FOR BBA (Hons.)

1. Subject Name : Macroeconomics
2. Semester/Year : Fourth (Semester-IV)
3. Name of the Teacher : Dr. Sudip Ghosh
4. Name of the topic : Effects of Fiscal and Monetary Policy

Effects of Fiscal Policy

Appointments

Fiscal policy is the setting of the federal budget and thus comprises decisions on government spending and taxation.

Government Spending

Consider the effects of an increase in government spending. The government has three sources of funds : taxation, selling bonds to the public (borrowing funds from the public) or creating new money. To increase spending the government must increase taxation, sell additional bonds to the public, or increase the money supply. For now, to avoid bringing in a monetary policy change, we assume that the money supply is fixed. We also assume that tax collection are fixed. The increased government expenditure are therefore assumed to be financed by selling bonds to the public.

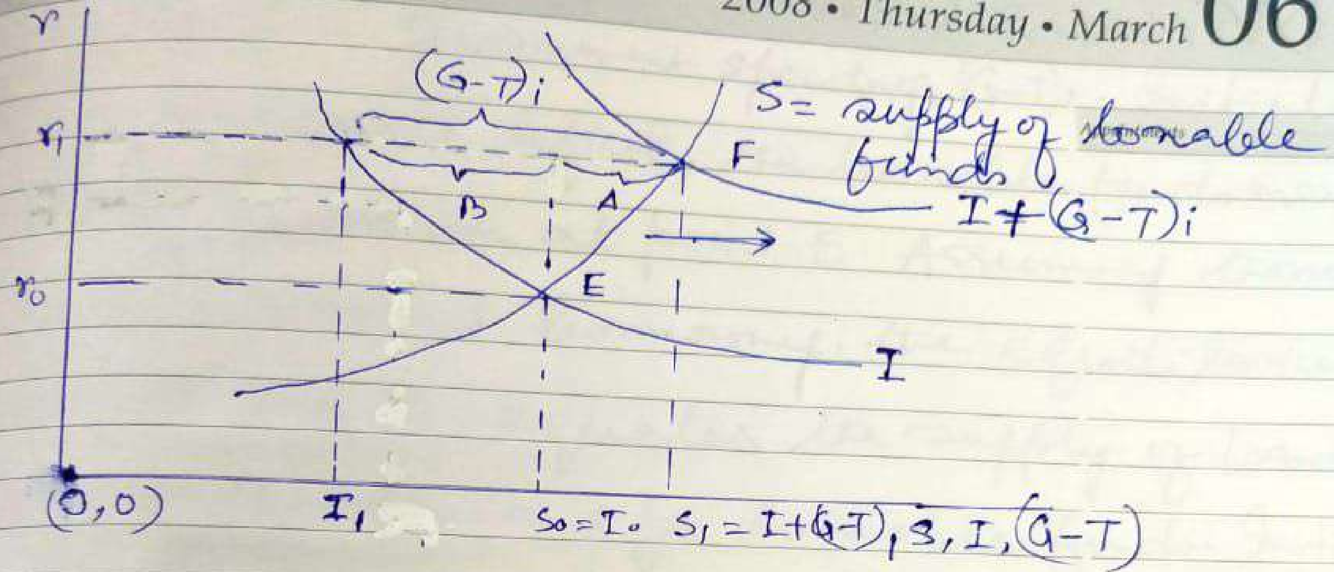

Figure 1: Effect of an increase in Government spending in the Classical Model

Figure 1 shows the effect in the loanable funds market of an increase in government spending financed by a sale of bonds to the public. If government is greater than tax revenue, then (G-T) is positive, where G is government spending, T is tax revenue and (G-T) is the government deficit. We assume that before the increase in government spending the government budget was in balance — that is, (G=T). The government deficit is then equal to

the increase in government spending, $(G-T)_1$. Initially with no government deficit, the loanable funds market is in equilibrium at point E. Assuming there is no government borrowing, the equilibrium interest rate r_0, equates the supply of loanable funds with the demand for loanable funds. Initially investment, I, is the only source of demand for loanable funds. If the increase in government spending is financed by selling bonds, then total demand for loanable funds includes both investment, I, and government borrowing, $(G-T)_1$. The increase in demand for loanable is shown as a rightward shift in demand from I to $I+(G-T)_1$, moving from equilibrium point E to equilibrium point F.

Sunday 9

The increase in government spending creates an increased demand for loanable funds as the government sells bonds to the public to finance the new spending.

This creates an excess of borrowers over lenders at the initial interest rate r_0 and the interest rate is pushed up to r_1. The increase in the interest rate has two effects. Savings increases from S_0 to S_1; this is the distance A in figure 1. Second, the quantity of investment declines with the higher interest rate. At r_1, we can read the new level of investment as I_1 along the I schedule. The investment decline is the distance B in figure 1.

The figure shows that the decline in consumption, which equals the amount of increased saving (distance A) plus the decline in investment (distance B), just equals the amount of increase in government spending $(G-T)_1$. The increase in government spending financed by selling bonds to the public pushes the interest rate up by enough to "crowd out" an equal amount of private expenditure (consumption plus investment).

Private expenditure is discouraged because ~~of~~ the higher interest rate causes households to substitute future consumption for current consumption — in other words, to save more. Investment declines because fewer projects appear profitable with higher borrowing costs. It is this crowding out that keeps aggregate demand from increasing when the government component of demand rises. Because aggregate demand is not changed, increases in government expenditures financed by bonds do not affect the price level.

Appointments

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Monetary Policy

Appointments

In the classical system, the quantity of money determines the price level and the level of nominal income. In this sense, monetary policy was quite important to classical economists. Stable money was a requirement for stable prices.

Work to do

In another sense, money was not important. The quantity of money did not affect the equilibrium values of the real variables in the system: output, employment, and the interest rate. Accordingly, monetary factors do not play a role in determining the real quantities.