Fiscal and Monetary Policy Cheatsheet

A concise guide to understanding fiscal and monetary policies, their tools, and their impact on the economy. This cheat sheet covers key concepts and applications for students and professionals alike.

Fiscal Policy Basics

Overview of Fiscal Policy

Definition: Fiscal policy involves the use of government spending and taxation to influence the economy.

Goals: Achieve macroeconomic objectives such as full employment, stable prices, and economic growth.

Key Tools:

- Government Spending (G)
- Taxation (T)
- Transfer Payments

Types of Fiscal Policy

Expansionary Fiscal Policy	Increases government spending and/or decreases taxes to increase aggregate demand (AD) and stimulate economic growth. Used during recessions. **Example:** Tax cuts or increased infrastructure spending.
Contractionary Fiscal Policy	Decreases government spending and/or increases taxes to decrease AD and control inflation. Used during periods of high inflation. **Example:** Increased taxes or reduced government programs.
Neutral Fiscal Policy	Maintains the current levels of government spending and taxation. No significant impact on AD.

Fiscal Policy Multipliers

Government Spending Multiplier: The ratio of the change in real GDP to the initial change in government spending.

Formula: `1 / (1 - MPC)` where MPC is the marginal propensity to consume.

Tax Multiplier: The ratio of the change in real GDP to the initial change in taxes.

Formula: `-MPC / (1 - MPC)`

Balanced Budget Multiplier: The effect on aggregate demand (and hence equilibrium output) of equal increases in government spending and taxation. This multiplier is equal to 1.

Monetary Policy Fundamentals

Introduction to Monetary Policy

Definition: Monetary policy involves actions undertaken by a central bank to manipulate the money supply and credit conditions to stimulate or restrain economic activity.

Primary Goal: Price stability (controlling inflation), but also aims for full employment and sustainable economic growth.

Tools of Monetary Policy

Open Market Operations (OMO)	Buying and selling government securities (bonds) to influence the money supply and interest rates. Buying bonds increases the money supply; selling bonds decreases it.
Reserve Requirements	The fraction of a bank's deposits that they are required to keep in their account at the central bank or as vault cash. Increasing reserve requirements decreases the money supply; decreasing them increases it.
Discount Rate	The interest rate at which commercial banks can borrow money directly from the central bank. Increasing the discount rate decreases the money supply; decreasing it increases it.
Interest on Reserves (IOR)	The interest rate the central bank pays commercial banks on the reserves they hold at the central bank. Raising the IOR tends to decrease lending; lowering it increases lending.
Quantitative Easing (QE)	Involves a central bank injecting liquidity into money markets by purchasing assets without the goal of lowering the policy interest rate. It is often used when interest rates are near zero.

Types of Monetary Policy

Expansionary Monetary Policy	Increases the money supply and lowers interest rates to stimulate economic activity. Used during recessions or periods of low growth.
Contractionary Monetary Policy	Decreases the money supply and raises interest rates to curb inflation. Used when inflation is high.

https://cheatsheetshero.com

Effects and Considerations

Impact of Fiscal Policy

Expansionary Fiscal Policy Effects	• Increases aggregate demand and output. • Reduces unemployment. • May lead to inflation if the economy is near full capacity. • Can increase government debt.
Contractionary Fiscal Policy Effects	• Decreases aggregate demand and output. • Increases unemployment. • Reduces inflation. • Can decrease government debt.

Impact of Monetary Policy

Expansionary Monetary Policy Effects	• Lowers interest rates, encouraging borrowing and investment. • Increases aggregate demand and output. • Can lead to inflation if the money supply grows too rapidly. • May lead to asset bubbles.
Contractionary Monetary Policy Effects	• Raises interest rates, discouraging borrowing and investment. • Decreases aggregate demand and output. • Reduces inflation. • Can slow economic growth.

Limitations and Challenges

Fiscal Policy Limitations:

- **Lags:** Implementation and impact lags can reduce effectiveness.
- **Crowding Out:** Government borrowing can increase interest rates and reduce private investment.
- **Political Constraints:** Difficult to implement unpopular policies (e.g., tax increases).

Monetary Policy Limitations:

- **Zero Lower Bound:** Interest rates cannot fall below zero, limiting the effectiveness of expansionary policy during severe recessions.
- **Liquidity Trap:** Lowering interest rates may not stimulate borrowing if confidence is low.
- **Time Lags:** Monetary policy actions take time to impact the economy.

Global Interdependence: Policies in one country can affect other countries, complicating policy decisions.

Key Economic Indicators

Major Economic Indicators

Gross Domestic Product (GDP): The total value of goods and services produced in an economy. Indicates the size and health of the economy.

Inflation Rate: The rate at which the general level of prices for goods and services is rising, and subsequently, purchasing power is falling. Central banks target specific inflation rates.

Unemployment Rate: The percentage of the labor force that is unemployed. Indicates the level of joblessness in the economy.

Consumer Price Index (CPI): A measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

Producer Price Index (PPI): A measure of the average change over time in the selling prices received by domestic producers for their output.

Understanding the Phillips Curve

Phillips Curve: A historical inverse relationship between rates of unemployment and corresponding rates of inflation in an economy.

- **Short-Run Phillips Curve (SRPC):** Shows the trade-off between inflation and unemployment in the short run.
- **Long-Run Phillips Curve (LRPC):** A vertical line at the natural rate of unemployment, indicating that there is no long-run trade-off between inflation and unemployment.

Changes in inflationary expectations can shift the SRPC.

The Role of Expectations

Rational Expectations: The idea that people make decisions based on their expectations of the future, which are based on all available information.

- Can reduce the effectiveness of policy interventions if people anticipate and counteract them.

Adaptive Expectations: The idea that people form their expectations of the future based on past trends.

- Can lead to persistent errors in forecasting the future.

 https://cheatsheetshero.com