Fiscal Policy

Closing the gaps

Fiscal Policy

- Fiscal policy is ***the manipulation of the federal budget to attain price stability, relatively full employment, and a satisfactory rate of economic growth***
  - ***To attain these goals, the government must manipulate its*** **spending** ***and*** **taxes**

Putting Fiscal Policy into Perspective

- **There was no such thing as fiscal policy until John Maynard Keynes invented it in the 1930s**
  - **He maintained that**
    - **The only way out of the Depression was to boost aggregate demand by increasing government spending**
    - **If we ran a big enough budget deficit, we could jump-start the economy and, in effect, spend our way out of the depression**

Putting Fiscal Policy into Perspective

- It's important that the aggregate supply of goods and services equals the aggregate demand for goods and services at just the level of spending that will bring about full employment at stable prices

Putting Fiscal Policy into Perspective

- Equilibrium GDP tells us the level of spending in the economy
- Full-employment GDP tells us the level of spending necessary to get the unemployment rate down)
- Fiscal policy is used to push equilibrium GDP toward full-employment GDP

The Deflationary Gap and the Inflationary Gap

- Equilibrium GDP is the level of output at which aggregate demand equals aggregate supply
  - Aggregate demand is the sum of all expenditures for goods and services (that is, $C + I + G + X_n$)
  - Aggregate supply is the nation's total output of final goods and services
  - So at equilibrium GDP, everything produced is sold

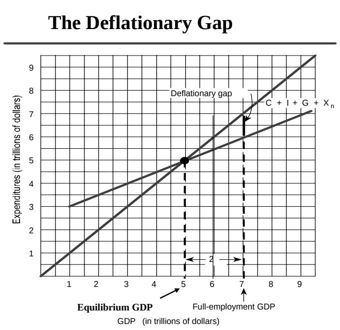
The Deflationary Gap and the Inflationary Gap

- **Full-employment GDP is the level of spending necessary to provide full employment of our resources**
  - **If our plant and equipment is operating at between 85 and 90% of capacity, that's full employment**

12-8

The Deflationary Gap & the Inflationary Gap

When the full-employment GDP is greater than the equilibrium GDP, there is a deflationary gap. How much is it?

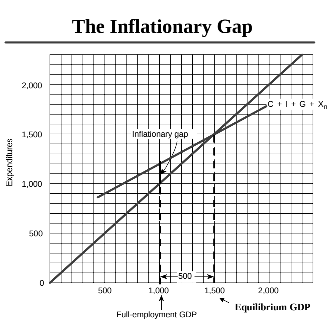


$1 trillion

12-9

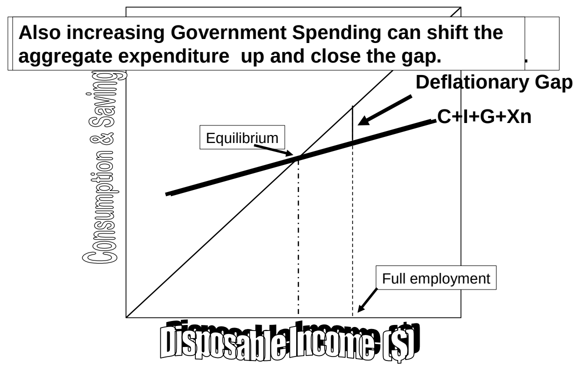
The Deflationary Gap & the Inflationary Gap

When equilibrium GDP is greater than full-employment GDP, there is an inflationary gap. How large is it?



$200 trillion

12-10



Summary

- Equilibrium GDP is less than full-employment GDP
  - Spending is too low
  - Results in a deflationary gap
    - Too eliminate the deflationary gap, we raise G and/or cut taxes

Summary

- Equilibrium GDP is above the full-employment GDP
  - Spending is too high
  - Results in an inflationary gap
    - Too eliminate the inflationary gap, we cut G and/or raise taxes