

FISCAL STIMULUS



Decoding Fiscal Stimulus
– By Prof. *Simply Simple*



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- Recession is the best time for some people to go on a vacation.
- They assume that by the time they will come back, things will be back to normal.
- But for the saviours of the world economy, recession is the time to work overtime.
- They test various methods to get the economy back on its feet.
- One of the methods used is that of providing a fiscal stimulus package.



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Fiscal stimulus package? How can it stop recession?

- ❑ **Well, you may have heard the name of John Maynard Keynes, the well-known British economist of the 20th century.**
- ❑ **The whole idea of fiscal stimulus is based on his analysis of factors that cause recession.**
- ❑ **During the Great US Depression of the 1930s, he wrote his most important work, *The General Theory of Employment, Interest, and Money*.**



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What was it all about?

- Keynes focused his analysis on factors affecting output and growth in an economy.
- He asked, what decides the output in an economy?
- He said that output in any economy is decided by people who spend money.
- People like you and me who earn money with one hand and spend it with the other ultimately decide how much goods and services are going to be produced in our economy.



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- ❑ If the demand of a product is less, then by the simple logic of demand and supply, the price of that product should fall.
- ❑ But it is difficult for firms to vary the price of their products frequently.
- ❑ For example, your baker may have to change the price of his bread every day if he goes strictly by demand and supply.
- ❑ Changing the price of goods every day is not a very happy way of doing business.
- ❑ Neither the baker nor his customers would be happy if prices just kept on changing forever.



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What options, then, does the baker have?

- ❑ He can let the price of the bread remain the same and reduce his production in response to lower demand.
- ❑ He can then meet the demand at the preset price by matching his supply with the demand.
- ❑ This is how demand affects output and growth in an economy.



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How can we use this understanding to fight recession?

- ❑ As per Keynesian analysis, the problem of recession is not due to lack of productive capacity in the economy.
- ❑ The factories have not lost their ability to produce goods, the real problem is due to insufficient spending to support the normal level of production.
- ❑ So, the solution is obvious. *If the fall in demand leads to fall in production, then we need to do something that can push up demand.*



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What can one do for that??

- ❑ We have two options.
- ❑ The first option, as recommended by Keynes, is to increase Government spending, which works as the most effective way of increasing the aggregate demand of goods and services.
- ❑ The second option is to increase the disposable income in the hands of people by cutting taxes. Put money in the hands of people and even the most pessimistic person starts making new plans.



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- ❑ It is believed that people will use part of their extra income on consuming extra goods and services.
- ❑ This creates what is known as a multiplier effect.
- ❑ You buy the bread of the baker, your baker in turn buys milk, and the milkman buys something else — in this manner, the game of passing the penny keeps going.
- ❑ Fiscal stimulus works as an instant source of energy.
- ❑ However, the timing of a fiscal stimulus and its size is most crucial for its success.



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To Sum Up

- ❑ **What:** Fiscal stimulus can be used as a tool for fighting recession.
- ❑ **How:** Increase in government spending coupled with tax cuts can lead to increase in aggregate demand and growth in the economy.
- ❑ **Who:** John Maynard Keynes, the well-known British economist, was a prominent advocate of the use of fiscal stimulus.



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Hope you have now understood
the concept of Fiscal Stimulus

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