



THEME 5

ECONOMIC GROWTH

AND CYCLICAL

GROWTH

OVERVIEW THEME 5

ECONOMIC GROWTH AND CYCLICAL GROWTH

- MONEY AND CAPITAL MARKETS
- CAUSES AND CONSEQUENCES OF INFLATION

- LABOUR MARKET POLICY
 - ECONOMIC GROWTH (long term)
 - **CYCLICAL GROWTH (short term)**
 - **FISCAL POLICY AND MONETARY POLICY**
 - ECONOMIC MODELS
- } 1 bundle

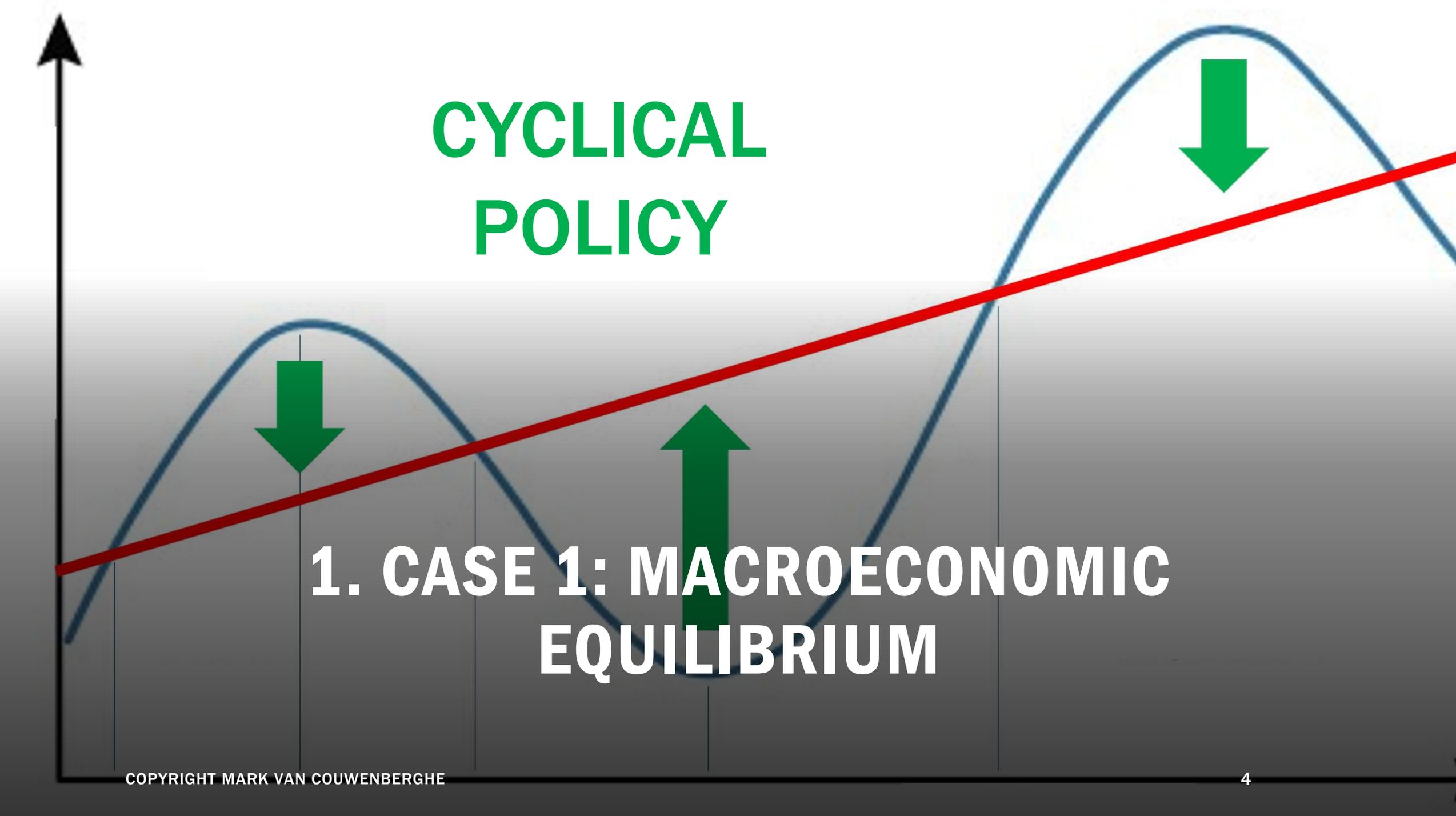
**STARTING FROM AND
ELABORATED THROUGH
CASES**

CHAPTER 6 (LPD 16): CYCLICAL GROWTH: FISCAL POLICY AND MONETARY POLICY

- 1. CASE 1: MACROECONOMIC EQUILIBRIUM**
- 2. CASE 2: CLASSICAL AND KEYNESIAN VISION**
- 3. CASUS 3: AD-AS-MODEL**
- 4. CASUS 4: FISCAL POLICY**
- 5. CASUS 5: MONETARY POLICY**
- 6. TEXT: FISCAL AND MONETARY POLICY**

CYCLICAL POLICY

**1. CASE 1: MACROECONOMIC
EQUILIBRIUM**



European inflation is at a healthy level

**Stable growth of the
Belgian economy
expected**

**Qatar's economy reaches almost
full employment**

HEALTHY INFLATION, STABLE GROWTH, FULL EMPLOYMENT, ...,
SIGNS OF A **"BALANCED ECONOMY"**

MACROECONOMIC EQUILIBRIUM OF A COUNTRY (OR GROUP OF
COUNTRIES), WHAT DO WE MEAN BY THAT?

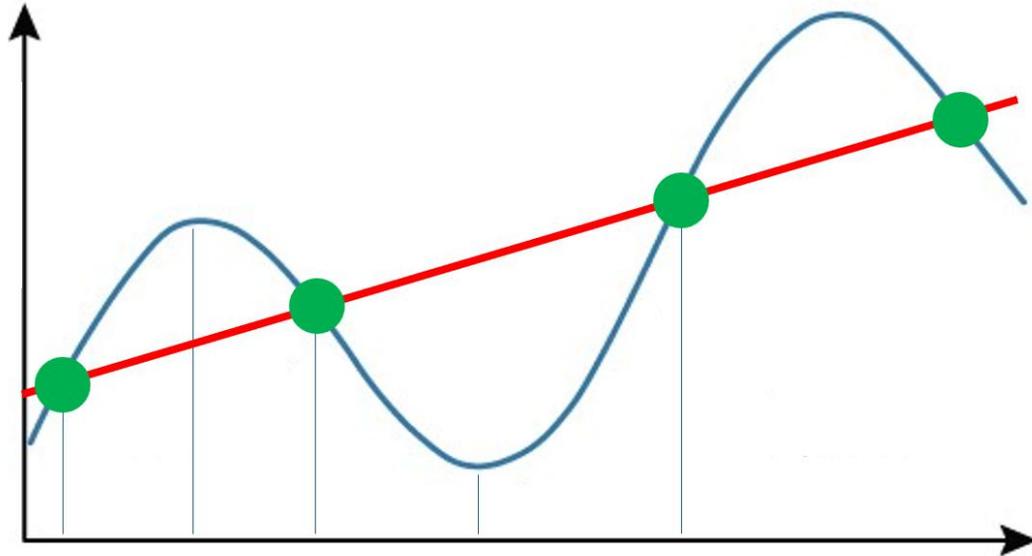
DEFINITION OF MACROECONOMIC EQUILIBRIUM

Macroeconomic equilibrium means that the total demand for goods and services in an economy is equal to the total supply.

In other words, everything that is produced is also bought (or used). It is a situation in which the economy is “in balance”.

**In macroeconomic terms, there is equilibrium when:
Aggregative demand (AD) = Aggregative supply (AS, LAS)**

DEFINITION OF MACROECONOMIC EQUILIBRIUM



See green dots

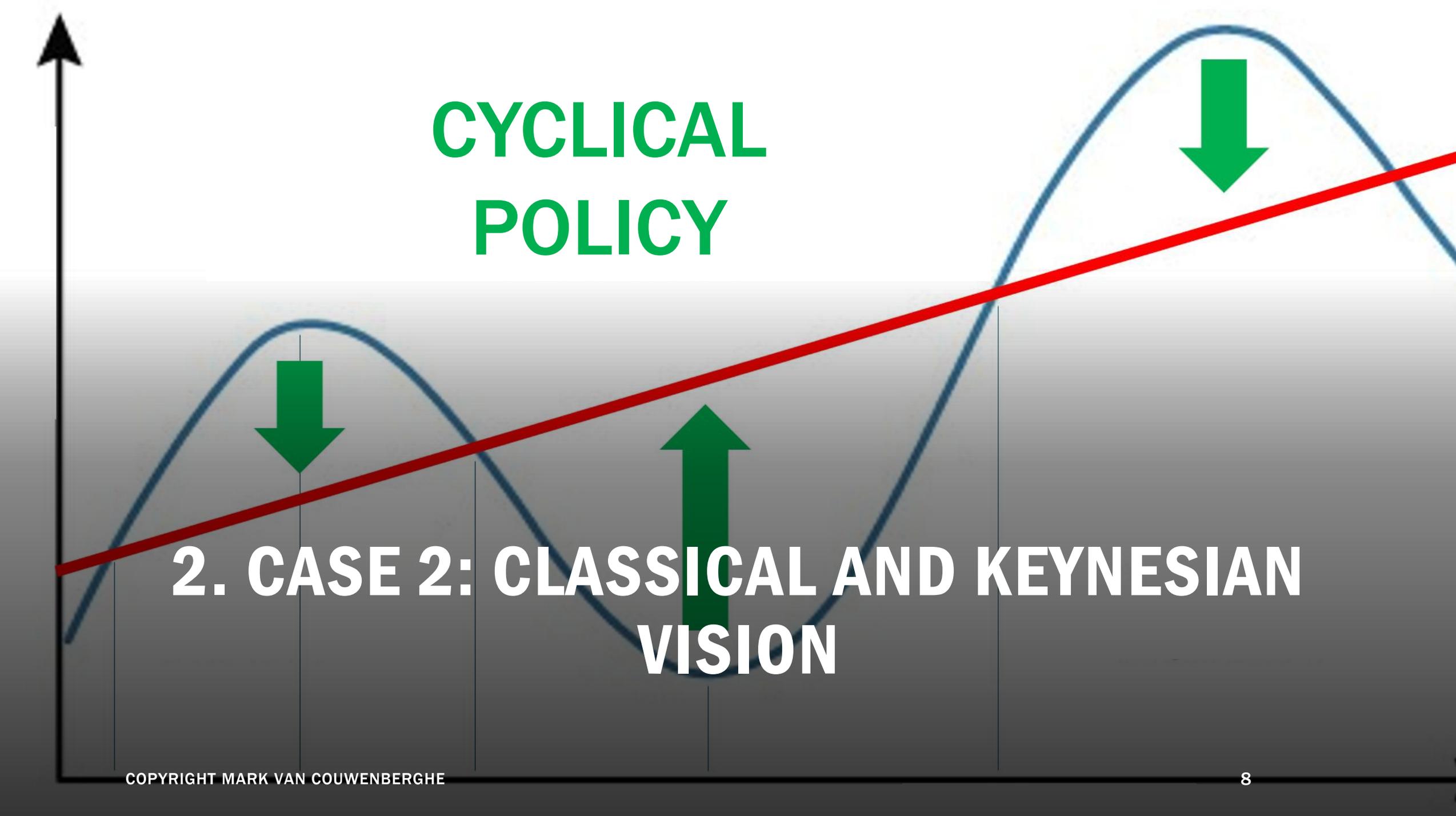
There is stable inflation.

There is no overproduction or shortages.

With equilibrium, there is often stable economic growth.

CYCLICAL POLICY

2. CASE 2: CLASSICAL AND KEYNESIAN VISION



**Can the German economy recover
without drastic measures?**

**US government launches
impressive investment
plan**

THE AIM IS TO ACHIEVE A BALANCED ECONOMY.

BUT HOW? WITHOUT OR WITH GOVERNMENT INTERFERENCE?

WHAT ARE THE VISIONS ON THE MACROECONOMIC EQUILIBRIUM?

VISIONS OF AN ECONOMY IN BALANCE

CLASSICAL VISION

The market automatically recovers itself.

According to the classics, free markets automatically create equilibrium.

Wages and prices are flexible: when there is unemployment, wages fall, so labour becomes cheaper, and as a result: companies hire people again.

No need for government intervention.

KEYNESIAN VISION

The market does not always recover on its own.

The government sometimes has to intervene.

In a crisis, wages and prices can "stick" – they do not automatically fall. As a result, the economy can remain stuck in underspending and unemployment for a long time.

So it is a must to increase government spending or lower taxes to stimulate demand.

ORIGINS OF KEYNESIANISM

Keynesianism originated in the 1930s, as a reaction to the Great Depression and the limitations of classical economic theories that had been dominant until then.

In 1929, the Wall Street stock market collapsed, leading to a global economic crisis.

Unemployment and poverty soared, and the economy seemed to be stuck.

Classical economists believed that markets would automatically recover themselves, as long as wages and prices were flexible.



ORIGINS OF KEYNESIANISM

Keynes's ideas became the standard in economic policy after WWII. Many Western countries pursue active fiscal policies and use public spending as a tool against unemployment.

In 1936, Keynes published his famous book: "The General Theory of Employment, Interest and Money".

He stated:

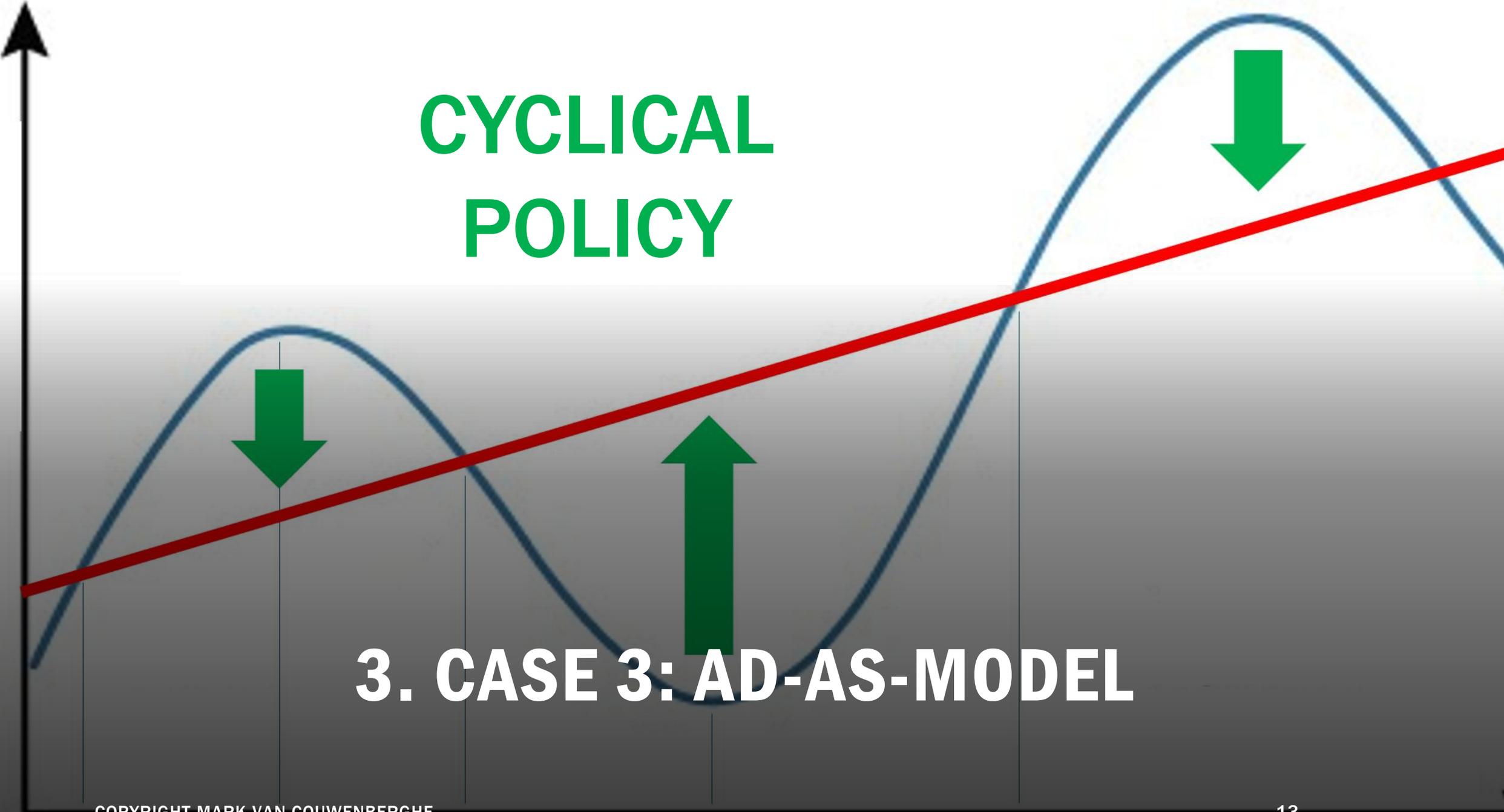
Demand in the economy determines total production and employment.

Governments must actively intervene during economic downturns, for example by investing and spending more, even if it means taking on debt.

This would stimulate demand, leading to more production and employment.

CYCLICAL POLICY

3. CASE 3: AD-AS-MODEL



**Unprecedented shock to Gaza's
economy due to war between
Israel and Hamas**

**China is prepared for
major shock in trade war,
says prime minister**

CYCLICAL FLUCTUATIONS ARE CAUSED BY **SHOCKS.**

HOW CAN WE **GRAPHICALLY ANALYZE SHOCKS?**

TYPES OF SHOCKS

DEMAND SHOCK	SUPPLY SHOCK	PRICE SHOCK
<p>A demand shock is a sudden change in demand for goods or services</p>	<p>A supply shock is an unexpected change in the supply of goods or services</p>	<p>A price shock is an abrupt change in the prices of key products</p>
<p>Positive demand shock: sudden increase in demand</p>	<p>Positive supply shock: supply rises suddenly</p>	<p>This may or may not be combined with a supply shock and/or demand shock</p>
<p>Negative demand shock: sudden drop in demand</p>	<p>Negative supply shock: supply suddenly drops</p>	<p>Usually cause is external</p>

TYPES OF SHOCKS

Examples of demand shock:

- A technology company launches a revolutionary product → the demand for the product skyrockets
- During an economic recession, incomes fall due to bankruptcies → consumers buy less → demand slumps

Examples of supply shock:

- A natural disaster destroys crops → less food available → supply decreases (temporary effect)
- A new production process makes production cheaper → supply increases (permanent effect)

TYPES OF SHOCKS

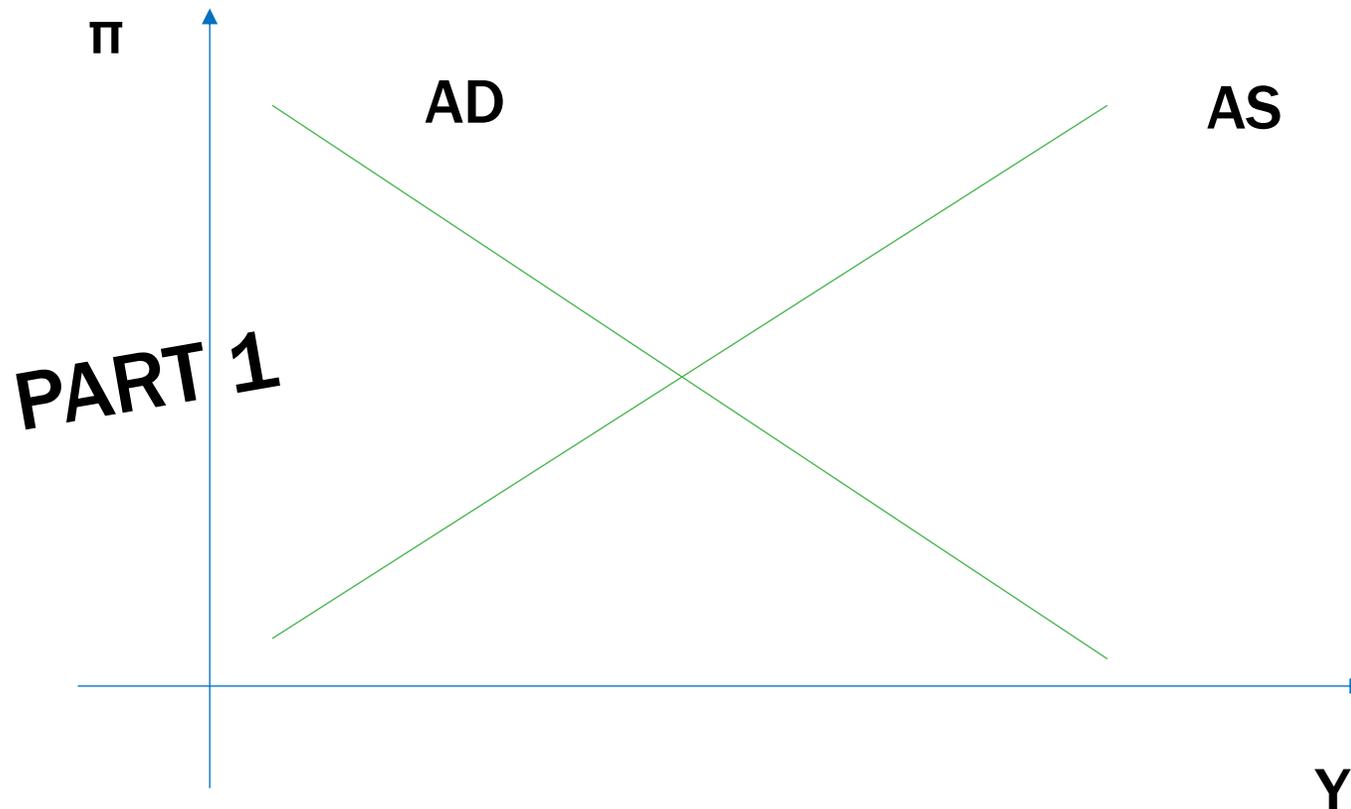
Price shock example:

Oil price doubles due to geopolitical tensions (countries start building up extra reserves) → fuel costs rise → impact on transport and production (prices of these are also rising)

ENDOGENEOUS SCHOK	EXOGENEOUS SCHOK
The cause of shock lies in the economy itself	Cause of shock lies outside the economy
E.g. financial crisis	E.g. war

AD-AS-MODEL: GENERAL

The AD-AS model (or Aggregate Demand – Aggregate Supply) is a core model in macroeconomics that shows how inflation and real GDP behave in an economic cycle (ST).



AD shows the total demand in the economy for goods and services at different price levels.

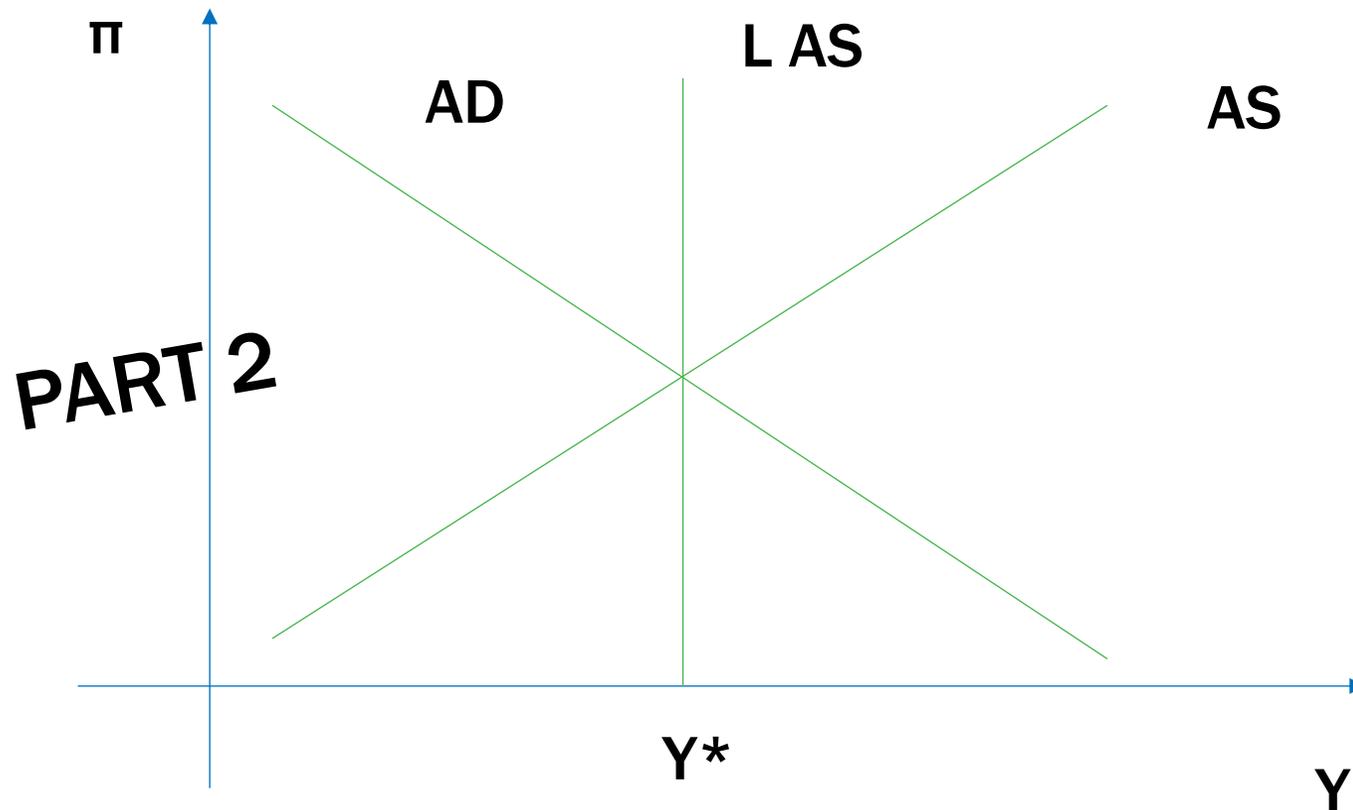
Short-term (ST): decreasing trend: the higher the price level, the lower the quantity demanded (and vice versa)

AS shows the total production that companies are willing to deliver at each price level.

Short-term (ST): upward trend: more production at higher prices

AD-AS-MODEL: GENERAL

The economy is in equilibrium if $AD = AS = L AS$



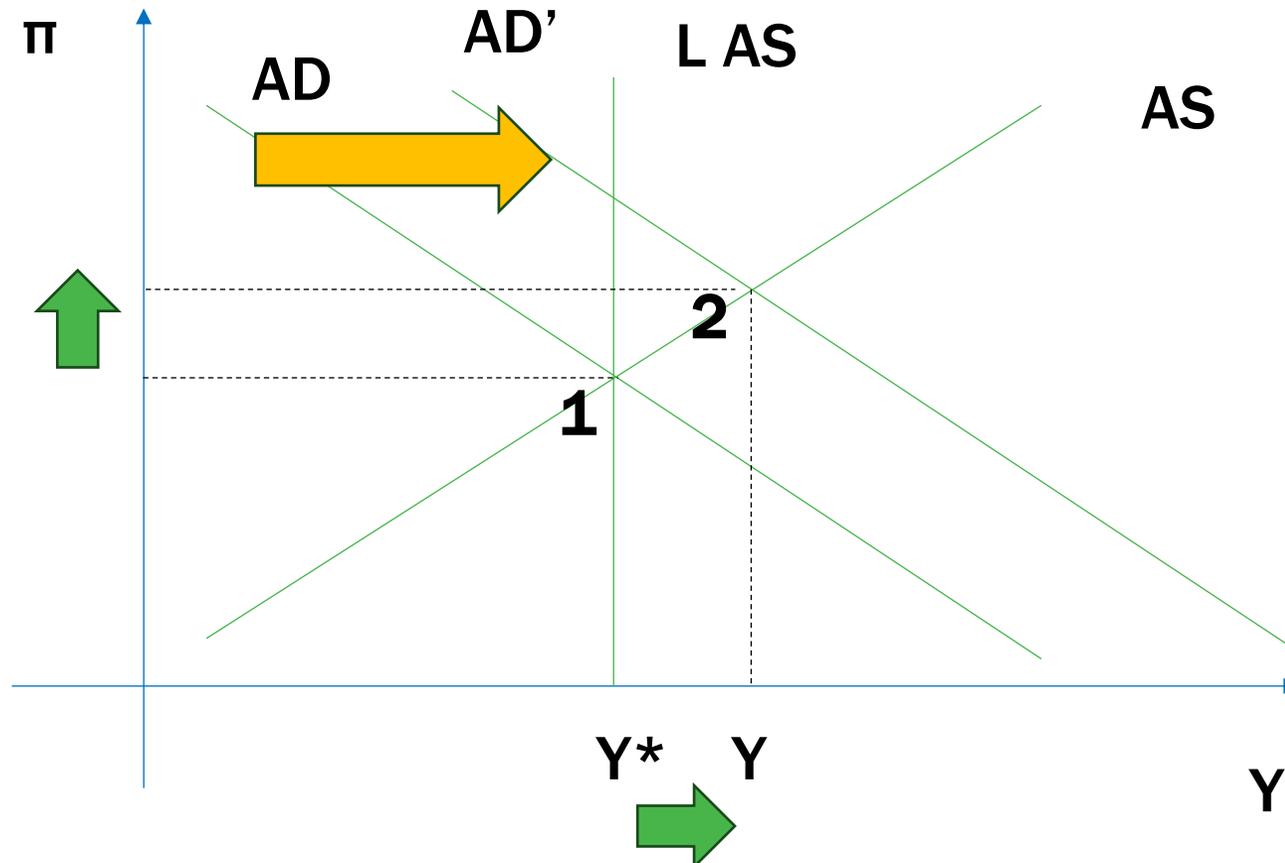
L AS shows the maximum production or production capacity of the economy (long term)

On ST it is fixed and therefore runs vertically!
Symbol: Y^*

(On LT, this L AS is variable: if the production capacity of the economy grows on LT, this line shifts to the right)

AD-AS-MODEL: ANALYSIS OF THE TWO MAIN SHOCKS

ANALYSIS 1: POSITIVE DEMAND SHOCK



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Situation:

Starting from a balance:

- 1** Consumer confidence gets a boost, resulting in an increase in demand

Graph:

AD curve shifts to the right (AD')

GDP rises from Y^* to Y

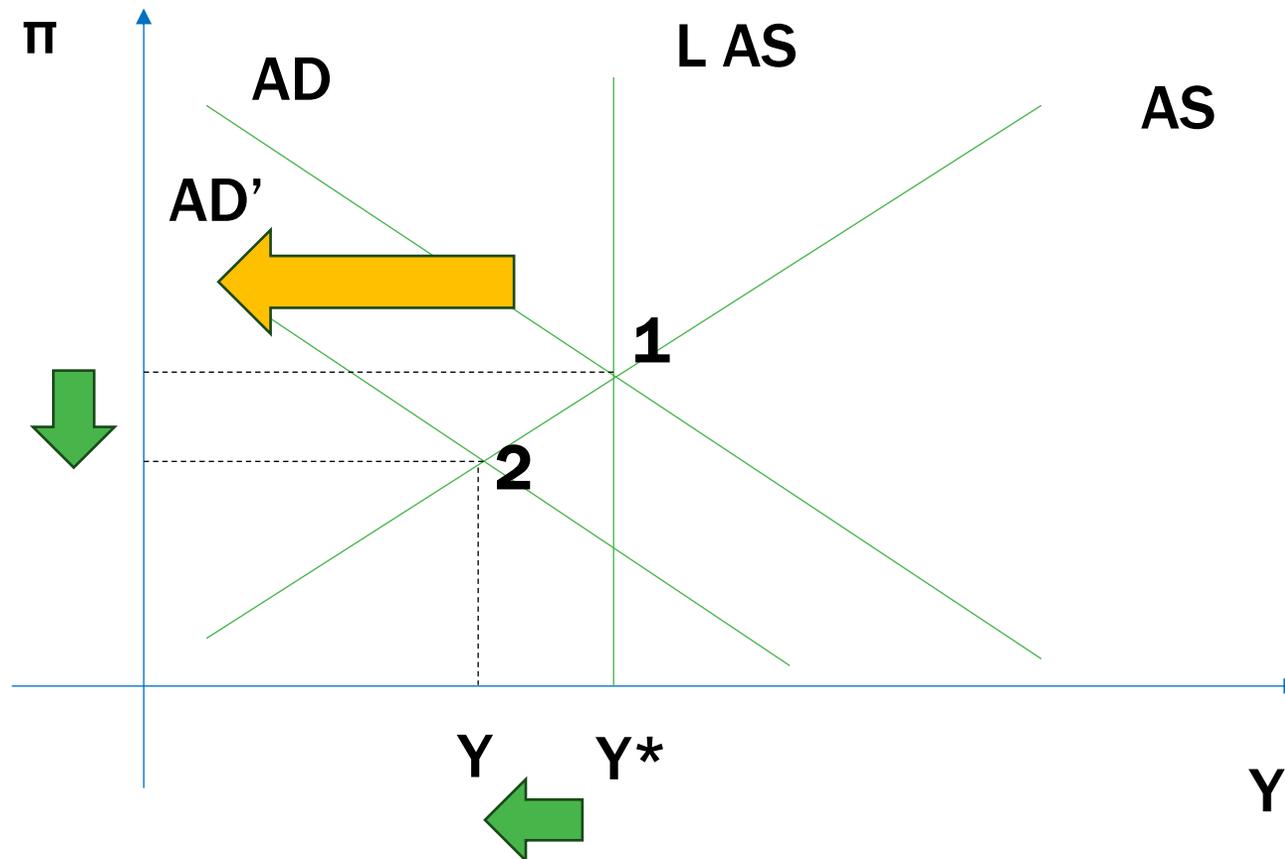
- 2** Inflation rises because $Y > Y^*$

The economy is in danger of overheating.

Rising inflation may rise further due to an upward spiral effect and thus become too high for the economy to grow in a healthy way

AD-AS-MODEL: ANALYSIS OF THE TWO MAIN SHOCKS

ANALYSIS 2: NEGATIVE DEMAND SHOCK



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Situation:

- 1** Starting from a balance:
Consumer confidence drops, resulting in a drop in demand

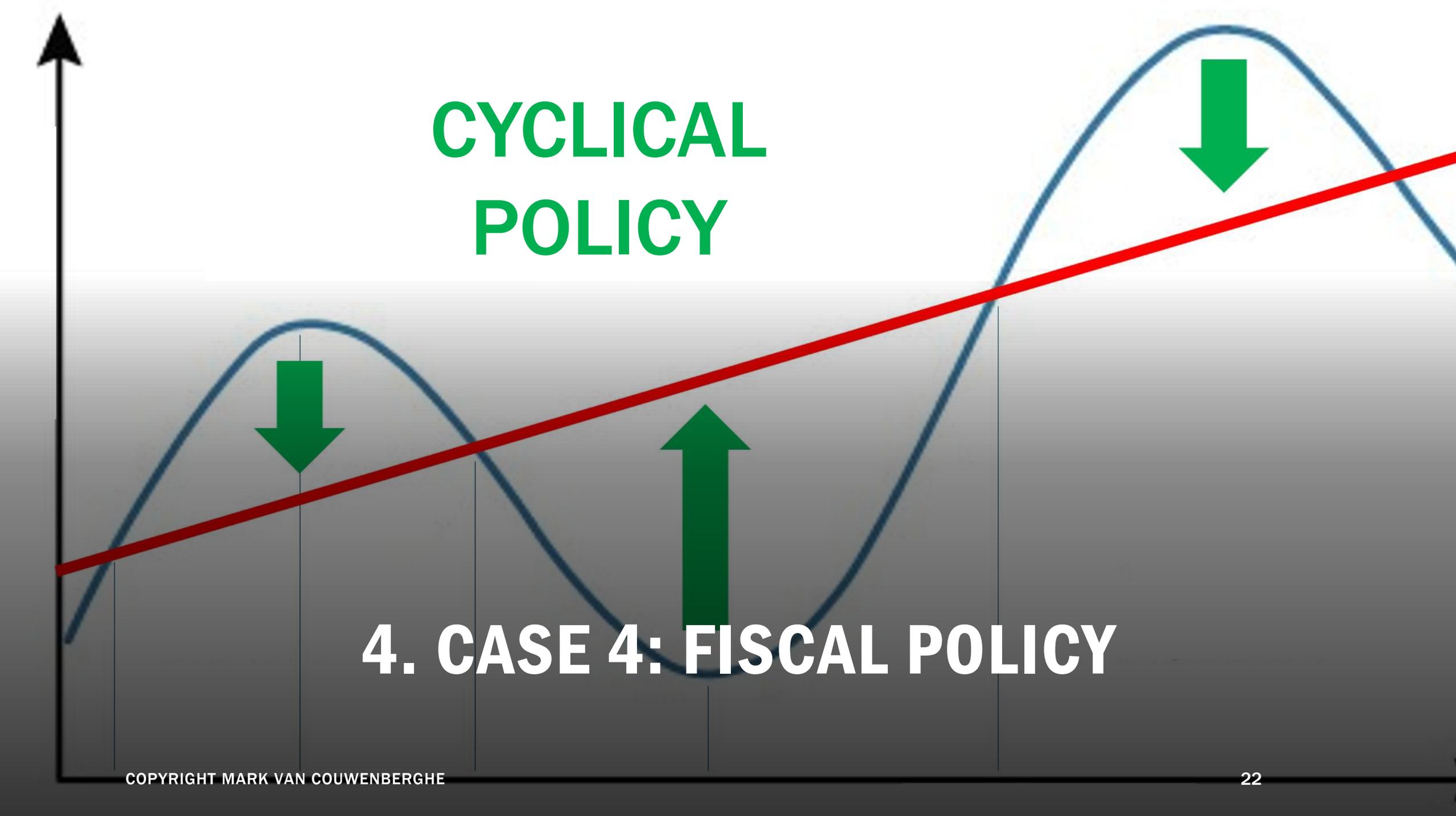
Graph:

- 2** AD curve shifts to the left (AD')
GDP falls from Y^* to Y
Inflation falls because $Y < Y^*$

The economy is in danger of collapsing. Falling inflation may collapse further due to a downward spiral effect and thus become too low for the economy to grow in a healthy way

CYCLICAL POLICY

4. CASE 4: FISCAL POLICY



**Brazilian government launches
stimulus program with large tax
cuts**

**IN FRANCE, DRASTIC CUTS
ARE ANNOUNCED**

CYCLICAL POLICY AIMS TO MITIGATE THE IMPACT OF CYCLICAL SHOCKS

= ANTI-CYCLICAL ECONOMIC POLICY

**FISCAL POLICY IS ONE WAY TO ADDRESS THIS: WHAT IS IT AND HOW CAN
WE ANALYZE IT GRAPHICALLY?**

FISCAL POLICY: DEFINITION

Fiscal economic policy is economic policy in which the government adjusts its expenditure and income (through taxes) in order to influence the economic cycle. The aim is to stabilise the economy, i.e. to smooth out fluctuations in growth.

RESTRICTIVE	EXPANSIONARY
Used in case of overheating of the economy (boom)	Used in case of hypothermia of the economy (economic downturn)
Government reduces spending (savings) or increases taxes	Government increases spending (e.g. investments in infrastructure) or lowers taxes
Less spending → less demand → cooling economy	More spending → higher demand → economic growth

FISCAL POLICY: ADVANTAGES AND DISADVANTAGES

ADVANTAGES

Direct impact on growth and employment (especially in the event of an increase in active government spending and investment), but also **long-term impact** and **multiplier effect** of public investments (e.g. infrastructure)

DISADVANTAGES

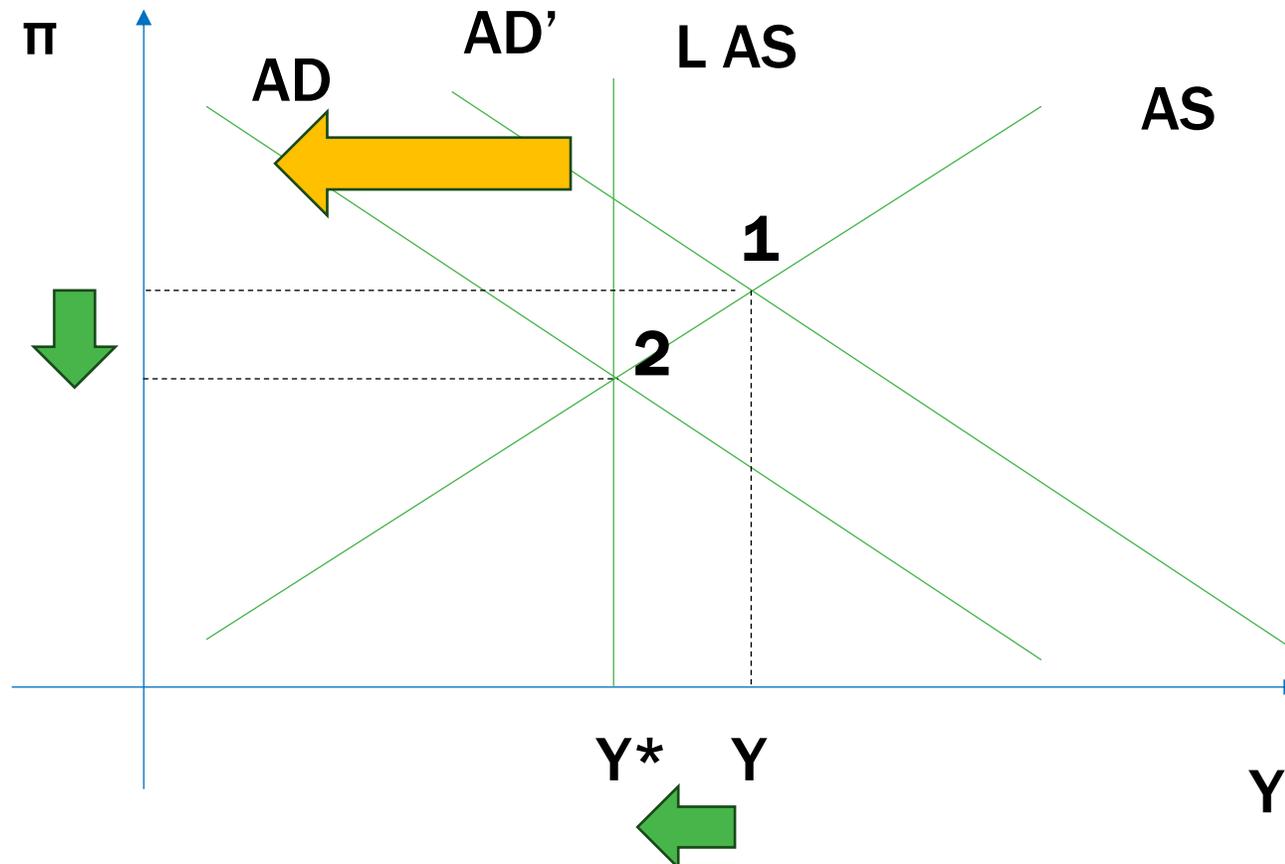
Political choices (not always 100% economic choices) e.g. austerity

Expansionary policies can lead to rising budget deficits and public debt, and also to **crowding-out effect** (if the government is very active in a market and therefore displaces families and businesses from the market because interest rates rise)

(multiplier effect means that an investment increases GDP many times the original investment; for example, an infrastructure investment of €1 billion that increases GDP by €3 billion has a multiplier effect of 3)

FISCAL POLICY: GRAPHICAL ANALYSIS

ANALYSIS 1: POSITIVE DEMAND SHOCK >>> RESTRICTIVE POLICY



1 Start

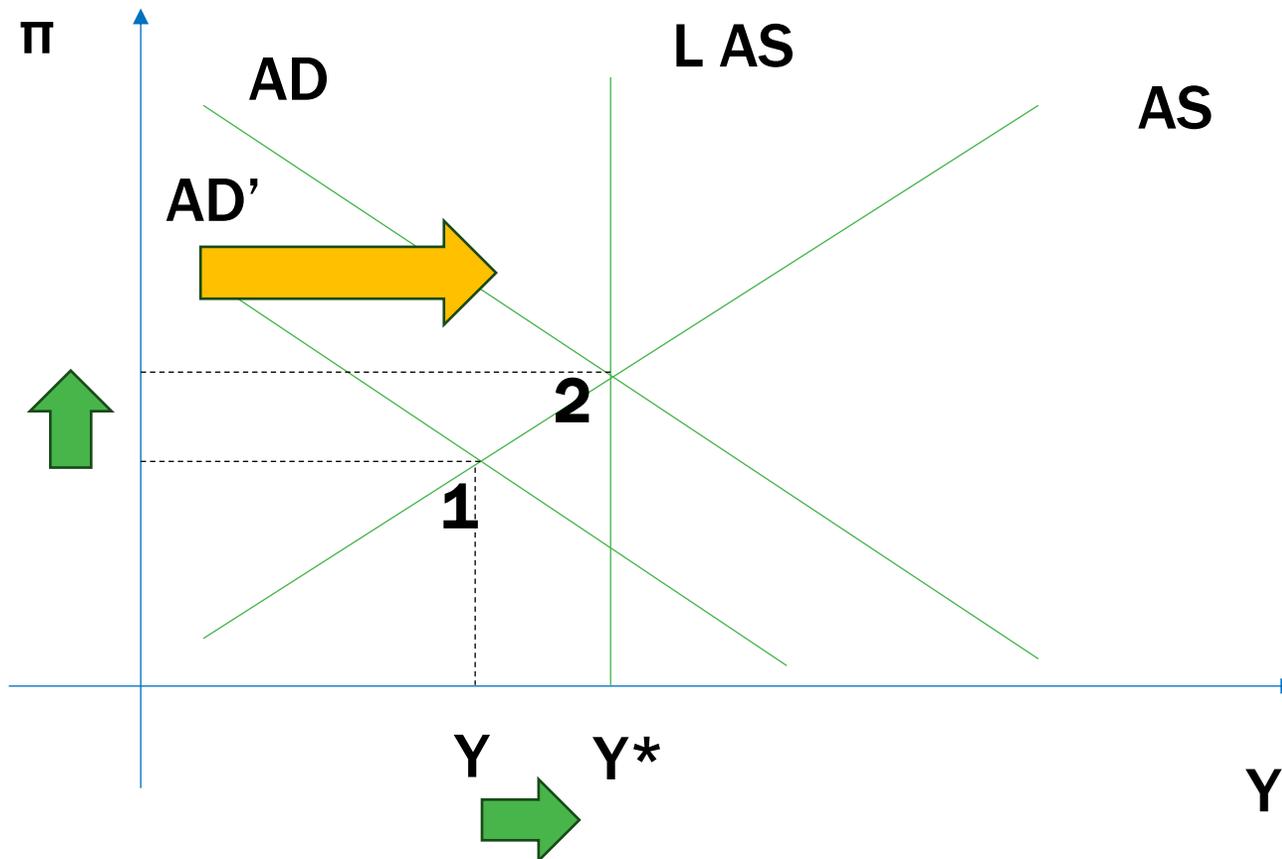
By pursuing a restrictive fiscal policy, the AD curve will shift to the left, $AD' \gg AD$

As a result, GDP falls from Y to Y^* and inflation weakens

2 The economy returns to equilibrium

FISCAL POLICY: GRAPHICAL ANALYSIS

ANALYSIS 2: NEGATIVE DEMAND SHOCK >>> EXPANSIONARY POLICY



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1 Start

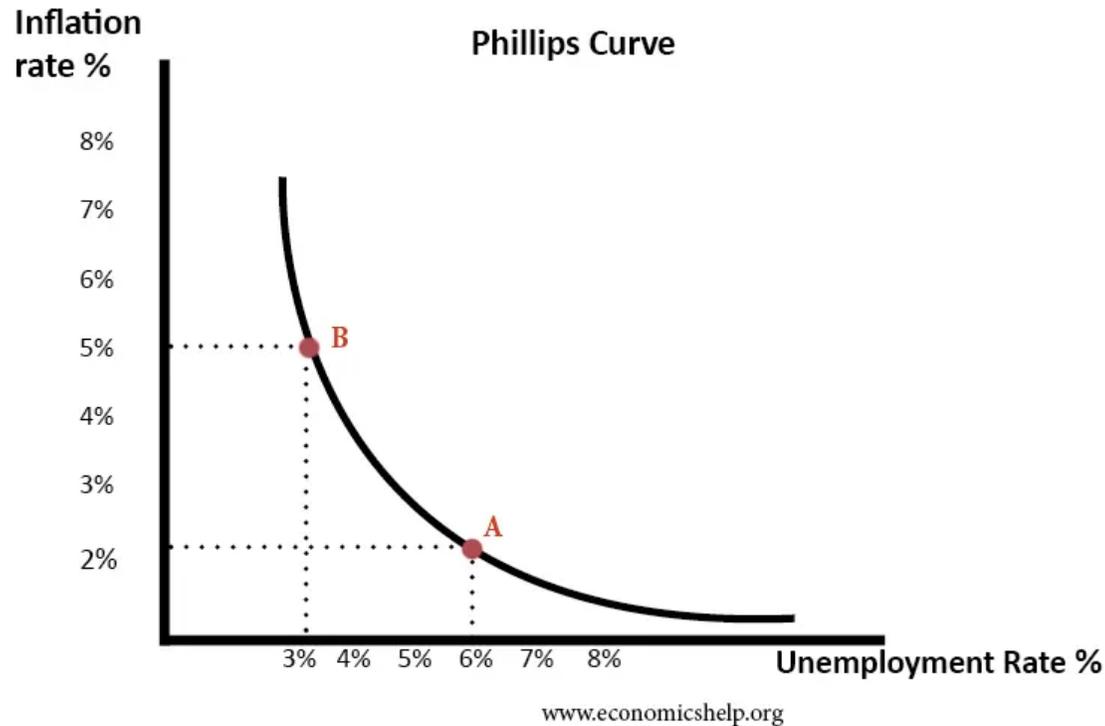
By pursuing an expansionary fiscal policy, the AD curve will shift to the right, $AD' >>> AD$

As a result, GDP rises from Y to Y^* and inflation rises

2 The economy returns to equilibrium

FISCAL POLICY: GRAPHICAL ANALYSIS

Fiscal policy is a confirmation of economist Phillips' theory and his Phillips curve:



The Phillips curve shows the negative relationship between inflation and unemployment

A >>> B: expansionary fiscal policy: inflation rises and unemployment falls

B >>> A: restrictive fiscal policy: inflation is falling and unemployment is rising

FISCAL POLICY: EXTRA

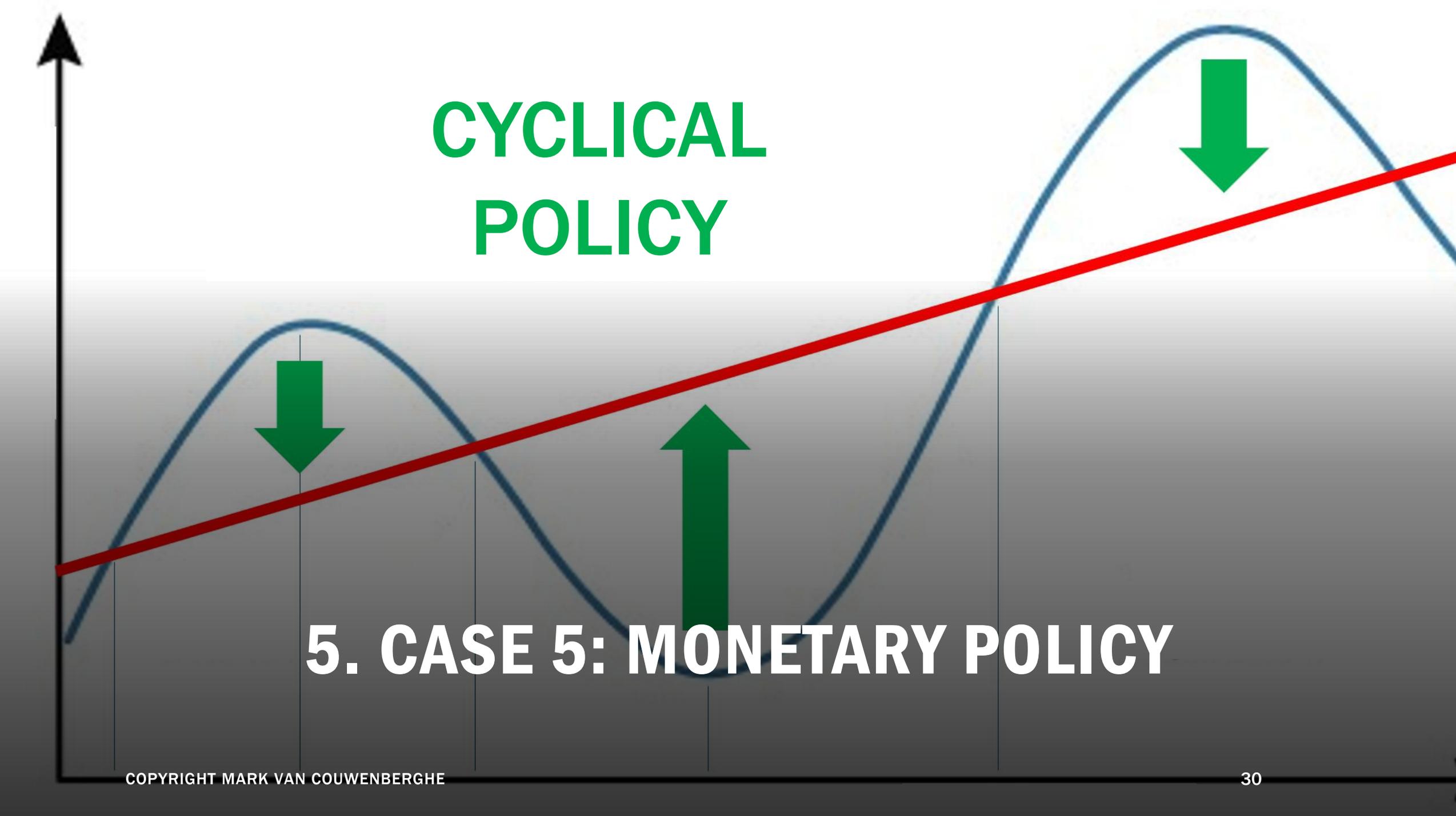
Apart from the budgetary policy, Belgium has something EXTRA:
AUTOMATIC CYCLICAL STABILISERS

Automatic cyclical stabilisers are mechanisms in the public budget that automatically smooth out economic fluctuations, without the need for new policies. They work automatically, so without political intervention.

STABILISER	SLUMP	BOOM
UNEMPLOYMENT BENEFITS	Purchasing power and C remain stable	Less pressure on government budget
PROGRESSIVE TAXES	Lower tax pressure on income and C	Higher tax pressure on income and C

CYCLICAL POLICY

5. CASE 5: MONETARY POLICY



**ECB cuts interest rates, predicts
slowing growth due to trade war**

**End of an era: Federal
Reserve turns off money
tap**

CYCLICAL POLICY AIMS TO MITIGATE THE IMPACT OF CYCLICAL SHOCKS

= ANTI-CYCLICAL ECONOMIC POLICY

MONETARY POLICY IS ONE WAY TO ADDRESS THIS: WHAT IS THIS?

MONETARY POLICY: DEFINITION

Monetary cyclical policy is economic policy in which the central bank (such as the ECB in Europe or the Fed in the US) influences the money supply and interest rates in order to stabilize the business cycle. The goal is to control inflation and boost or slow down the economy.

RESTRICTIVE	EXPANSIONARY
Used in case of overheating of the economy (boom)	Used in case of hypothermia of the economy (economic downturn)
Central bank raises interest rates and/or reduces money supply (selling bonds)	Central bank lowers interest rates and/or increases money supply (buying bonds)
Less spending → less demand → cooling economy	More spending → higher demand → economic growth

MONETARY POLICY: ADVANTAGES AND DISADVANTAGES

ADVANTAGES

Independent policy

(independent of political choices)

The aim is price stability

(inspires confidence among consumers and entrepreneurs)

DISADVANTAGES

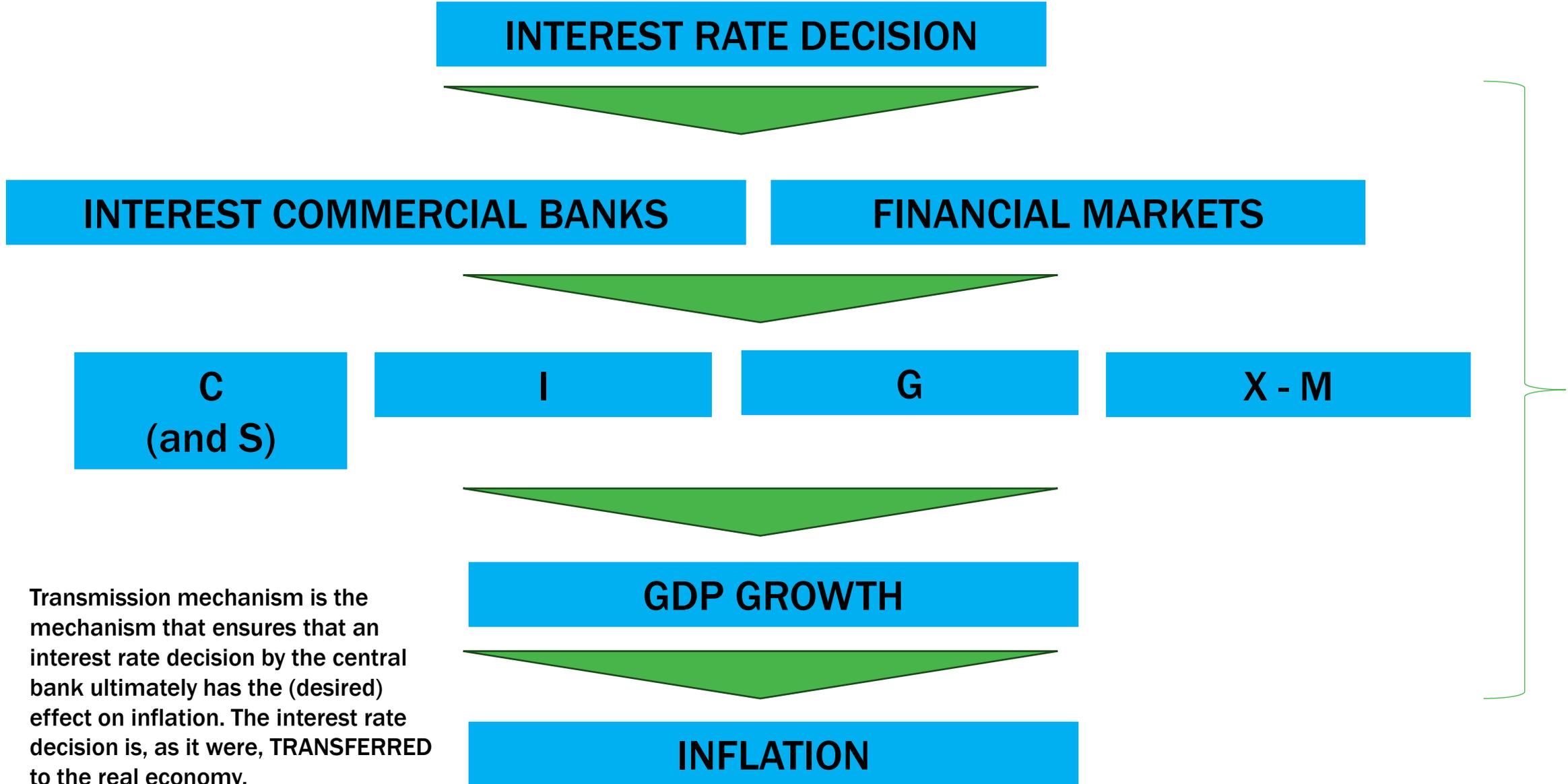
Does not always have a (direct) effect

(due to the monetary transmission mechanism)

Expansionary policies (free money policies) can weaken fiscal discipline

Restrictive policies can take oxygen out of the economy and cause recession

MONETARY POLICY: TRANSMISSION MECHANISM



TRANSMISSION MECHANISM

Transmission mechanism is the mechanism that ensures that an interest rate decision by the central bank ultimately has the (desired) effect on inflation. The interest rate decision is, as it were, TRANSFERRED to the real economy.

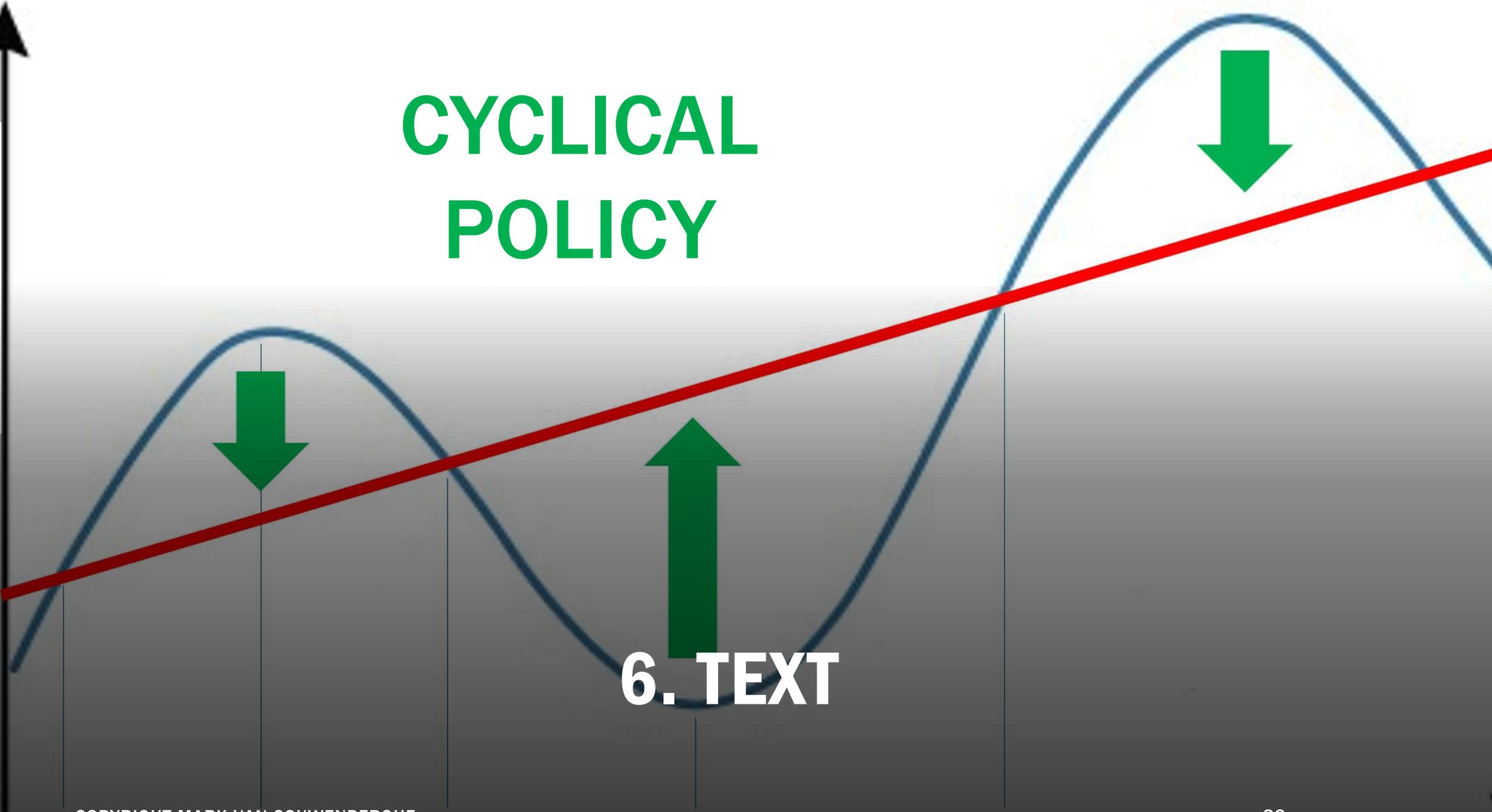
MONETARY POLICY: GRAPHICAL ANALYSIS

(See the graphical analysis of fiscal policy)

Monetary policy aims to drive the AD curve in the model:

RESTRICTIVE MONETARY POLICY	EXPANSIONARY MONETARY POLICY
<p>Money is getting more expensive, money supply is shrinking</p>  <p>Less oxygen for consumption and investment</p>  <p>AD curve shifts to the left</p>  <p>GDP growth slows down, inflation falls</p>	<p>Money is getting cheaper, money supply is expanding</p>  <p>More oxygen for consumption and investment</p>  <p>AD curve shifts to the right</p>  <p>GDP growth accelerates, inflation rises</p>

CYCLICAL POLICY



6. TEXT