Econ 305–Fall 2007
Problem Set 3
Posted: October 29
Due: November 5 IN CLASS

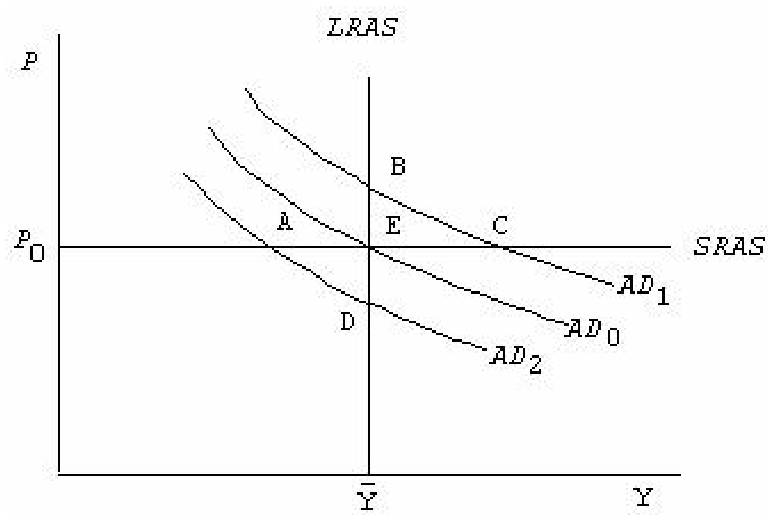
1 Question 1

Answer the following questions using the AD & AS model developed in Chapter 9.

(a) Starting from long-run equilibrium, if the velocity of money increases (due to, for example, the invention of automatic teller machines) and no action is taken by the government, what will happen to the output and prices in the short-run and long-run?

(b) Starting from long-run equilibrium, if the velocity of money increases (due to, for example, the invention of automatic teller machines), what could the Fed do to stabilize output?

(c) In the graph below, initially the economy is at point E, with price P_0 and output Y. Aggregate demand is given by curve AD_0, and $SRAS$ and $LRAS$ represent, respectively, short-run and long-run aggregate supply. Now assume that the aggregate demand curve shifts so that it is represented by AD_1. The economy moves first to point (?), and then, in the long-run, to point (?).



2 Question 2

Answer the following questions regarding the IS-LM model:

1. Along any given IS curve:
   (a) tax rates are fixed, but government spending varies.
   (b) government spending is fixed, but taxes vary.
   (c) both government spending and taxes vary.
   (d) both government spending and taxes are fixed.

2. The IS curves shifts when all of the following economic variables change except:
   (a) the interest rate
   (b) government spending
   (c) tax rates
   (d) the marginal propensity to consume

3. When LM curve is drawn, the quantity that is held fixed is:
   (a) the nominal money supply
   (b) the real money supply

(c) government spending

(d) tax rates

4. The IS and the LM curve together generally determine:

   (a) income only

   (b) the interest rate only

   (c) both income and the interest rate

   (d) income, the interest rate, and the price level

3 Question 3

According to the Keynesian-cross analysis, if the marginal propensity to consume is 0.6, and the government expenditures and autonomous taxes are both increased by 100, what will happen to the equilibrium level of income ?

4 Question 4

In the Keynesian-cross analysis, if the consumption function is given by $C = 100 + 0.6(Y - T)$, and planned investment is 100, G is 100, and T is 100, then what is the equilibrium Y?

5 Question 5

Assume that the money demand function is $(M/P)^d = 2200 - 200r$, where r is the interest rate in percent. The money supply M is 2000, and the price level P is 2. What is the equilibrium interest rate?