Chapter 26



(Refer to PPT Notes) The table shows the aggregate demand and short-run aggregate supply schedules in Virtual Kingdom. Potential GDP is £1,100 billion(2007 pounds).

a. What is the short-run equilibrium real GDP and price level? *P=120, RGDP = 1150B*

b. What is the output gap and is it an inflationary gap or a recessionary gap? *Inflationary output gap of 50B.*

c. What is the long-run equilibrium price level? *P=130.*

Indicate in an AS-AD model the effect of following events, assuming each event happened separately:

* A technological improvement: *both SAS and LAS shift rightward.*
* An increase in the money wage rate: *SAS shifts upward (leftward).*
* Government expenditures increase: *AD shifts rightward.*
* The quantity of money decreases: *AD shifts rightward.*
* Expected future disposable income increases: *AD shifts rightward.*

Chapter 27



Chapter 29

* Evaluate each of the following proposals to “control the deficit” in order to avoid the long-run burden of the debt.
  1. Maintain a zero cyclically adjusted deficit.
  2. Keep the debt-to-GDP ratio constant.
  3. Limit government borrowing in each year to some fixed percentage of national income in that year.

Answer: a) is to control deficit by maintaining a zero structural deficit. This allows government to run cyclical deficits during recessions and cyclical surpluses during expansion periods. In the long run, debt will be effectively controlled as government uses cyclical surpluses to pay back cyclical deficits. Another advantage is that this helps stabilizing business cycle. During recessions, government can cut taxes, increasing transfers and G to stimulate AD and help economy to recover faster (As a result, government will run cyclical deficit). During expansions, government uses surplus to pay back past owing debt, instead of spending it on G or transfers, which may bring inflation up further.

b) is to keep a constant debt ratio. This may control long run debt problem, however it will not achieve the macroeconomic goal of stabilizing business cycle. For example, during recessions, Real GDP falls. To keep debt ratio constant, government is required to run surplus in order to use it to reduce debt. Running surplus during recessions only means government will have to raise taxes and/or cut G and transfers, which will only make recessions even worse.

c) controls debt similarly as b) and it has the common problem as b). As to keep borrowing ratio constant during recessions only means government has to borrow less by raising taxes, for instance, and that will only make recession worse.