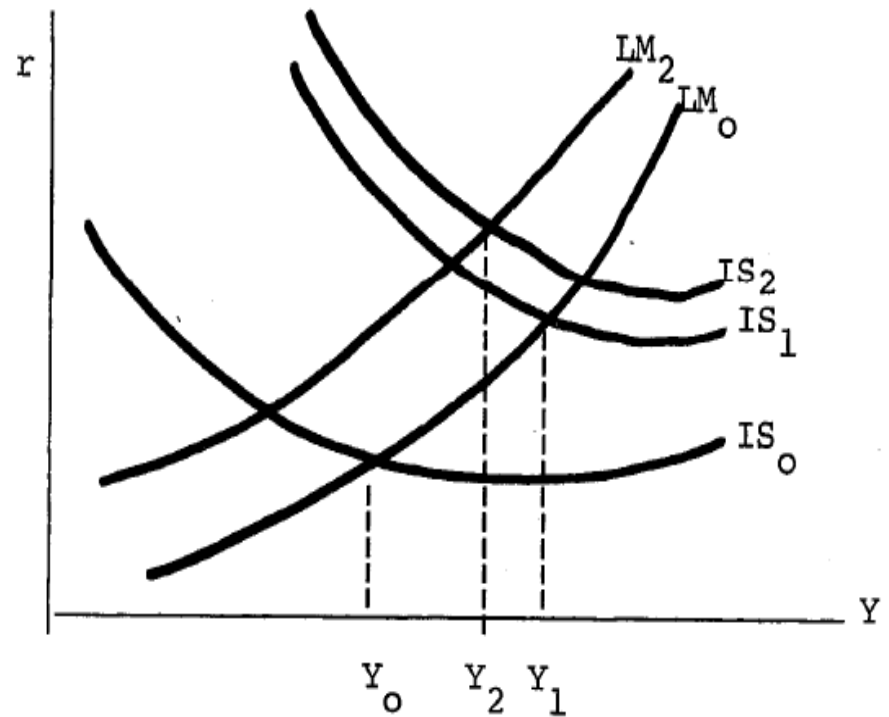
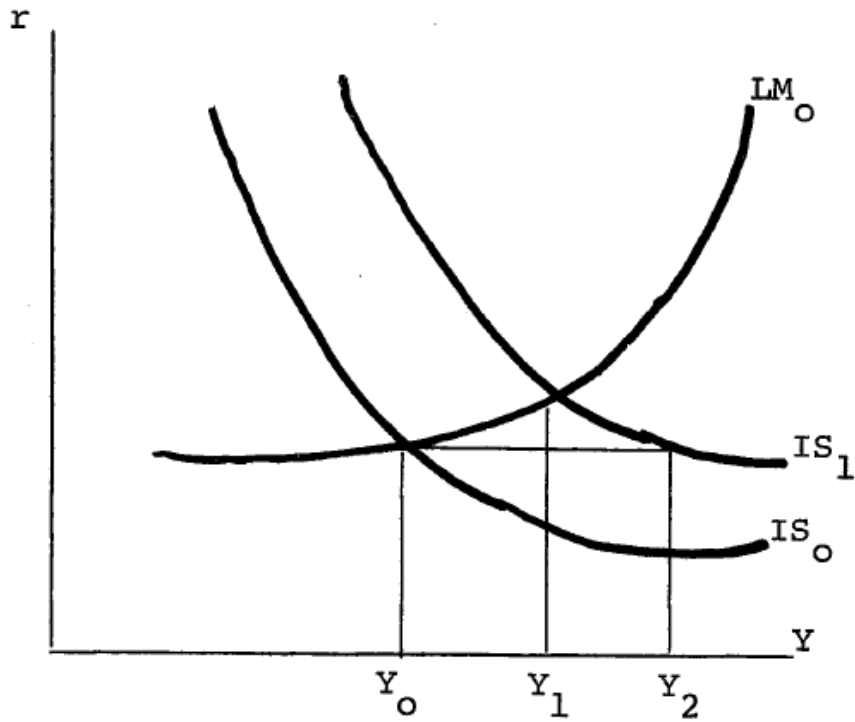


Does fiscal policy matter?
The Solow-Blinder Theorem - II

Introduction

- We had a detailed discussion on levels of crowding out in our previous lecture.
- We also had a discussion about the concept of wealth and its relationship with consumption demand and demand for money.
- Now, we are going to discuss the central part of the Solow-Blinder Theorem.

Introduction of the core issue



Explanation

- The figure 1 shows, the Keynesian equilibrium situation. Increase in government expenditure tends to shift IS towards right side. And equilibrium income rises from Y_0 to Y_1 .
- If there was no crowding out of any type then equilibrium income would have been to Y_2 which is a pure multiplier effect.
- However, as per Solow-Blinder, the story goes beyond it.
- Increase in bond holdings (because of debt subscriptions issues by the government to finance its additional spending) will alter wealth levels.
- Higher bond holdings will lead to higher wealth stock at household level which on the one hand, will have positive impact on consumption demand which ultimately shift IS curve to further towards right (in figure 2 IS_2).
- On the other hand, increased wealth stock will lead to higher demand for money (because of transaction and precautionary motives which are positive function of income flow) which shifts LM curve towards left (in figure 2 LM_2).

Explanation

- The actual equilibrium will be at Y_2 rather than Y_1 .
- The final impact of shifts in IS and LM curves may be expansionary or contractionary.
- The advocates of crowding out say that effects will be contractionary.
- On the other hand, Keynesian economists believe that deficit financed by the bond will always have expansionary effects.
- Solow-Blinder showed that government spending financed by the bond issuance will always be expansionary means fiscal policy works.
- Solow-Blinder (1972, p. 7) proved two things:

- **Theorem I:**
- In the simple IS-LM model (with fixed capital stock), the sign of the pure government expenditure multiplier is in principle ambiguous in the long run; but the empirical magnitudes necessary to render deficit spending contractionary imply that the system is unstable under bond-financed deficits (though stable under money financing).
- **Theorem II:**
- When we allow for the fact that the capital stock changes whenever net investment deviates from zero, no such ambiguity arises; under the usual assumptions deficit spending is always expansionary, and the system is always stable, irrespective of the mode of financing.

Theorem I: Explanation

- The wealth effect of increase in the stock of government bonds are two folds – one, expansionary effect due to increase in consumption.
- Second, contractionary effect due to higher demand for money – leading to higher interest rates, and reduced investment.
- Let us assume, that net wealth effects are contractionary.
- It means that national income and tax receipts would be lower in the next time period.
- As it is generally assumed that government spending remain constant, means, government keeps on spending the same amount in each time period.
- This means in the second period the deficit would be larger than the first.
- To meet this gap, issue of bonds would be required in the second period even larger than the first period.

Theorem I....

- And the net wealth effect remains contractionary, then third period national income will be lesser than second period.
- The process will continue indefinitely with falling national income in each subsequent time period and the budget deficit rising.
- Thus, the economy would be unstable and there would be no convergence towards stable equilibrium or balanced budget equilibrium.

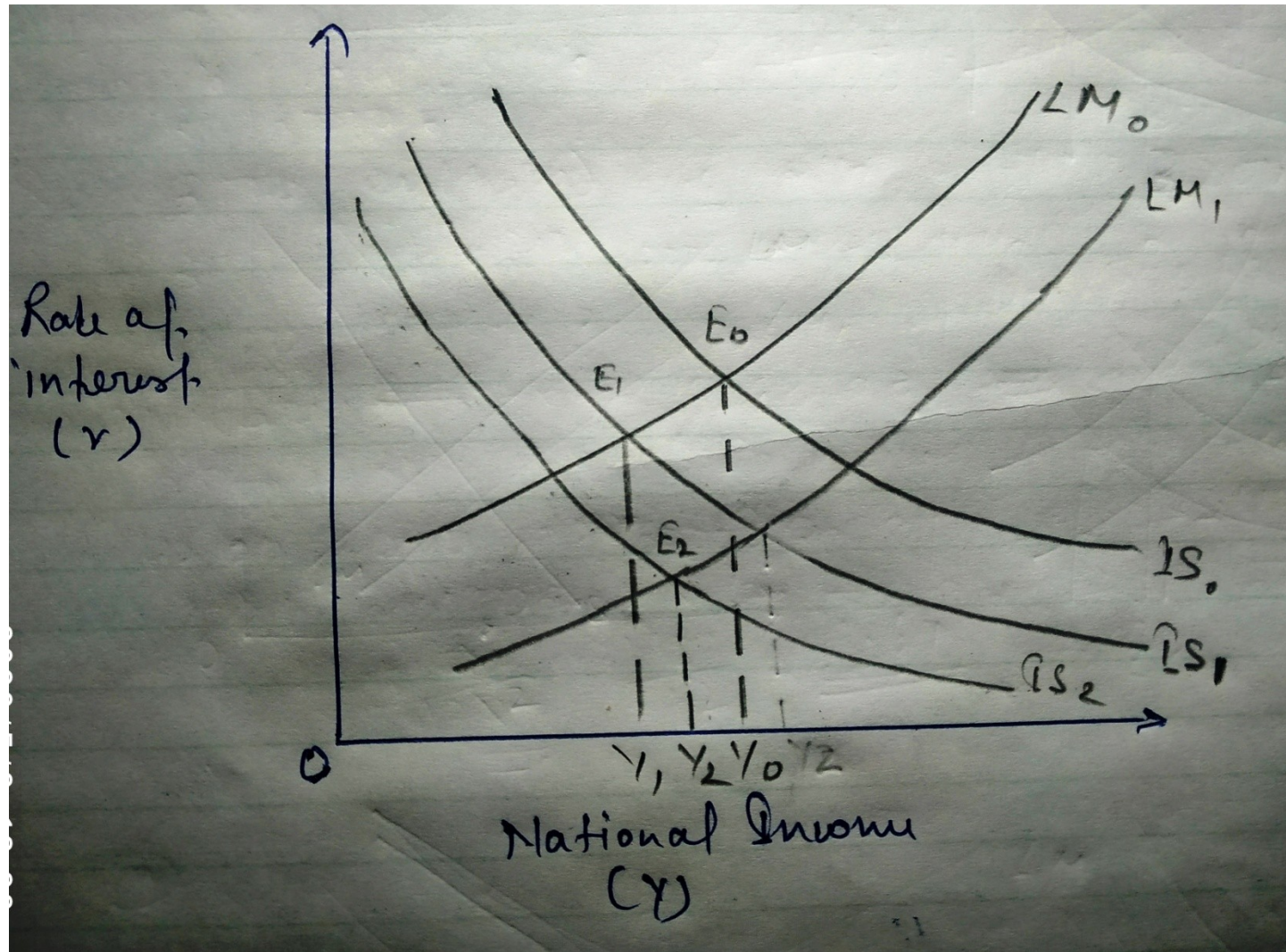
Theorem II: Explanation

- Let us continue from the figure 2 situation, where net wealth effect is contractionary.
- Then, the continuing issue of government debt will put pressure on interest rates to rise and national income to fall.
- Due to rising interest rates, investment declines which means the total stock of capital next year will also be lower.
- The smaller capital stock will induced producers to invest in the next period which will increase aggregated demand and push IS curve towards right.

Wealth effects.....

- The falling capital stock will also have the net wealth effects.
- On the one hand, the falling capital stock will decrease stock of wealth resulting decline in consumption demand as well.
- This will lead to leftward shift in the IS curve.
- On the other hand, the decline in wealth stock will create lower demand for money leading to rightward shift in LM curve.
- So, if the net wealth effect of rising holdings of government bonds is contractionary, similarly and simultaneously, the effect of the falling capital stock will be expansionary.

Wealth effects of falling capital stock



Concluding remarks

- Solow-Blinder showed mathematically with different possibilities that the joint effect of increase in investment in the next period and expansionary effect of net wealth of falling capital stock will offset the deflationary net wealth effect of increasing bond financing.
- And, the final effect will be expansionary.
- Hence, they concluded, if the capital stock are not fixed, government spending either financed through bond or new currency will always have expansionary effects on the economy. Fiscal policy does matter.

For any additional query

nagendrainsearch@gmail.com