

Introduction to Economics

Topic 9 (Macroeconomics): Economic policy

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Overview



1. Demand policies: fiscal policy and monetary policy

Goal: What fiscal policy is and why it is an important tool in managing economic fluctuations.
How monetary policy affects aggregate output in the short-run

1. Demand policies: fiscal policy and monetary policy
 - 1.1. Fiscal policy

Fiscal Policy: The Basics



Instruments:

- Taxes
- Purchases of Goods and Services
- Government Transfers
- Borrowing

How do tax policy and government spending affect the economy?

Let's recall the basic equation of national income accounting:

$$GDP = C + I + G + (X - IM)$$

The government directly controls only one of the variables on the right-hand side. But that's not the only effect fiscal policy has on aggregate spending in the economy. Through changes in taxes and transfers, it also influences consumer spending.

Fiscal Policy: The Budget



The budget balance is the difference between (tax) revenue and government spending.

The budget surplus is when (tax) revenue exceeds government spending.

The budget deficit is when government spending exceeds (tax) revenue.

$$\text{Budget Balance} = T - G - TR$$

Fiscal Policy: Tax Revenue



Tax revenue is the income that is gained by governments because of taxation of households and firms.

The term **direct tax** generally means a tax paid directly to the government by the persons or firms on whom it is imposed.

An **indirect tax** may increase the price of a good so that consumers are actually paying the tax by paying more for the products.

Fiscal Policy



Fiscal policy causes a shift of the aggregate demand curve of the economy.

Quiz - *Why would the government want to shift the aggregate demand curve?*

Fiscal Policy

Expansionary fiscal policy increases aggregate demand.

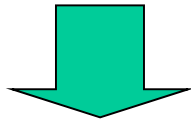
- A cut in taxes (T)
- An increase in government transfers (TR)
- An increase in government purchases (G)

Contractionary fiscal policy reduces aggregate demand.

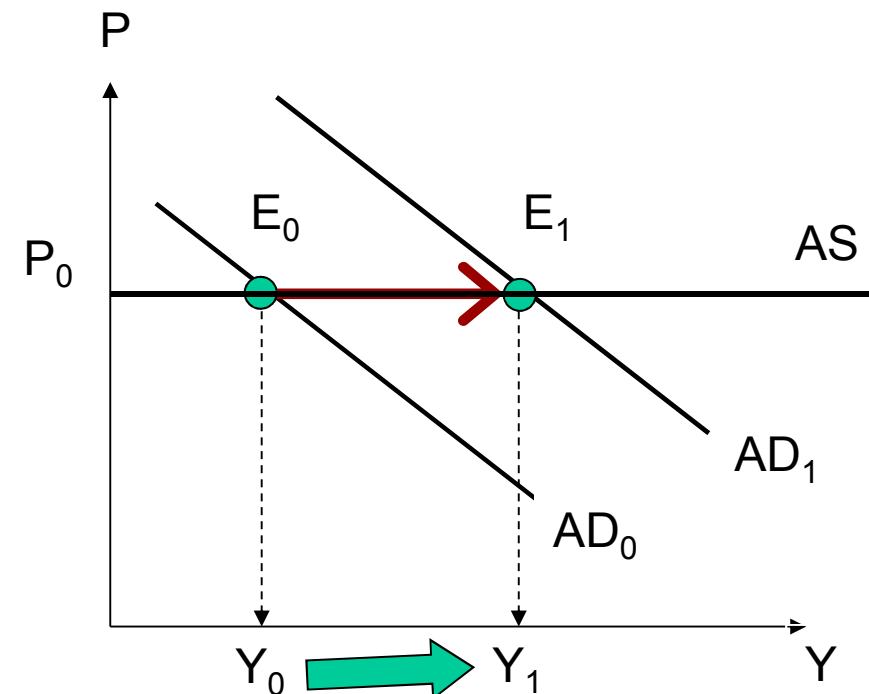
- An increase in taxes (T)
- A cut in government transfers (TR)
- A cut in government purchases (G)

Expansionary Fiscal Policy

$\uparrow G, \uparrow TR, \downarrow T$

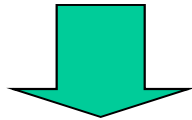


$-AD \rightarrow \uparrow$ aggregate output and employment

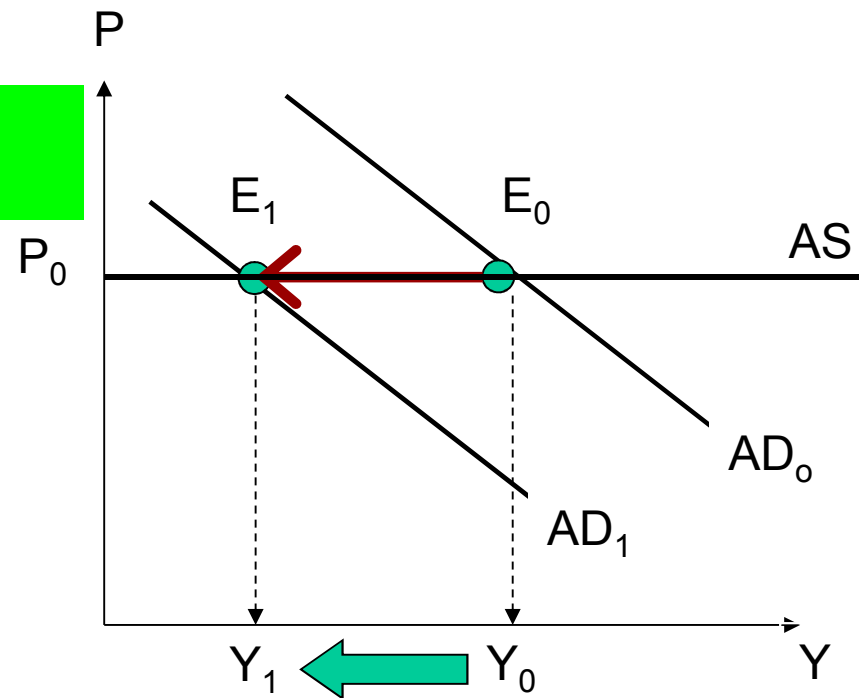


Contractionary Fiscal Policy

$\downarrow G, \downarrow TR, \uparrow T$



$\downarrow AD \rightarrow \downarrow$ aggregate output and employment



Fiscal Policy: The Budget II



$$\text{Budget Balance} = T - G - TR$$

Expansionary fiscal policy either increases the budget deficit or reduces the budget surplus.

Contractionary fiscal policy either reduces the budget deficit or reduces the budget surplus.

1. Demand policies: fiscal policy and monetary policy
 - 1.2. Monetary policy

Quiz – *What do you know about the European Central Bank (ECB)?*

Monetary Policy



Two things to keep in mind:

(1) $M = EMP + D$

(2) The interest rate is set in the market of money (money supply – money demand)

Monetary Policy

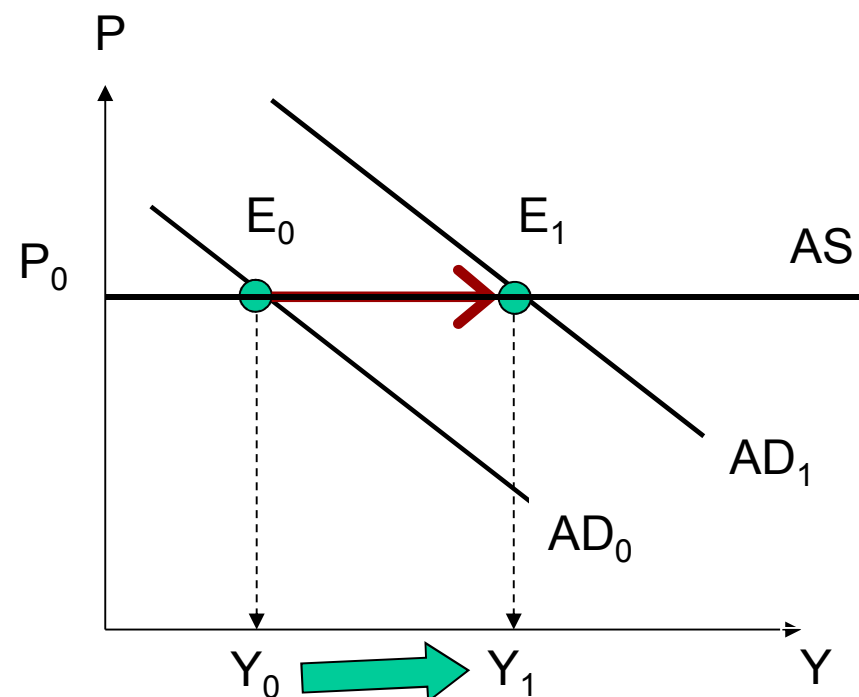


Instruments:

- **Open-market operations:** Purchase or sale of government debt.
- **Granting credits to banks.**

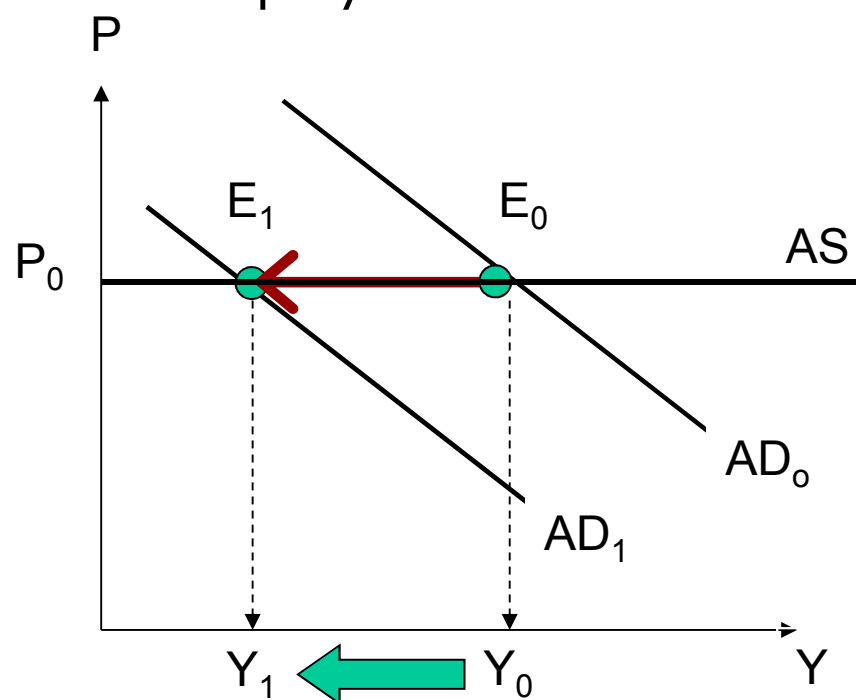
Expansionary Monetary Policy

$\uparrow M \rightarrow$ money supply surplus $\rightarrow \downarrow$ interest rate (price of money) $\rightarrow$
 $\uparrow$ investment spending $\rightarrow \uparrow AD \rightarrow \uparrow$ aggregate output and employment.



Contractionary Monetary Policy

↓M → money demand surplus → ↑ interest rate (price of money) →
↓ investment spending → ↓ AD → ↓ aggregate output and employment.



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