

7. Policy Effectiveness

EE 212

(2/2012), sec:046042

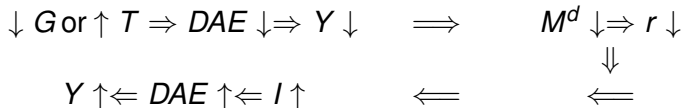
March 2013

- Continued from Page 12
- Fiscal Policy crowding out effect
- Ch 7 Fiscal Policy Effectiveness

- $G \uparrow T \downarrow \Rightarrow Y \uparrow$ or $Y \downarrow$ depending on the relative size of the two effect
- Effectiveness of fiscal policy
 - $G \uparrow T \downarrow \xRightarrow{\text{Strongly causes}} Y \uparrow$
 - $G \downarrow T \uparrow \xRightarrow{\text{Strongly causes}} Y \downarrow$
- Crowding out effect weakens the effect of expansionary fiscal policy.
- Contractionary Fiscal Policy

Commodity Market

Money Market



- Two effects :a negative effect and a positive one
- Crowding out effect usually refers to “ the offsetting reduction in private expenditure caused by the rise in interest rates that follows an expansionary fiscal policy”

- When the fiscal policy is effective?
- \Rightarrow when the second effect is
- What are the conditions for a small second effect?
 - $\frac{\Delta M^d}{\Delta r}$ is (M^d is)
 - $\frac{\Delta I}{\Delta r}$ is (I is)
 - Fiscal policy is
- On the contrary, the second effect is large when
 - $\frac{\Delta M^d}{\Delta r}$ is small (M^d is steep)
 - $\frac{\Delta I}{\Delta r}$ is large (I is flat)
 - Fiscal policy is ineffective.

Commodity Market

Money Market

$$\begin{array}{ccc} \uparrow G \text{ or } \downarrow T \Rightarrow DAE \uparrow \Rightarrow Y \uparrow & \Longrightarrow & M^d \uparrow \Rightarrow r \uparrow \\ & & \downarrow \\ Y \downarrow \Leftarrow DAE \downarrow \Leftarrow I \downarrow & \Longleftarrow & \Longleftarrow \end{array}$$

- Notice that the investment multiplier is equal to the government multiplier.
- When money demand is inelastic, the effect of Y on r is strong.
- The second effect will bring about a big change in r and I as a consequence.
- Given the size of ΔG , ΔI could be bigger.
- Although $\frac{\Delta Y}{\Delta G} = \frac{\Delta Y}{\Delta I}$, ΔI is bigger than ΔG .
- Hence, the first effect can be smaller than the second effect.