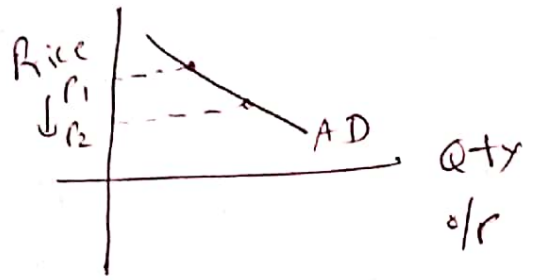
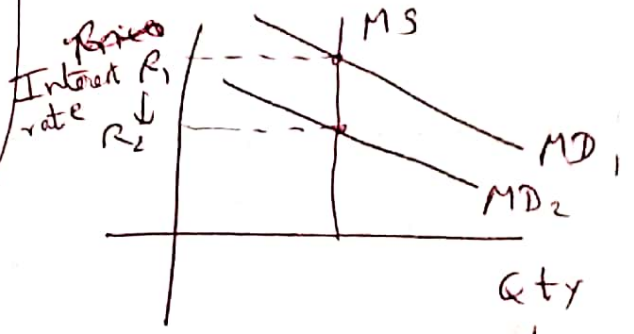
MONETARY & FISCAL POLICIES ON AGGREGATE DEMAND.

↳ Monetary policy:

↳ P ↓ ⇒ AD ↓



↳ AD ↓ ⇒ Money demand ↓.



shift in AD curve

by Monetary policy changes made by RBI.

→ Money demand of money. ↓ ⇒ eq. Rate of interest ↓

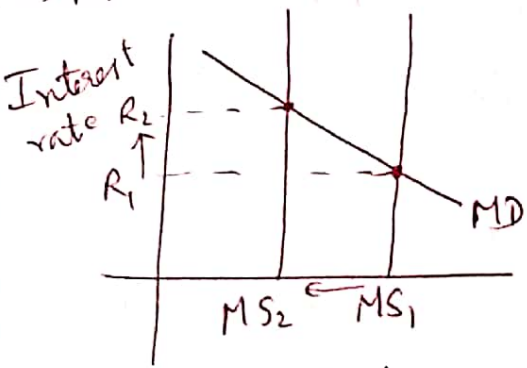
↳ MS changes ⇒ change in interest rate & shift in AD curve.

→ When RBI ↓ser money supply: (stock market boom ⇒ ↑ household wealth)

⇒ rate of interest ↑ser

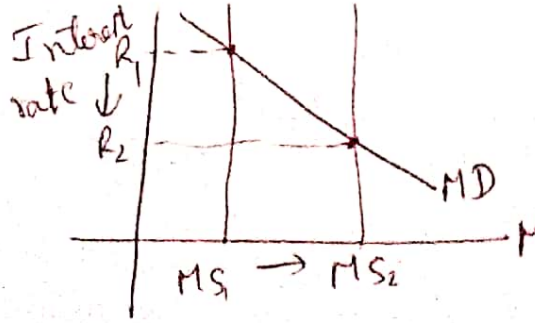
⇒ ↓ q+y of goods & services demanded.

⇒ ↓ in AD.



Eg: If Govt wants to ↓ Govt spending ⇒ ↓ in rate of interest, ↑ in AD ⇒ RBI ↑ MS.

→ When RBI ↑ser money supply:



↓ Govt. expenditure → ↓ money it has ⇒ ↑ MS

when oil prices surge (↑ a lot) ⇒ AD for oil ↓ ⇒ Fed ↑ AD for oil.

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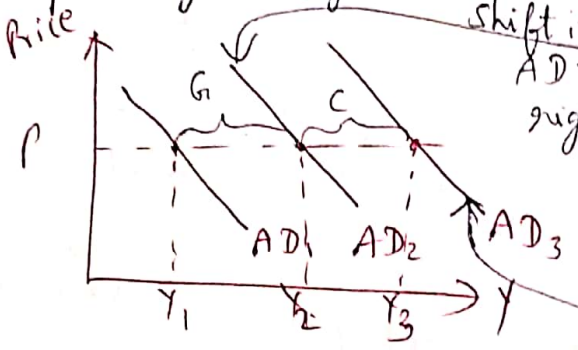
↳ Fiscal Policy & AD: → govt. spending & taxation

- Expansionary → ↑ in G &/or ↓ in T. Shifts AD right.
- Contractionary → ↓ in G &/or ↑ in T. Shifts AD left

① Multiplier effect → Additional shifts in AD that result when fiscal policy ↑ income & consumer spending. Eg: When a company earns (profit) Govt. buys sth. ↓



shift in AD to right ↑ income to owners & workers.

↑ consumer spending

Govt. expenditure (G) ↑.

↑ in C

→ Marginal propensity to consume (MPC) → fraction of extra income that households consume rather than save.

Eg: MPC = 0.8, Income ↑ sol to $100

⇒ C = 0.8 × 100 = $80. (consumption).

→ determines how big the multiplier effect is.

→ Y = C + I + G + NX → const. when G ↑ sol

ΔY = ΔC + ΔG

ΔY = (MPC) ΔY + ΔG

⇒ $\Delta Y = \left(\frac{1}{1-MPC}\right) \Delta G$ → Multiplier factor. ∝ MPC.

→ Multiplier size

↑ ⇒ Y↑ ⇒ C↑

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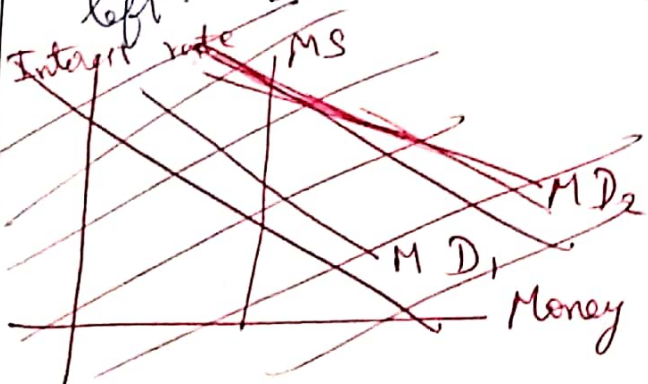
↳ Multiplier effect → each $1 ↑ in G ⇒ > $1 ↑ in AD.

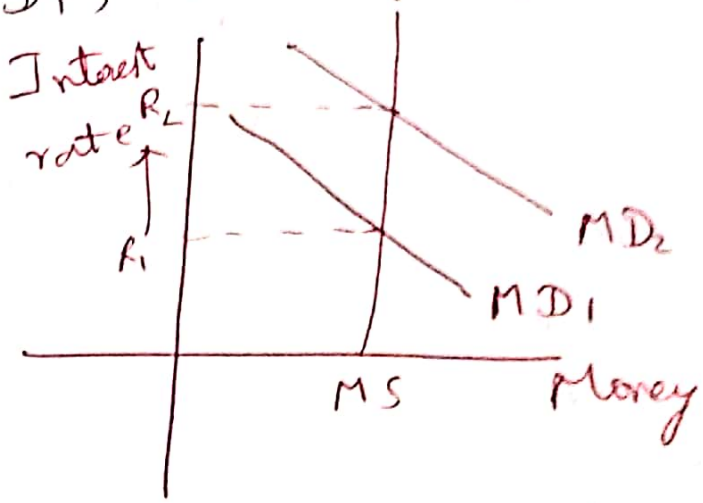
Eg: ↓ in US exports' AD ⇒ ↓ in Y ⇒ ↓ in C ⇒ ↓ in AD & income.

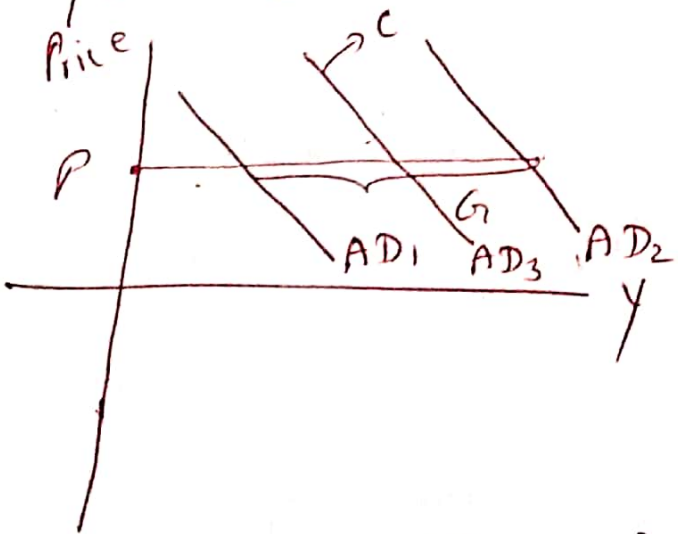
② The Crowding-out Effect:

→ Fiscal expansion → r ↑ ⇒ investment ↓ & ↓ in net increase in AD ⇒ qty by which AD shifts ↓.

→ r on goods & services ↑ ⇒ C ↓ ⇒ AD_3 shifts left. but w.r.t. AD_1, rt. shift of AD_3.







→ Crowding out ↓ impact of G on AD.

→ Change in Taxes & AD:

• Permanent tax cut ⇒ C ↑ ⇒ AD ↑ towards rt. than temporary tax cut as ppl take ↑ money home ⇒ ↑ spend.

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↳ Fiscal Policy & AS:

→ ↓ in T ⇒ workers work ↑ & ↑ in AS of goods & services → ppl who believe this → Supply-siders.

→ ↑ in G ⇒ Govt. builds better roads ⇒ transportation → businesses successful ⇒ ↑ AS of g&s. → Shifts AS to right.

↳ effect ↑ in long-run as it takes ↑ time to build roads.

↳ Stabilization Policy:

→ Reason: To reduce economic fluctuations / stock markets booms & crashes / recessions → handle.

→ GDP ↓ < natural rate ⇒ expansionary monetary / fiscal policy → prevent / reduce a recession.

→ GDP ↑ > natural rate ⇒ contractionary policy ⇒ prevent / reduce an inflationary boom.

→ Tax is cut sometimes → recover from a recession / stimulate AD.

↳ Against Active Stabilisation policy:

→ Monetary & fiscal policies → respond in the long-run only.
↳ on AD ↑

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→ Long-lag of Monetary policy & Fiscal policy:

• Monetary policy → long-lag to change AD ↑ time as investments are planned in advance, investors take ↑ time to respond to ↑ in rates of interest by when economic cond^{n}s change.

• Fiscal policy → Changes in G and T → legislative process takes time

• Sol^{n}: Policymakers focus on long-run goals like economic growth & ↓ inflation.

↳ Automatic Stabilizers:

→ Changes in Fiscal policy that stimulate AD when economy goes into recession

→ policymakers dont have to take any deliberate action.

Eg:

→ Taxes → during recession, ↓ automatically. ⇓ stimulates ↑ D

→ Govt. Spending

during recession → ↑ ppl. for public assistance ⇒ G ↑^{sly} on providing welfare, unemployment insurance etc, to the public

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↳ Economy is in recession.
Shifting the AD curve rt. by $200b ⇒ end recession.

(a) MPC = 0.8, no crowding-out, $\Delta G = ?$

Multiplier = $\frac{1}{1-MPC} = \frac{1}{1-0.8} = 5.$

Govt. expenditure (G) ↑ set by $40b

⇒ Shift agg. demand by = 5 × $40b
= $200b.

(b) If there is crowding out, should Govt. spend ↑ than this amt or ↓ ?

Crowding out ⇒ effect of G on AD ↓ ⇒ G ↑ more.

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