Stabilization Policy Problems

Watch Fiscal Policy and Stimulus: Crash Course Economics #8
https://www.youtube.com/watch?v=otmgFQHbaDo&index=8&list=PL8dPuuaLjXtPNZwz5_o_5uirJ8gQXnhEO

Fiscal Policy – The way a government adjusts its spending levels and tax rates to monitor and influence a nation’s economy.

- When the economy is going too ________________, or too fast the government can step on the gas or the brake by changing government ___________________________ or ___________________.

Expansionary Fiscal Policy - stimulate the economy during or in anticipation of a business cycle contraction

- When the economy falls into a deep recessionary gap the government can increase government ___________________________, cut _____________________ or do some of both.
- The idea that government spending creates ___________________________ and increases income for construction workers and teachers and other laborers. In turn, these workers spend more of their additional income, increasing _______________________________________________________ and boosting the entire economy.
- Cutting taxes follows a similar logic. A tax cut will increase ___________________________. That will increase our consumer spending and boost the entire economy.

Contractionary Fiscal Policy - enacted by a government to reduce the money supply and ultimately the spending in a country.

- When the economy has an ___________________________ gap the government can cut spending, or raise taxes or do some combination of the two.
- Higher taxes will leave consumers with ________________ money to spend, and lower government spending will mean fewer public _____________________, all that should reduce consumer spending, cooling off the economy and reducing ___________________________.

The theory that the economy will fix itself in the long run dominated policy decisions during the early years of the Great Depression. The idea is demonstrated with this diagram:

The Economy is Back on Track

John Maynard Keynes – invented modern economics and developed theories and models about spending and production

- Keynes suggested using ___________________________ fiscal policy to speed up the economy.
- Keynes argued that government spending can make-up for a decrease in ___________________________ spending.
• According to Keynes theory if consumer spending falls, the ______________ can spend instead.
• The flaw in this thinking is that the government needs to pay for all that spending. They can’t just raise __________ to cover it because that would cause a ______________ in consumer spending and defeat the purpose.
• To stimulate the economy, the government needs to ______________ spend; they need to spend more money than they collect in tax revenue.

Crowding out – Where increased public sector spending replaces or drives down private sector spending.
• If the government borrows a lot of money, that increases ______________ making it harder for business to borrow money and buy things like factories and tools. This weakens the economy while increasing government debt.
• Keynesian economists argue that crowding out does not occur if the economy is operating ______________. In that case more government spending can raise overall output by putting idle resources back to work.
• Government stimulus when the economy is below capacity can actually raise private spending. All those newly hired workers will start ______________.

The Multiplier the multiplier effect complicates fiscal policy. Explain it here
• ____________________________________________________________________________________________
• ____________________________________________________________________________________________
• ____________________________________________________________________________________________

Narvaizville is a small, closed economy that is currently operating at the long-run equilibrium level of output. It is therefore producing Yp where Yp is potential output. Its aggregate price level is P1.

Draw a graph of this long-run equilibrium for Narvaizville depicting the AD curve, the SRAS curve, and the LRAS curve. Label both axes and identify Yp and P1 on your graph.
Suppose that Narvaizville experiences a **negative demand shock**. Draw a new graph beginning at long run equilibrium and depicting the short-run changes that will occur because of this demand shock. On your graph identify the new short-run equilibrium level of output \( Y_2 \) and the new short-run equilibrium aggregate price level \( P_2 \). Label any shifts in AD or AS clearly.

As a result of this shift:

a. price level will _______

b. Inflation will _______

c. GDP will _______

d. unemployment will _______

Given the negative demand shock, suppose the government wishes to engage in activist fiscal policy in order to restore the economy to its initial equilibrium. Give two examples of fiscal policies that would enable this economy to return to its initial equilibrium.

Redraw the graph above. Show the long-run adjustment that will eventually happen as a result of the negative demand shock. Label any shifting curves clearly and identify the new long-run equilibrium level of aggregate output \( Y_3 \) and the new long-run aggregate price level \( P_3 \).

As a result of this new shift:

a. price level will _______

b. Inflation will _______

c. GDP will _______

d. unemployment will _______

Draw an AD/AS graph showing the economy in long-run equilibrium using all the appropriate labels. Suppose the economy experiences a 25% increase in the price of petroleum and petroleum-based products. Makes changes to the graph that show the result of this situation.

As a result of this new shift:

a. price level will _______

b. Inflation will _______

c. GDP will _______

d. unemployment will _______