

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?

$$G = vY$$

$$\frac{\Delta M}{M} = \frac{\Delta Y}{Y}$$

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

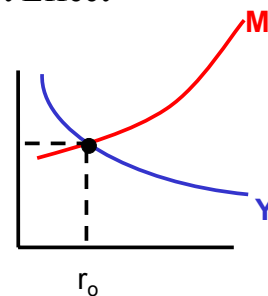
Must Increased Spending be Inflationary?

- Increase G from vY to $v'Y$.
- Finance with a tax on interest income

$$M_t^d = \xi \frac{1 + r_N}{r_N} C_t$$

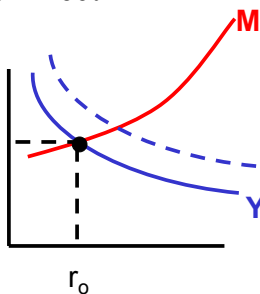
$$M_t^d = \xi \frac{1 + (1 - \lambda_r)r_N}{(1 - \lambda_r)r_N} C_t$$

The Net Effect



The Net Effect

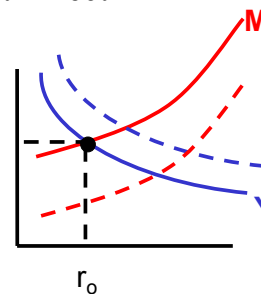
- Y curve shifts up and to the right



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The Net Effect

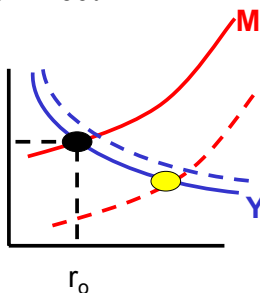
- Y curve shifts up and to the right
- M curve shifts down and to the left.



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The Net Effect

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



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Permanent Effects

$$\eta = \frac{\Delta M}{M} - \frac{\Delta Y}{Y} = 0$$

No permanent change in inflation rate.

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Conclusions

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

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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.**

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End

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