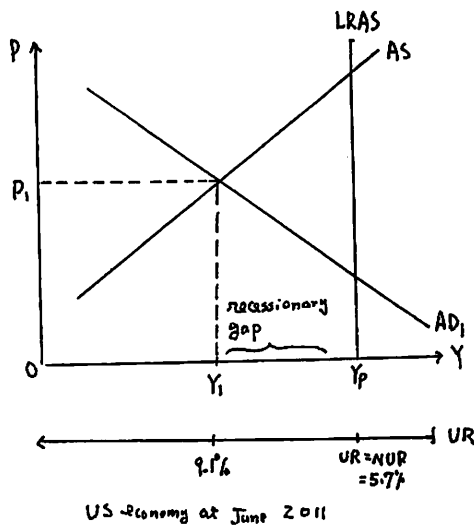


Quiz 11 (answer)

Please use AD, SAS, LRAS and UR line to answer the following question verbally and graphically.

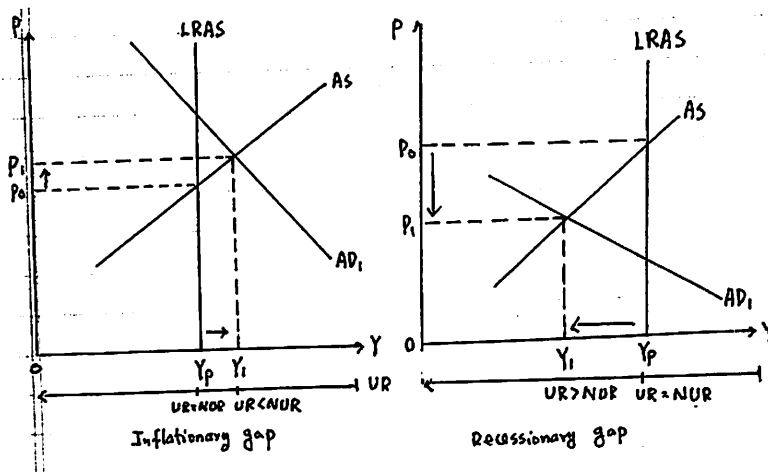
- a. U.S. unemployment rate (UR) = 9.1% in June 2011. On AS-AD-LRAS-UR graph show the macroeconomic equilibrium in U.S. in June 2011. Please show equilibrium Y , P , Y_p , UR and NUR explicitly. [2]



$Y_1 < Y_p$, $UR = 9.1\% > NUR = 5.7\%$. There is a recessionary gap in U.S.

- b. Explain carefully what is inflationary gap? What is recessionary gap? [2]

- (1) **Inflationary gap:** A gap exists when $Y > Y_p$ and that brings a rising price level, i.e., $P \uparrow$.
- (2) **Recessionary gap:** A gap exists when $Y < Y_p$ and that brings a falling price level, i.e., $P \downarrow$.



- c. Is U.S. facing a recessionary gap or inflationary gap? Explain your answer. [1]

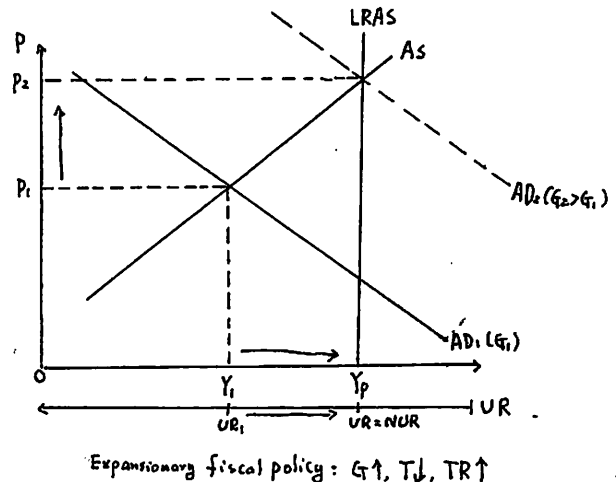
U.S. faces a recessionary gap because $Y_1 < Y_p$ and $UR = 9.1\% > NUR = 5.7\%$. See the AS-AD-LRAS-UR figure in a.

- d. Which type of fiscal policy would move this economy to full employment equilibrium (potential output)? What are some examples of such policies? Also show your answer graphically. State the cause and the effect explicitly. [3]

An expansionary fiscal policy will move the economy to full employment equilibrium. Examples of this policy are $G \uparrow$ (an increase in government expenditure), $T \downarrow$ (cut tax), and $TR \uparrow$ (an increase in transfer payment).

Cause: $G \uparrow$, or $T \downarrow$, or $TR \uparrow \Rightarrow AD \uparrow$, $AS \rightarrow$.

Effect: $p \uparrow$, $Y \uparrow$ to $Y = Y_p$,
and $UR \downarrow$ to $UR = NUR$.



- e. In his radio address in July 2, 2011, President Obama claims *Government has to start living within its means, just like families do. We have to cut the spending (government purchase, G) we can't afford so we can put the economy on sounder footing, and (move back to full employment, i.e., $Y = Y_p$ and $UR = NUR$).* Please show the effect of Obama's proposal on equilibrium of Y , P , UR graphically. Also state the cause and the effect explicitly. [4]

The effect of Obama's proposal will be:

Cause: $G \downarrow \Rightarrow AD \downarrow$, $AS \rightarrow$.

Effect: $p \downarrow$, $Y \downarrow$ and $UR \uparrow$
 \Rightarrow the recessionary gap increases
and the recession gets worse.

