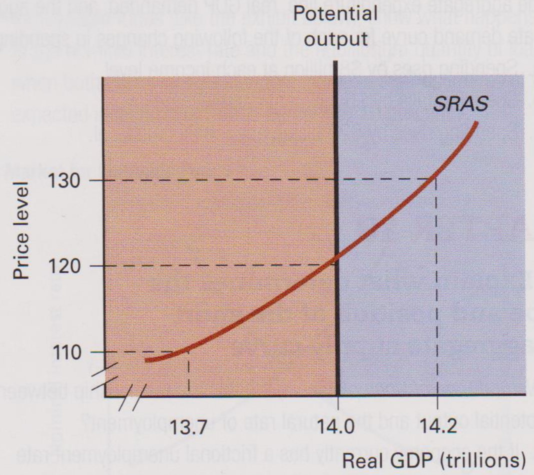
10-2 Describe the market forces that push the economy toward its potential output in the long run

3. *(Expansionary and Recessionary Gaps)* Answer questions a through f on the basis of the following graph:



a. If the actual price level exceeds the expected price level reflected in long-term contracts, real GDP equals _______ and the actual price level equals _______ in the short run.

b. The situation described in part (a) results in a(n) _______ gap equal to _______.

c. If the actual price level is lower than the expected price level reflected in long-term contracts, real GDP equals _______ and the actual price level equals _______ in the short run.

d. The situation described in part (c) results in a(n) _______ gap equal to _______.

e. If the actual price level equals the expected price level reflected in long-term contracts, real GDP equals _______ and the actual price level equals _______ in the short run.

f. The situation described in part (e) results in a(n) _______ gap equal to _______.

4. *(Long-Run Adjustment)* The ability of the economy to eliminate any imbalances between actual and potential output is sometimes called self-correction. Using an aggregate supply and aggregate demand diagram, show why this self-correction process involves only temporary periods of inflation or deflation.

10-3 Explain why shifts of the aggregate demand curve change the price level in the long run but do not change potential output

5. *(Changes in Aggregate Supply)* List three factors that can change the economy's potential output. What is the impact of shifts of the aggregate demand curve on potential output? Illustrate your answers with a diagram.

10-4 Summarize what can shift an economy's potential output in the long run

6. *(Supply Shocks)* Give an example of an adverse supply shock and illustrate graphically. Now do the same for a beneficial supply shock.

CHAPTER 11

11-1 Describe the discretionary fiscal policies to close a recessionary gap and an expansionary gap

1. *(Fiscal Policy)* Define *fiscal policy*. Determine whether each of the following, other factors held constant, would lead to an increase, a decrease, or no change in the level of real GDP demanded:
   a. A decrease in government purchases
   b. An increase in net taxes
   c. A reduction in transfer payments
   d. A decrease in the marginal propensity to consume

2. *(Recessionary Gap)* What is a recessionary gap? What fiscal policy might close that gap? Show with a graph.

3. *(Expansionary Gap)* What is an expansionary gap? What fiscal policy might close that gap? Show with a graph.

4. *(Changes in Government Purchases)* Assume that government purchases decrease by $10 billion, with other factors held constant, including the price level. Calculate the change in the level of real GDP demanded for each of the following values of the MPC. Then, calculate the change if the government, instead of reducing its purchases, increased autonomous net taxes by $10 billion.
   a. 0.9
   b. 0.8
   c. 0.75
   d. 0.6

5. *(Fiscal Multipliers)* Explain the difference between the government purchases multiplier and the net tax multiplier. If the MPC falls, what happens to the tax multiplier?

6. *(Multipliers)* Suppose investment, in addition to having an autonomous component, also has a component that varies directly with the level of real GDP. How would this affect the size of the spending multiplier?

7. *(Fiscal Policy)* Chapter 11 shows that increased government purchases, with taxes held constant, can eliminate a recessionary gap. How could a tax cut achieve the same result?

8. *(Fiscal Policy with an Expansionary Gap)* Using the aggregate demand–aggregate supply model, illustrate an economy with an expansionary gap. If the government is to close the gap by changing government purchases, should it increase or decrease those purchases? In the long run, what happens to the level of real GDP as a result of government intervention? What happens to the price level? Illustrate this on an *AD–AS* diagram, assuming that the government changes its purchases by exactly the amount necessary to close the gap.

11-2 Summarize fiscal policy from the Great Depression to stagflation

9. *(Evolution of Fiscal Policy)* What did classical economists assume about the flexibility of prices, wages, and interest rates? What did this assumption imply about the self-correcting tendencies in an economy in recession? What disagreements did Keynes have with classical economists?