

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

- 1) During a recession, would classical economists propose that changes in government spending or taxes be used to improve economic conditions? Briefly explain.
- 2) Why might firms pay an efficiency wage rather than a market-clearing wage?
- 3) If you were president of the United States, what would you do to reduce the natural rate of unemployment? Propose at least three different methods.
- 4) Describe the major costs of inflation, being sure to distinguish between anticipated and unanticipated inflation.
- 5) In the Keynesian model in the short run, what is likely to happen to employment after each of the following shocks?
 - (a) An increase in taxes
 - (b) An increase in consumer spending generated by a reduced desire for saving
 - (c) An increase in the money supply
- 6) Draw a saving-investment diagram to show how each of the following changes shifts the *IS* curve.
 - (a) Future income rises.
 - (b) The future marginal productivity of capital increases.
 - (c) Government purchases decrease temporarily.
 - (d) The effective corporate tax rate increases.
- 7) Use the classical (RBC) *IS—LM—FE* model to show the effects on the economy of a temporary beneficial supply shock; for example, a decrease in the price of oil. You should show the impact on the real wage, employment, output, the real interest rate, consumption, investment, and the price level.
- 8) Analyze the short-run and long-run effects of an unanticipated decrease in the money supply in the misperceptions model. Tell what happens to output, the price level, and the expected price level in both the short run and long run.
- 9) Use the classical (RBC) *IS—LM—FE* model to show the effects on the economy of a temporary adverse supply shock; for example, an increase in the price of oil. You should show the impact on the real wage, employment, output, the real interest rate, consumption, investment, and the price level.

Answer Key

Testname: CHAPTERS10,11,12PROBLEMSETWITHSOLUTIONS

- 1) No. Classical economists do not endorse changes in government spending or taxes designed to offset business cycle fluctuations; the classical model shows that such policy attempts are not likely to improve macroeconomic conditions. From a classical viewpoint, government spending and tax decisions should be long-run decisions based on cost-benefit analysis.
- 2) An efficiency wage is better than a market-clearing wage in that it maximizes effort per dollar of wage income paid to labor. This means that labor productivity per dollar spent on labor is maximized, which means that labor cost per unit of output is minimized. The gift-exchange motive and the shirking model provide two explanations for why an efficiency wage that is above the market-clearing wage may increase productivity per wage dollar. The gift-exchange motive suggests that workers who believe their employer is treating them fairly will want to do a good job. The shirking model views the wage as the reward that workers risk losing if they are so unproductive that they get fired; a higher wage increases productivity by increasing the expected cost of shirking (i.e., having low productivity).
- 3) Provide support for job training and worker relocation; increase labor-market flexibility by reducing the minimum wage; reform the unemployment insurance system; run a high-pressure economy (if there is hysteresis).
- 4) Costs of anticipated inflation include an erosion of the value of currency, which leads to shoe-leather costs, and the costs of changing prices. Costs of unanticipated inflation arise because unanticipated inflation transfers wealth between people and because it disturbs the role of prices as signals in the economy.
- 5) (a) The increase in taxes shifts the *IS* curve to the left, reducing output in the short run and thus employment, based on the effective labor demand curve.
(b) The increase in consumer spending shifts the *IS* curve to the right, increasing output in the short run and thus employment, based on the effective labor demand curve.
(c) The increase in the money supply shifts the *LM* curve to the right, increasing output in the short run and thus employment, based on the effective labor demand curve.
- 6) (a) *IS* shifts up and to the right.
(b) *IS* shifts up and to the right.
(c) *IS* shifts down and to the left.
(d) *IS* shifts down and to the left.
- 7) The marginal productivity of labor is increased, shifting the labor demand curve to the right. As a result, the real wage rises and employment increases. Both the higher productivity and increased employment increase output. The *FE* line shifts right, with the *IS* curve unchanged, so the *LM* curve must shift down (the price level declines) to restore equilibrium. As a result, the real interest rate declines, increasing consumption and investment.
- 8) The reduction in money supply shifts the *AD* curve left, reducing output and the price level, while the expected price level is unchanged, since the decrease in money supply was unanticipated. In the long run, the *SRAS* curve shifts down as people reduce their expected price level. The economy returns to full-employment output, but at a lower price level.
- 9) The lower *TFP* reduces the marginal product of labor, thus shifting the labor—demand curve to the left, reducing the real wage and employment. The adverse supply shock thus shifts the *FE* line to the left because both *TFP* and employment decline. To restore equilibrium, the price level rises, shifting the *LM* curve left. The result is lower output and a higher real interest rate. The higher real interest rate reduces investment. The lower income and higher real interest rate reduce consumption.