An economy is in long-run macroeconomic equilibrium when each of the following aggregate demand shock occurs. What kind of gap-inflationary o recessionary- will the economy face after the shock, and what type of fiscal policies would help move the economy back to potential output? How would your recommended [fiscal policy](https://moodle.unive.it/mod/resource/view.php?id=41308) shift the aggregate [demand curve](https://moodle.unive.it/mod/resource/view.php?id=38952)?

a. A stock market boom increases the value of stocks held by households.

b. Firms come to believe that a recession in the near future is likely.

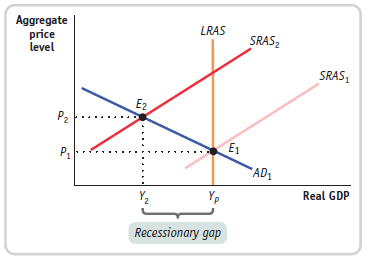
c. Anticipating the possibility of war, the government increases its purchases of military equipment.

d. The quantity of money in the economy declines and interest rates increase.

1. In this case, households will increase their consumer expenditure and AD curve will shift rightwards. As a result, a new short-run equilibrium will be reached with a lower unemployment rate and higher aggregate price level and aggregate output. This way, actual output exceeds potential output, causing an **inflationary gap**. A **contractionary policy** would help shifting the AD curve leftwards, making potential and actual output correspond and aggregate price level fall by means of a reduction in government purchases and government transfers or an increase in taxes.
2. If they have negative expectations, firms will reduce investment, causing a negative demand shock and making the AD curve shift leftwards. In this case, the economy faces a **recessionary gap**, namely a situation in which resources are not exploited at their maximum, leading to a high unemployment rate and a reduction in both aggregate price level and aggregate output (actual < potential) in the short run. To restore macroeconomic equilibrium, the government could implement an **expansionary fiscal policy** that would help stimulating the economy (incentive for consumption and investment) and shifting the AD curve rightwards by mean of an increase in government purchases and government transfers and a cut in taxes.
3. If government purchases increase, there will be a positive demand shock, leading to a higher level of aggregate output and aggregate prices and, therefore, to an **inflationary gap**. The government could respond by cutting its purchases and transfers and increasing taxes, therefore implementing a **contractionary policy**.
4. In this case, consumption and investment will be discouraged and, as a result, the economy will face a **recessionary gap**. The government could stimulate the economy by means of an **expansionary policy**.

In this question we try to understand why stagflation is particularly hard to fix using [fiscal policy](https://moodle.unive.it/mod/resource/view.php?id=41308).

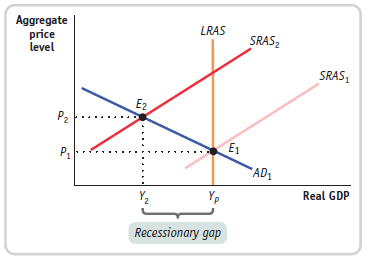
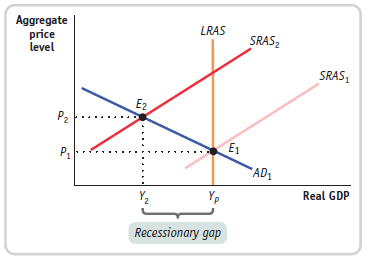
Assume that the economy is facing the situation described by the following figure:



a) What would be the appropriate [fiscal policy](https://moodle.unive.it/mod/resource/view.php?id=41308) response to this situation if the primary concern of the government was to maintain economic growth? Illustrate the effect of the policy on the equilibrium point and the aggregate price level using the diagram.

b) What would be the appropriate [fiscal policy](https://moodle.unive.it/mod/resource/view.php?id=41308) response to this situation if the primary concern of the government was to maintain price stability? Illustrate the effect of the policy on the equilibrium point and the aggregate price level using the diagram.

c) Discuss the effectiveness of the policies in parts a and b in fighting stagflation.

1. In this case, the main concern of the government is restoring the potential output and, to do this, it should adopt an expansionary policy (lower taxes or increases government spending and transfers) to shift the AD curve to the right, setting a new equilibrium with a higher price.  
   
2. If the government was primarily concerned with price stability it should implement a contractionary fiscal policy, further reducing the quantity of output and enlarging the recessionary gap.  
   
3. There is a trade-off in the implementation of different fiscal policies: an expansionary one will bring output back to its potential level but will aggravate inflation, raising price level. On the contrary, a contractionary policy may help reducing inflation but would worsen the output gap.