PART 1: Expansionary fiscal policy and Unemployment insurance

For this question you need the standard setting studied in class: labor market is represented through the wage and price setting equations, goods market through the IS, financial market through the LM. The production function is Y=aN, and expected price is equal to the price in the previous period.

1- Write down the AS/AD equations

2- Expansionary fiscal policy: Draw AS/AD and IS/LM immediately below, with output in the horizontal axis. Assume the economy is at the natural level of output equilibrium.

Now assume government spending increases. What happens to AD and AS in the short run? Show and explain. What happens to IS/LM? Show the new equilibrium and explain. Show the equilibrium point in the IS/LM both before and after the change in prices.

3- Show what the final equilibrium is going to be, and explain how the economy moves to that point. What is the final effect on Y, P, and M/P? Is there any change in the composition of output?

Now we are going to assume that all of the increase in G is used to finance a more generous unemployment insurance (UI) program. First we will work with the supply side only.

4- Draw the wage and price setting relationships. What happens to the natural rate of unemployment when UI increases? (Hint: an increase in UI can be represented by an increase in z)

5- Show in the AS/AD setting the effect of an increase in z. Does the AS shift? By how much? What happens in the long run? Show and explain.

6- Combine the previous changes. Draw a new AS/AD and show the short run equilibrium after the policies are implemented, starting from an equilibrium at Y_n. Then show the long run equilibrium point. Is output higher in the long run?

PART 2: Multiple Choice Questions (Choose the best answer for each question.)

1- An increase in the nominal stock of money will
   a) shift AD outwards
   b) shift AD inwards
   c) not shift the AD but will move from one point to another on the same curve
   d) shift AD outwards but in the long run AD goes back to its original position
   e) none of the above
2- If consumers become more optimistic about the future, starting from an equilibrium point $Y_n$, $P_n$, in an AD/AS setting,
   a) prices and output increase in the short run
   b) $P$ and $Y$ increase in the long run
   c) $P$ and $Y$ stay the same in the long run
   d) (a) and (b)
   e) (a) and (c)

3- Which of the following will shift the aggregate supply curve upwards?
   a) increase in firms' markup over costs
   b) increase in the expected price level
   c) increase in unemployment benefits
   d) all of the above
   e) none of the above

4- In the aggregate demand relation, a rise in the price level causes output to drop through its impact on
   a) government spending
   b) the real money supply
   c) consumer confidence
   d) the firms markup over cost
   e) natural rate of unemployment

5- Which of the following will move the economy along the aggregate supply curve in the short run?
   a) an increase in the money supply
   b) an increase in government spending
   c) a decrease in taxes
   d) all of the above
   e) none of the above

6- A decrease in consumer confidence will, in the short run, cause a decrease in
   a) interest rate
   b) price level
   c) output
   d) all of the above
   e) none of the above