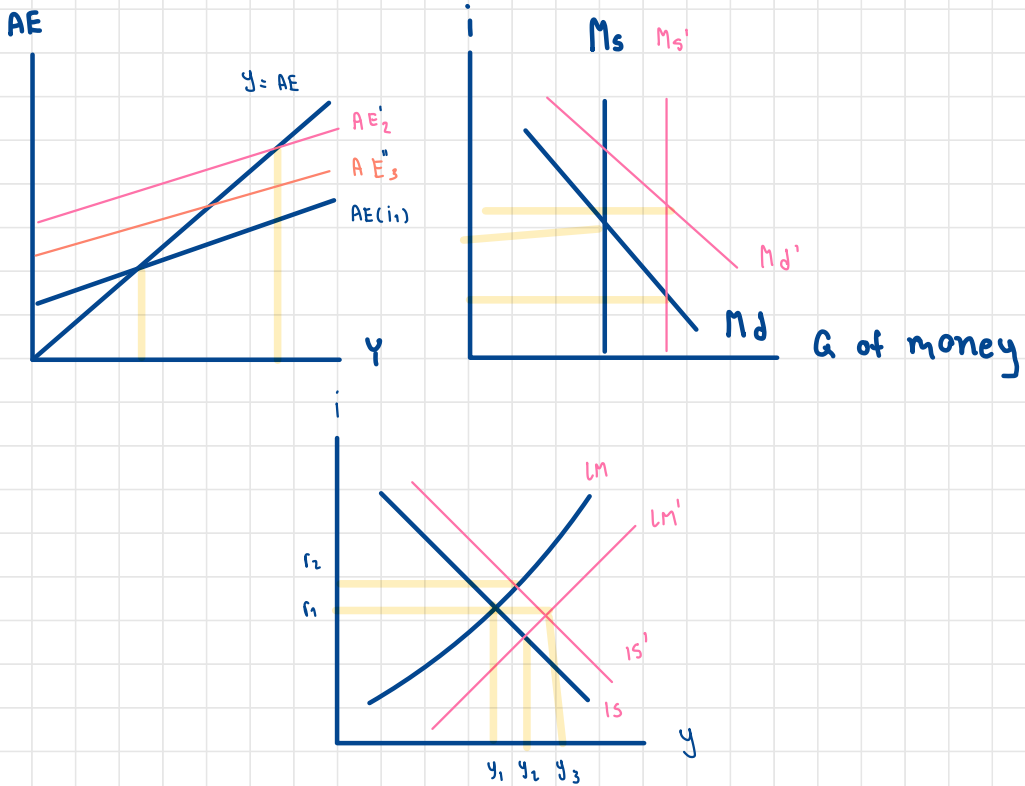


Question 1

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Draw 3 diagrams (Keynesian Cross, Money Market, IS-LM) to **show and briefly explain** the followings:

- The crowding-out effect when the government increases its spending $G \uparrow$
- Another policy that can be used to avoid the crowding-out effect



- GM : $G \uparrow \rightarrow AE \rightarrow Y \uparrow$
 - MM : $Y \uparrow \rightarrow Md \uparrow \rightarrow i \uparrow$
 - GM : $i \uparrow \rightarrow I \downarrow \rightarrow AE \downarrow \rightarrow Y \downarrow$
 - $M \uparrow \rightarrow i \downarrow$
 - $i \downarrow \rightarrow I \uparrow \rightarrow AE \uparrow \rightarrow Y \uparrow$
- \therefore OUTPUT \uparrow i not \uparrow

When the government increase its spending, this raises demand in the economy (AE). Firm produce more to supply at the higher demand ($Y = AE$). This raises output and hence income (Y). When people have more income (Y) They want to buy more goods. This raises the money demand (Md). The raises the interest rate. However, higher interest rate (i) discourages investment (I) with lower investment, output fall (Y). As a result the crowding out effect To avoid crowding out affect we need to use monetary policy by increase money reduce interest rate when interest rate is low people will invest more employee have money raises demand in the economy, and more output.

\therefore To conclude it will increase output but not increase interest rate.