CHAPTER 34

The Influence of Monetary and Fiscal Policy on Aggregate Demand

PRINCIPLES OF
Economics

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Premium PowerPoint Slides
by Ron Cronovich

In this chapter, look for the answers to these questions:

- How does the interest-rate effect help explain the slope of the aggregate-demand curve?
- How can the central bank use monetary policy to shift the *AD* curve?
- In what two ways does fiscal policy affect aggregate demand?
- What are the arguments for and against using policy to try to stabilize the economy?

Introduction

- Earlier chapters covered:
  - the long-run effects of fiscal policy on interest rates, investment, economic growth
  - the long-run effects of monetary policy on the price level and inflation rate
- This chapter focuses on

Aggregate Demand

- Recall, the *AD* curve slopes downward for three reasons:
  - The wealth effect
  - The interest-rate effect
  - The exchange-rate effect
- Next:
  A supply-demand model that helps explain the interest-rate effect and how monetary policy affects aggregate demand.

The Theory of Liquidity Preference

- A simple theory of the interest rate (denoted ***r***)
- ***r*** adjusts to balance
- Money supply:

The Theory of Liquidity Preference

- Money demand
- For simplicity, suppose household wealth includes only two assets:
  - Money – liquid but pays no interest
  - Bonds – pay interest but not as liquid
- A household's "money demand" reflects its *preference* for *liquidity*.
- The variables that influence money demand:

Money Demand

- Suppose real income (***Y***) rises. Other things equal, what happens to money demand?
- If ***Y*** rises:
- *I.e.*, an increase in ***Y*** causes an increase in money demand, other things equal.

ACTIVE LEARNING ***1***

The determinants of money demand

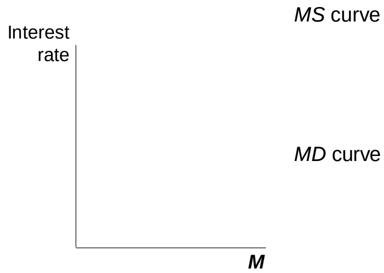
A. Suppose ***r*** rises, but ***Y*** and ***P*** are unchanged. What happens to money demand?

B. Suppose ***P*** rises, but ***Y*** and ***r*** are unchanged. What happens to money demand?

ACTIVE LEARNING ***1***

Answers

How *r* Is Determined



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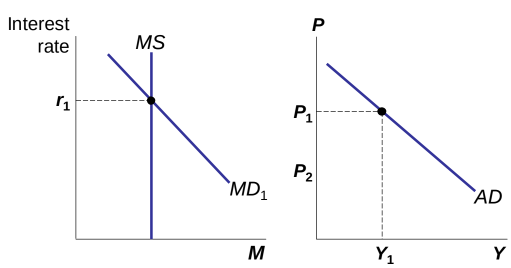
How the Interest-Rate Effect Works



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Monetary Policy and Aggregate Demand

- To achieve macroeconomic goals, the Fed can use monetary policy to
- The Fed's policy instrument is
- The news often reports that the Fed targets the interest rate.
  - More precisely,
- To change the interest rate

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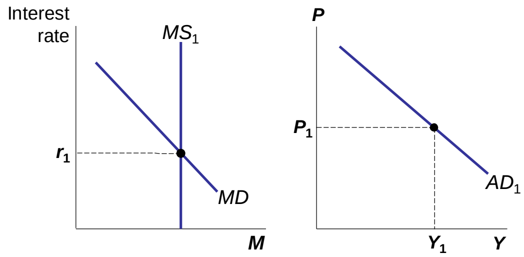
The Effects of Reducing the Money Supply



ACTIVE LEARNING **2**

Monetary policy

For each of the events below,

- determine the short-run effects on output
- determine how the Fed should adjust the money supply and interest rates to stabilize output

A. Congress tries to balance the budget by cutting govt spending.

B. A stock market boom increases household wealth.

C. War breaks out in the Middle East, causing oil prices to soar.

ACTIVE LEARNING **2**

Answers

Fiscal Policy and Aggregate Demand

- **Fiscal policy**:
- **Expansionary** fiscal policy
- **Contractionary** fiscal policy
- Fiscal policy has two effects on *AD*...

1. The Multiplier Effect

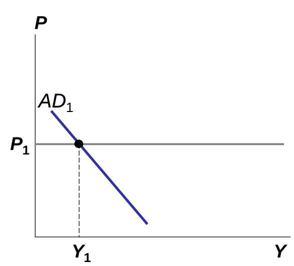
- If the govt buys $20b of planes from Boeing, Boeing's revenue increases by $20b.
- This is distributed to Boeing's workers (as wages) and owners (as profits or stock dividends).
- These people are also consumers

Multiplier effect:

1. The Multiplier Effect

A $20b increase in ***G*** initially shifts *AD* to the right by $20b.

The increase in ***Y*** causes



Marginal Propensity to Consume

- How big is the multiplier effect? It depends on
- **Marginal propensity to consume (MPC)**:

E.g., if *MPC* = 0.8 and income rises $100, ***C*** rises $________

A Formula for the Multiplier

Notation: D***G*** is the change in ***G***,
D***Y*** and D***C*** are the ultimate changes in ***Y*** and ***C***

Y = ***C*** + ***I*** + ***G*** + ***NX***	identity
	I and ***NX*** do not change
	because D***C*** = *MPC* D***Y***
	solved for D***Y***

A Formula for the Multiplier

The size of the multiplier depends on *MPC*.

E.g., if *MPC* = 0.5 multiplier =
if *MPC* = 0.75 multiplier =
if *MPC* = 0.9 multiplier =

A bigger *MPC* means

$$DY = \boxed{\frac{1}{1 - MPC}} DG$$

The multiplier

Other Applications of the Multiplier Effect

- The multiplier effect:
  Each $1 increase in ***G*** can generate
  more than a $1 increase in agg demand.
- Also true for the other components of GDP.

  Example:

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2. The Crowding-Out Effect

- Fiscal policy has another effect on *AD* that works in the opposite direction.
- A fiscal expansion raises ***r***,
- So, the size of the *AD* shift may be ___________ than the initial fiscal expansion.
- This is called the **crowding-out effect**.

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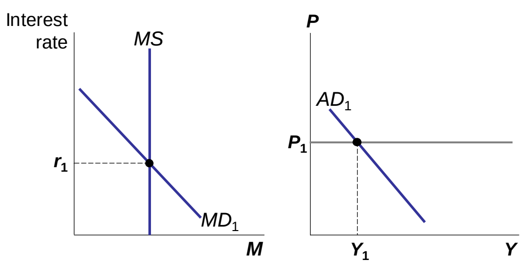
How the Crowding-Out Effect Works

A $20b increase in ***G***



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Changes in Taxes

- A tax cut increases households' take-home pay.
- Households
- The size of the shift is affected by the multiplier and crowding-out effects.
- Another factor: whether households perceive the tax cut to be

ACTIVE LEARNING ***3***

Exercise

The economy is in recession.
Shifting the *AD* curve rightward by $200b would end the recession.

A. If *MPC* = .8 and there is no crowding out, how much should Congress increase ***G*** to end the recession?

B. If there is crowding out, will Congress need to increase ***G*** more or less than this amount?

ACTIVE LEARNING ***3***

Answers

Fiscal Policy and Aggregate Supply

- Most economists believe the short-run effects of fiscal policy mainly work through agg demand.
- But
- Recall one of the Ten Principles from Chap 1: ***People respond to incentives.***
-
- People who believe this effect is large are called

Fiscal Policy and Aggregate Supply

- Govt purchases might affect agg supply. Example:
- This effect is probably more relevant in the long run: it takes time to build the new roads and put them into use.

Using Policy to Stabilize the Economy

- Since the Employment Act of 1946, economic stabilization has been a goal of U.S. policy.
- Economists debate how active a role the govt should take to stabilize the economy.

The Case for Active Stabilization Policy

- Keynes:

  among households and firms, leading to shifts in aggregate demand and fluctuations in output and employment.
- Also, other factors cause fluctuations, *e.g.,*
- If policymakers do nothing, these fluctuations are destabilizing to businesses, workers, consumers.

The Case for Active Stabilization Policy

- Proponents of active stabilization policy believe the govt should use policy to reduce these fluctuations:
  - When GDP falls below its natural rate,
  - When GDP rises above its natural rate,

Keynesians in the White House

1961:
John F Kennedy pushed for a tax cut to stimulate agg demand. Several of his economic advisors were followers of Keynes.

2001:
George W Bush pushed for a tax cut that helped the economy recover from a recession that had just begun.

The Case Against Active Stabilization Policy

- Monetary policy
  - Firms make investment plans in advance, so
  - Most economists believe it takes at least ____________ for mon policy to affect output and employment.
- Fiscal policy
  - Changes in ***G*** and ***T*** require Acts of Congress.
  - The legislative process can take months or years.

The Case Against Active Stabilization Policy

- Due to these long lags, critics of active policy argue that
- These critics contend that policymakers should focus on long-run goals like economic growth and low inflation.

Automatic Stabilizers

- **Automatic stabilizers**:

Automatic Stabilizers: Examples

- The tax system
- Govt spending
  -
  - Govt spending on these programs automatically rises, which stimulates agg demand.

CONCLUSION

- Policymakers need to consider all the effects of their actions. For example,
  - When Congress cuts taxes, it should consider
  - When the Fed reduces the rate of money growth, it must take into account not only