

Cooleconomics.com
Principles of Economics

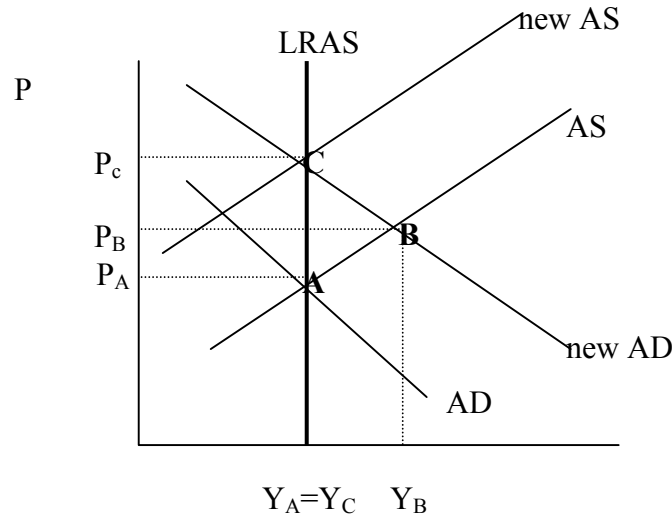
Model 5 Study Questions

1. Suppose the government wants to reduce unemployment in the short run.
 - a) Name 1 monetary policy that would possibly reduce unemployment in the short run. Explain how it works. Illustrate its short run and long run effects using model #5 of the economy.
 - b) In 14 separate responses (7 for the short run and 7 for the long run), indicate how the policy above would affect (in the short run and long run), and explain why each changes:
 - unemployment
 - disposable income
 - consumption
 - savings
 - investment
 - the budget deficit
 - the trade deficit
 - c) Name 1 fiscal policy that would possibly reduce unemployment. Explain how it works. Illustrate its effects using model #5 of the economy.
 - d) In 14 separate responses (7 each for the short run and the long run), indicate how the policy above would affect (in the short run and long run), and explain why each changes:
 - unemployment
 - disposable income
 - consumption
 - savings
 - investment
 - the budget deficit
 - the living standards of future generations

2. Suppose an oil embargo drastically increases production costs.
 - a) Illustrate the macroeconomic effects of this on an AD/AS/LRAS graph (model #5).
 - b) In 14 separate responses (7 each for the short run and the long run), explain how the policy above would affect (in the short run and long run), and explain why each changes.
 - unemployment
 - disposable income
 - consumption
 - savings
 - investment
 - the budget deficit
 - the trade deficit

1. Suppose the government wants to reduce unemployment in the short run.
 a) Name 1 monetary policy that would possibly reduce unemployment in the short run. Explain how it works. Illustrate its short run and long run effects using model #5 of the economy.

The Central bank could cut the discount rate OR lower the required reserve ratio OR buy government securities. Any of these policies cause short run interest rates to fall, causing investment to rise in the short run, the dollar to depreciate in the short run, and net exports to rise in the short run. Higher investment and net exports result in higher aggregate demand in the short run, resulting in higher GDP in the short run, resulting in lower unemployment in the short run.



- b) In 14 separate responses (7 for the short run and 7 for the long run), indicate how the policy above would affect (in the short run and long run), and explain why each changes:

short run:

- unemployment: lower due to higher GDP
- disposable income: higher due to higher national income
- consumption: higher due to higher disposable income
- savings: higher due to higher disposable income
- investment: higher due to lower interest rates
- the budget deficit: lower due to higher tax revenue (and constant government spending)
- the trade deficit: lower due to a depreciated dollar

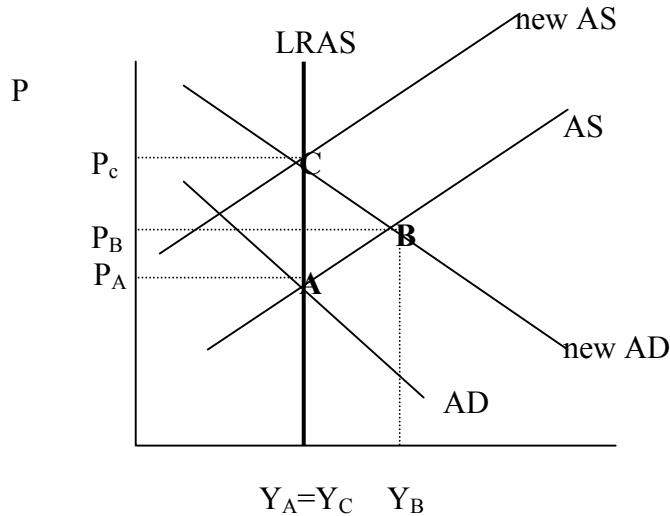
long run:

- unemployment
- disposable income
- consumption
- savings
- investment
- the budget deficit
- the trade deficit

All of the above things are unchanged from their original (pre monetary policy) levels in the long run, since monetary policy affects no real variable in the long run. In the long run, prices rise by the same % as the increase in the money supply, causing interest rates to return to their original levels at A. (This is because the increase in money demand caused by the price hikes equals the increase in the money supply.) Since interest rates are at their original levels, all other variables (except for the price level) are at their original real levels.

c) Name 1 fiscal policy that would possibly reduce unemployment. Explain how it works. Illustrate its effects using model #5 of the economy.

Government could cut household taxes or raise transfer payments or raise government purchases. If it cuts taxes or raises transfers then consumption will rise, resulting in higher aggregate demand, higher gdp, and lower unemployment. If, on the other hand, government raises G then aggregate demand directly rises, causing higher aggregate demand, higher gdp and lower unemployment.



d) In 14 separate responses (7 each for the short run and the long run), indicate how the policy above would affect (in the short run and long run), and explain why each changes:

short run:

- unemployment: lower due to higher GDP
- disposable income: higher due to higher national income
- consumption: higher due to higher disposable income
- savings: higher due to higher disposable income
- investment: lower due to higher interest rates
- the budget deficit: higher due to lower tax revenue or higher government spending

long run:

--unemployment: at original level, since GDP is back to its original level.
 --disposable income: If government cuts taxes or raises transfers then it remains higher in the long run, because the "T" in the equation $Y_d = Y - T$ is smaller

If, on the other hand, government raised its purchases, then disposable income is unchanged from its original level at A, since neither the Y nor the T in the Y-T equation are changed from their original levels.

--consumption: : If government cuts taxes or raises transfers then it remains higher in the long run, because disposable income remains higher in the long run.

If, on the other hand, government raised its purchases, then disposable income is unchanged from its original level at A, meaning that consumption is unchanged from its level at A.

--savings: If government cuts taxes or raises transfers then it remains higher in the long run, because disposable income remains higher in the long run.

If, on the other hand, government raised its purchases, then disposable income is unchanged from its original level at A, meaning that savings is unchanged from its level at A

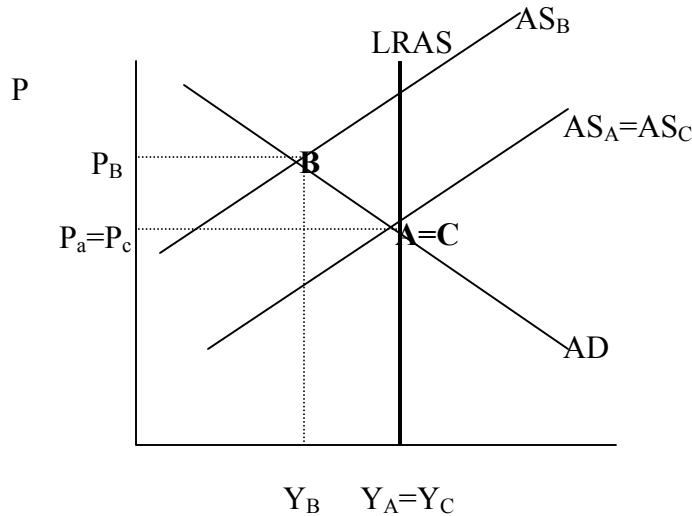
--investment: lower due to higher interest rates

--the budget deficit: higher due to lower tax revenue or higher government spending

--the living standards of future generations: lower due to crowding out of investment and increased sales of U.S. assets to foreigners.

2. Suppose an oil embargo drastically increases production costs.

a) Illustrate the macroeconomic effects of this on an AD/AS/LRAS graph (model #5).



b) In 14 separate responses (7 each for the short run and the long run), explain how the policy above would affect (in the short run and long run), and explain why each changes.

short run:

- unemployment: higher due to lower GDP
- disposable income: lower due to lower National income
- consumption: lower due to lower disposable income
- savings: lower due to lower disposable income
- investment: lower due to higher interest rates
- the budget deficit: higher because lower national income has resulted in lower tax

revenue

- the trade deficit: higher because the dollar has appreciated

long run:

- unemployment:
- disposable income
- consumption
- savings
- investment
- the budget deficit
- the trade deficit

All of the above have returned to their original levels at A, since all facets of the economy are back to the way they were at A.