

Chapter 7: Policy Effectiveness

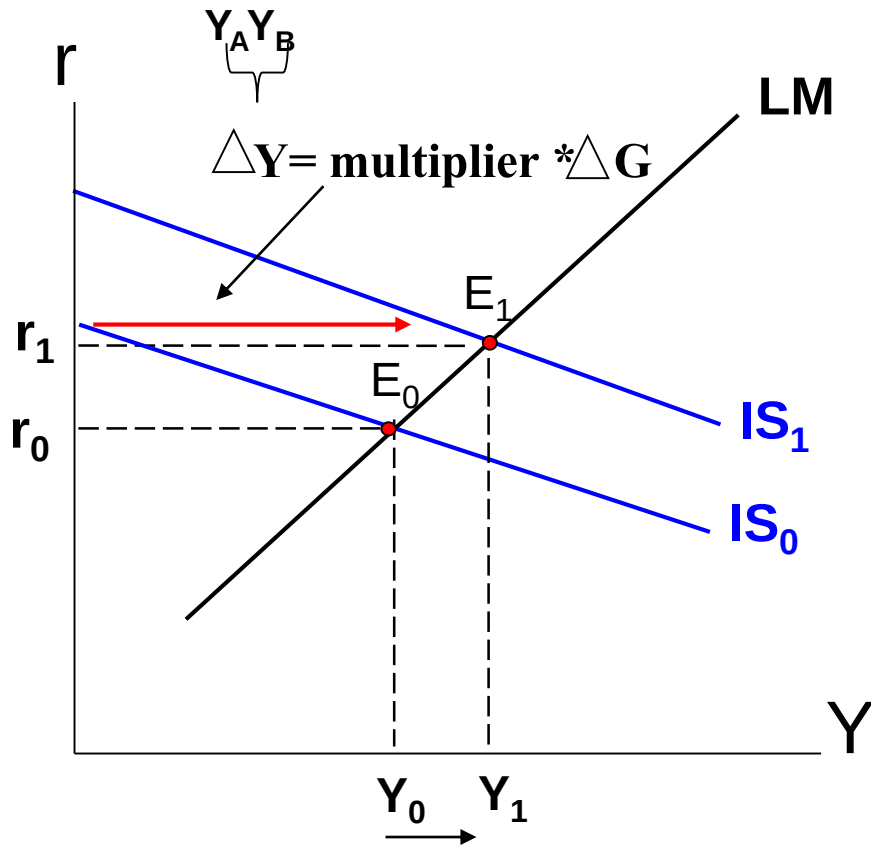
7.1 Fiscal Policy Effectiveness

7.1.1 Fiscal policy effectiveness and slope of IS curve

7.1.2 Fiscal policy effectiveness and slope of LM curve

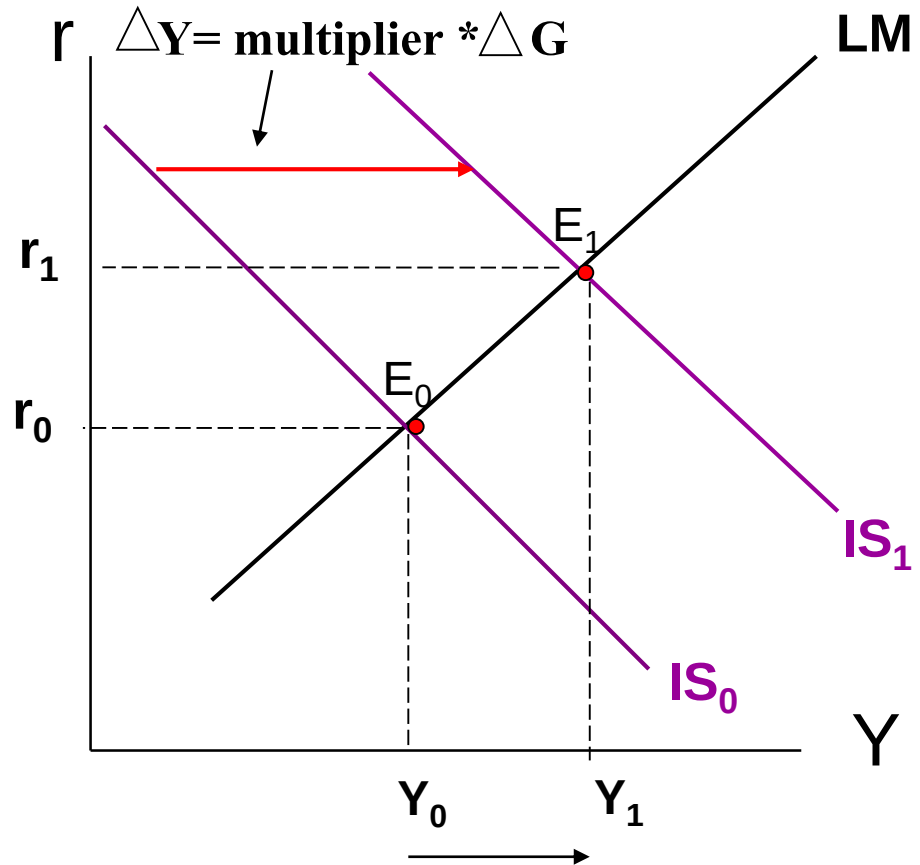
7.1.1 Fiscal policy effectiveness and slope of IS curve

(a) IS curve is quite flat



$Y \uparrow$ a little

(b) IS curve is quite steep



$Y \uparrow$ a lot

7.1.1 Fiscal policy effectiveness and slope of IS curve

(a) IS curve is quite flat: suppose due to **high** $\varepsilon_{I,r} = \frac{\Delta I}{\Delta r} \times \frac{r}{I}$

• $G \uparrow \Rightarrow DAE \uparrow \Rightarrow Y \uparrow \uparrow$, $\Delta Y = \text{multiplier} \times \Delta G$

• $Y \uparrow \uparrow \Rightarrow M^d \uparrow \Rightarrow r \uparrow \Rightarrow I \downarrow \text{ a lot } \Rightarrow DAE \downarrow \text{ a lot } \Rightarrow Y \downarrow \text{ a lot }$

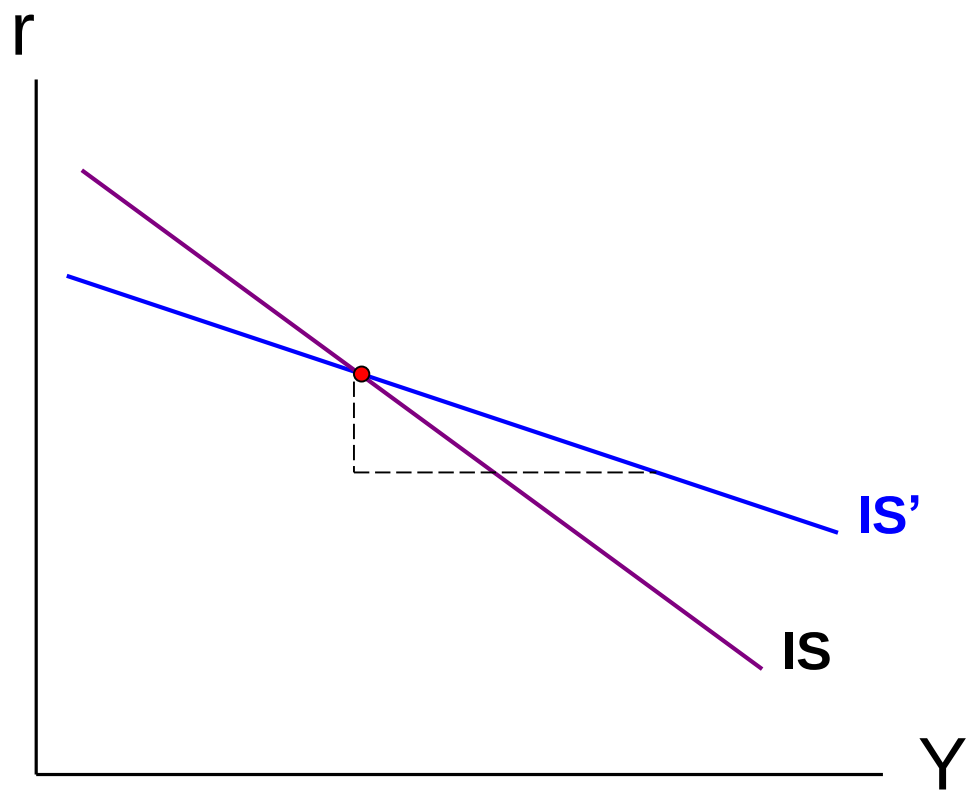
• crowding-out effect a lot $\Rightarrow$ Net change in Y, $Y \uparrow \text{ a little } \Rightarrow$ **Fiscal policy is not that effective**

(b) IS curve is quite steep: suppose due to **low** $\varepsilon_{I,r} = \frac{\Delta I}{\Delta r} \times \frac{r}{I}$

• $G \uparrow \Rightarrow DAE \uparrow \Rightarrow Y \uparrow \uparrow$, $\Delta Y = \text{multiplier} \times \Delta G$

• $Y \uparrow \uparrow \Rightarrow M^d \uparrow \Rightarrow r \uparrow \Rightarrow I \downarrow \text{ a little } \Rightarrow DAE \downarrow \text{ a little } \Rightarrow Y \downarrow \text{ a little }$

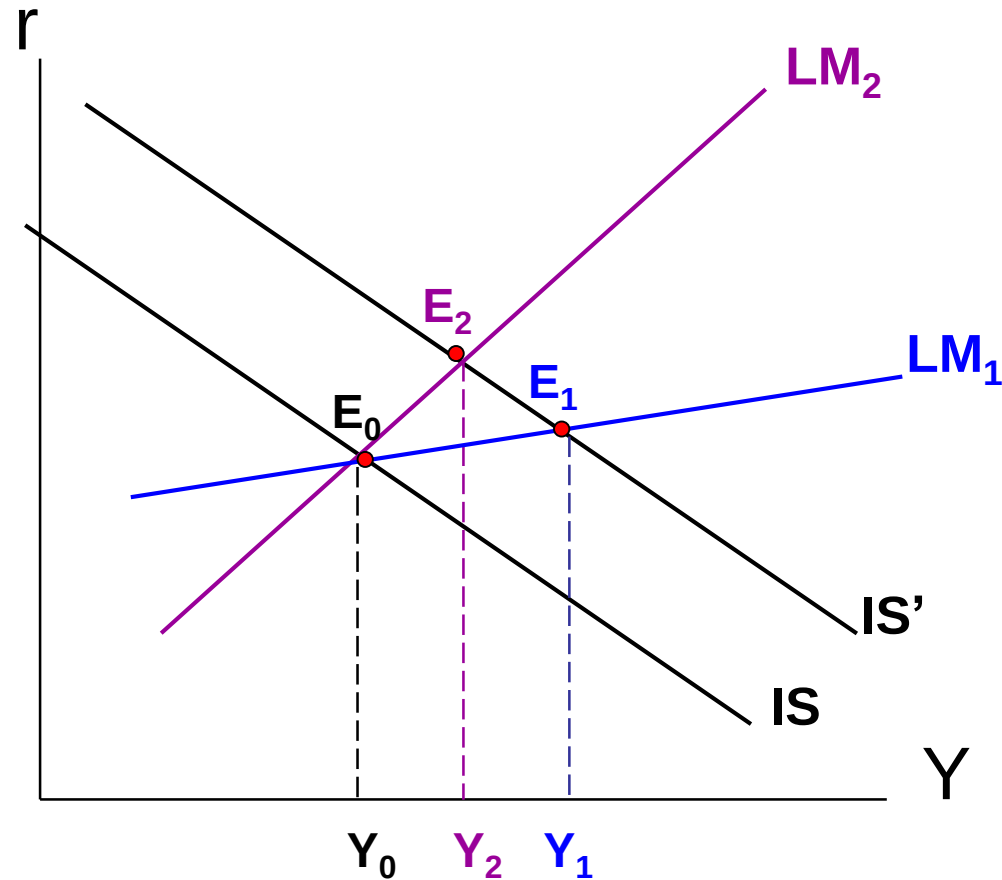
• crowding-out effect a little $\Rightarrow$ Net change in Y, $Y \uparrow \text{ a lot } \Rightarrow$ **Fiscal policy is very effective**



7.1.2 Fiscal policy effectiveness and slope of LM curve

(a) LM is quite flat

(b) LM is quite steep



7.1.2 Fiscal policy effectiveness and slope of LM curve

(a) LM curve is quite flat: suppose due to **high** $\varepsilon_{M^d, r} = \frac{\Delta M^d}{\Delta r} \times \frac{r}{M^d}$

• $G \uparrow \Rightarrow DAE \uparrow \Rightarrow Y \uparrow \uparrow$, $\Delta Y = \text{multiplier} \times \Delta G$

• $Y \uparrow \uparrow \Rightarrow M^d \uparrow \Rightarrow r \uparrow \text{ a little} \Rightarrow I \downarrow \text{ a little} \Rightarrow DAE \downarrow \text{ a little} \Rightarrow Y \downarrow \text{ a little}$

• crowding-out effect a little

$\Rightarrow$ Net change in Y,
 $Y \uparrow \text{ a lot}$

$\Rightarrow$ **Fiscal policy is very effective**

(b) LM curve is quite steep: suppose due to **low** $\varepsilon_{M^d, r} = \frac{\Delta M^d}{\Delta r} \times \frac{r}{M^d}$

• $G \uparrow \Rightarrow DAE \uparrow \Rightarrow Y \uparrow \uparrow$, $\Delta Y = \text{multiplier} \times \Delta G$

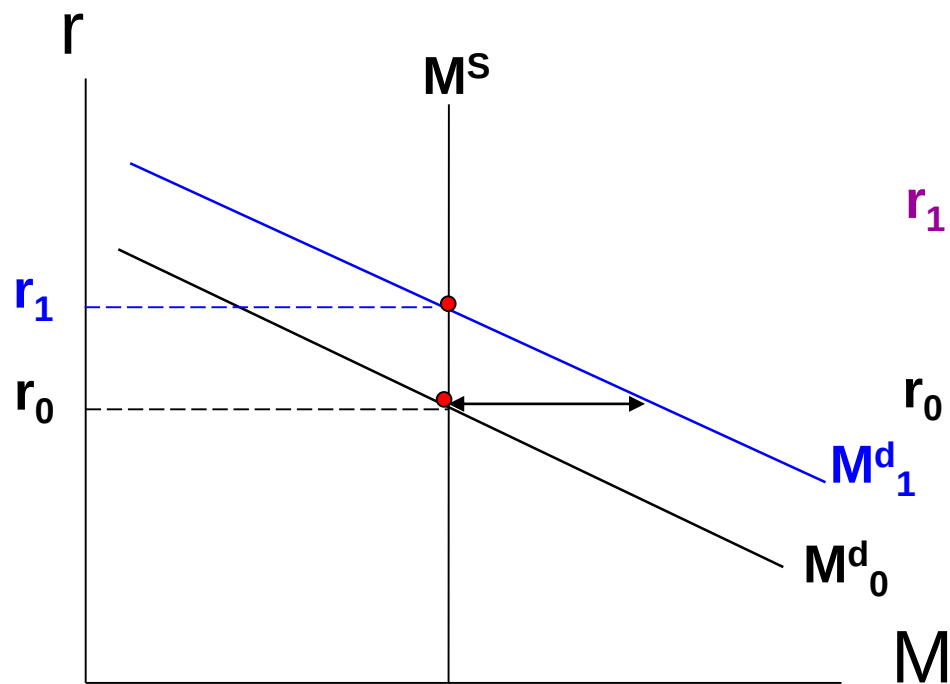
• $Y \uparrow \uparrow \Rightarrow M^d \uparrow \Rightarrow r \uparrow \text{ a lot} \Rightarrow I \downarrow \text{ a lot} \Rightarrow DAE \downarrow \text{ a lot} \Rightarrow Y \downarrow \text{ a lot}$

• crowding-out effect a lot

$\Rightarrow$ Net change in Y,
 $Y \uparrow \text{ a little}$

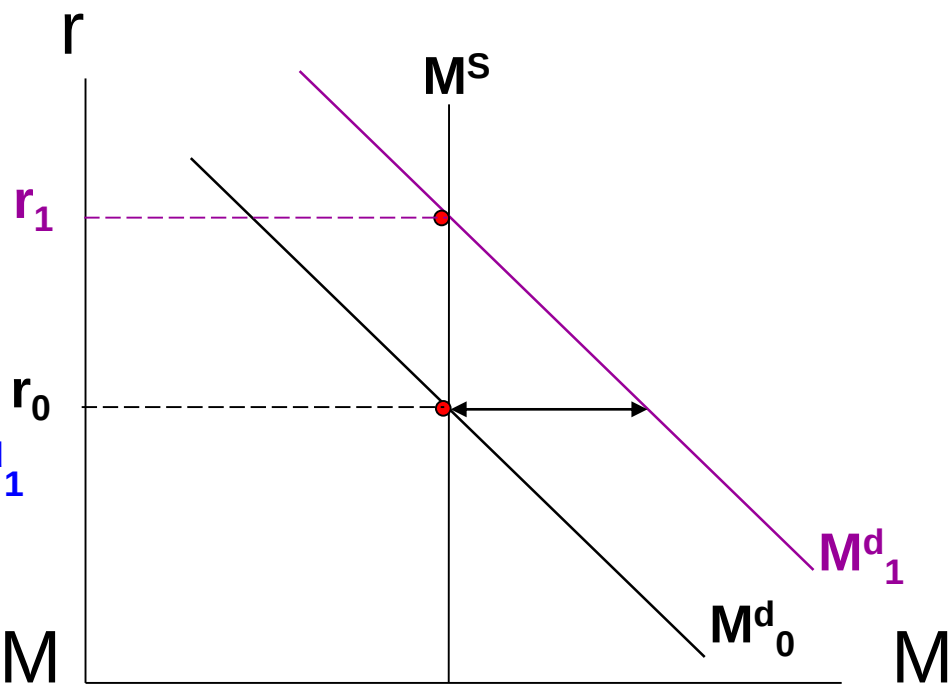
$\Rightarrow$ **Fiscal policy is not that effective**

$\mathcal{E}_{Md, r}$ high

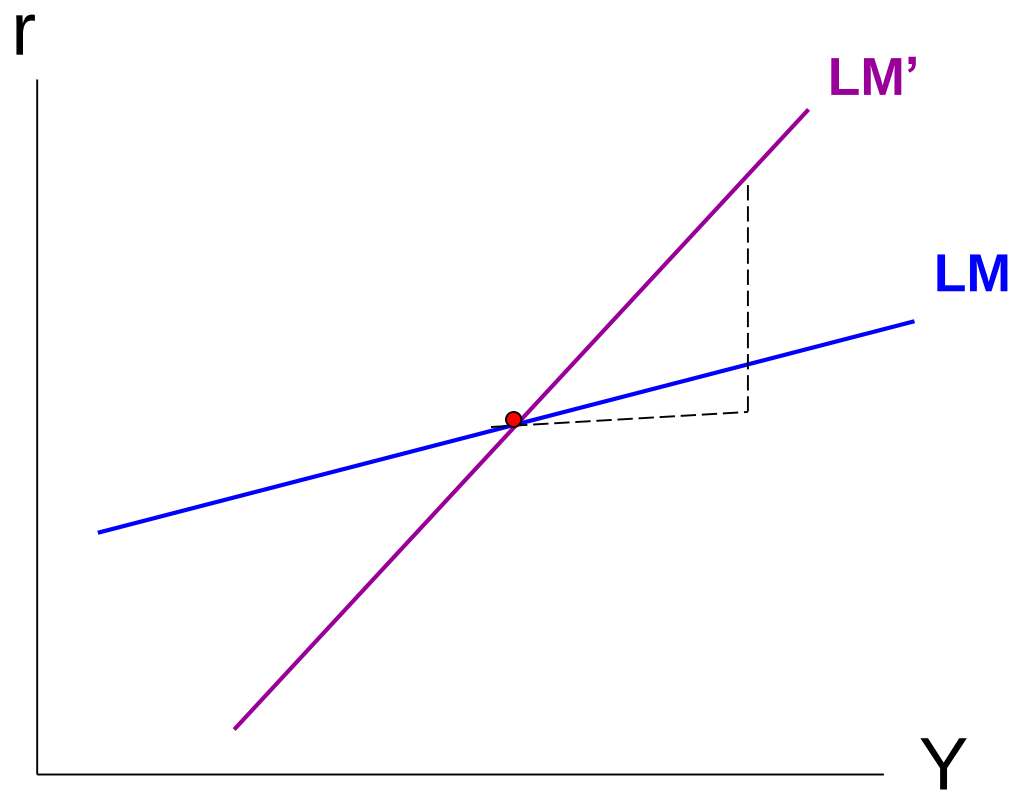


LM is quite flat

$\mathcal{E}_{Md, r}$ low



LM is quite steep



7.1.2 Fiscal policy effectiveness and slope of LM curve

(a) LM curve is quite flat: suppose due to **low** $\varepsilon_{M^d, Y} = \frac{\Delta M^d}{\Delta Y} \times \frac{Y}{M^d}$

• $G \uparrow \Rightarrow DAE \uparrow \Rightarrow Y \uparrow \uparrow$, $\Delta Y = \text{multiplier} \times \Delta G$

• $Y \uparrow \uparrow \Rightarrow M^d \uparrow \text{ a little} \Rightarrow r \uparrow \text{ a little} \Rightarrow I \downarrow \text{ a little} \Rightarrow DAE \downarrow \text{ a little} \Rightarrow Y \downarrow \text{ a little}$

• crowding-out effect a little

$\Rightarrow$ Net change in Y,
 $Y \uparrow \text{ a lot}$

$\Rightarrow$ **Fiscal policy is very effective**

(b) LM curve is quite steep: suppose due to **high** $\varepsilon_{M^d, Y} = \frac{\Delta M^d}{\Delta Y} \times \frac{Y}{M^d}$

• $G \uparrow \Rightarrow DAE \uparrow \Rightarrow Y \uparrow \uparrow$, $\Delta Y = \text{multiplier} \times \Delta G$

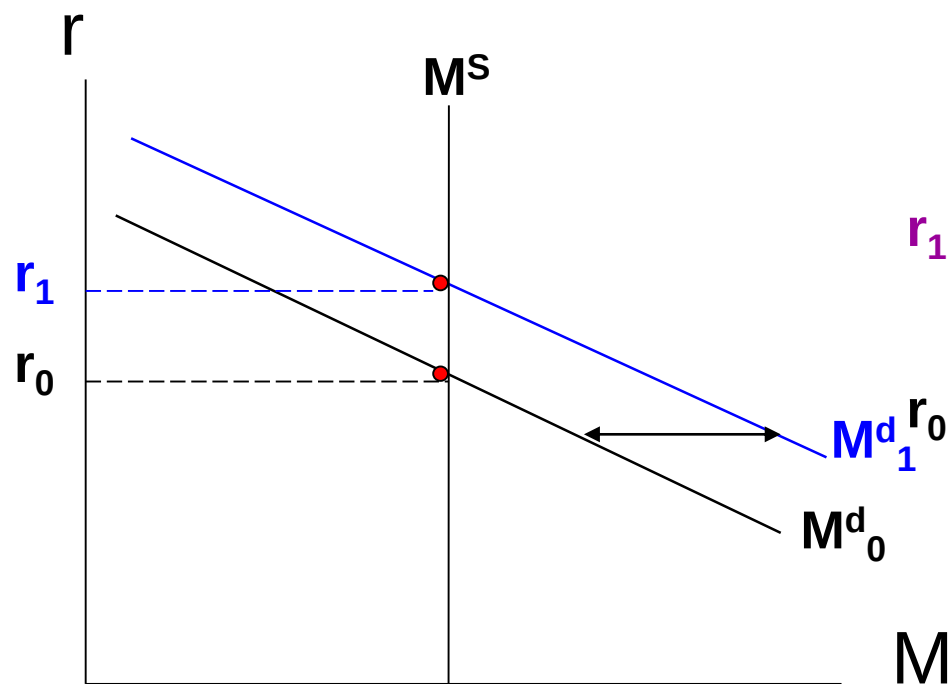
• $Y \uparrow \uparrow \Rightarrow M^d \uparrow \text{ a lot} \Rightarrow r \uparrow \text{ a lot} \Rightarrow I \downarrow \text{ a lot} \Rightarrow DAE \downarrow \text{ a lot} \Rightarrow Y \downarrow \text{ a lot}$

• crowding-out effect a lot

$\Rightarrow$ Net change in Y,
 $Y \uparrow \text{ a little}$

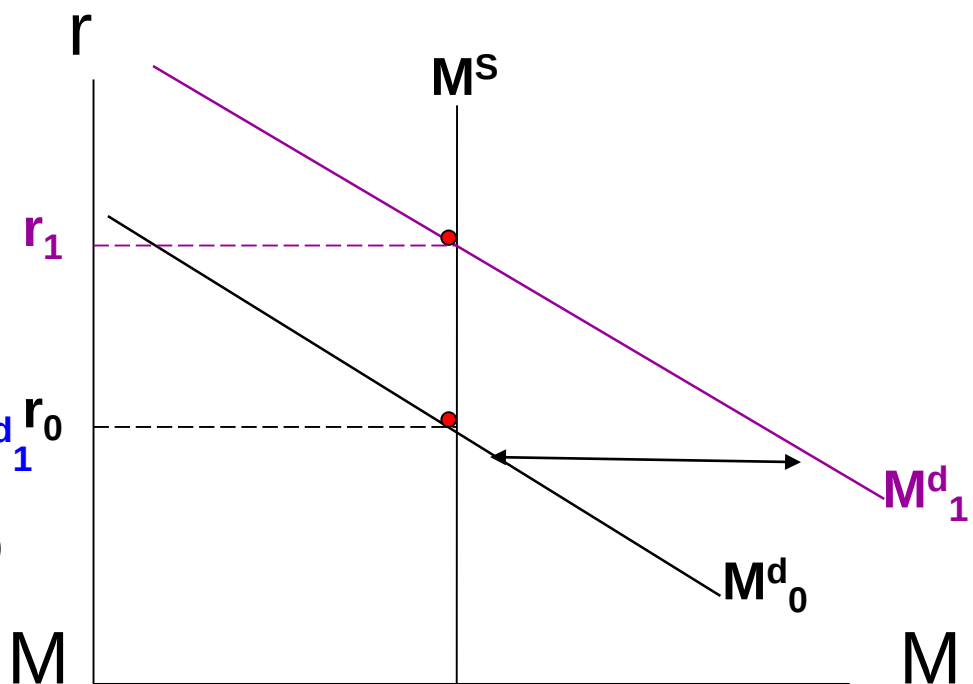
$\Rightarrow$ **Fiscal policy is not that effective**

$\varepsilon_{M^d, Y}$ low



M^d shifts a little

$\varepsilon_{M^d, Y}$ high



M^d shifts a lot