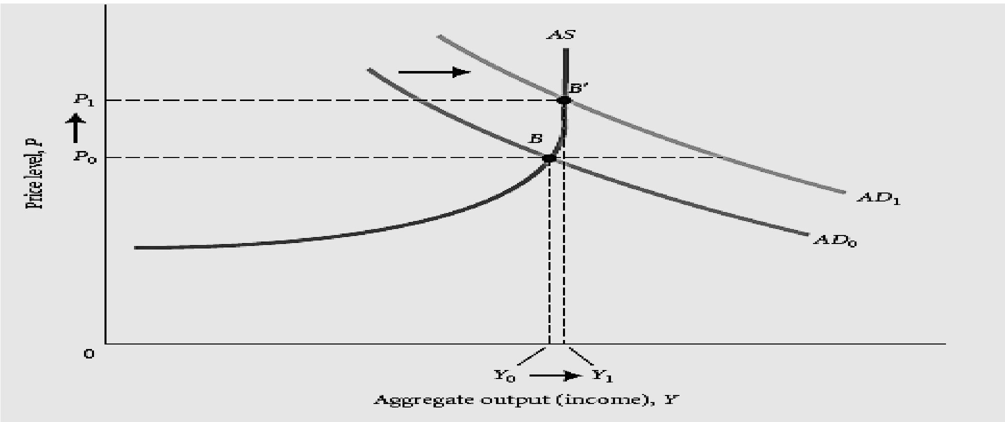
2-A Shift of the *AD* Curve When the Economy is Operating at or Near Capacity



1-Here, an expansionary fiscal policy does not work well. The output multiplier is close to zero.

2-Output is initially close to capacity(full employment), this lead to that increase output further mostly lead to a higher price level.

3-With a higher price level, (Md shift right) the Fed increases the interest rate (*r*), and in this case, there is almost(near) complete crowding out of planned investment.

4-If the shift in the *AD* curve caused by a decrease in net taxes, it is consumption, Not government spending that causes the crowding out of investment.

Note:-

If wages adjust fully to match higher prices, then the long-run *AS* curve is vertical at Y1. In this case it is easy to see **that fiscal policy will have no effect on output** because output multiplier equal zero.