

EC1010: Tutorial Questions 8

March 26, 2010

1. Suppose that output is currently 50, but potential output is 80. The multiplier is 3.
 - i. According to Okun's law, what do we know about the level of cyclical unemployment in the economy relative to the NAIRU?
 - ii. To attain potential output, by how much must the government raise expenditure?
 - iii. According to Okun's law, what is the unemployment rate after the expansionary fiscal policy?
2. Suppose there are two economies, A and B. The marginal propensity to consume is higher in A. In which economy is *contractionary* fiscal policy more powerful?
3. Many economists argue that, because of greater uncertainty, the marginal propensity of consume falls in a recession. What implications does this have for Keynesian economics?
4. In Ireland today, many people are highly indebted. What implications would this have for a) the marginal propensity to consume and b) the Keynesian multiplier? What does the observation suggest about the value of expansionary fiscal policy in Ireland today?
5. Suppose that Investment is a function of current production, and in particular,

$$I = b + dY,$$

where b and d are positive constants. Intuitively, if output is currently high, firms might increase investment to ensure they can meet greater demand in the future.

- i. Assuming no taxes and a closed economy, write down the equilibrium output condition in the Keynesian economy.
- ii. Use the condition above to find the equilibrium level of output.
- iii. What is the Keynesian multiplier?
- iv. Explain intuitively why the multiplier is bigger in this environment.

Problem Set 8

6. A well-known economist, Robert Barro, recently wrote that “a much more plausible starting point is a multiplier of zero.” What does a multiplier of zero imply?
7. Writing about his research, Robert Barro wrote

“I have estimated that World War II raised U.S. defense expenditures by 540 billion (1996 dollars) per year at the peak in 1943-44, amounting to 44% of real GDP. I also estimated that the war raised real GDP by 430 billion per year in 1943-44.”

According to these findings, estimate the value of the Keynesian multiplier.

8. In his analysis, Keynes assumed interest rates were fixed. If interest rates were flexible, how would that affect his analysis?
9. If all economic activity is subject to taxation, in what sense can an increase in government expenditure in the Keynesian model pay for itself?
10. Suppose that people expect a future fall in their incomes, and as a result, decide to save more. How could we represent this in the consumption function? What are the implications for the level of equilibrium output/income in the economy. Use your answer to explain how, in the Keynesian model, expectations about the future can be self-fulfilling.