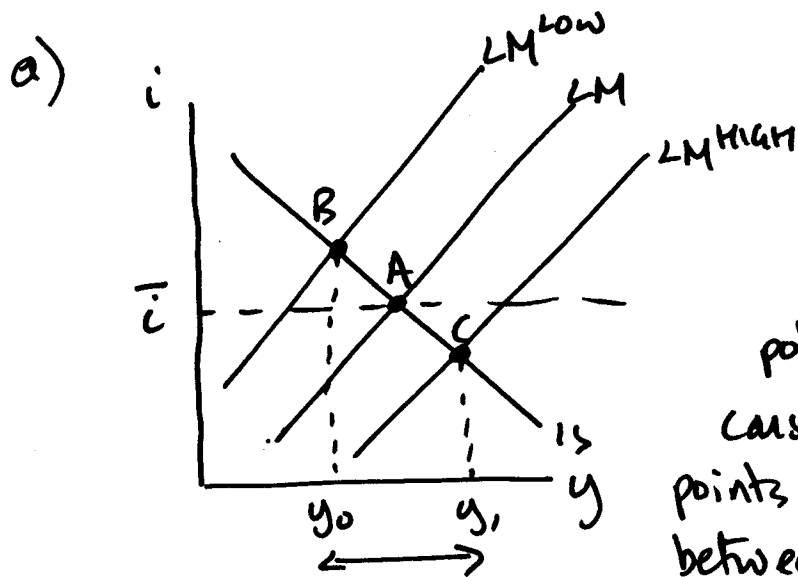


Two things you need to know to get started on this question:

- money market shocks cause random shifts in the LM curve
- goods market shocks cause random shifts in the AS curve.

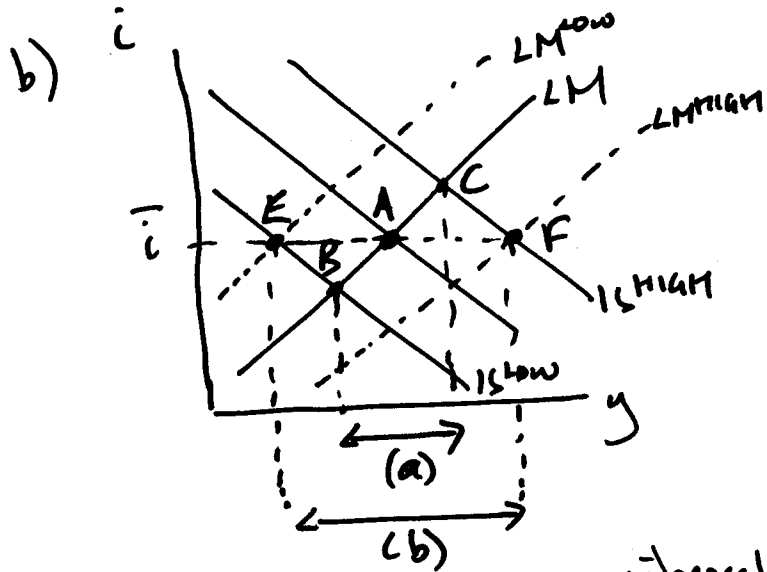


Assume money market shocks cause the LM curve to fluctuate between LM^{LOW} and LM^{HIGH} .

If the central bank follows a policy of keeping the money supply constant, the economy fluctuates between points B and C , and output fluctuates between y_0 and y_1 . In contrast, if the central bank adjusts the money supply

to keep i constant at \bar{i} , output will be completely stabilized.

An unfavorable money market shock causes a movement to B , which has a higher interest rate. The bank responds by increasing the money supply, shifting the LM curve back to its central location at A . A favorable money market shock is counteracted by contracting the money supply. Thus a constant interest rate policy is more stabilizing than a constant money supply policy when short-run fluctuations are driven by shocks to the money market.



Just an outline here....

Goods market shocks
shift IS curve left and right.

When bank does nothing to
adjust the money supply,
output fluctuates between B
and C. Under a constant

interest rate policy, output fluctuates
much more, between E and F. This is because the constant
interest rate rule induces the bank to contract the money
supply when the economy is in a recession and raise it
when it is in a boom!