attitudes toward it—will redefine careers well into the 21st century. Just as the Great Depression produced a generation of frugal worry-warts, those of us benefiting from the long jobs boom of the 1990s sport an often brazen self-confidence about how we connect to our jobs. . . .

What is worth knowing? That more Americans are creating entirely new styles of employment. They're found in the expanding ranks of self-employed Free Agents who find financial and professional independence in everything from personal training to urban planning. Or they are the new Nomads, workers who never seem to stop job hunting. There's an emerging class of Globalists, too—those have-laptop-will-travel workers who straddle time zones in today's borderless economy. . . .



The most striking—and frightening—feature of this new landscape is how much it demands of us. Once expertise in a single discipline, like marketing, was enough to ensure a secure corporate future. But today's free agent needs skills in selling himself (how else to drum up business?), finance (to win that bank loan) and technology (is this computer upgrade a wise investment?).

Think About It

1. **According to the article, why are workers so confident about their jobs?**
2. **How have the new styles of employment changed what is demanded of workers?**

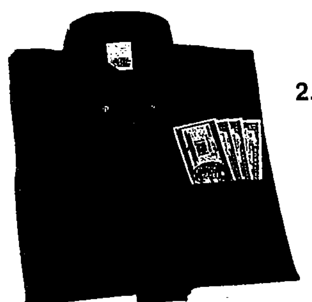
SECTION 2

The Fiscal Policy Approach to Stabilization

COVER STORY

THE NEW YORK TIMES, JULY 14, 1999

For all the recent talk of cutting taxes, Congress rarely cuts them when the economy is growing robustly, as it is now, and unemployment is low. The worry among economists is that the extra money in people's pockets may make an already strong economy too strong, finally stoking inflation after a long period of relatively stable prices.



READER'S GUIDE

Terms to Know
- fiscal policy
- circular flow of income

Reading Objectives
1. How does income flow between businesses and consumers?
2. How can the federal government use fiscal policy to combat unemployment?

Most economists belong to one of two groups on the question of stabilization. One group emphasizes the role of the Federal Reserve in stabilizing the economy, which you learned about in Chapter 15. In this section, you'll learn that the other group concentrates more on the use of **fiscal policy**, the federal government's deliberate use of its taxation rates and expenditures to affect overall business activity.

fiscal policy: *federal government's use of taxation and spending policies to affect overall business activity*

John Maynard Keynes

John Maynard Keynes developed fiscal policy theories during the Great Depression. Keynes believed that the forces of aggregate supply and demand operated too slowly in a serious recession, and that government should step in to stimulate aggregate demand.

The Circular Flow of Income

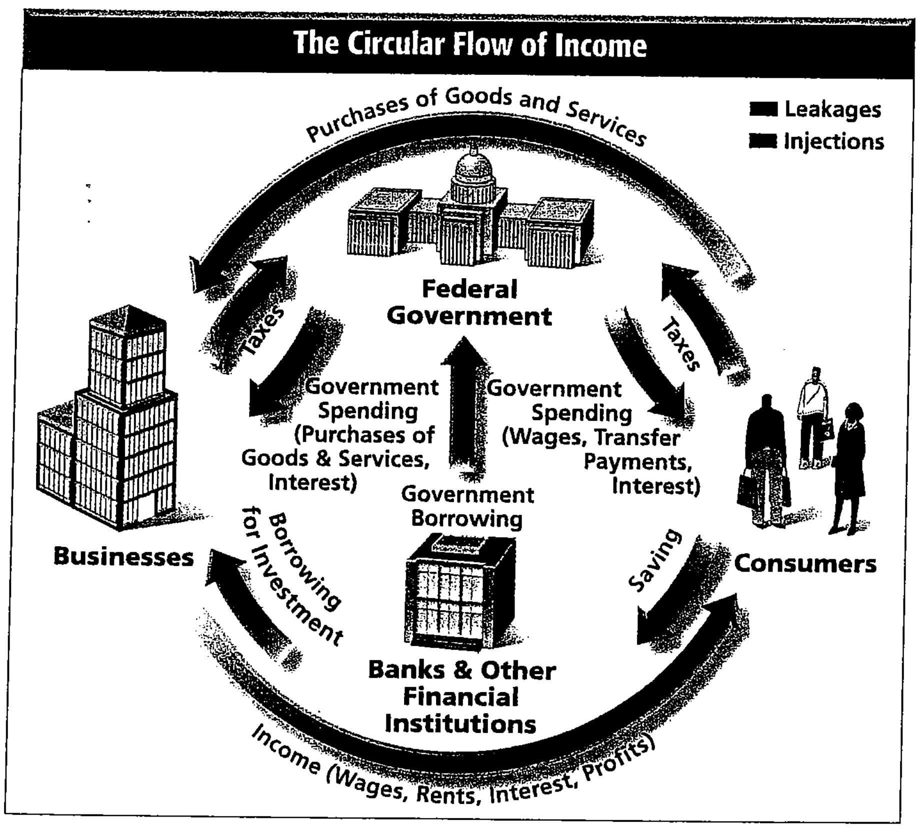
circular flow of income: *economic model that pictures income as flowing continuously between businesses and consumers*

To understand Keynesian theory, you must first understand what is known as the **circular flow of income**. You learned about this model in Chapter 2. The model pictures income as flowing from businesses to households as wages, rents, interest, and profits. Income flows from households to businesses as payments for consumer goods and services.

Not all income, however, follows this circular flow. Some of it is removed from the economy through consumer saving and government taxation. Economists use the term *leakage* to refer to this removal of money income. **Figure 17.4** shows these leakages. Offsetting leakages of income are injections of income into the economy. Injections occur through business investment and government spending.

FIGURE 17.4

Circular Flow Government occupies a central position in the circular flow of income. By using fiscal policy, the federal government partially controls the levels of leakages and injections. This, in turn, may control the overall level of economic activity.



FRANK & ERNEST

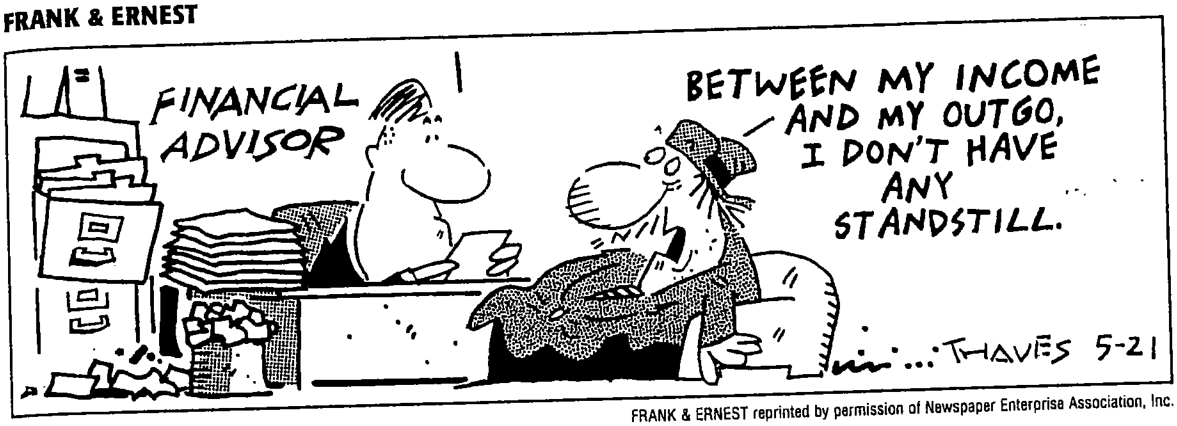


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FIGURE 17.5 **Equilibrium** The customer above is unhappy that his income and outgo are in equilibrium. Keynesian economists, however, want injections and leakages (income and outgo) to balance in the circular flow of economic activity.

Ideally, leakages and injections balance each other. See **Figure 17.5.** In this state of equilibrium, the income that households save is reinjected through business investment. Income taken out through taxes is returned through government spending.

Fiscal Policy and Unemployment

Many public officials and labor leaders have suggested starting jobs programs to reduce unemployment and stimulate the economy. Several suggestions for forming new government-sponsored jobs programs to bring down unemployment rates were made in the early 1980s and again in 1992 and 1993.

Cuts in federal taxes are another way in which fiscal policy has been used in an attempt to speed up economic activity and fight unemployment. Giving businesses tax credits on investments allows them to deduct from their taxes some of the costs of new capital equipment. The goal is to encourage businesses to expand production and hire more workers.

Fiscal Policy and Supply-Side Effects

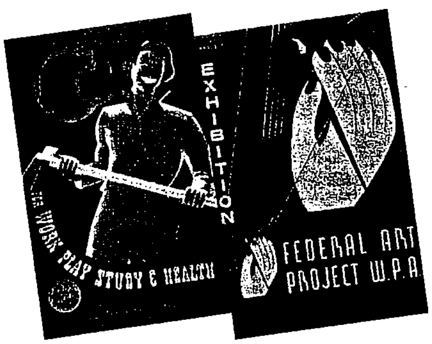
Some argue that tax cuts lead to more work, saving, and investment. These are called supply-side effects because they affect the supply of key ingredients of economic growth. President Bush used this supply-side argument to promote his Jobs and Growth Tax Act of 2003.

Economic Connection to... History

Jobs Programs

Jobs programs were created by the federal government during the 1930s. The Federal Art Project employed artists to depict American history and everyday life in public buildings. These artists created more than 2,500 murals and 17,700 sculptures.

The Federal Writers Project employed writers who worked on many different publications. The best known was the *American Guide* series—tour guides that included information on the history, geography, industry, and culture for each of the 48 states. ■



CCC and WPA posters

Many features of this act were aimed at increasing economic growth. Tax rates that were to be phased in over several years instead became effective in January 2003. The highest tax rate fell from 39.6 percent to 35 percent. Investors got a big break, too. The tax rate applied to dividends–income payments to shareholders of corporations–fell from as high as 39.9 percent to 15 percent. The tax rate on long-term capital gains (see Chapter 6) dropped from 20 percent to 15 percent. For some low-income earners, this rate fell to 5 percent.

Practice and **assess** key skills with ***Skillbuilder Interactive Workbook, Level 2.***

SECTION 2 Assessment

Understanding Key Terms

1. Define fiscal policy, circular flow of income.

Reviewing Objectives

2. **Graphic Organizer** Create a diagram like the one below to show what types of income flow from businesses to consumers in the circular flow.

Businesses ⇄ **Consumers**

3. How can the federal government use fiscal policy to combat unemployment?

Applying Economic Concepts

4. **Fiscal Policy** Explain how the government policy of increasing federal, state, or local taxes could eventually lower inflation.

Critical Thinking Activity

5. **Evaluating Primary and Secondary Sources** Research the Depression-era writings of Studs Terkel and photographs of Dorothea Lange. Write a report describing the economic conditions of the early 1930s and what actions you think the government should have taken to ease the crisis.

CRITICAL THINKING SKILLS

Summarizing Information

Have you ever read something and just a short time later forgotten what it was all about? Summarizing information—reducing many sentences to just a few well-chosen phrases—helps you remember the main ideas and important facts contained in a longer reading selection.

- Your summary should be much shorter than the reading selection.
- Your summary should contain the main ideas of the reading selection.
- Your summary should not contain your opinion. It should contain only the opinion of the person who wrote the selection.
- Your summary sentences and phrases should not be copied word for word from the selection. Write a summary in your own words to be sure that you understand the main ideas of the selection.

LEARNING THE SKILL

To learn how to summarize information, follow the guidelines listed on the left.

PRACTICING THE SKILL

Read the excerpt below, then answer the questions.

"Tomorrow's school, it turns out, may remind parents more of a sleek shopping mall than of the long, chalk-choked corridors of their youth. Retailers and health clubs of today 'have got it figured out,' says Paul Hansen, the principal architect in charge of a $118 million retrofit of Sandburg High School [Chicago]. The new Sandburg will incorporate some of the hottest ideas in school design: a central library that resembles a Barnes & Noble superstore, a gym with updated amenities like a rock-climbing wall, and a food court to replace the cafeteria. . . . Schools of the future will be wired to the hilt. Fiber optics, internal computer networks, videoconferencing, and the like are musts."

—*Newsweek*, December 14, 1998

1. What is the main idea of this paragraph?
2. What are the supporting details of the main idea?
3. Write a short summary that will help you remember what the paragraph is about.

APPLICATION ACTIVITY

Spend 15 minutes reading and summarizing two articles on the front page of today's newspaper. Circle the articles and have a classmate ask you questions about them. How much were you able to remember after summarizing the information?

Practice and **assess** key skills with ***Skillbuilder Interactive Workbook, Level 2.***

SECTION 3

Monetarism and the Economy

READER'S GUIDE

Terms to Know
- monetarism
- monetarists
- monetary rule
- time lags

Reading Objectives
1. What do monetarists think the government and the Fed should do to stabilize the economy?
2. Why do monetarists criticize fiscal policy?

COVER STORY

ROCKY MOUNTAIN NEWS, AUGUST 19, 2003

The amount of money in the banking system may soar after the Federal Reserve responded to the worst blackout in North American history by adding the most cash since the September 11, 2001, terrorist attacks.

The central bank added $20 billion of reserves on Friday, the day after an electrical failure . . . shut down New York City and cut off power in other major cities including Detroit. Monday the Fed added $12 billion to help meet the demand for cash through Wednesday.

monetarism: *theory that deals with the relationship between the amount of money the Fed places in circulation and the level of activity in the economy*

monetarists: *supporters of the theory of monetarism, often linked with Milton Friedman*

In this section, you'll learn about **monetarism,** the theory that deals with the relationship between the amount of money the Federal Reserve places in circulation and the level of activity in the economy. The supporters of this theory are called **monetarists.**

The Theory of Monetarism

Monetarism is often linked with economist Milton Friedman (see page 466). As you remember from Chapter 15, the Federal Reserve can change the growth rate of the money supply. Friedman and many other economists believe that the Fed should increase the money supply at a smooth, given percent each year. They argue that when the amount of money in circulation expands too rapidly, people spend more. If the economy is operating below capacity, this extra demand will lead to a rise in output. To produce more, businesses will have to hire more workers, and unemployment will decrease. If there is already full employment, however, the increased aggregate demand will lead to a rise in prices—inflation.

Government Policy According to Monetarists

Friedman and his monetarist followers believe the economy is so complex and so little understood that government does more harm than good in trying to second-guess businesspeople and consumers. As a result, monetarists generally oppose using fiscal policy to stimulate or slow the economy.

For example, they do not believe the government should operate with budget deficits each year in an attempt to stimulate the economy. Instead, monetarists believe that the government should balance the federal budget. This action would keep government from competing with private business to borrow money in the credit market. It would also reduce the amount of interest that the government must pay each year.

The Fed, according to monetarists, should also stop trying to smooth the ups and downs in the economy. Rather, the Fed should follow a **monetary rule**, or allow the money supply to grow smoothly and consistently at a rate of perhaps 3 to 5 percent per year. Monetarists believe that a steady growth in the money supply within strict guidelines (or targets, as they are called) is the best way to provide businesses and consumers with more certainty about the future. According to monetarism, this policy would result in a controlled expansion of the economy without rapid inflation or high unemployment.

CAREERS

Social Worker

Job Description
- Assist families dealing with unemployment, illness, or serious conflicts
- Refer clients to specialists

Qualifications
- Bachelor's degree in social work
- State licensing certification

Median Salary: $31,470

Job Outlook: Above average

—*Occupational Outlook Handbook*, 2002–03

__monetary rule:__ *monetarists' belief that the Fed should allow the money supply to grow at a smooth, consistent rate per year and not use monetary policy to stimulate or slow the economy*

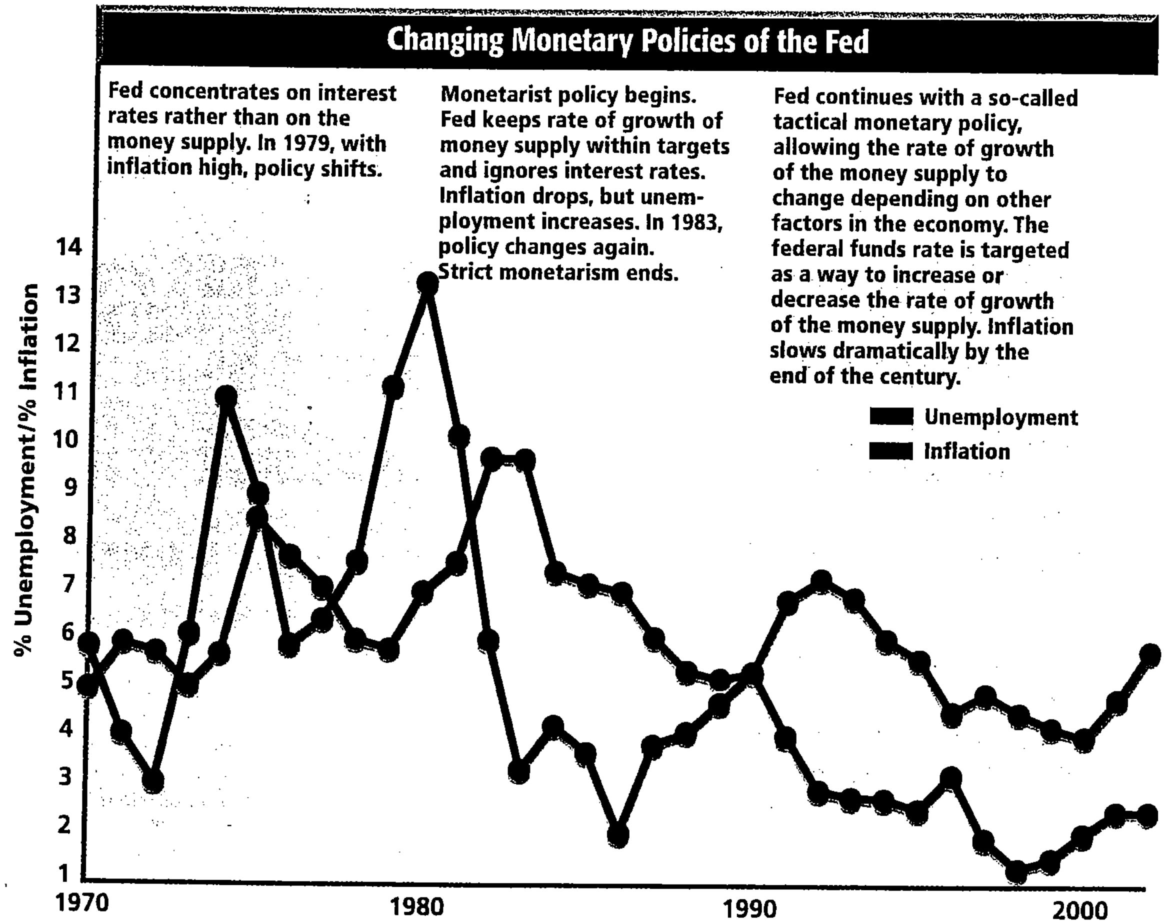
Monetarist Theory and the Federal Reserve Monetarist theory had a major influence on Federal Reserve policies in the 1980s. You can trace the changing monetary policies of the Fed in **Figure 17.6** on page 464.

Monetarists' Criticism of Fiscal Policy

Monetarists believe that the theory of fiscal policy never matches the reality of fiscal policy. Two reasons account for this discrepancy. The first reason concerns the political process of fiscal policy. Monetarists point out that no single government body

FIGURE 17.6

Changing Fed Policies To monetarists, the reduction in the amount of money in circulation can mean only one thing—a reduction in aggregate demand. With less aggregate demand, fewer workers are needed and unemployment increases. ***What happened to the unemployment rate when Fed policies began to lower inflation from 1980–1982?***



Sources: *Economic Report of the President,* 2001; Bureau of Economic Analysis designs and implements fiscal policy. The President, with the aid of the director of the Office of Management and Budget (OMB), the secretary of the Treasury, and the Council of Economic Advisers, designs yet only *recommends* the desired mix of taxes and government expenditures.

Congress, with the aid of many committees (the House Ways and Means Committee, the Senate Finance Committee, and the Senate Budget Committee, to name a few), actually enacts fiscal policy. One built-in organizational problem is that the power to enact fiscal policy does not rest with a single government institution. Disagreement as to the proper fiscal policy emerges among members of Congress and between Congress and the President. Furthermore, being politicians, they have incentives to take actions that will look good today and help them get reelected, but which may hurt the economy in the long run.

Monetarists also point out that even if fiscal policy could be enacted when the President wanted, there are various **time lags** between when it is enacted and when it becomes effective. It takes many months, if not years, for fiscal policy stimuli to cause employment to rise in the economy. Consequently, a fiscal policy designed to combat a recession might not produce results until the economy is already experiencing inflation. In this event, the fiscal policy could worsen the situation.

time lags: *periods between the time fiscal policy is enacted and the time it becomes effective*

Practice and **assess** key skills with ***Skillbuilder Interactive Workbook, Level 2.***

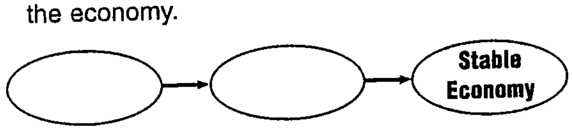
SECTION 3 Assessment

Understanding Key Terms

1. **Define** monetarism, monetarists, monetary rule, time lags.

Reviewing Objectives

2. **Graphic Organizer** Create a diagram like the one below to analyze what monetarists think the government and the Fed should do to stabilize the economy.



3. Why do monetarists criticize fiscal policy?

Applying Economic Concepts

4. **Monetarism** Do you agree or disagree with the theory of monetarism? Explain your response.

Critical Thinking Activity

5. **Making Comparisons** Describe in your own words the difference between monetarism and monetary policy. Share your description with a classmate, making sure he or she understands the difference.

People & Perspectives

Milton Friedman

ECONOMIST (1912–)

- **Won Nobel Prize for Economics in 1976**
- **Leading supporter of monetarism**
- **Publications include *The Monetary History of the U.S. 1867–1960* with Anna J. Schwartz (1963), *Capitalism and Freedom* (1962), and *Free to Choose* with Rose Friedman (1980)**

Milton Friedman has written extensively on the monetary history of the United States. Here, Friedman explains why he does not approve of the Fed and gives a possible alternative solution to regulating the money supply:

"The establishment of the Federal Reserve System . . . established a separate official body charged with explicit responsibility for monetary conditions, and supposedly clothed with adequate power to achieve monetary stability or, at least, to prevent pronounced instability. It is therefore instructive to compare experience as a whole before and after its establishment–say, from just after the Civil War to 1914 and from 1914 to date.

. . . The stock of money, prices, and output was decidedly more unstable after the establishment of the Reserve System than before. . . .

. . . Any system which gives so much power and so much discretion to a few men that mistakes–excusable or not–can have such far-reaching effects is a bad system. It is a bad system to believers in freedom just because it gives a few men such power without any effective check by the body politic–this is the key political argument against an 'independent' central bank.

. . . My choice at the moment would be . . . instructing the monetary authority to achieve a specified rate of growth in the stock of money. . . . I would specify that the Reserve System shall see to it that the total stock of money so defined rises . . . at an annual rate of X percent, where X is a number between 3 and 5."

Checking for Understanding

1. **What is Friedman's argument against an "independent" central bank?**
2. **What rule does Friedman propose to govern decisions of the Federal Reserve System?**

CHAPTER 17 Summary

ECONOMICS Online

Chapter Overview Visit the *Economics Today and Tomorrow* Web site at ett.glencoe.com and click on ***Chapter 17—Chapter Overviews*** to review chapter information.

SECTION 1 Unemployment and Inflation

- Two of the biggest threats to the nation's economic stability are high unemployment and inflation.
- Maintaining a low **unemployment rate** is a goal of **stabilization policies.**
- The four types of unemployment are cyclical, structural, seasonal, and frictional.
- According to the theory of **demand-pull inflation,** prices rise because excessive business and consumer demand increases faster than total supply.
- The theory of **cost-push inflation** states that the wage demands of labor unions and the excessive profit motive of large corporations push up prices.

SECTION 2 The Fiscal Policy Approach to Stabilization

- Some economists believe economic stabilization can be met with **fiscal policy**—the federal government's deliberate use of taxation and spending to affect overall business activity.
- John Maynard Keynes developed fiscal policy theories during the Great Depression.
- Keynesian theory states that leakages out of and injections into the **circular flow of income** affect aggregate demand, and should be counteracted by government taxing and spending policies.
- To bring down unemployment, Keynesian economists believe in forming government-sponsored jobs programs and cutting federal taxes.

SECTION 3 Monetarism and the Economy

- **Monetarists** believe in using the growth rate of the money supply to stabilize the economy.
- The theory of **monetarism** is often linked with economist Milton Friedman.
- Friedman and his supporters believe that the Fed should follow a **monetary rule** by increasing the money supply at a smooth, given percent per year.
- Monetarists criticize fiscal policy because of the political arena in which it is developed, and because **time lags** between enactment and implementation of fiscal policies may worsen the situation.

CHAPTER 17

Assessment and Activities

ECONOMICS Online

Self-Check Quiz Visit the *Economics Today and Tomorrow* Web site at ett.glencoe.com and click on ***Chapter 17—Self-Check Quizzes*** to prepare for the Chapter Test.

Identifying Key Terms

Write a one-sentence explanation of each of the following terms.

1. unemployment rate
2. full employment
3. underground economy
4. demand-pull inflation
5. stagflation
6. cost-push inflation
7. fiscal policy
8. monetarism
9. monetary rule
10. time lags

Recalling Facts and Ideas

Section 1

1. What are the four types of unemployment?
2. What causes demand-pull inflation?
3. What causes cost-push inflation?

Section 2

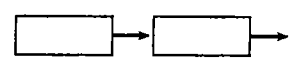
4. What are the leakages out of the circular flow of income?
5. What are the injections of income into the circular flow of income?
6. What do Keynesian economists think the federal government should do to reduce unemployment?

Section 3

7. Who is the economist most often linked to monetarism?
8. What do monetarists believe the Fed should do in terms of monetary policy?

Thinking Critically

1. **Making Generalizations** Analyze why full employment cannot be defined as zero unemployment.
2. **Understanding Cause and Effect** Create a diagram like the one below to explain why the unemployment rate might rise if fiscal policy were used to combat inflation.



Technology Activity

Using the Internet Choose a contemporary economic issue such as unemployment or inflation to investigate. Using a search engine, type in *unemployment* or *inflation* to locate current statistics on your chosen topic. Visit a government Web site to learn about the most up-to-date statistics. Write a one-page summary of your findings.

Applying Economic Concepts

Unanticipated Versus Anticipated Inflation Unanticipated inflation may affect you in many ways. For example, when inflation is high, banks charge higher interest rates to compensate for inflation. If you borrowed money at the high interest rates and then the rate of inflation fell, you would be worse off. You would be paying too much interest on that borrowed money. Make a list of other problems that you might encounter if there were a change in the rate of inflation that you did not anticipate.

Reviewing Skills

Summarizing Information Read the excerpt below, then answer the questions that follow.

"In recent years–as the second-longest economic expansion on record has spread its impact–most of the country has experienced a shortage of workers.

What's most perplexing is this: Tight labor markets are not affecting the economy the way textbooks say they should.

Normally, in the organic life of an economy, tight labor leads to higher wages, which triggers inflation, which leads to higher interest rates, which cause the economy to slow, which then eases the demand for labor.

For years now, economists have expected this chain of events to play out. But the scenario has been nipped from the start. Tight labor has not led to spiraling wages."

–*The Columbus Dispatch*, August 23, 1999

1. According to the article, what should happen when there is a shortage of workers?
2. Summarize what the article states about the economy.

Cooperative Learning Project

Organize into four groups. The first three groups will each track one of the following: government fiscal policies, monetary policies, and major economic indicators. The last group will create visuals from the information that is collected.

Using the front page of 10 consecutive issues of the *Wall Street Journal*, three groups will record a summary of news in each of their categories. Fiscal policy includes taxes and government spending. Monetary policy includes central bank interest rates, money supply, open-market operations, and reserve requirements. Economic indicators include such measurements as the consumer price index, industrial production, producer prices, retail sales, stocks and bonds, and unemployment. Each item should include the category, the date of the news, and a brief summary of the news.

As the information is being gathered by the first three groups, the last group should begin creating headlines that place the events in chronological order on a bulletin board. To conclude this project, the class should discuss the state of the economy as reflected in the headlines.

Analyzing the Global *Economy*

Scan the international section of a newspaper or business magazine. Keep track of the number of times that you read about the topics of unemployment and inflation in other countries. Create a table listing the specific countries and the specific topics. After each entry, indicate whether the economic news was positive or negative.