

Suggested Solutions to Assignment 4

Part B **True/ False/ Uncertain Questions** **[20 marks]**

Each question is worth 5 marks.

Explain why the following statement is True, False, or Uncertain according to economic principles. Use diagrams and / or numerical examples where appropriate. Unsupported answers will receive no marks. It is the explanation that is important.

B-1 A contractionary fiscal policy can control a demand-pull inflation in a closed economy.

True.

When an economy has an inflationary gap caused by excessive growth of aggregate demand, the demand-pull inflation occurs. A contractionary fiscal policy can control the inflationary pressure on prices. Refer to Figure 9-2 from the text book (10th ed.). Assume that a shift of the aggregate demand curve from AD_2 to AD_3 increases the GDP from the full-employment level (GDP_f) to GDP_0 and the price level from P_2 to P_3 . This increase in aggregate demand might have resulted from a sharp increase in, say, consumption, investment or net export spending. To control this situation the government has three contractionary fiscal policy options: (1) decrease government spending, (2) raise taxes, or (3) use some combination of these two policies. Any of these three policies can reduce aggregate demand so that the aggregate demand curve shifts leftward from AD_3 to AD_2 . Real output returns to the full-employment level of GDP at GDP_f .

B-2 A net export effect may partially reinforce an expansionary fiscal policy.

False.

A net export effect may partially offset an expansionary fiscal policy. For example, assume that the Canadian economy is going through a period of recession or slow growth, that is, the current output is below the full-employment level of output. The government undertakes expansionary fiscal policy by increasing government spending to raise the aggregate demand, which in turn, will help to increase the output. Because of this expansionary fiscal policy during the recession, the government has to incur a budget deficit. To finance this budget deficit, the government has to borrow funds in the money market, which in turn, will increase the demand for money. As a result, the price paid for borrowing money, which is the interest rate, increases. The higher Canadian interest rate will attract financial capital from abroad, where interest rates are unchanged. But foreign investors must acquire Canadian dollars to invest in Canadian securities. That means, the demand for Canadian dollars will increase, which will raise the price of Canadian dollar in terms of foreign currencies- that is, the dollar appreciates.

Because of the appreciation of the dollar, Canadian goods and services will become relatively more expensive to the rest of the world. Canadians, who can now exchange their dollars for more units of foreign currencies, will find foreign goods and services relatively cheaper. Consequently, the Canadian exports will fall and imports will rise, leading to a decrease in Canadian net exports. This decrease in the net exports will decrease the aggregate demand, partially offsetting the rise in the aggregate demand resulting from the expansionary fiscal policy.

This point can be illustrated with the AD-AS diagram like Figure 9-5 of the text (10th ed.). An expansionary fiscal policy aimed at increasing aggregate demand from AD_0 to AD_1 may hike the domestic interest rate and ultimately reduce net exports through the process just described. Because of this decline in net exports, the aggregate demand curve will shift rightward from AD_0 to AD_1' , not to AD_1 , and equilibrium GDP will not increase as much.

B-3 The crowding-out effect from government borrowing to finance the public debt is reduced when public investment complements private investment.

True.

Some public and private investments are complementary. Thus, the public investment financed through the debt could spur some private sector investment by increasing its expected rate of return. For example, a federal building in a city may encourage private investment in the form of nearby office buildings, shops, and restaurants.

Refer to the Figure 10-2 of the text (10th ed.). If the investment demand (I_{d1}) is fixed, the increase in the interest rate from 6 percent to 10 percent caused by financing a large public debt will crowd out \$10 billion of private investment and decrease the size of the capital stock inherited by future generations. However, if the government spending enabled by the debt improves the profit expectations of businesses, the private investment demand curve will shift rightward, as from I_{d1} to I_{d2} . That shift may offset the crowding-out effect wholly or in part. In this case, the crowding-out effect is wholly offset.

B-4 The pursuit of an annually balanced budget policy can stabilize the business cycle to some extent.

False.

An annually balanced budget is not compatible with government fiscal activity as a stabilizing force. Indeed, an annually balanced budget can intensify the business cycle. For example, assume that the Canadian economy experiences an onset of unemployment and falling incomes. In such circumstances tax receipts of both the federal and provincial governments automatically decline. To balance its budget, government must either (1) increase tax rates, (2) reduce government expenditures, or (3) do both. But all three policies are contractionary; each further dampens, rather than expands, aggregate demand.

Similarly, an annually balanced budget will intensify an inflationary gap. As nominal incomes rise in an over-heated economy, tax revenues automatically increase. To avoid the impending surplus, government must either (1) cut tax rates, (2) increase government expenditures, or (3) do both. But any of these policies adds to inflationary pressures.

Therefore, an annually balanced budget is not neutral. The pursuit of such a policy can intensify the business cycle, not dampen it.