UNIT 5 AP MACROECONOMICS

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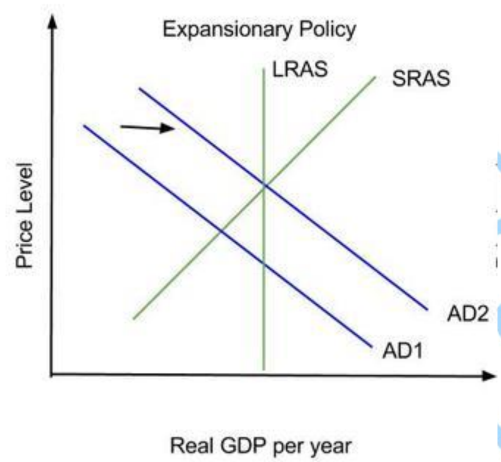
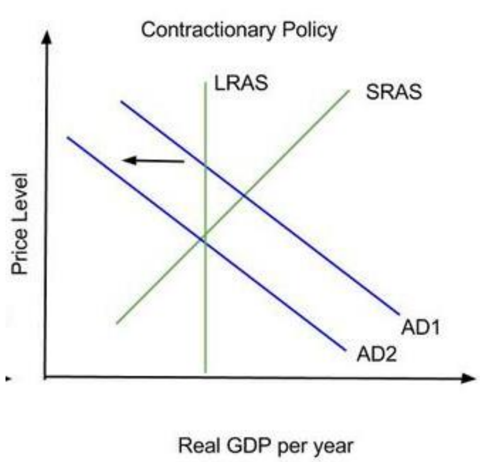
UNIT 5: Long-run Consequences of Stabilization Policies

FISCAL POLICIES:

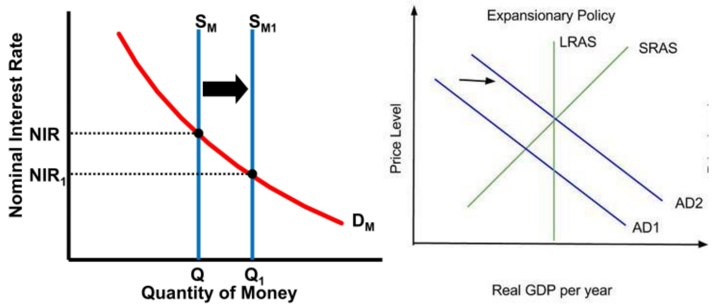
Expansionary Fiscal Policy increases AD curve in short-run (fixes recessionary gap & creates a budget deficit).



Contractionary Fiscal Policy decreases AD curve in short-run (fixes expansionary gap & creates a budget surplus).



==Expansionary Monetary Policy== increases AD (helps fix ***recessionary gaps***).



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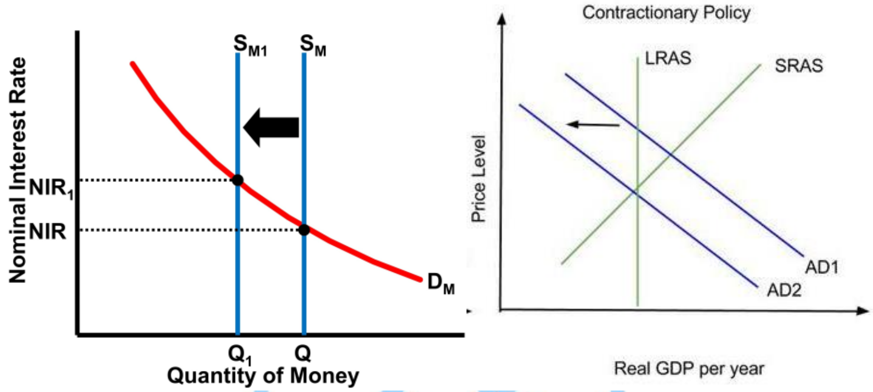
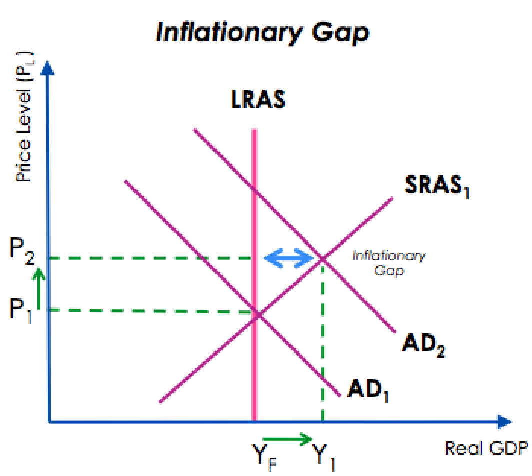


Combination of fiscal & monetary policies can influence AD, real output, PL, and interest rates.

- Thus, in the **short run**, government deficits can cause an inflationary gap and raise interest rates which can **delay economic growth.**
  - ==**Government deficits**== means **government spending is a lot.** (This causes the AD curve to shift to the right resulting in an inflationary gap.)

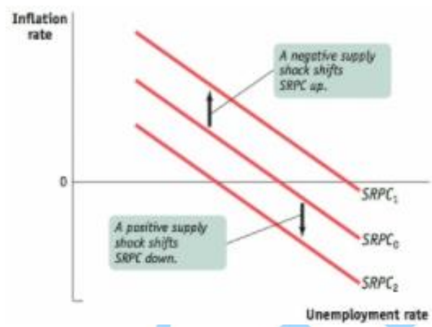


- In the long run, government deficits can **add to rising government debt.**

Short-run Phillips curve:

- Shows short-run trade-off b/w the unemployment rate & inflation rate

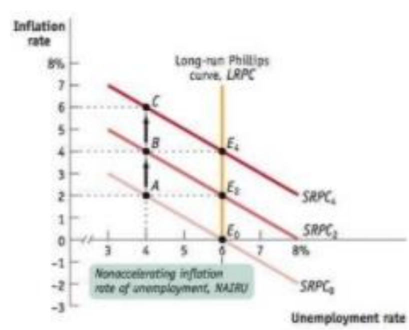
  - **Negative supply shock** would shift the SRPC up and a positive supply shock would shift the SRPC down.



- SRPC also shifts up the same amount that the **expected inflation rate increases.**
- Demand shocks move the economy along the SRPC (ex. Positive demand shock → economy move up the SRPC)
- **Supply shocks shift SRPC**

Long-run Phillips curve (LRPC):

- Is the **natural rate of employment**
- The point where the economy would ***not have accelerating inflation.***
  - **Accelerating inflation -** The cycle of the inflation rate *constantly increasing* from the government trying to make the ***unemployment rate below the natural rate.*** (This causes expected inflation to rise, and then actual inflation, and then expected…)



- Shifters of the natural rate of unemployment also ***shift the LRPC.***
- Long-run equilibrium is the **intersection of SRPC & LRPC.**

- Economy is in an inflationary gap if **left to the equilibrium.**
- Economy is in an recessionary gap if **right to the equilibrium**

Rapid uses of **expansionary monetary policy** can **<u>cause inflation:</u>**

- ○ When the economy is at full-employment, changing the money supply would have *no effect on real output in the long-run.*

Quantity theory of money: The money supply and price level are in ***direct proportion*** (ex. Increase in the money supply → inflation) in the long-run.

Budget Balance

- Budget Balance = Tax revenue - government spending + transfer payments

  Budget surplus - tax revenue > government spending

  Budget deficit - tax revenue < government spending

- Government has to pay interest on accumulated debt which **increases national debt.**

Crowding-out

- Government usually starts **<u>borrowing a budget deficit.</u>** (This increases money demand and therefore, the interest rate which then decreases private investment.)
- May cause a lower rate of physical capital accumulation & less economic growth in the long-run

Economic growth

- Growth rate of GDP/capita over time
- **Rule of 70** tells us how long GDP/capita takes to double

  = 70 / (Annual growth rate of variable)

- Sources
  - ○ ***Labor productivity*** (more workers and more productive ones increase GDP)
  - ○ Determined by the amount of ***technology, physical, and human capital***
  - ○ More/better technological, physical, & human capita → ***more productivity***
  - ○ PPC curve is ***analogous*** to the ***LRAS curve.*** (ex. LRAS shifting right causes the PPC curve to shift to the left)
  - ○ Public policies affecting productivity & # of employed workers. (ex. Unemployment benefits) affect RGDP/capita & economic growth

Supply-side fiscal policies

- When producers focus on **employing contractionary fiscal policies** to foster increased production
- Affects AD, SRAS, & potential output in the **short-run**

KEY:

UMP - Unemployment

PL - Price level

MB - Market basket

G&S - Goods and services

PV - Present value

FV - Future value

RGP - Real gross domestic product

AD - Aggregate demand

SRAS - Short-run aggregate supply

LRAS - Long-run aggregate supply

SRPC - Short-run phillip's curve

LRPC - Long-run phillip's curve

PPC - Production possibilities curve

SOURCES:

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- https://matermiddlehigh.enschool.org/ourpages/auto/2015/8/25/54609372/Krugman_s%20Economics%20for%20AP.pdf
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