HS201

Economics

Submitted by:

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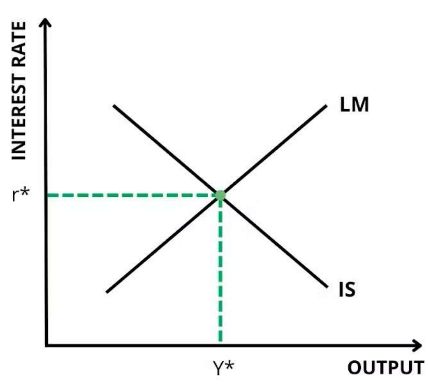
PROBLEM STATEMENT

Let us suppose there is an economic crisis driven by demand deficiency. In that case, the government intervenes through an expansionary fiscal policy since it assumes a **higher MPC**. However, the policymakers **don't want to hamper the investment and money demand**, wherein the **latter's sensitivity to the interest rate is high**. So, what should monetary policymakers do in order to tackle this concern? Using an IS-LM framework, show graphically and explain in detail how the fiscal and monetary policy will interact under these circumstances

SOLUTION

INTRODUCTION

In economic downturns characterized by insufficient demand, governments often turn to expansionary fiscal policies to stimulate economic activity. However, these policies can lead to unintended consequences, such as higher interest rates, which may dampen investment and money demand. This report examines how monetary policy can complement fiscal policy under these circumstances, using the IS-LM framework to illustrate their interaction. The report aims to provide policymakers with insights into effectively managing the economy without adverse effects on investment and Money Demand.



The IS-LM model, standing for Investment-Savings and Liquidity preference-Money supply, is a macroeconomic tool that describes the interactions between the goods and money markets. Developed during the Great Depression by John Hicks, based on theories published by another British economist, John Maynard Keynes, only a few months earlier it provides a comprehensive framework for understanding how policies affect economic variables like output and interest rates.

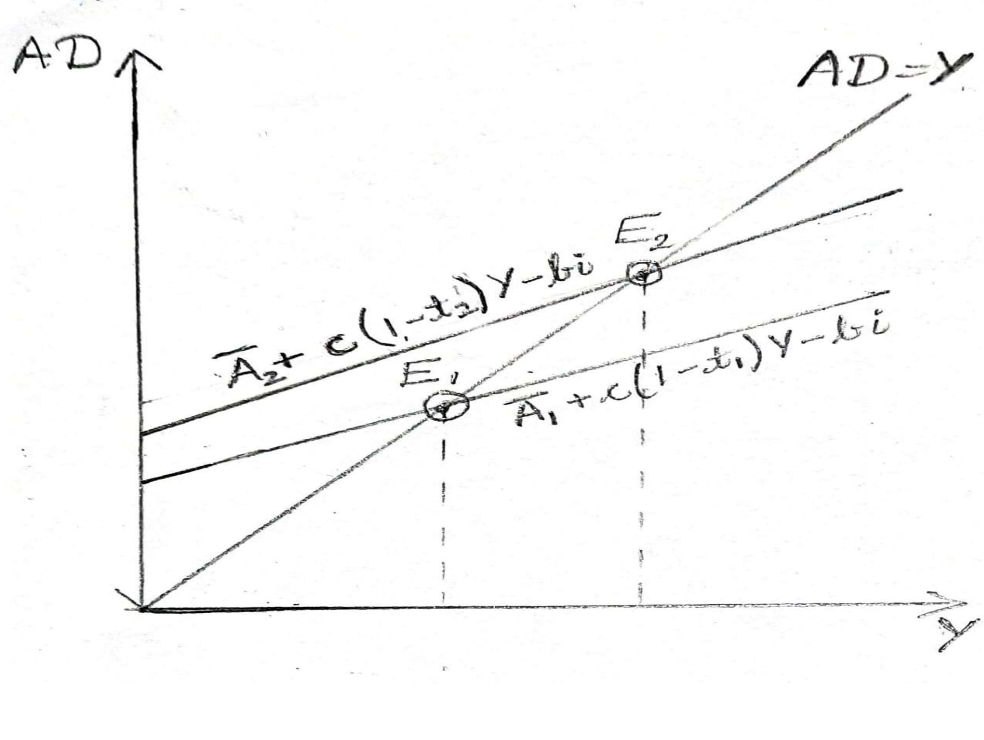
Demand Deficiency is caused mainly by two factors those are **Low Income** and **Lost in Faith** in the future income that would cause the demand to decrease greatly. As the MPC is higher that means people spend much more than what they save for future and the increase in income would also result in consuming more than saving. So, the government intervene with the Expansionary fiscal policies and the expansionary monetary policies.

The Need of Expansionary Fiscal Policy

In situations of demand deficiency, where economic output is below its potential, governments may increase spending or decrease taxes. These measures aim to boost aggregate demand, thereby stimulating economic growth

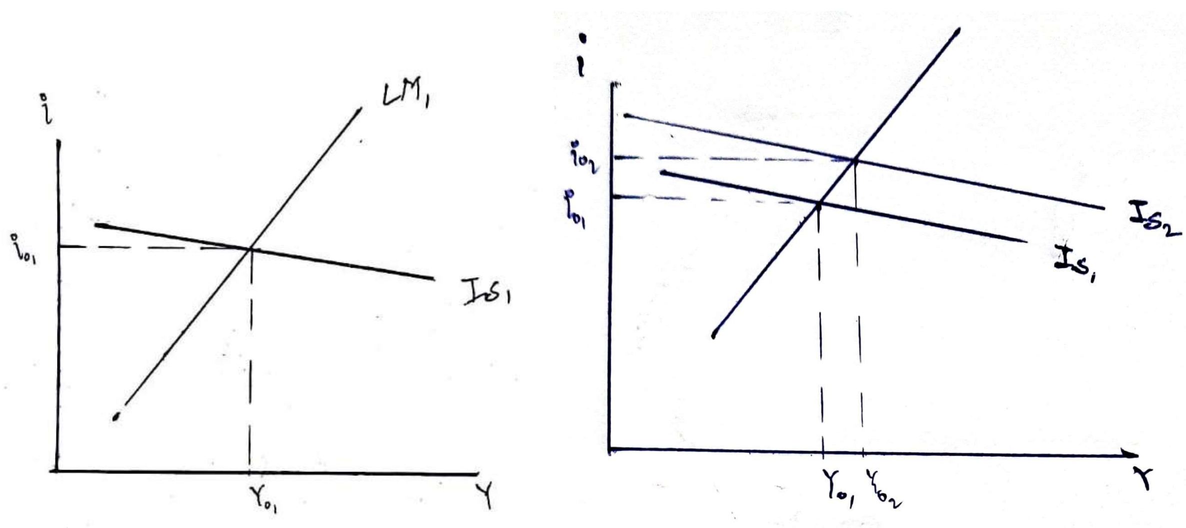
- Government Spending: Increased government spending directly raises demand for goods and services, leading to higher output.
- Tax Cuts: Reductions in taxes increase disposable income for consumers, encouraging higher spending and investment by businesses and households.

In this what we are focusing in on the increase in the autonomous spending that would shift the IS curve towards right as from the demand deficit there is a leftward shit in the IS curve. This can be achieved by either of the 2 given ways or by increasing the transfers or net exports.



The above curve depicts that any change(increases) in the Autonomous spending will shift (Upwards) the graph that will automatically affect the IS curve (Shift).

These all actions will shift the IS-curve towards Right and as mentioned in the problem we are given the high marginal propensity to consume (MPC) and high sensitivity of investment spending to the interest rate that means the Existing IS-curve is flatter, hence a small increase in the interest rate will cause the Investment to increase by a considerable amount. To counter this the role of expanding monetary policy arises.



In the above figure shown We can see the first figure shows the IS-LM curve with high sensitivity of investment to the interest rate and high MPC whereas the second figure explain the expansionary fiscal policy. How it increases the Interest rate and the GDP. That counters the demand deficiency.

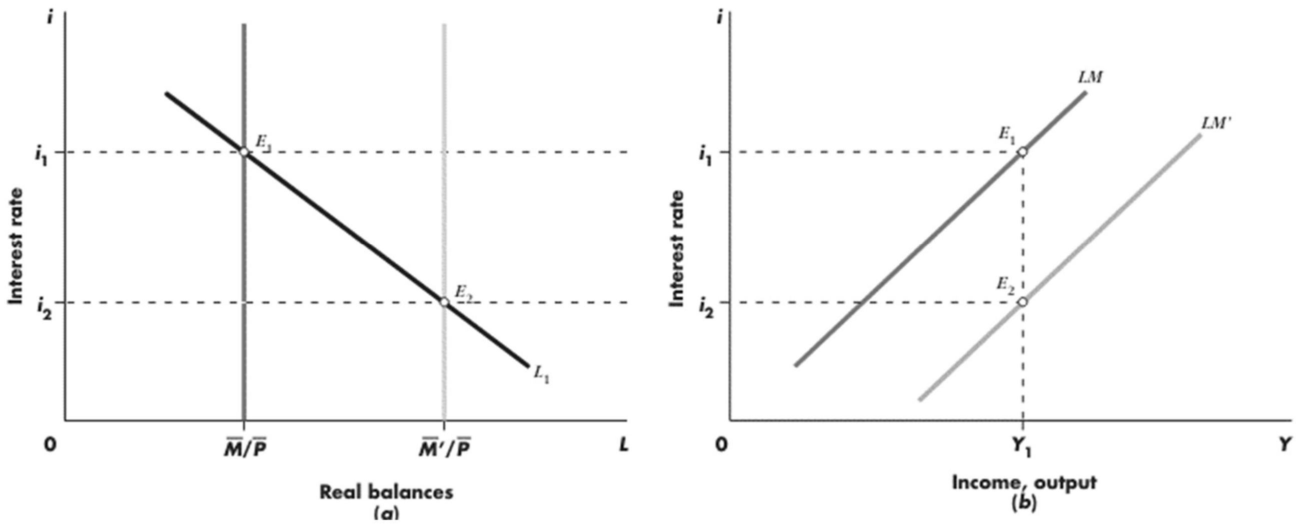
Role of Monetary Policy in Supporting Fiscal Expansion

To counteract the inflationary impact on interest rates from fiscal expansion and support economic growth, the central bank can adopt an expansionary monetary policy.

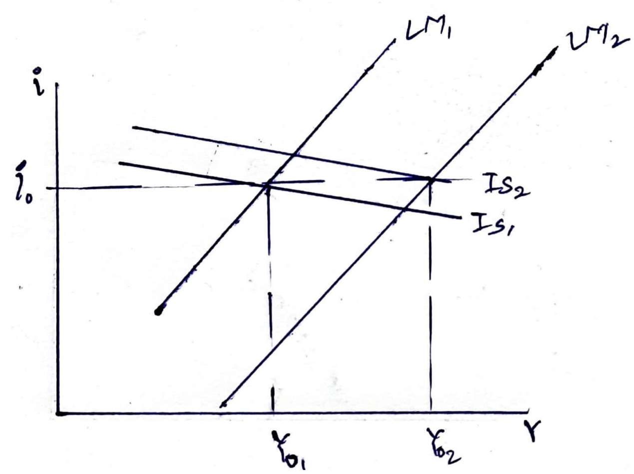
- This involves increasing the money supply, usually through open market operations. The increase in money supply aims to shift the LM curve rightward, reducing interest rates and thus supporting increased investment and consumption that were potentially hampered by the fiscal policy's initial effects on interest rates.

- In addition to open market operations, expansionary monetary policy can also involve lowering reserve requirements for banks or reducing the discount rate, further increasing the money supply.

By shifting the LM curve rightward, this policy not only lowers interest rates but also encourages borrowing and spending, which can counterbalance the inflationary pressures stemming from fiscal expansion while stimulating economic growth.



The curve shows an increase in money supply shifts the LM curve rightward.



This curve represents how the expansion in the monetary policies reduces the interest rate and there isn't any hamper to the investment.

This combination of policies shows that if coordinated well, monetary policy can mitigate the adverse effects of fiscal expansion on interest rates, fostering a more robust economic recovery without compromising investment incentives or liquidity preferences.

CONCLUSION

When it comes to steering the economy through tough times, it's crucial that fiscal and monetary policies work hand in hand. Imagine them as partners on a dance floor: they need to move together smoothly. The IS-LM model helps policymakers understand how these policies interact. By coordinating them effectively, policymakers can stabilize the economy during downturns, ensuring steady growth while keeping interest rates in check to encourage investment and meet people's need for money.