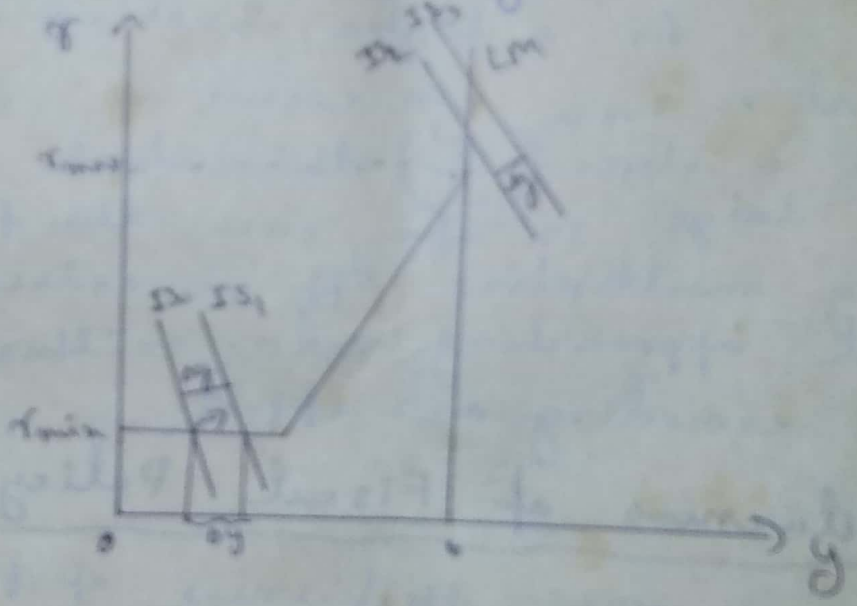
Crowding - out - effect :- [Shocker note]

In multiplier process when we consider the existence of the money market, then there emerges the "crowding-out effect".

Through multiplier process due to rise in govt. expenditure when income starts to increase it raises transaction demand for money in money market. Remaining price level and money supply constant, rate of interest goes up; following the rise in rate of interest, the interest induced part of investment, I(r), goes down and multiplier effect on income is reduced to some extend. This is called the crowding-out effect.



In presence of money market, govt. expenditure multiplier is $\frac{dy}{dg} = \frac{1}{\left[1 - c'(1-t') + \frac{a'k'}{s'}\right]}$ ∴ A = the effectiveness of crowding out effect

depends largely on the presence and adjustment in money market, here in multiplier the term $\frac{i'k'}{d'}$ measures the crowding out effect. In absence of money market multiplier becomes

$$\frac{dy}{dg} = \frac{1}{1 - c'(1-t')}$$

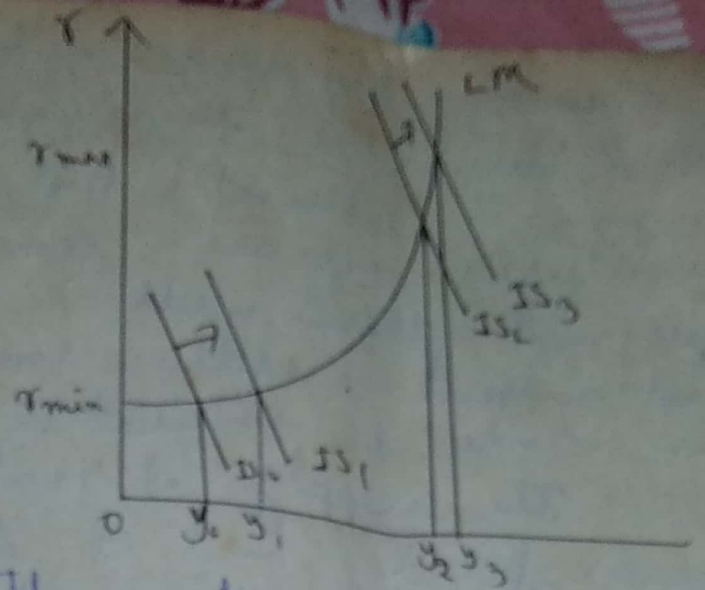
Since, $\frac{i'k'}{d'} > 0$, multiplier effect in absence of crowding out effect) multiplier effect in presence of crowding out effect.

At the very low level of interest, as at $r = r_{min}$, LM is horizontal. So its slope $\left(\frac{k'}{d'}\right)$ is zero. So there is no crowding out effect.

As a higher level of interest as at $r = r_{max}$ LM curve is vertical with a slope $\left(=\frac{k'}{d'}\right)$ this which is very large. In this case the fiscal policy multiplier $\frac{dy}{dg}$ is extremly small approaching zero. So there is full crowding-out effect.

Effectiveness of Fiscal Policy:-

The effectiveness of fiscal policy depends on whether the policy is initiated at a low or high level of output relative to the full-employment output.



The govt. expenditure multiplier $\frac{dy}{dg} = \frac{1}{\left[1 - c^1(1-t^1) + \frac{i^1 k^1}{l^1}\right]}$ also ensures the above fact. At this initial equilibrium y_0, the LM curve is relatively flat. So that its slope $\left(-\frac{k^1}{l^1}\right)$ is nearly zero. This gives a large fiscal policy multiplier nearly equal to $\frac{1}{1 - c^1(1-t^1)}$, the simple money market effect.

At equilibrium output y_2 the LM curve is nearly vertical with a slope $\left(-\frac{k^1}{l^1}\right)$ which is ~~vertical with a~~ very large. Here the fiscal policy multiplier is extremely small approaching towards zero.

Hence the size of fiscal policy multiplier depends on the slope of the LM schedule. At the initial equilibrium point, due to ~~change~~ a given increase in govt. expenditure the shift in IS schedule will yield a large increase in income;

if the economy begining with a low output level (i.e high unemployment) and low rate of interest. But if the govt. expenditure increase comes near fullemployment there will be little effect at output, with a large increase rate of interest.

The supply of real money balances is fixed and it determines the ~~position~~ position of LM. At low level of (r-y) there is a lot of money in speculative balances that can be drawn-out to finance a higher level of transaction, i.e a higher y, by a small increase in interest rate. But at the high level of (r-y) there is very small amount of speculative balances. The increase in demand for money due to a rising y, serves mostly to raise r, reducing investment, rather than bringing out the funds of speculative balance in any substantial amount.

Effectiveness of monetary policy:-

Ans:- We take the answer from the page no. 93 of the book which is knows as 'Branson'.