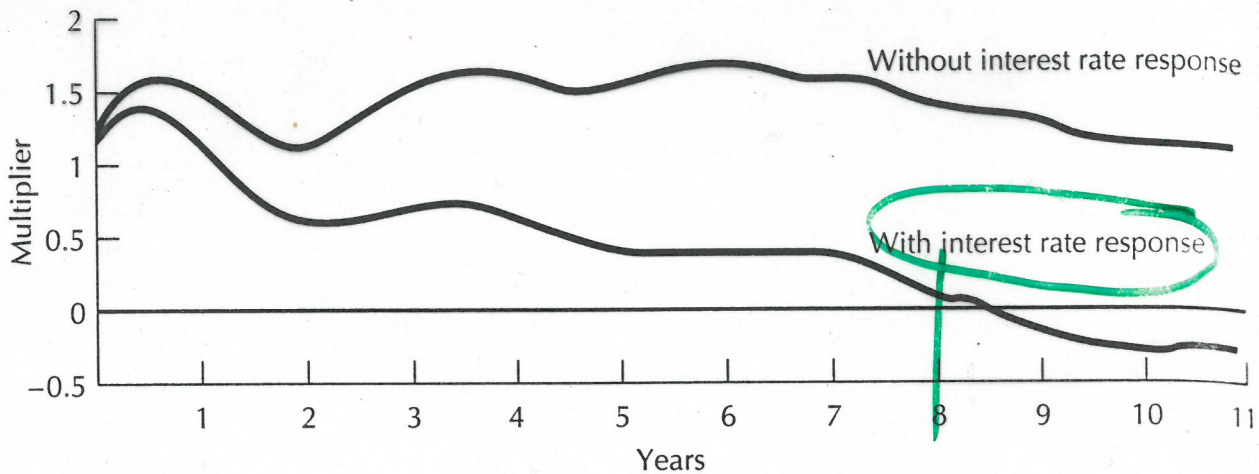


GOVERNMENT SPENDING MULTIPLIER



MONEY MULTIPLIER

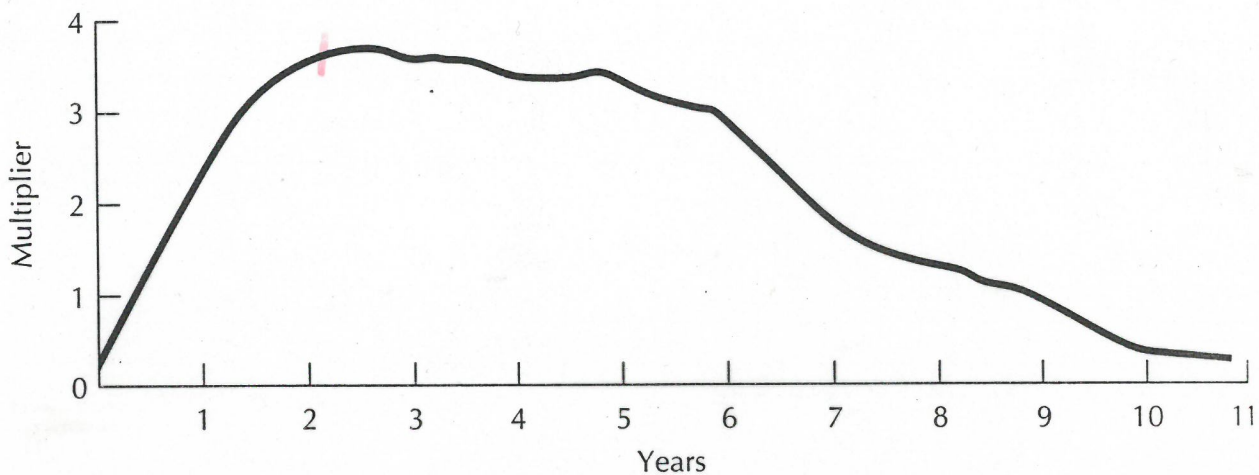


Figure 5-4 Actual Fiscal and Monetary Multipliers

This graph shows multipliers for monetary and fiscal policy over ten years, following a policy change, with time plotted on the horizontal axis. The vertical axis plots the ratio of the change in real GDP to the change in government spending (top frame) or to the money supply (bottom frame). The two lines in the top frame show the response of GDP to an increase in government spending. The red line shows the actual multiplier, which holds the money supply constant and peaks after two quarters at a 1.4 dollar increase in real GDP in response to a 1.0 dollar increase in government spending. After three quarters this multiplier fades away, reaching zero after eight years. The black line in the top frame shows the hypothetical multiplier on the alternative assumption that the interest rate remains fixed; it does not fade away. The bottom frame shows the multiplier for an increase in the money supply, which fades away after about ten years. *Source:* Allen Sinai, "Financial and Real Business Cycles," *Eastern Economic Journal*, vol. 18, no. 1 (Winter 1992), pp. 1-54, Figures 5 and 17. Used by permission.

What actually happens in the economy to make the fiscal policy multiplier fade away over time along the red line?

- The higher interest rate reduces consumer spending on items that are typically financed by borrowing, particularly cars and residential houses and condominiums.