



Quiz 1: Keynesian macroeconomics
EE312: Intermediate macroeconomics
Semester 1/2018
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Question 1 (10 points) True/False.

“The effect of fiscal policy (either a tax cut or the increase in government spending) is *always* stronger under the traditional Keynesian cross than under the IS-LM model.”

First of all, let's make it clear for the terminologies: Keynesian cross, IS-LM and AD-AS. The AD-AS is the full-blown version of macroeconomic model that encompasses (nests) several features studied in Keynesian cross and IS-LM. The distinction among the three are followings!

Keynesian cross: Both interest rate and price are treated as exogenous!

IS-LM: Interest rate is not endogenously determined, but price is still fixed.

AD-AS: Both price and interest rate are adjustable.

I read the way most of you answered. You compare IS-LM equilibrium with AD-AS equilibrium. For the sake that you might be confused about the terminology used, I'll allow for this quiz. However, I will be more STRCIT in the future when I mark the midterm exam!

Now, get to answer of this question.

In general, the line of reasoning for T/F question is simple; **find a rebuttal case**. Proofing the statement correct is hard unless it is totally obvious. It is easier to find a counter example. The word “always” should be alarming to you. Is it “always” that Keynesian-cross fiscal multiplier is higher than IS-LM fiscal multiplier? The answer is: “NO, it is not always!”

IS-LM fiscal multiplier is “*generally*” smaller than Keynesian-cross multiplier because of the crowding-out effect. Most of you got this part right. But, the statement is that it is always!. A counter example is when there is NO crowding-out effect. If the interest rate doesn’t rise with income, there won’t be a crowding-out effect. The statement is then obviously rebutted.

From the framework that we use, imagine about the case that money demand is not driven by the level of income. IN this case, there is no relationship between income and interest rate! The interest rate will be fixed as the money demand is only driven by the speculative demand. The question over the possibility might pop up in your mind. A realistic example that comes closed to the regarding situation is the cashless society where people do not need to hold money, and use money for the transactional purpose. You save all the money, and only use QR code to transfer the money. Another realistic example might be related to the situation called “liquidity trap” during 2009 – 2014 in the US. During the period, FED had kept the interest low for an extended period of time. Fiscal policy does not cause an increase in the interest rate. Therefore, IS-LM fiscal multiplier should be as big as the Keynesian-cross fiscal multiplier.