Fiscal Policy-Part 3

\[ \eta = \frac{\Delta M}{M} - \frac{\Delta Y}{Y} = 0 \]

The Argument

• The myth:
  – Increased Government Spending causes inflation.

• The reality:
  – It is a complicated story.

Must Increased Government Spending cause Inflation?

\[ G = \nu Y \]

\[ \frac{\Delta M}{M} = \frac{\Delta Y}{Y} \]

• Finance via wage taxes and money.
• There is no government debt.

Must Increased Spending be Inflationary?

• Increase G from \( \nu Y \) to \( \nu'Y \).
• Finance with a tax on interest income

\[ M_t^d = \xi \frac{1 + r^N}{r^N} C_t \]

The Net Effect

\[ M_t^d = \xi \frac{1 + (1 - \lambda_r) r^N}{(1 - \lambda_r) r^N} C_t \]
The Net Effect

- Y curve shifts up and to the right
- M curve shifts down and to the left.

Effect on price level as shown here is deflationary.
Interest rate rises.

Permanent Effects

\[ \eta = \frac{\Delta M}{M} - \frac{\Delta Y}{Y} = 0 \]

No permanent change in inflation rate.

Conclusions

- Government spending has no impact on long run inflation rate.
- It can have an impact on short run inflation rate.

- Of course, if we finance spending by printing money, that is inflationary.
End