Econ 108: Principles of Macroeconomics Spring 2023

HW 1

Ch 24: AD & AS Model <u>and</u> **Ch 27:** Fiscal Policy

Instructions: You need to submit your work as a word file to moodle by May 5, Friday 23:59. Your typed file can include the picture of the figure that you have worked on.

<u>Question 1</u> [22 pts]**: Multipliers in Effect**

a. Read the Report that is on Moodle Page: Fiscal Policy and Recovery from the COVID-19 Recession [45 min]

b. (4 pts) **<u>Fiscal policy tools:</u>** Keynes favored government spending (G) as a fiscal policy tool over T and TR (tax and transfer payments). Explain why this is so, and then use your findings from the report to suggest that T and TR have their own benefits as fiscal policy tools

c. **<u>Different Consumption Theories:</u>** From **page 15** of the report: *"Economists have long been concerned that temporary tax cuts for individuals (compared to permanent ones) have smaller effects on spending because they are seen as one-time benefits to spread over a longer period."*

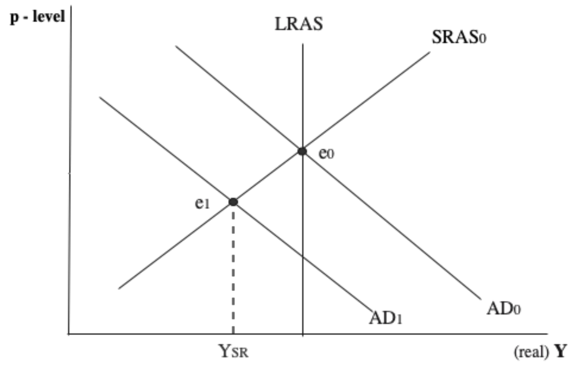
- (5 pts) <u>Explain this statement.</u> Act as if you are explaining it to a friend that has no clue about the life-cycle hypothesis of consumption, or permanent income hypothesis. What would be the effect of a temporary tax cut on aggregate demand if these theories do explain the consumption behavior? (Yes, your friend has idea about the Keynesian multiplier, so you do not have to start explaining from scratch).
- (5 pts) <u>Find evidence</u> in the report suggesting that spending depends on current income at least for some individuals and hence even a temporary tax cut can have effects on spending. Explain intuitively why these individuals would not/could not act as the permanent income hypothesis predicts. Explain how these individuals would respond to a temporary tax cut, and how this would affect the aggregate demand (AD) compared to the predictions of the permanent income hypothesis.

d. (4 pts) **<u>Does behavior change:</u>** We have indicated that *mpc* is a behavioral parameter; and can change with behavioral changes. What does report suggest about how *mpc* might change in the aftermath of the pandemy if it does?

e. (4 pts) **<u>Discretionary vs Non-Discretionary Policy:</u>** Explain how automatic stabilizers (non-discretionary fiscal policy tools) and discretionary fiscal policy tools differ from each other. Consider the increase in the unemployment benefit payments made by the US government during the pandemy (TR). Conceptually explain the discretionary and non-discretionary parts of this TR increase.

Question 2 [28 pts]**: Negative Demand Shock**

Starting with a long-run equilibrium at e_0, economy experiences a negative demand shock that shifts AD curve to the left and reaches a SR equilibrium at point e_1.



Basics:

a. (5 pts) Explain why the aggregate supply curve is **vertical** in the long-run and what determines its position. Provide an argument to prove the position of the LRAS by referring to what an equilibrium is.

b. (3 pts) Give one potential reason (a real-world example) for a negative demand shock. Explain its effects on the p-level and real GDP in the short-run.

c. (3 pts) Explain the adjustment mechanism that brings the economy from the initial equilibrium point of e_0 to the short-run equilibrium of e_1. Explain why this is only a SR equilibrium but not a long-run equilibrium.

Self-adjustment in the LR:

d. (3 pts) What would be the long-run equilibrium after self-adjustment process? **Explain** the mechanism by which economy reaches to a long-run equilibrium without intervention and show your work and mark this equilibrium on figure.

Intervention:

e. (2 pts) Suppose that rather than waiting for the self-adjustment process policy makers decided to intervene by increasing G that is financed by borrowing to correct the recessionary effects of the negative demand shock. Mark the equilibrium point that will be reached by this policy on your graph assuming that enough stimulus was created to correct the market.

Compare:

f. (4 pts) While markets can adjust themselves without intervention; some economists advocate intervention instead. What might be the potential arguments for favoring intervention over self-adjustment process. State and explain **two** arguments for intervention.

g. (5 pts) Compare the side effects of this expansionary fiscal policy in the Keynesian and classical models. To do so remember that 'recessions' Keynes is referring to is deep recessions, but the classical model above gives us a GDP decrease of a small size (still close to potential GDP). How do these two models differ in explaining the side effects of the expansionary fiscal policy regarding price changes and crowding out effects.

h. (3 pts) Given your answers to part (g) in which of the models (Classical or Keynesian) would a smaller G increase can correct the economy. **Argue your case** by referring to relevant concepts. Is the claim "fiscal multipliers being larger during recessions than during expansions" correct?