Government and the Demand for Loans

\[ D = I - S + (G-T) + (X-M) \]

Our Graph

- The government deficit enters our equation.

Two key phrases: 
- Ceteribus Paribus (other things equal)
- Mutatis Mutandis (changing what must be changed)
A $300 Gift

- Suppose the government gives everyone a one-time tax rebate this year of $300. What happens?

Ceteribus Paribus

- Suppose the government must borrow $300 so the demand for loans curve shifts up and to the right.

The government must borrow $300 so the demand for loans curve shifts up and to the right. Interest rates rise. The balance on current account worsens and investment falls.

Ceteribus Paribus

- Suppose the government must borrow $300 so the demand for loans curve shifts up and to the right.

Mutatis Mutandis

- What do consumers do with the $300?

Life Cycle Consumption

- What do consumers do with the $300?

Even if consumers thought the $300 was a gift, they would save most of it, reducing the demand for loans.

Wealth Effects

- What do consumers do with the $300?

Moreover, the government borrowing means additional taxes in the future. With a bequest motive, no change in wealth.
Wealth Effects

Even if consumers thought the $300 was a gift, they would save most of it, reducing the demand for loans. Moreover, the government borrowing means additional taxes in the future. With a bequest motive, no change in wealth. In the limit, no change in interest rates, investment, or the balance on current account.

Where This Leaves Us

• These are the things of which controversies (& homework & exam questions) are made.

Stay tuned

End

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