ECN-100: Homework Week 12: AS-AD Model and Fiscal Policy

1. About the shifts of the AD-AS Model:

1. List the factors that determine shifts of each of AD curve ?
2. List the factors that determine shifts of each of SRAS curve?

2. Consider an economy that is initially in the long-run equilibrium where SRAS and AD intersection (the short-run macro equilibrium) is exactly on the LRAS – which means that the real output (Ye) equals the potential output (Yp). Draw this initial situation, then assess the following separate events, write down with “negative/positive demand/supply shock” (for example: “negative demand shock”):

1. the economy’s central bank decreases government spending
2. productivity decreases in the economy
3. consumer confidence in the economy increases
4. commodity prices fall dramatically
5. The price of commodities increases by 10% this year
6. Labor unions successfully negotiate an increase in nominal wages for their workers
7. The number of unsold houses in an economy increases by 20%
8. There is an increase in labor productivity due to increases in human capital
9. The government increases spending in order to finance the war against terrorists.
10. The Consumer Confidence Index has risen since last month.

3) For each of the following situations identify whether it is an example of *expansionary* fiscal policy or *contractionary* fiscal policy:

1. During 2006, as the economy enters a recession, income and consumption falls, government gave a tax rebate to families.
2. During 2006, in light of projected deficiencies in aggregate demand, the government authorize an expenditure of $200 million in order to build a new dam
3. In 2009, fearing too rapidly expanding economy, a government adopts a budget that calls for 10% spending cuts in all government departments for the following fiscal year.
4. In 2008, budget on unemployment benefits rise 5% in response to rising unemployment

For problems 4) below: $budget spent on fiscal policy x the multiplier = the change in AD (eventually on GDP);

If the fiscal policy is “G”: use multiplier: 1/ 1- (MPCx(1-t));

If the fiscal policy is “T or TR”: use multiplier: MPC/ 1- (MPCx(1-t)).

4. Suppose Macroland is experiencing a recessionary gap in its economy. Its MPC is around 0.6, and the tax rate is 25%.

The government wishes to produce at its potential output level (Yp), and the recessionary gap was estimated around $500 billion. Calculate the amount of budget needs to be allocated to conduct each of the following fiscal policy to close that gap of $500 billion in GDP:

* 1. the government gives tax exemptions on consumers and corporations
  2. the government authorizes new spending programs for infrastructure.
  3. The government extended its unemployment benefits for another year.