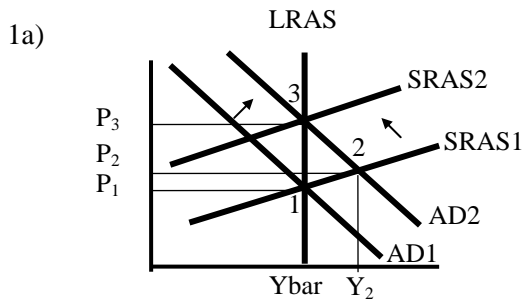


Solution Key: Homework 5 Economics 101 - Chapters 13



The expansionary policy will shift the aggregate demand curve to the right, from AD1 to AD2. In the short run, this will raise output and price some, as equilibrium moves from point 1 to point 2. Output goes up because people are surprised by the rise in price, so they can be tricked into producing more output than they were intending to.

In the long run, price expectations will adjust to the new policy, and shift the short run aggregate supply curve left (from SRAS1 to SRAS2). So equilibrium moves from point 2 to point 3, where price level rises much and output returns to Y_{bar} . So the president could be successful in getting a rise in output prior to the election, and getting most of the inflation after the election.

- b) If the SRAS were steeper, then price would rise more in the short run. A steep SRAS means it takes a bigger price rise to induce people into producing more. Perhaps a smaller fraction of prices or wages are set ahead of time in contracts, or perhaps workers or suppliers are harder to surprise (expectations are closer to the assumption of rational expectations).

$$2a) \pi = \pi_1 - 2(u - u^n) \qquad b) 0.02 = 0.02 - 2(u - 0.05)$$

$$0.02 = 0.04 - 2(u - 0.05) \qquad u = u^n = \underline{0.05}$$

$$u = \underline{0.06}$$

Note that the unemployment level only needs to be raised one period to bring inflation down. This is because it takes one year for inflation expectations to adjust, shifting the Phillips curve by the next year. Inflation then stays at the lower level without the need for contractionary policy.

- 3a) There are multiple acceptable ways of writing this essay. It should cover the short run benefits of reduced unemployment and avoiding the waste of underutilized factors of production, as well as the long-run costs in terms of a federal government debt and potentially higher inflation. Krugman also makes a less-standard argument that there are long-run benefits to reducing unemployment now, in terms of promoting worker training and investment in capital stock, which raise long-term productivity. Clearly there is a limit to the range of time over which a fiscal stimulus policy can work. Our theory is clear that an attempt to lower unemployment below its natural rate in the long run will fail, and will result in higher inflation.