

Examining the condition of crowding out economics essay



Crowding out is a condition that occurs when there is a reduction in private consumption or even private investment. This is usually caused by an increase in the government expenditure. In case the government increases its expenditure, while doing nothing on tax increase, it will mean that, the government will borrow more to finance its expenses, and in the process, interest rates will tend to go higher. This as an effect will reduce private investment, due to reduced private borrowing as a result of high interest rates which corporations and individuals no longer afford to pay. In summary, "the problem occurs when government debt 'crowds out' private companies and individuals from the lending market" (Herman & Daly, 2003).

Considering the term crowding out in health economics, is a condition which occurs when programs that were expanded with the aim of covering the uninsured, have resulted to an effect of promoting the already enrolled in private insurance to change to the new programs.

In looking at the effects of an increase in the government spending on the IS curve, it is good to explain first that, the independent in an IS curve is the interest rate, while the dependent variable is the income level. The curve is usually drawn down sloping with interest rate on the vertical axis while GDP on the horizontal axis. An increase in the government spending will mean that, "consumer spending + planned private investment + government purchases + net exports" (Herman & Daly, 2003), is not equal to an economy's total output (equivalent to real income, Y, or GDP). This is because; an increase in government spending might affect the interest rates. For instance, if the government decides to raise the interest rates, fixed investment and the likes will be discouraged, which will then affect the

income, which is at the equilibrium level for a given interest rate when the saving that the consumers along with other participants in the economy might choose to do out without of this income equals investment. The multiplier effect of a reduced fixed investment as a result of higher interest rates lowers the real GDP. This will then explain the entire shift of the IS curve on the right. In simple terms, the curve will be affected because in real sense, it just represents the causation from the increasing rates to reducing planned fixed investment and the likes to reducing national income and the output.

An increase in the supply of money, will lead to different alterations on the LM curve. For instance, the vertical intercept lets say (r) will be lower, while the horizontal intercept say (y), will be larger, as an effect, the whole LM curve will move to the right. In addition, the exogenous alterations that might bring about the excess money supply, that is, driving money supply above the money demand, will make the interest rates to rise in order to lower money demand along with equilibrating the demand of money, and the money supply. This will shift the LM curve out too. Another factor arising on the LM curve due to an increase in money supply is that, an increase in money supply will make individuals to put extra money into non-monetary financial assets, as an effects, the issuers of assets can still offer lower interest rates yet still attracts the buyer. Graphically, an increase in money supply for instance by Fed M , will result in an excess money supply. An effect, this will make the LM curve to shift to the right, with the aim of restoring equilibrium as shown in figure 1

Figure 1 LM curve shift due to increased money supply

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Being an essential component of any country's economy, there are different ways through which the government expenditure in education can be increased, without any increase in the money supply. For instance, the government can use the fiscal policy to influence the aggregate demand in the economy. In order for the government to attain " economic objectives of price stability, full employment and economic growth" (Herman & Daly, 2003), this is based on the fact that, after increasing government expenditure in education and decreasing tax rates will end up stimulating the aggregate demand. This can be best applied during recession or low economic actions, with the aim of framework construction of strong economic growth. Then the resulting deficits will end up being paid for by the outcomes off an expanded economy in the booming season that will follow. The process of cutting taxes will ensure that taxpayers have extra money to spend, and as an effect, there will be an increase in consumption, hence creating markets for the products and services produced in the country. While the increase in government expenditure will increase, it will also pump some money in the economy, the two will result to expansionary effects. In addition, the government has the ability of using debt financing and borrows some money for the education project. For instance, the government can issue out bonds with the aim of lowering prices while rising driving up the interest rates. Another source of finance that the government can use in financing its increased expenses in education includes raising taxes. It has been shown that, when the government rises, individuals will then have less to spend. As an effect, this will tend to reduce demand, resulting to fewer investments. As a side effect, it will then shrink the country's economy. But when the entire increased tax is spend by the government; the stimulus of <https://assignbuster.com/examining-the-condition-of-crowding-out-economics-essay/>

increased expenditure in education will over weigh the raised contractions due to high taxes. This is based on the fact that, some of the tax money being spent would have been saved.

In looking at the causes on inflation and the available method of combating it, it is good to start with the definition of inflation. Inflation has been defined as an increase in prices that makes the purchasing power of a country to fall. It has been considered as a normal economic development, provided that the annual percentage continues remaining low, but, when the percentage rises above the predetermined level, and then it becomes an inflation crisis. There are several causes of inflation depending on a number of factors.

In most cases, inflation might occur due to excessive money supply. This usually happens when the government prints a lot of money to deal with a certain crisis. As an effect, prices ends up escalating at an extremely high rate to keep up with the currency surplus. This form of demand is called demand pull, which, the prices are forced to go up due to high demand, (Herman & Daly, 2003).

Another common cause of inflation is an increase in the cost of production. This in one way or the other, results to an increase in the prices of final products. For instance, if the prices of raw materials increase, this increases the cost of production, which in response makes the industries to increase the prices of their products with the aim of maintaining steady profits. In addition, labor costs can also cause inflation. This is based on the fact that, when workers demand wage increase, industries usually have no choice apart from passing similar costs to their customers. Also an increase in

workers wages, increases demand, since such workers will be having more money, as an effect, raises the demand pool, which one form of inflation.

Apart from the two discussed above, inflation can also be caused by international lending along with national debts. This is due to the fact that, when nations borrow money, they normally have to deal with interests, which at the end leads to price increase as a method of keeping at par with their debts. A drop in the exchange rate can also lead to inflation. This is because; the government will have to deal with differences in the import and export levels.

Inflation can also result as an effect of federal taxes imposed on consumer products like cigarettes or fuel. An increase in tax, will make suppliers to pass on such like expenses to the consumer; the catch, on the other hand is that, once prices have increased, it has been proved that it will then be very difficult to come down, even if the taxes are reduced later on. wars have been the cause of inflation in the recent times. This is rooted in the reason that, during and after wars, the governments have to recoup the money spend and repay the cash borrowed from the central bank. In addition, it has been proved that, wars affect everything that is on the international markets, starting with labor costs to product demand, so at the end, wars usually produces a rise in prices which rarely comes down after wards.

Since 19th century, unemployment has been the major cause of inflation. The reality in the 19th century is that, there was an emergence of large unemployment scale. The connection between inflation and unemployment is invested in that Marxian theory. The theory asserts that, unemployment

acts as a reservoir of labor, which in one way or the other restrains the wage inflation. In the 20th century, some aspects in the Keynesian economics include Non-Accelerating Inflation Rate of Unemployment and the Philips curve, which further explains the connection of inflation and unemployment.

There have been several policies that have been recommended for combating inflation. Monetary policy has been considered as being the main tool for combating inflation. The central bank has to be charged with the responsibility of maintaining federal funds lending rate at a very low level per year along with a targeted low inflation range. This low inflation rate is aimed as deflationary circumstances are seen as being dangerous for the economy health. The central bank can affect inflation through interest setting, along with other operations. The central bank can maintain high interest rates and low growth of money supply as the traditional way of inflation control. Monetarists have emphasized to control inflation, maintaining steady money growth rate and usage of monetary policy are the best ways. On the other hand, Keynesians have on their part emphasized that, the process of reducing aggregate demand at the times of economic expansions and increasing demand at recession times, are the best methods of controlling inflation. Controlling aggregate demands can be attained by the use of both fiscal policy as well as monetary policy.

Another policy that has been proposed in dealing with inflation is fixed exchange rate. In a regime of fixed exchange rate, the currency of the country is usually tied in value to another single currency, or a group of other currencies. In the process of stabilizing currency value, affixed exchange rate has been proposed as being the best method. It can also be applied as a <https://assignbuster.com/examining-the-condition-of-crowding-out-economics-essay/>

means of controlling inflation. “ But as a currency reference value falls and rises, so does the currency pegged to it” (Abel & Bernanke, 2005). This reasonably means that, in a country with fixed exchange rate, inflation is determined by the rate of inflation of the country whose currency has been pegged on. In addition, the government is prevented from the usage of domestic monetary policy with the aim, of attaining macro-economic stability by the fixed exchange rate. Currently, most countries have their currency pegged on the U. S dollar. This in one way or the other limits the inflation rate in such countries, however, are exposed to the danger of speculative attacks.

Wage and price control has been proposed by several economists as another way of dealing with inflation. This has been successive during war times, though the policy has been regarded as a short term inflation control policy, but long term if coupled with policies that are designed for the reduction of inflation causes during wage and price control regime. Though its notable failure occurred in 1972 when it was imposed by Nixon Richards. This policy has perverse impacts as a result of distorted signals that it sends to the market. Artificially, low prices leads to rationing and shortages, which might discourage future investment, which might further the shortages. Normal analysis of economy, underpriced commodities is over consumed, hence resulting to its own effects in the long run. Temporary controls might complement recession as a way of fighting inflation. They usually control recession efficiently, as a way of dealing with inflation. However, generally, the advice of economists is not price imposition, but controlling and liberalizing prices by making an assumption that, economy will adjust which

will result to the abandoning of unprofitable economic activities. The lower practices will place fewer demands regardless of the commodities that were driving inflation, as inflation will fall economic output in total. This in most cases has proved to giving rise to a severe recession period. This is based on the fact that, due to the reallocation of productive capacities, will result to unpopular outcome to individuals whose livelihoods were destroyed, (Abel & Bernanke, 2005).