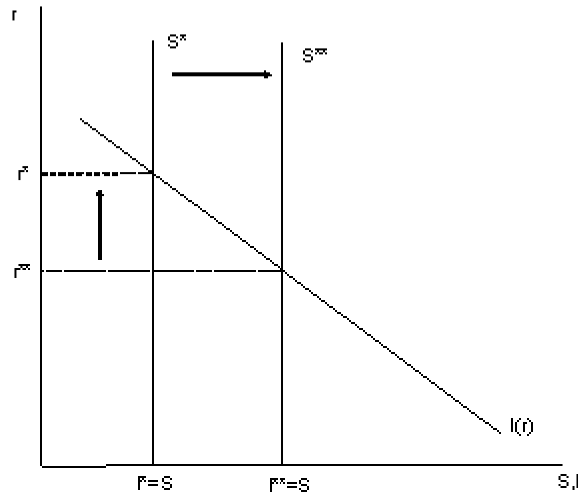
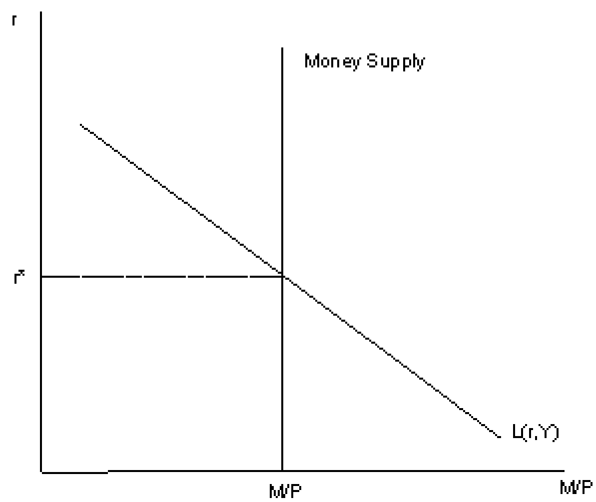
Answer Key for Final
Ec 3334 - Fall 2005

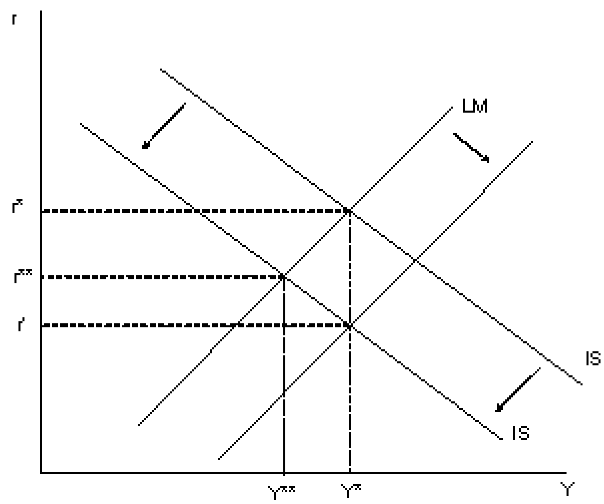
1) a)



b)



c)



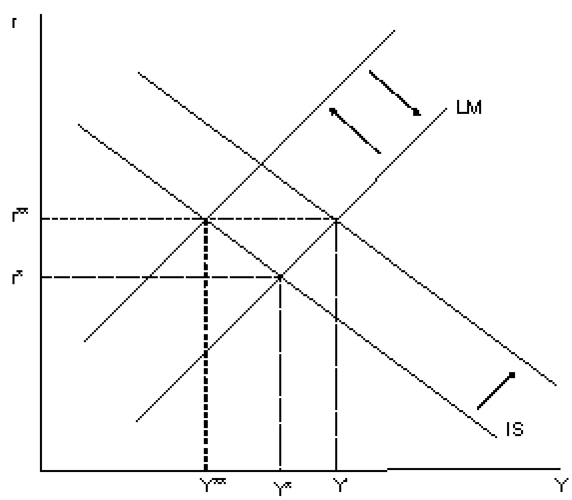
d) See diagram in part a). Savings curve shifts to the right, and thus the interest rate is lower.

e) The IS curve shifts down. Why? Because at any income level the equilibrium interest rate is lower because of the higher saving rate. With the IS curve shifting down output goes down and the interest rate goes down.

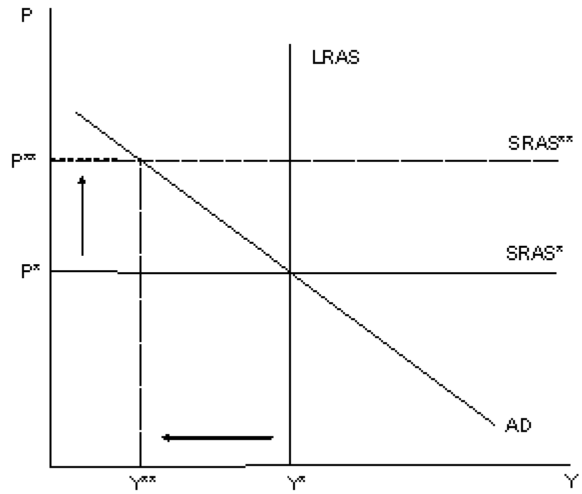
f) The Fed should raise the money supply. This will shift the LM curve down, pushing income back up to Y* and the interest rate down even further.

g) If the Fed didn't act, then the increase in savings would lower income, which would put downward pressure on prices (think of the AD/AS diagram) and thus prices would fall over time.

2. a)



b)



c) See diagram. SRAS shifts up, so prices go up and output goes down.

d) The LM curve shifts UP with an increase in prices. Output goes down and the interest rate goes up.

e) In the long run, the price level will drop back to P*.

f) As prices fall back to P*, the LM curve shifts back down to its original position. So there is NO long-run impact to either output or interest rates.

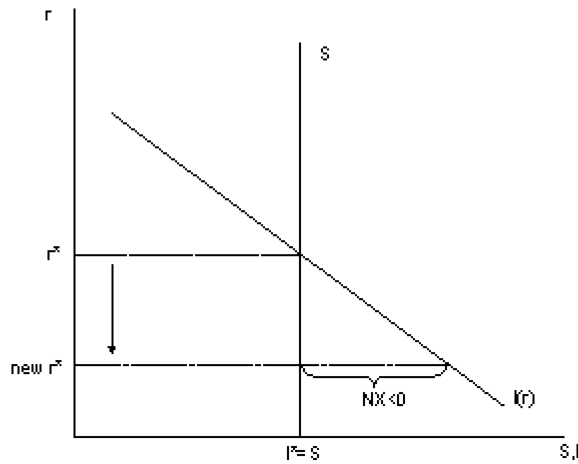
g) The tax cut shifts the IS curve up. Output and interest rates both go up.

h) In the long run the price level will rise because of the tax cut. (The AD curve shifts up because of the tax cut, and so the price level in equilibrium has to go up)

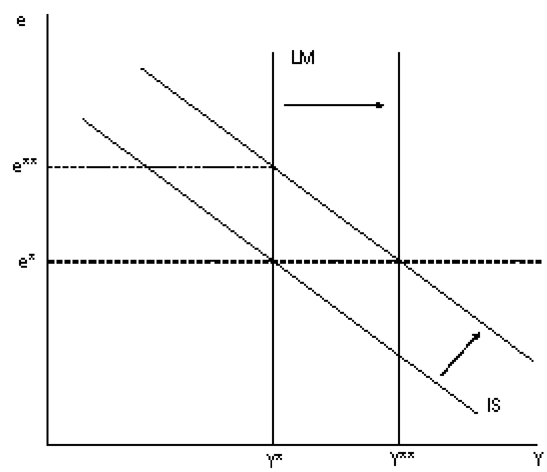
i) Interest rates will be higher in the long run because of the tax cut. Why? Because as prices rise the LM curve shifts up as well, and while output goes back to Y* this occurs at a higher interest rate.

3.

a)



b)



c) Net exports FALL in the small country as the interest rate goes down.

d) The IS curve shifts UP because of the lower interest rate. (To see this, think about what happens. Interest rates go down, and so investment goes up relative to savings, meaning net exports fall. If NX falls, then it must be the case that the exchange rate rises. So the IS curve must shift up) The exchange rate appreciates and output stays the same (its fixed by the LM curve)

e) The central bank would have to raise the money supply to keep the exchange rate down at e*. See the diagram.

f). The increase in money supply raises income. What happens to net exports? If income goes up, then savings goes up. If savings go up then NX goes up. (The difference between S and I shrinks).

g) If the LM curve shifts out and output goes up, then in the long run the price level must increase in the country.

4.

a)

$$M = \frac{cr + 1}{cr + rr} B$$

b) If cr goes up then the money supply decreases. Think about it. If people put less cash in the bank, then the banks have less to loan out, and bank loans are what drives the money creation process.

c) The Fed could either 1) raise the monetary base B (print cash, buy bonds, etc..) or 2) lower the reserve ratio, rr.

5.

a) True (although unconfirmed)
b) False (there is no evidence debt relief actually helps)
c) True
d) True
e) False (our trade deficit exists because we save very little money, that's it)
f) True
g) True
h) True
i) How could this not be true?