

Teaching assistantship # 2

Financial market and LM curve

Problem 1: Fiscal balance and production

For both political and macroeconomics reasons, governments are reluctant to incur budget deficits ($G > T$). Here we examine whether policy changes in government spending and taxes affect production or not.

$$Y = c_0 + c_1(Y - T) + I + G$$

1. How does change production if government spending increases by one unit?
2. How does change production if taxes increase by one unit?
3. Why are your answer at parts (1) and (2) different?
4. Suppose a balanced fiscal budget $T = G$. Does GDP change if both government spending and taxes increase by one unit?
5. How does affect propensity to consume (c_1) to your answer in part (4)? Why?

Problem 2: Impact of internet banking

Suppose that money demand is given by $M^d = \$Y(0,25 - i)$.

1. Explain how does money demand change because a popularization of internet banking.
2. Which of the following equations could characterize the economy after the impact of part (1): (i) $M^d = \$Y(0,5 - 2i)$, (ii) $M^d = \$Y(\frac{0,25-i}{2})$, (iii) $M^d = \$Y^{\frac{3}{2}}(0,25 - i)$. Why?

Problem 3: Financial market and liquidity trap

1. Suppose that the interest rate of Central Bank's bonds is almost zero. Would the people tend to hold bonds or money? Explain.
2. Draw money demand (M^d) as a function of interest rate (i). How does affect your answer in part (1) (Hint: Note that money demand (M^d) is very flat when interest rate (i) is almost zero.)
3. What happens with LM curve when interest rate (i) is almost zero?
4. Consider your LM curve. Suppose that the interest rate (i) is almost zero and Central Bank decides to increase money supply (M^s). What happens to the interest rate for a given level of GDP (Y)?
5. Could an expansionary fiscal policy increase the GDP when interest rate (i) is almost zero?