Fiscal Policy: Practice Examples and Questions
Introduction to Macroeconomics

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Problem Set 1 with Examples

Example 1

1. Consider the examples presented in Figure 16.1

   FIGURE 16.1

   Expansionary Fiscal Policy

   A decrease in aggregate demand from AD_1 to AD_2 moves the economy from point A to equilibrium at point b, with less than full-employment output (Y_1) and unemployment (u) greater than the natural rate (u*). In the long run, all prices adjust (short-run aggregate supply adjusts to $SRAS_2$), moving the economy back to full-employment equilibrium at point C. The goal of expansionary fiscal policy is to shift aggregate demand back to AD_1 so that the economy returns to full employment without waiting for long-run adjustments.
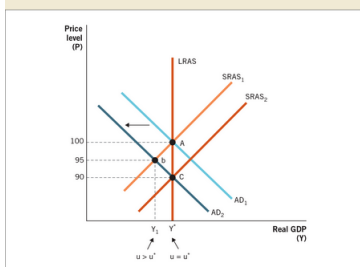
   Initially, the economy is in long-run equalibrium at point A, with $P = 100$, $Y = Y^*$ (full employment, and