The Magic of the Money Multiplier

Two options for consumers: Spend or Save

Households spend a % of an increase in income and save a % an increase in income.

Together they can spend & save 100% of income. The two percentages added together will equal 1.

Spending Multiplier: 1/(1-MPC) or 1/MPS Example: 80% MPC. 1/(1-MPC) 1/(1-.80)=1/.2=5 or 1/.20(MPS)=5

If the government increases spending by \$100b and if the multiplier is 5 then the economic impact is \$100b*5=\$500b

NOTE: The government spending multiplier and the investment (Ig) multiplier are the same calculation

Tax Multiplier: -MPC/MPS The change in income (increase in taxes) is a negative. The spending and investment multiplier are STRONGER than the tax multiplier.

MPC= (1-mps)	MPS= (1-mpc)	Spending/Investment Multiplier (1/mps)	Tax Multiplier (-mpc/mps)	Calculate: An increase in spending of \$500b will =?	Calculate: An increase in taxes of \$500b will =?
.95	.05	1/.05=20	95/.05=-19	\$500b * 20=\$10,000b	\$500b * -19= -\$9,500
	.10				
.80					
.75					
	.40				
.50					

FRQ:

(c) Assume instead that no fiscal policy action is taken. Suppose a change in investment spending causes real GDP to increase by \$200 billion. Calculate the minimum change in investment spending that could have caused this increase in real GDP if the marginal propensity to save is 0.25. Show your work.

Answer: SHOW YOUR WORK

Answer and show your work:

If the marginal propensity to save is 0.25, a \$15 billion increase in government spending will lead to an increase in national income by a maximum of

- (A) \$60 billion
- (B) \$45 billion
- (C) \$15 billion
- (D) \$11.25 billion
- (E) \$3.75 billion

An increase in government spending that is financed by an equal increase in taxes results in which of the following changes in aggregate demand (AD) and short-run aggregate supply (SRAS) curves?

AD Curve	SRAS Curve
(A) Shifts to the right	Shifts to the right
(B) Shifts to the left	Shifts to the left
(C) Shifts to the right	No change
(D) Shifts to the left	No change
(E) No change	No change