



MACROECONOMICS UNIT 3

AD-AS and Fiscal Policy



BIG PICTURE IDEAS

- #1. Changes in an economy can be represented on a graph using _____ demand, _____ -run aggregate supply, and _____ -run aggregate supply.
- #2. An economy can have either a _____ output gap (or recessionary gap), a _____ output gap (or inflationary gap), or it can be at full _____ at the natural rate of unemployment.
- #3. An initial change in spending is amplified in the economy due to the _____ effect. The amount of the change depends on how much people spend, the marginal propensity to _____.
- #4. An unhealthy economy will eventually self- _____ even without government intervention. This is because wages and resource prices are _____ in the long run.
- #5. The government uses _____ policy, which includes changes in government spending and _____ to stabilize the economy and achieve full employment.

■ Topic 3.1- Aggregate Demand (AD)

1. What is the difference between a market demand curve and the aggregate demand curve?
2. What three concepts explain why aggregate demand is downward sloping?
3. What are the shifters of aggregate demand?

■ Topic 3.3- Short-run Aggregate Supply

4. Explain the difference between the short run and the long run.
5. Why is short-run aggregate supply upward sloping?
6. What are the shifters of short-run aggregate supply?

■ Topic 3.2- Multipliers

7. The _____ effect is the idea that an initial change in spending (or taxes) results in a larger change in spending.
 8. Define marginal propensity to consume (MPC).
 9. Define marginal propensity to save (MPS).
 10. What is the equation for the simple spending multiplier?
 11. What is the equation for the tax multiplier?
- True or False:
12. The MPC plus the MPS equals 1.
 13. The spending multiplier increases when the MPC increases.
 14. A \$10 billion increase in government spending results in the same total change as a \$10 billion tax cut.
 15. Transfer payments don't get multiplied since they don't count in GDP.

16. Fill in the table below:

Initial Change	Initial Amount	MPC	Maximum Change
↓ G	\$30 billion		↓\$60 billion
↑ C		.9	↑\$200 billion
↓ Taxes	\$10 billion	.8	
↑ I		.75	↑\$80 billion
↓ C	\$10 billion	.9	
↑ X	\$10 billion		↑\$50 billion
↑ Transfer Payments	\$20 billion	.9	



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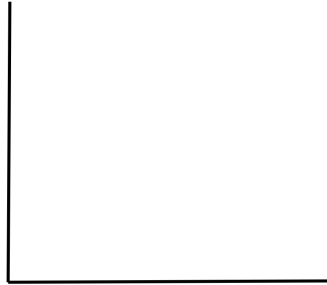


■ Topic 3.5- Equilibrium in the AD-AS Model

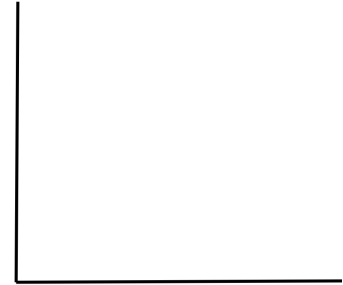
17. Draw a negative output gap



18. Draw an economy at full employment



19. Draw a positive output gap



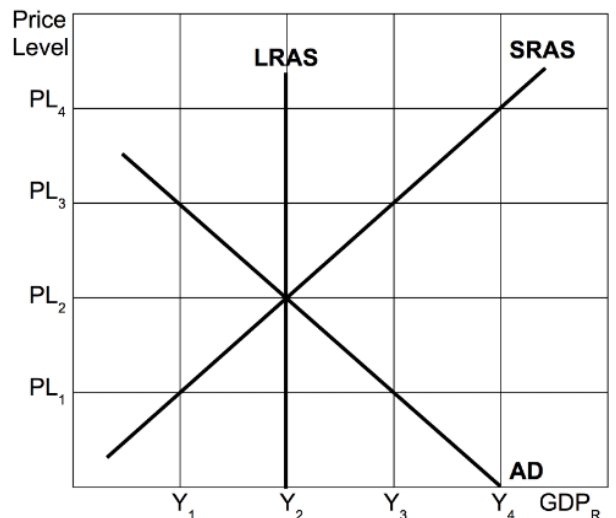
■ Topic 3.6- Changes in the AD-AS Model in the Short Run

For each scenario, identify the initial change (\uparrow , \downarrow , or no change) in aggregate demand or aggregate supply, price level, and real GDP.

Scenario	AD	SRAS	PL	RGDP
20. The effect on production from a significant increase in the worldwide price of oil				
21. The effect on investment from an increase in interest rates				
22. Decrease in infrastructure spending due to fear of rising inflation				
23. A rise in business productivity due to new artificial intelligence technologies				
24. Depreciation of a country's currency causing exports to increase				

Use the graph to the right to complete the following. Assume that each event takes place independently.

- What is the short-run equilibrium price level and output?
- Identify the short-run equilibrium price level and output if consumption increased?
- Identify the short-run equilibrium price level and output after a negative supply shock?
- What happens to output and unemployment if investment falls?
- Explain the difference between demand-pull and costs-push inflation.



- An unexpected decrease in the availability of a key resource is an example of a negative shock.
- is when SRAS decreases and there is high unemployment and high inflation.
- What is deflation?
- What is disinflation?
- What is autonomous consumption?
- What is disposable income?

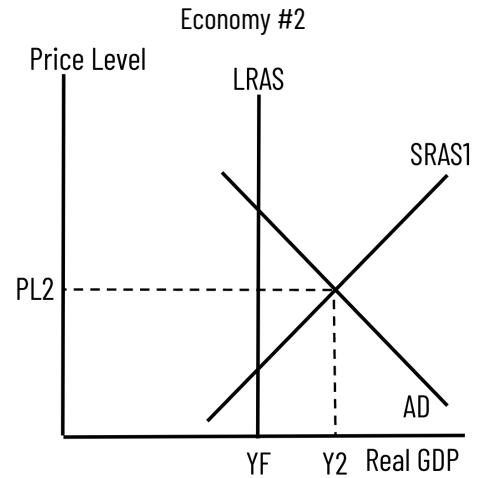
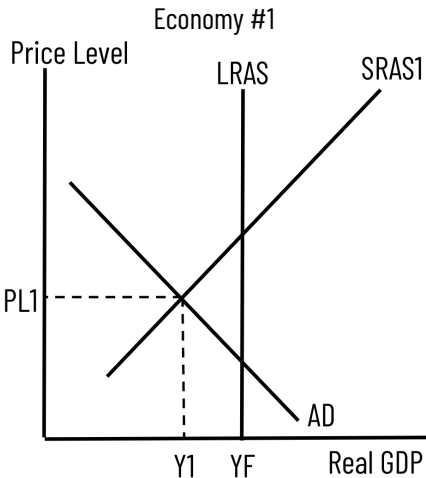


■ Topic 3.7- Long-run Self-Adjustment

36. Describe how the economy self-adjusts in the long run when there is a negative output gap.

37. Describe how the economy self-adjusts in the long run when there is a positive output gap.

38. Assuming wages and resource prices are flexible, show how each economy below will self-adjust in the long run.



True or False

39. An economy will take longer to self-adjust if wages and resource prices are flexible.
 40. When an economy experiences economic growth, the LRAS will shift to the right and output will increase.
 41. If an economy experiences economic growth the natural rate of unemployment will decrease.

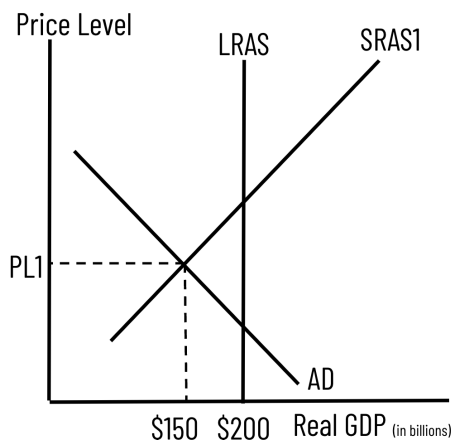
■ Topic 3.8- Fiscal Policy

42. Identify two examples of expansionary fiscal policy.

43. Identify two examples of contractionary fiscal policy.

44. Explain why an increase in government spending will lead to more total spending than a decrease in taxes by the same amount.

Use the graph below to answer the questions. Assume wages and resource prices are flexible.



45. Does the economy have a recessionary gap or inflationary gap?

46. What happens to price level and output in the long run if no policy action is taken?

47. Assume instead that the government decides to use fiscal policy. Identify two policies that could close the gap.

48. If the MPC is .5, what is the least amount of government spending that could close the gap?

49. If the MPC is .5, what is the least amount the government could cut taxes to close the gap?

50. Assume instead that the MPC is .9. What is the least amount of government spending that could close the gap?

51. Assume that an economy has a positive output gap of \$80 billion and MPS is .2. Identify the change in government spending that could close the gap?



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■ Topic 3.9- Automatic Stabilizers

52. What is the difference between discretionary fiscal policy and non-discretionary fiscal policy?
53. Identify three different examples of automatic stabilizers.
54. Why are there lags when the government uses discretionary fiscal policy?

■ Unit Review

True or False:

55. An increase in consumer spending causes aggregate demand to shift right.
56. Stagflation is the result of an increase in the short-run aggregate supply.
57. An increase in expected inflation will decrease the SRAS.
58. An increase in interest rates will increase investment and aggregate demand.
59. The spending multiplier is always one less than the tax multiplier.
60. Fiscal policy includes government spending and taxation.
61. An increase in private savings decreases the effectiveness of fiscal policy.
62. If the MPS is .2 the tax multiplier is -4.
63. When the MPC increases, the spending multiplier decreases.
64. Jacob Clifford's resources are super helpful.

Scenario	Change in AD or AS	↑ or ↓
65. Government uses expansionary fiscal policy		
66. No policy when there is a recession		
67. Government increases taxes on consumers		
68. There is a decrease in exports		
69. Positive output gap. Government takes no policy		

■ Sample FRQ

70. Assume an economy is producing below full employment with a \$300 billion gap and that the marginal propensity to consume is .9.
- Draw a correctly labeled graph with aggregate demand, short-run aggregate supply, and long-run aggregate supply. Label the price level PL_1 , the output Y_1 , and the full employment output Y^* .
 - Assume the government implements fiscal policy.
 - Calculate the minimum change in government spending that could close the gap. Show your work.
 - Identify what will happen to the price level and output.
 - Would contractionary fiscal policy cause the natural rate of unemployment to increase, decrease, or stay the same in the long run?
 - Assume instead of using fiscal policy, the government takes no policy action. Label the new price level PL_2 and the output Y_2 .