

2. An economy is currently in short-run equilibrium with a recessionary output gap of \$600 billion.

(a) Draw a single correctly labeled graph with both the short-run and long-run Phillips curves. Label the initial short-run equilibrium point X.

(b) Suppose the government implements fiscal policy in order to achieve full-employment output and the marginal propensity to consume is 0.75.

(i) Calculate the minimum change in government spending required to increase aggregate demand by the amount of the output gap of \$600 billion. Show your work.

(ii) Suppose instead the government wants to change taxes rather than government spending. Calculate the minimum change in taxes required to increase aggregate demand by the amount of the output gap of \$600 billion. Show your work.

(c) Assume instead the government takes no policy action to close the output gap shown in part (a). Explain how the economy will adjust in the long run.

Begin your response to this question at the top of a new page in the separate Free Response booklet and fill in the appropriate circle at the top of each page to indicate the question number.