Chapter 9  Fiscal Policy and the Multiplier Effect

1. Fiscal policy

What is fiscal policy?

What is expansionary fiscal policy?

What is contractionary fiscal policy?

2. Which fiscal policy should the government apply?

Case 1. Recession
Actual GDP =
Potential GDP =
GDP gap =
Unemployment rate
Inflation

Which fiscal policy should be applied?

Case 2. Overheating
Actual GDP =
Potential GDP =
GDP gap =
Unemployment rate
Inflation

Which fiscal policy should be applied? ___________.

Figure 9-1.

Figure 9-2.
Case 3. Stagflation
Actual GDP =
Potential GDP =
GDP gap =
Unemployment rate
Inflation (CPI at A was 100, CPI at C is 110)

Which fiscal policy should be applied? ___________.

Case 4. Full Employment
Actual GDP =
Potential GDP =
GDP gap =
Unemployment rate
Inflation

Which fiscal policy should be applied? ___________.

3. The multiplier effect

1) What is Marginal Propensity to Consume (MPC)?

*If you receive $100 extra money, and you spend $90 of it, your MPC =

*If a country’s income increased by $100 billion, and the households spend $92 billion out of the $100 billion, the MPC for the country = ___________

*If your MPC is 0.95, it means

2) What is Multiplier Effect?

Case 1. If the government increases spending by $3000, would GDP increase by $3000, given that MPC is 0.8?
Answer:
Case 2. An economy has an average MPC being 0.95. If the government increases spending by $2000, how much would GDP increase?
Answer:

Case 3. If MPC is 0.8 and a government decreases the spending by $1000 million, what is $G^M$? How much would GDP decrease?

Case 4. Tax policy
If the government cuts tax by $2000, would GDP increase by $2000, given MPC is 0.9? Answer:

Case 5. If MPC is 0.95 and the government cuts tax by $1000, what is $T^M$? How much would GDP increase?

Case 6. If MPC is 0.9 and a local government runs a balanced budget, i.e. increase tax by $5000 and increase government spending by $5000, would the local GDP get affected?

4. Deficit finance and the public debt
What is budget deficits?
What is budget surplus?
What is the Keynesian argument about the fiscal policy?