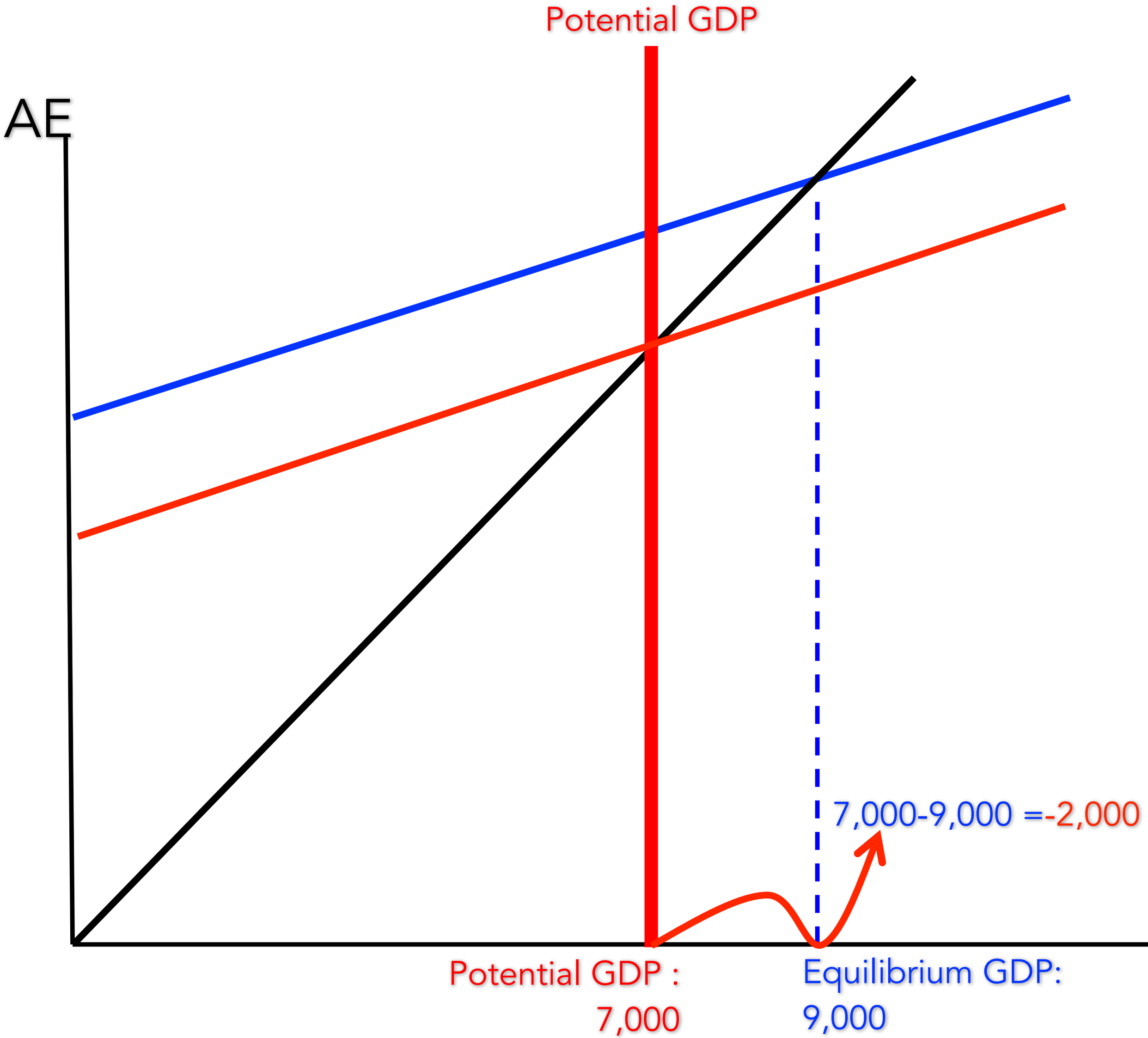
Potential GDP
AE
7,000-9,000 =-2,000
Potential GDP :
7,000
Equilibrium GDP:
9,000

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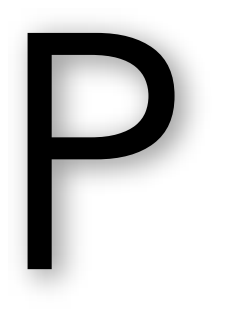

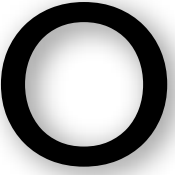

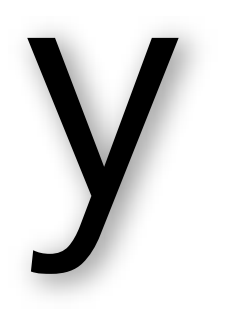
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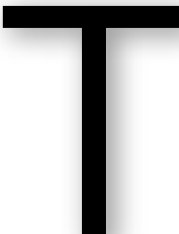

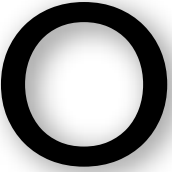

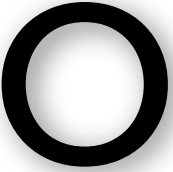

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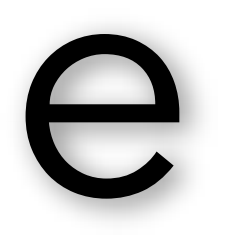

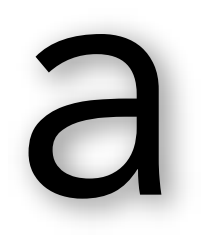
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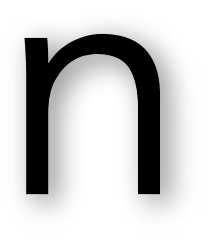
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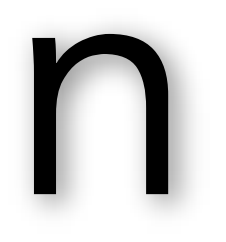

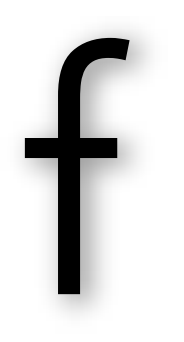

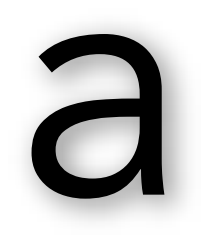
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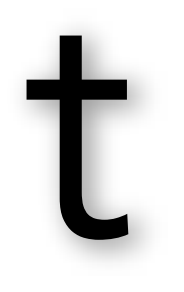

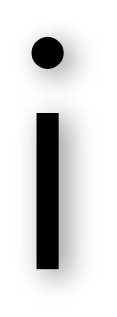

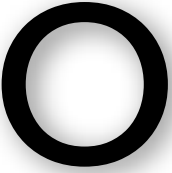

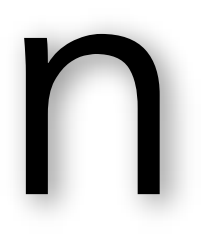

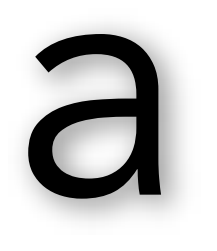
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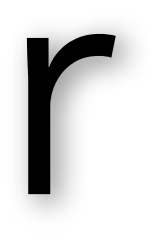

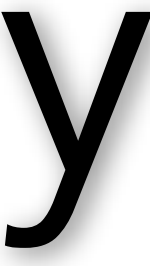
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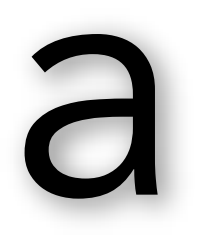
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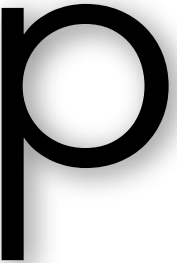

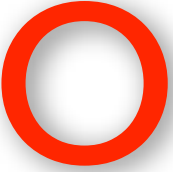

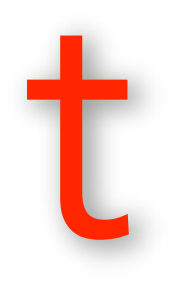

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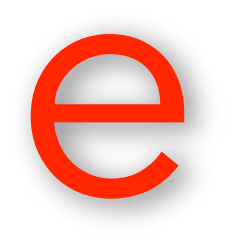

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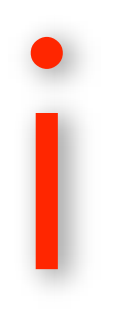

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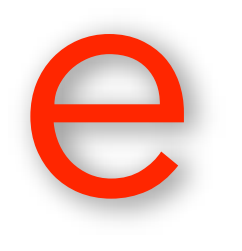

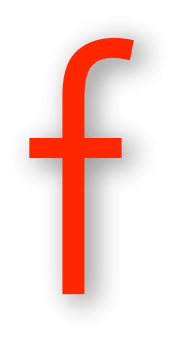

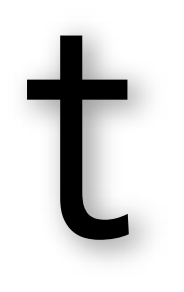

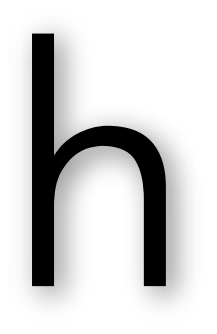

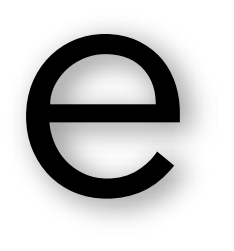

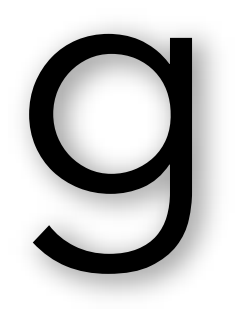

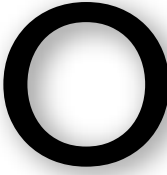

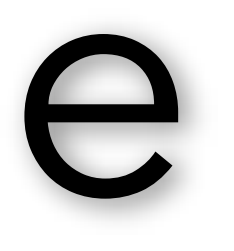

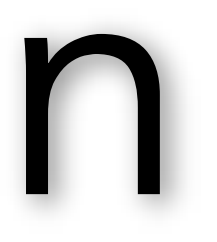
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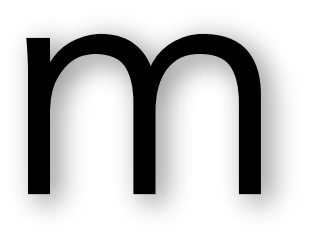

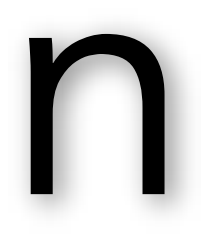

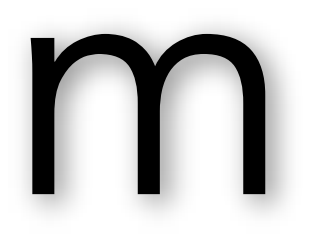

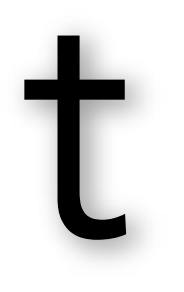
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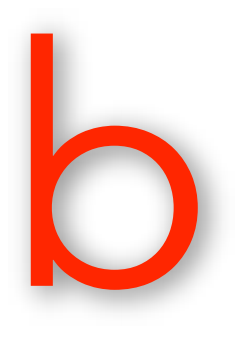

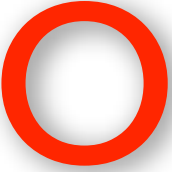

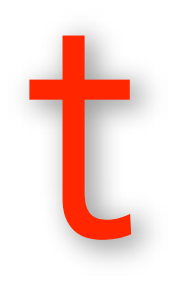

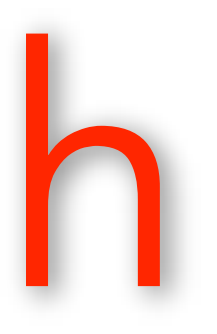

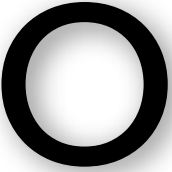

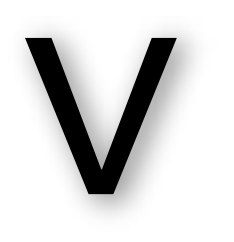

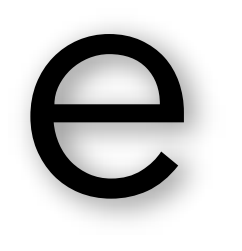

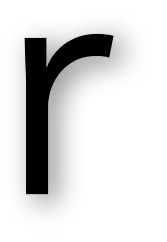

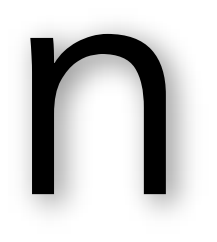

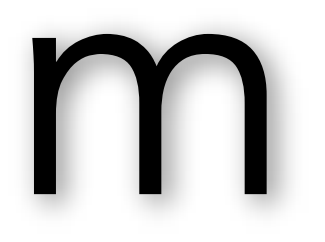

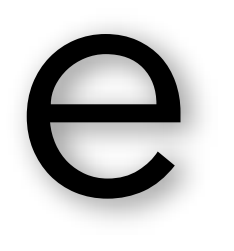

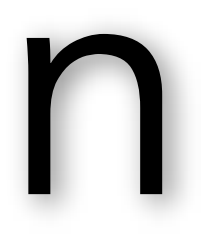
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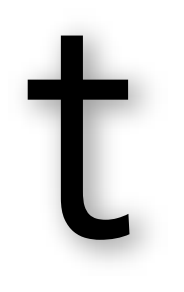

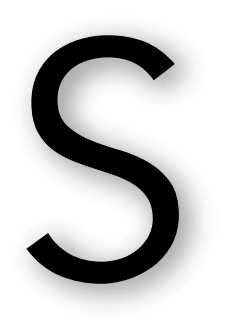

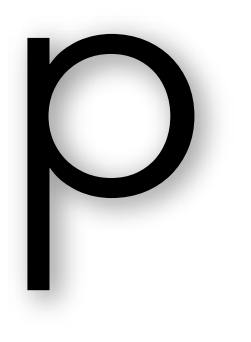

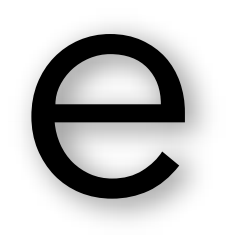

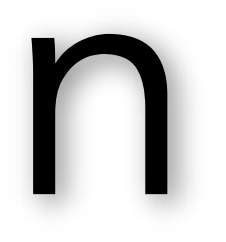
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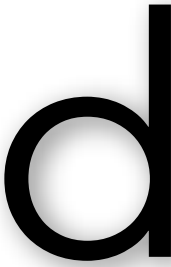

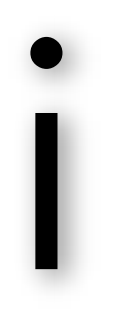

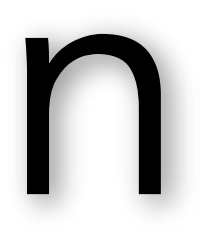

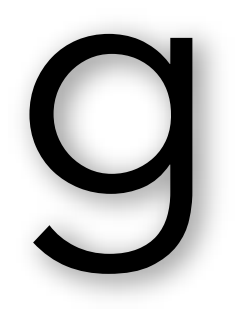

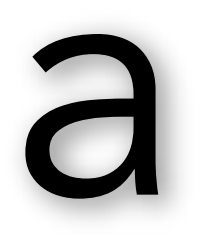
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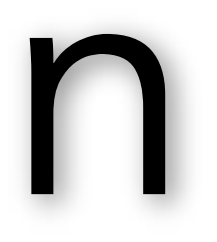

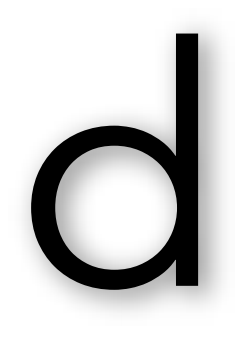

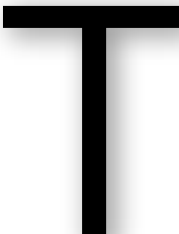

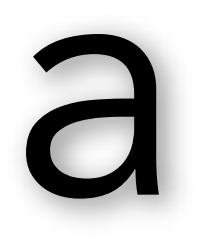
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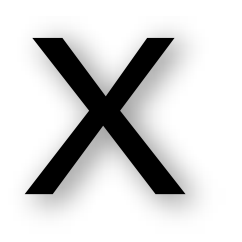

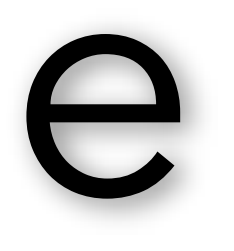

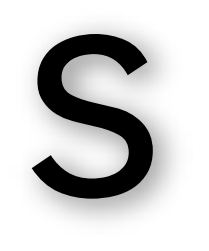
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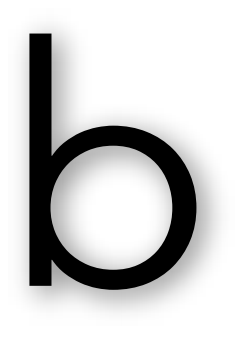

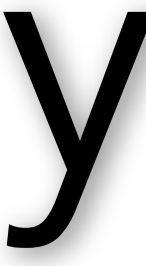

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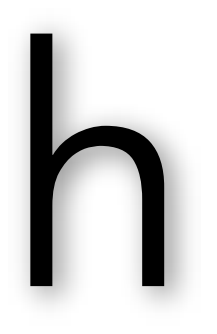

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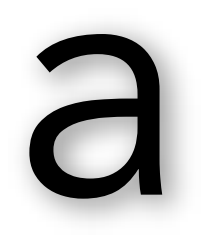
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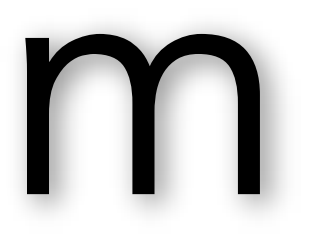
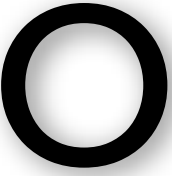
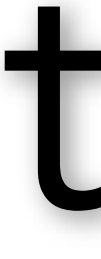






The Government must decrease both Taxes and Government Spending by 2,000 in order to close a 2,000 Inflationary Gap

If taxes decrease by 2,000, Disposable Income increase by 2,000 and Consumption increase by

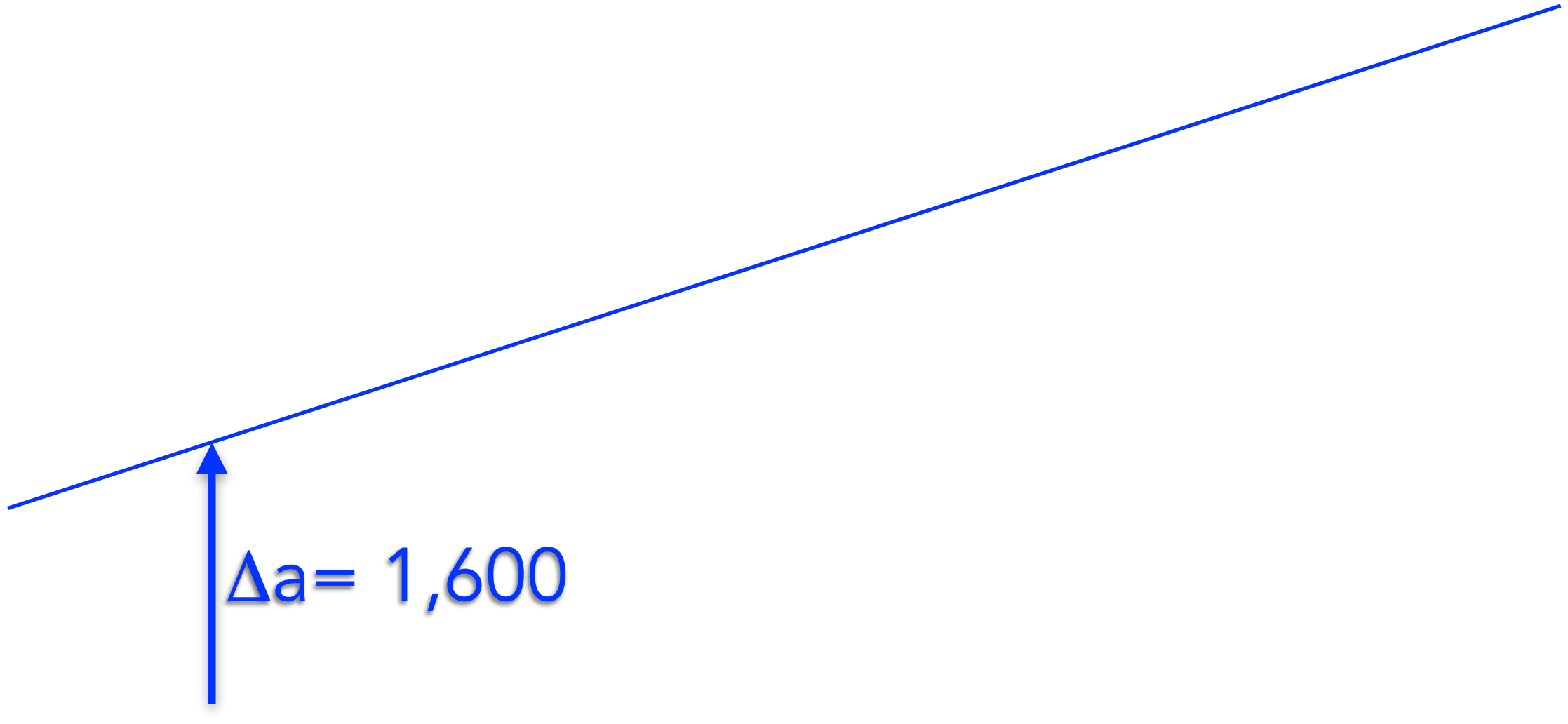
2,000 x MPC = 2,000 x 0.8 = 1,600

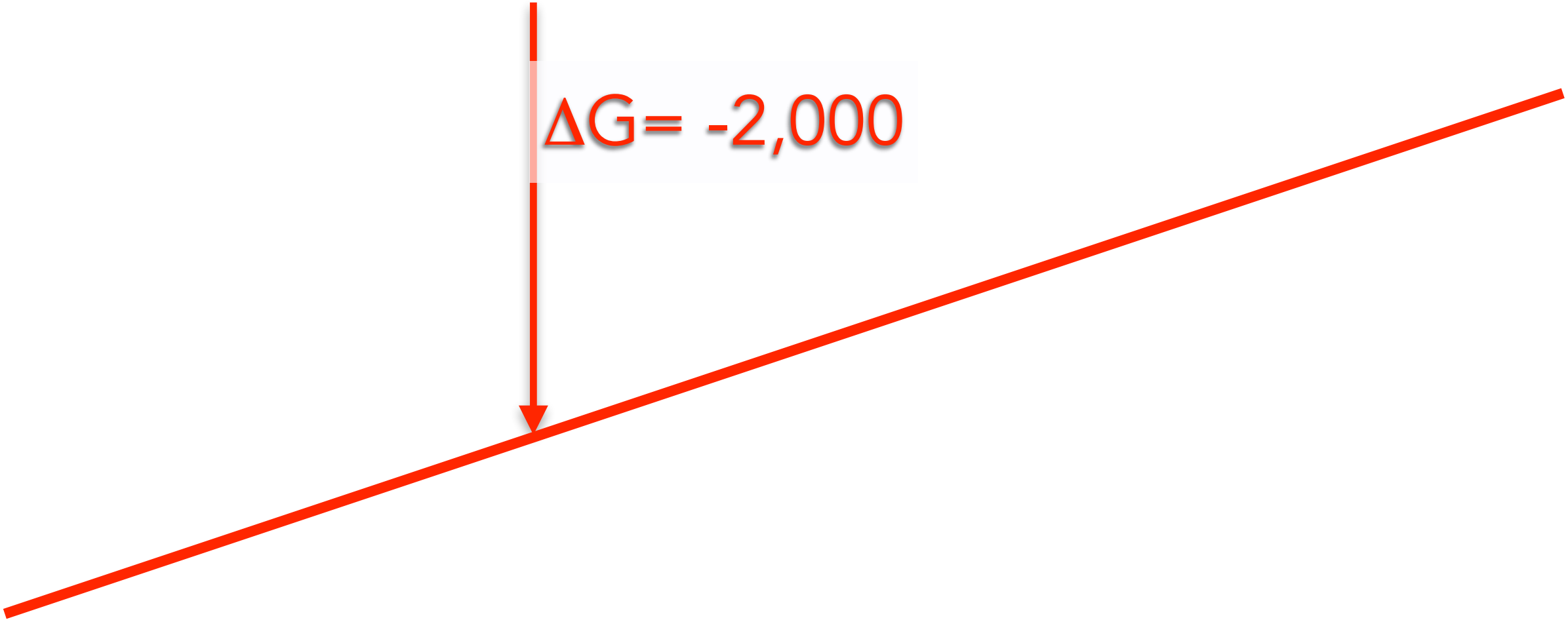
Δa= +1,600 The AE line shifts up by 1600

If Government Spending decrease by 2,000

ΔG= -2,000, the AE line shifts down by 2,000

The net effect of decreasing G and T by 2,000 is a net decrease of 400: the AE line shifts down by 400


Δa= 1,600


ΔG= -2,000

ΔAE = -400

Fiscal Policy: To close an Inflationary Gap without increasing the Deficit the government must decrease both Government Spending and Taxes by the same amount

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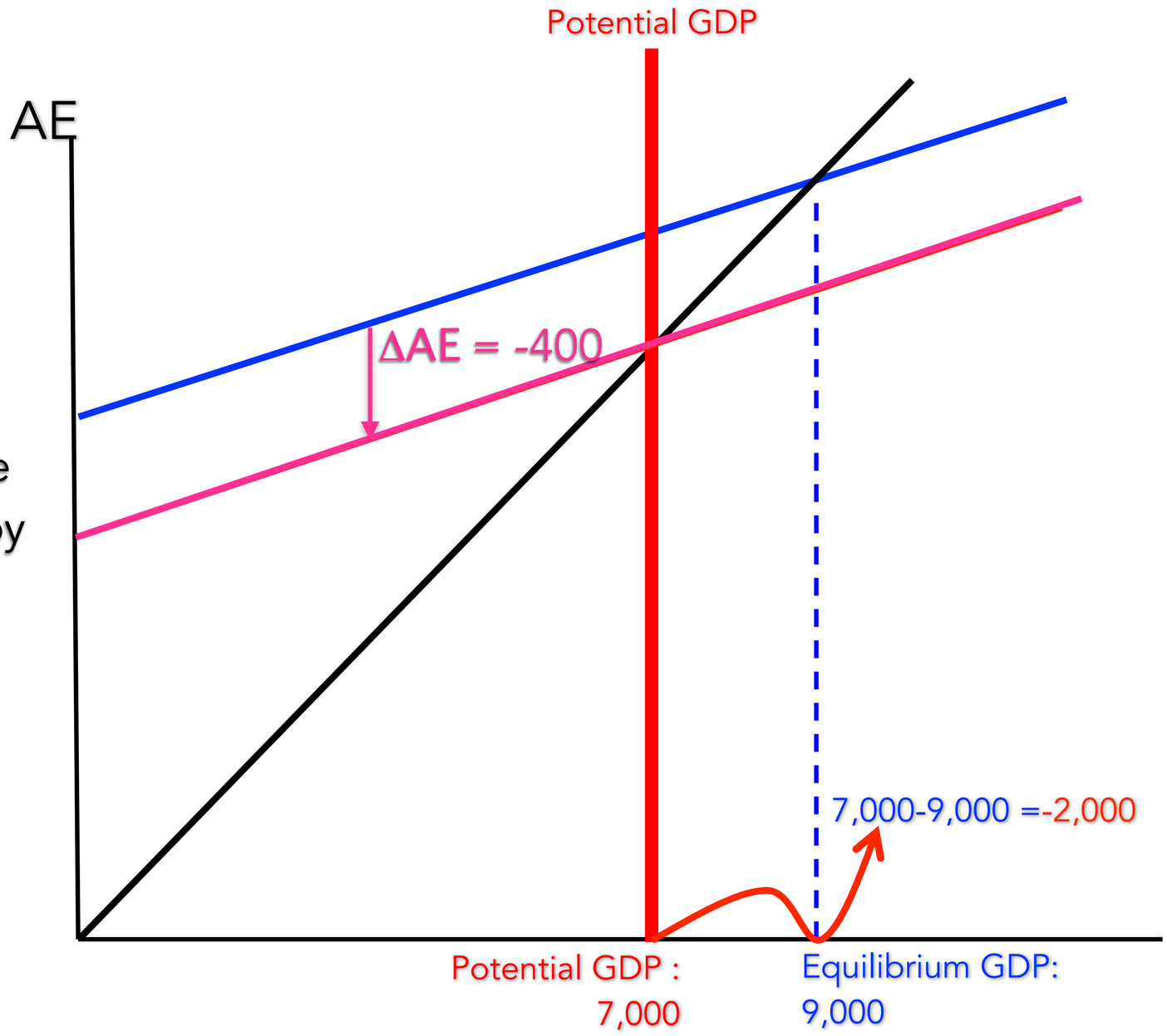
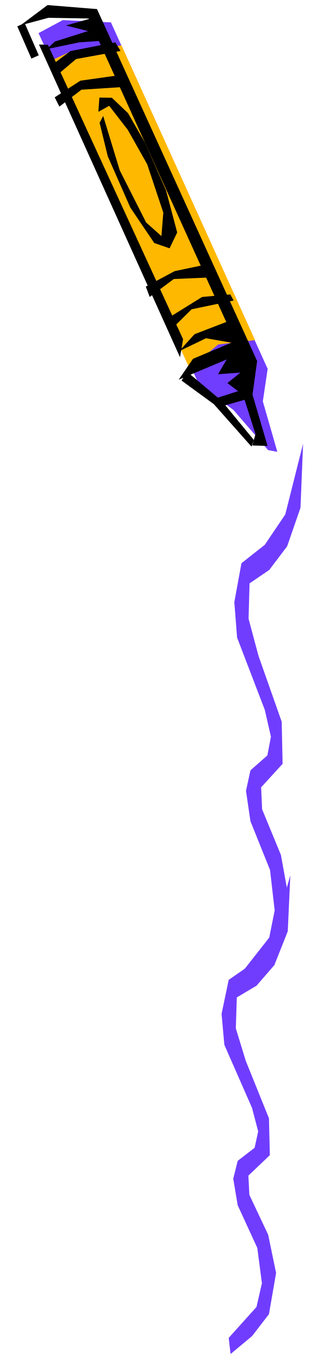
MPC	G Multiplier	Tax Multiplier
0.95	20.00	19.00
0.9	10.00	9.00
0.85	6.67	5.67
0.8	5.00	4.00
0.75	4.00	3.00
0.7	3.33	2.33
0.65	2.86	1.86
0.6	2.50	1.50
0.55	2.22	1.22
0.5	2.00	1.00