1. Use the goods market, financial market, IS-LM and AS-AD diagrams (you can optionally draw the labor market as well) to both explain in words and graphically depict the short run and medium run effects on GDP \( Y \), the interest rate \( i \), investment \( I \), consumption \( C \), the economy’s price level \( P \) and the unemployment rate \( u \) of a *decrease in government spending* \( G \). You can assume that the economy starts at the natural output level and therefore the price level equals the expected price level (meaning the price level the workers based their wage contracts on). So initially \( Y=Y_n, P=P^e \).

2. Use the goods market, financial market, IS-LM and AS-AD diagrams (you can optionally draw the labor market as well) to both explain in words and graphically depict the short run and medium run effects on GDP \( Y \), the interest rate \( i \), investment \( I \), consumption \( C \), the economy’s price level \( P \) and the unemployment rate \( u \) of a *decrease in the money supply* \( M \). You can assume that the economy starts at the natural output level and therefore the price level equals the expected price level (meaning the price level the workers based their wage contracts on). So initially \( Y=Y_n, P=P^e \).

Hint: In order to answer both questions, you can review the examples of the government spending and money supply *increases* we will study in the class. The effects of the two decreases will be the opposite of the effects of the increases. However, make sure that you understand and carefully explain in words what is going on, including the economic logic behind the multiple variable changes and curve shifts.

The following equations may be useful for solving the problems, but you do not have to use them:

\[
\text{The goods market/the IS curve: } Y = \frac{1}{1-c_1-b_1} \left( c_0 - c_1 T - b_2 i + G + NX \right)
\]

\[
\text{The financial market/the LM curve: } i = \frac{d_1 Y - M/P}{d_2}
\]

\[
\text{The IS-LM equilibrium/the AD curve: } Y = \frac{1}{1-c_1-b_1 + \frac{b_2 d_1}{d_2}} \left( c_0 - c_1 T + \frac{b_2}{d_2} \frac{M}{P} + G + NX \right)
\]

\[
\text{The labor market equilibrium/the AS curve: } P = (1+m) \frac{A^e}{A} P^e (1-u+z)
\]