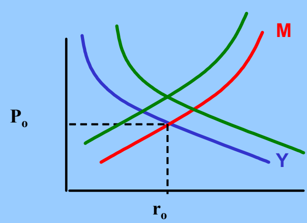
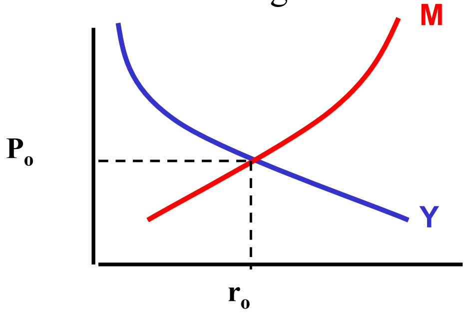
Fiscal Policy-Part 1



The Argument

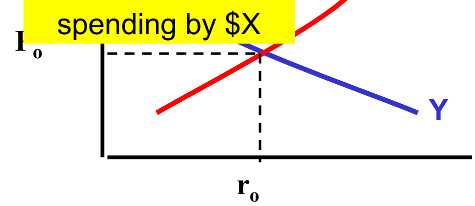
- The myth:
  - Increased Government Spending causes inflation.
- The reality:
  - It is a complicated story.

Our Starting Point



An Example

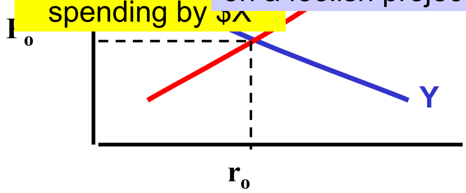
Suppose the government decides to increase spending by $X



An Example

Suppose the government decides to increase spending by $X

A one period spending increase on a foolish project

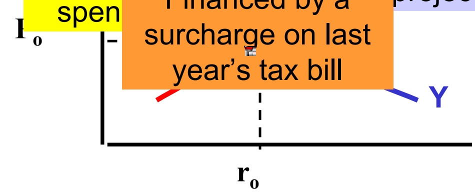


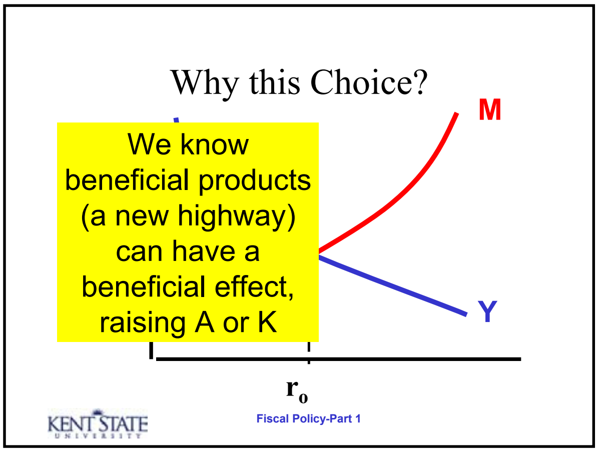
An Example

Suppose the government decides to increase spending by $X

A one period spending increase on a foolish project

Financed by a surcharge on last year's tax bill




Why this Choice?
M
We know beneficial products (a new highway) can have a beneficial effect, raising A or K
Y
r_o
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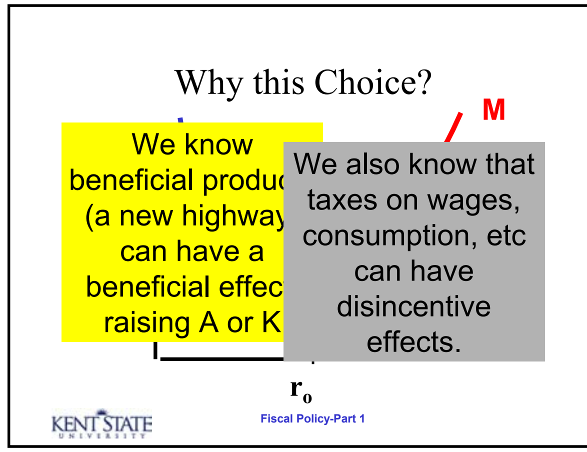
Why this Choice?
M
We know beneficial produc (a new highway can have a beneficial effec raising A or K
We also know that taxes on wages, consumption, etc can have disincentive effects.
r_o
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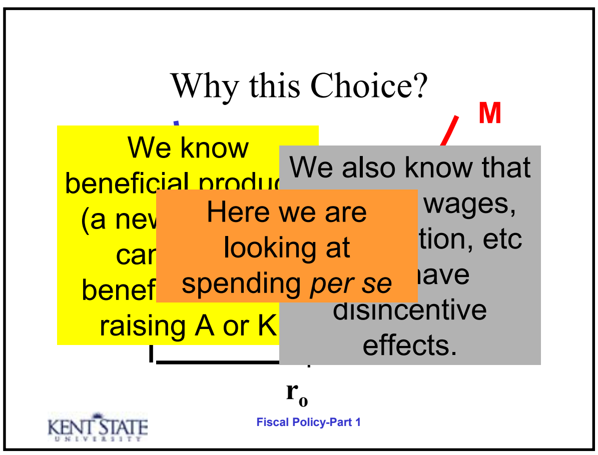
Why this Choice?
M
We know beneficial produc (a nev car benef raising A or K
We also know that wages, tion, etc ave disincentive effects.
Here we are looking at spending *per se*
r_o
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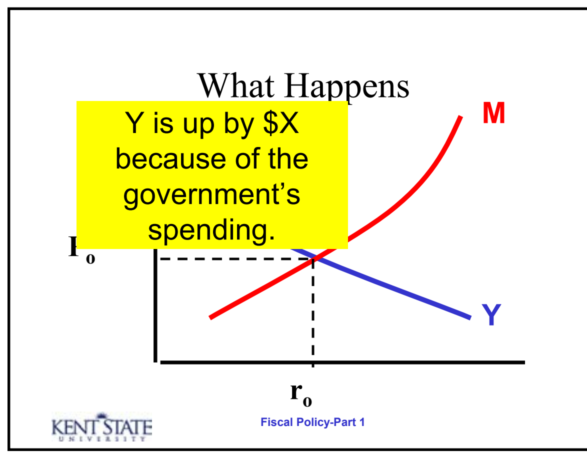
What Happens
M
Y is up by $X because of the government's spending.
Y
r_o
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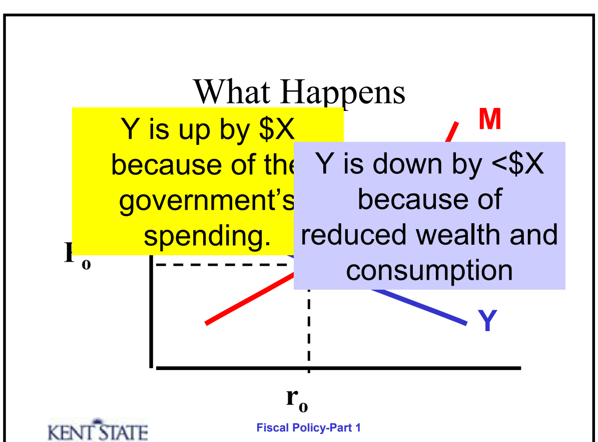
What Happens
M
Y is up by $X because of the government's spending.
Y is down by <$X because of reduced wealth and consumption
Y
r_o
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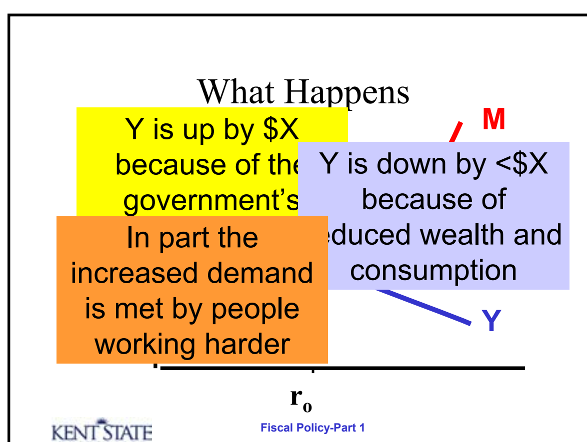
What Happens
M
Y is up by $X because of the government's
Y is down by <$X because of educed wealth and consumption
In part the increased demand is met by people working harder
Y
r_o
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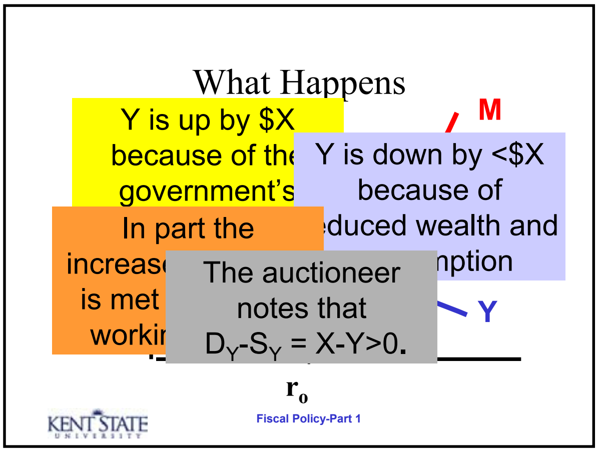
What Happens
Y is up by $X
because of the
government's
Y is down by <$X
because of
educed wealth and
nption
In part the
increas
is met
workir
The auctioneer
notes that
D_Y-S_Y = X-Y>0.
M
Y
r_o
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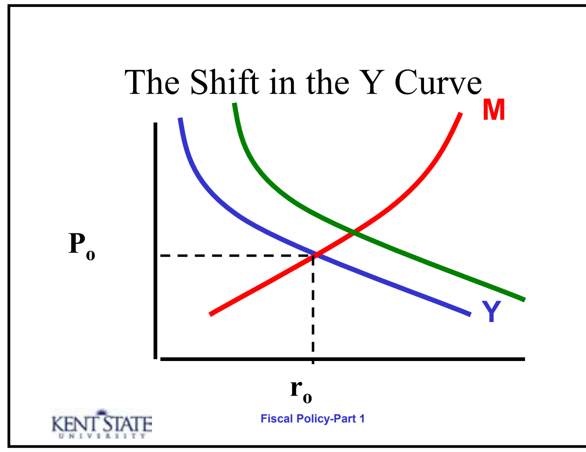
The Shift in the Y Curve
M
P_o
Y
r_o
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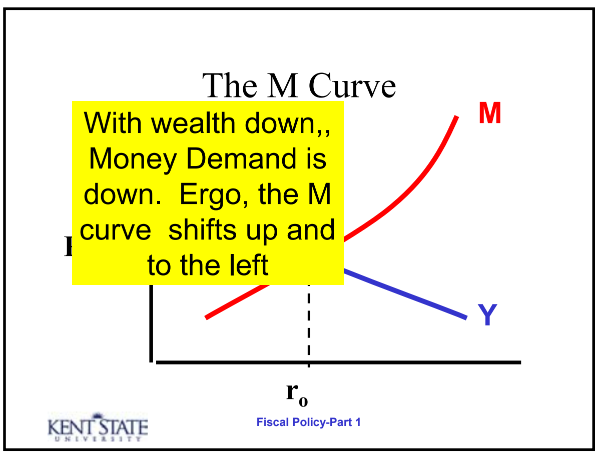
The M Curve
With wealth down,,
Money Demand is
down. Ergo, the M
curve shifts up and
to the left
M
Y
r_o
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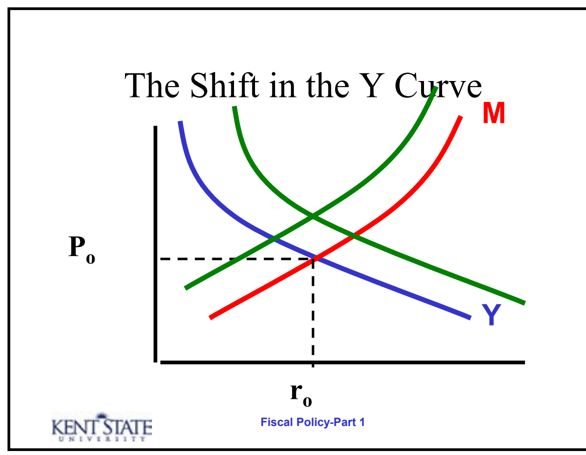
The Shift in the Y Curve
M
P_o
Y
r_o
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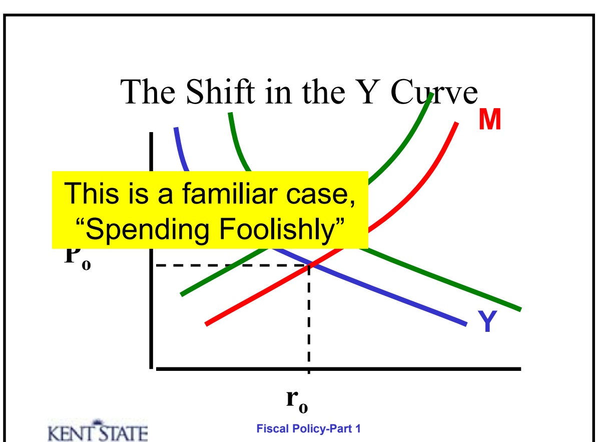
The Shift in the Y Curve
M
This is a familiar case,
"Spending Foolishly"
Y
r_o
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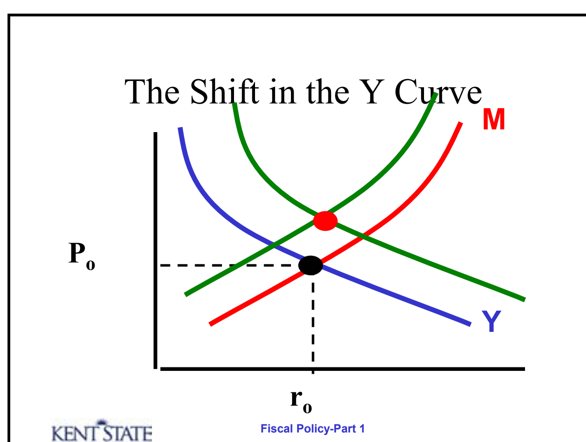
The Shift in the Y Curve
M
P_o
Y
r_o
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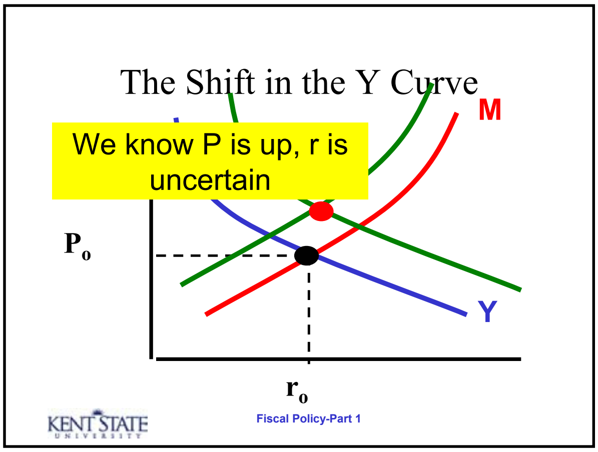
The Shift in the Y Curve
We know P is up, r is uncertain
M
P0
Y
r0
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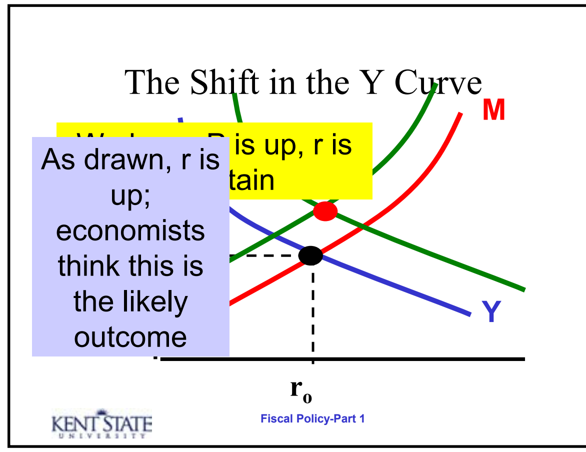
The Shift in the Y Curve
As drawn, r is up; economists think this is the likely outcome
is up, r is
tain
M
Y
r0
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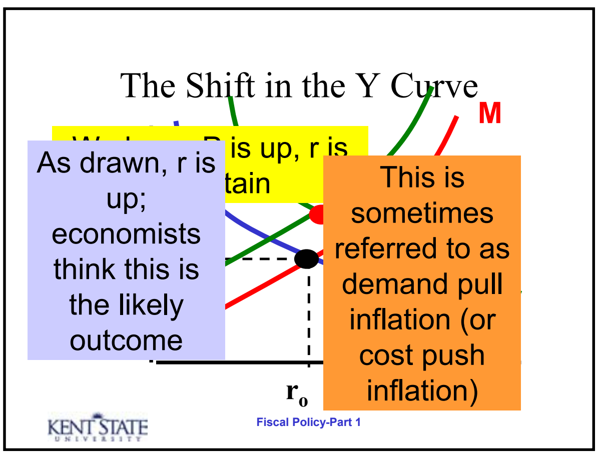
The Shift in the Y Curve
As drawn, r is up; economists think this is the likely outcome
is up, r is
tain
This is sometimes referred to as demand pull inflation (or cost push inflation)
M
r0
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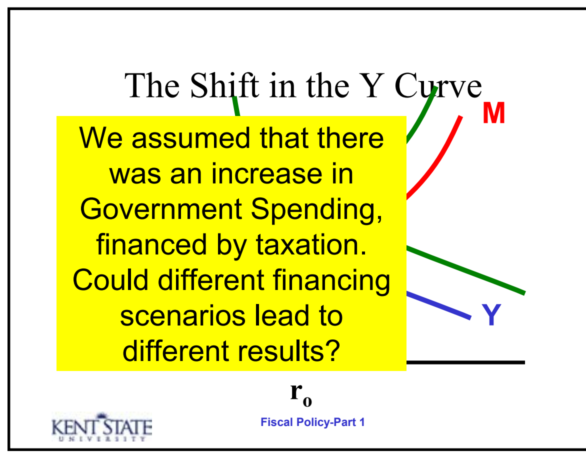
The Shift in the Y Curve
We assumed that there was an increase in Government Spending, financed by taxation. Could different financing scenarios lead to different results?
M
Y
r0
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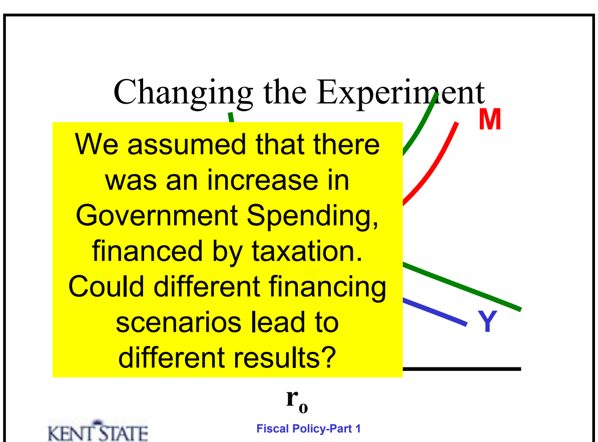
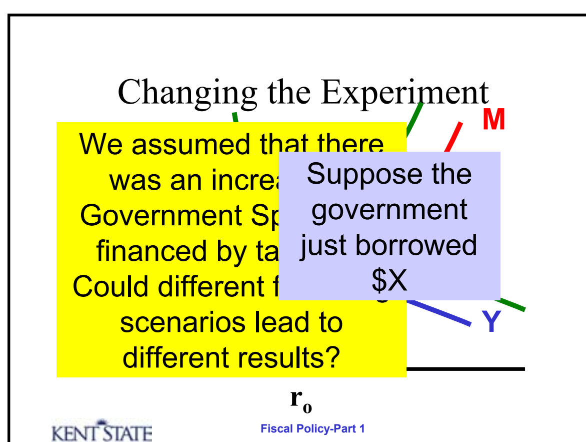

Changing the Experiment
We assumed that there was an increase in Government Spending, financed by taxation. Could different financing scenarios lead to different results?
M
Y
r0
Fiscal Policy-Part 1
KENT STATE


Changing the Experiment
We assumed that there was an increa Government Sp financed by ta Could different f scenarios lead to different results?
Suppose the government just borrowed $X
M
Y
r0
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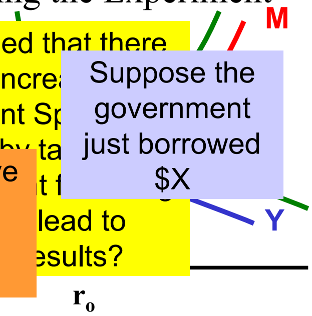
Changing the Experiment

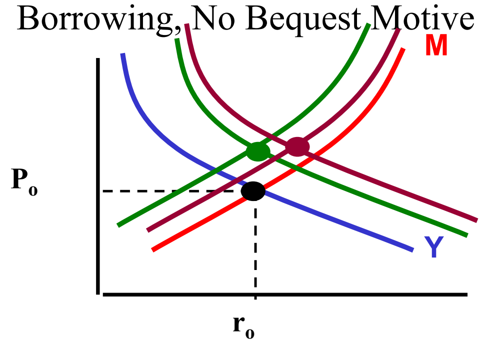


We assumed that there was an increa
Government Sp
financed by ta
t f
lead to
esults?

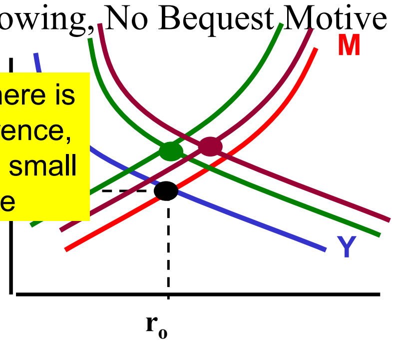
Suppose the government just borrowed $X

If people have a bequest motive, no change

Borrowing, No Bequest Motive



Borrowing, No Bequest Motive



Here there is a difference, albeit a small one

End