## Unit 3: Aggregate Demand, Aggregate Supply, and Fiscal Policy

<table>
<thead>
<tr>
<th>AD, AS, and LRAS</th>
<th>Short Run vs. Long Run Aggregate Supply</th>
</tr>
</thead>
</table>
| **Draw the economy at full employment** | 1. In the short run, wages and resource prices will **not** as price levels increase  
2. In the long run, wages and resource prices will **up** as price levels increase |

### Shifters of AD and AS

**Shifters of Aggregate Demand**
1. C  
2. I  
3. G  
4. Xn

**Shifters of Aggregate Supply**
1. input prices  
2. taxes and subsidies  
3. productivity

### Recessionary Gap

**Draw an economy in a recession**

### Inflationary Gap

**Draw an economy with an inflationary gap**

### Graphing Practice

**Draw an economy at full employment. Show what happens to price level and GDP if consumption falls**

### Define Key Terms

**Negative Supply Shock** - unexpected decrease of a resource (SRAS↓)

**Positive Supply Shock** - unexpected increase of a resource (SRAS↑)

**Stagflation** - high inflation + high unemployment (SRAS↓)

**Autonomous Consumption** - the amount people spend even if they have no income

**Disposable Income** - income after taxes
Classical vs. Keynesian Economics

What is classical economic theory?
*The economy will fix itself (supply side economics) if no policy is enacted. SRAS will shift back to LR.*

What is Keynesian economic theory?
*Gov't should step in and help the economy get back to full employment.*

Fiscal Policy

Define Discretionary Fiscal Policy - Congress must make policy to change G or T

Define Non-Discretionary Fiscal Policy - automatic stabilizers that do not need an act of Congress

Three Ranges of the Aggregate Supply Curve

Draw and label the three ranges of the AS curve

Government Spending and Taxation

Expansionary Fiscal Policy - fights recession

Contractionary Fiscal Policy - fights inflation

The Multiplier Effect

Define Marginal Propensity to Consume (MPC) - how much people consume/spend of added or extra income

Define Marginal Propensity to Save (MPS) - how much people save of added or extra income

Policy and Multiplier Practice

1. Is there a recessionary or inflationary gap?

2. If the government does no policy and resource prices are flexible, in the long run wages will _____ and aggregate supply will _____

3. If fiscal policy is used to close the gap the government could _____ spending or _____ taxes on consumers

Assume the MPC is .5:

4. What is the least amount of government spending that could potentially close the gap? \( \frac{.9}{.5} = 2 \) billion

5. How much could the government cut taxes to close the gap? \( \frac{.4}{.5} \) billion

Now assume that the MPC is .8:

6. What is the least amount of government spending that could potentially close the gap? \( \frac{.8}{.2} = 5 \) billion

Problem with Fiscal Policy

1. Deficit Spending - occurs during a recession. Congress increases spending w/out increasing taxes

2. Time Lags - policy takes a long time to implement

3. Crowding out - Congress deficit spends so they must borrow.

Inflationary Expectations

What happens to aggregate supply when people expect inflation?

\( \downarrow \) People will ask for higher wages & input costs will increase (SRAS \( \uparrow \))
**Short Run and Long Run Phillips Curve**

<table>
<thead>
<tr>
<th>Price Level</th>
<th>LRAS</th>
<th>AS</th>
<th>PL₁</th>
<th>PL₂</th>
<th>AD₁</th>
<th>AD₂</th>
</tr>
</thead>
</table>

**Phillips Curve**

1. If interest rates fall, investment **↑** causing capital stock to **↑** and economic growth to **↑**.
2. If interest rates go up, investment **↓** causing capital stock to **↓** and economic growth to **↓**.

**Economic Growth Practice**

<table>
<thead>
<tr>
<th>Economic Growth Practice</th>
<th>Showing Economic Growth with AD and AS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. If interest rates fall, investment <strong>↑</strong> causing capital stock to <strong>↑</strong> and economic growth to <strong>↑</strong>.</td>
<td>Draw an economy at full employment. Show what happens in the long run if investment increases</td>
</tr>
<tr>
<td>2. If interest rates go up, investment <strong>↓</strong> causing capital stock to <strong>↓</strong> and economic growth to <strong>↓</strong>.</td>
<td></td>
</tr>
<tr>
<td>3. An increase in consumer spending leads to more economic growth in the long run. <strong>False</strong></td>
<td></td>
</tr>
<tr>
<td>4. Crowding out due to deficit spending causes less economic growth. <strong>True</strong></td>
<td></td>
</tr>
<tr>
<td>5. When the long run aggregate supply shifts right the natural rate of unemployment increases. <strong>False</strong></td>
<td></td>
</tr>
<tr>
<td>6. A sustained increase in productivity causes both the long run aggregate supply curve and production possibilities curve to shift right. <strong>True</strong></td>
<td></td>
</tr>
</tbody>
</table>