

1 Answer Keys for Homework 13

1.1 Exercise 1:

1. Sales of government bonds decrease the supply of nominal money in the economy. This shifts the LM curve to the left. The IS curve remains constant. Hence, interest rate increases and output decreases.
2. An increase in P displaces the LM curve to the left leaving the IS curve unchanged. Effects on output and interest rate are the same as in 1.
3. An increase in taxation to the young increases F , and hence IS moves to the right. LM remains the same. Output increases and interest rate falls.
4. If the expected inflation rate increases, then the nominal interest rate will do so (in order to keep the real interest rate constant). This will cause the LM curve to shift to the right and the IS curve to the left.

1.2 Exercise 2:

Yes, some of them will change. For example, decreases in the nominal money supply would be neutral (ie output would not change) in a full capacity economy.

1.3 Exercise 3:

See pages 210, 221 and 226 in the book.

1.4 Exercise 4:

Assume that there is an initial increase of \$1000 in spending. This money goes to someone who's wealth increases in \$1000. Since the marginal propensity to consume is 10%, then he or she will want to spend $0.1 * \$1000 = \100 . But this extra \$100 will go to someone else, that will want to spend $\$100 * 0.1 = \10 , an amount that will go in turn to another person, and so on. Then this burst of consumer confidence has a multiplier effect and will cause the total expenditures to be $\$1000 * (1 + 0.1 + 0.1^2 + 0.1^3 + \dots) = \$1000 * \frac{1}{1-0.1} = \1111.1