

## Answers

### Ch 10.

#### *Questions*

1. Because of the consumption function.

#### *Problems and Applications*

1. a) A multiple increase.  
b) A multiple but smaller decrease than the increase in a.  
c) Y will increase by  $\Delta G$ .
3. a) When taxes rise and fall with income, C responds less to  $\Delta Y$ .  
b) It falls.  
c) The IS curve becomes steeper.
4. a) It falls.  
b) It remains unchanged because I is fixed.  
d) It doesn't arise in the classical model.

### Ch 11.

#### *Questions*

2. i, Y and C fall, I rises.
3. i increases. Y, C and I fall.
4. Y increases because of the Pigou effect.

#### *Problems and Applications*

1. a) i falls. Y, C and I rise.  
b) i, C and Y rise. I falls.  
c) i, C and Y fall. I rises.  
d) i and Y rise. C and I fall.
2. a) IS shifts to right.  
i, C, I and Y all rise.  
Fed should shift LM to left.  
b) LM shifts up.  
i increases. C, I and Y fall.  
Fed should increase M.  
c) IS shifts left (up).  
i, C and Y fall. I increases.  
Fed should increase M.
5. a) Tight fiscal and easy monetary policy.  
b) i rises and I falls.
7. a) Money supply constant.  
b) Hold interest rate constant.

### Ch12.

#### *Questions*

\* (Remember the text is always assuming perfect capital mobility)

1. a) IS\* shifts to left. The exchange rate fall, Y is unchanged and the trade balance increases by the same amount as the increase in taxes.

2. The LM\* shifts left, Y falls, exchange rate appreciates and trade balance falls.

***Problems and Applications***

1. a) IS\* shifts to left. Y is unchanged. The currency depreciates. The trade balance increases by the same as the fall in consumption.  
b) IS\* shifts to left. Output and trade balance don't change. The currency depreciates.  
c) Under flexible, LM\* shifts to right. Y and X-M increase. The currency depreciates.  
Under fixed, LM\* again shifts right. Y, X-M and exchange rate are all unchanged.
2. Increase M and cut T or increase G.
8. a) Fixed  
b) Fiscal policy  
c) IS\* shifts to right in the short run and Y increases. In the long run, Y would return to its original level and P would be higher.

**Ch 13.**

***Questions***

5. Rational expectations, credible policy and flexible wages and prices.

***Problems and Applications***

4. a) The LM shifts to the right. This shifts out the AD curve. In the short run, the economy moves along SRAS with rising prices and output. As inflationary expectations adjustment the SRAC curve shifts up causing prices to continue to rise and Y to fall back to the original level. For the Phillips curve, the increase in demand moves the economy up the SRPC, which then shifts up leading the economy back to the old rate of unemployment and high inflation.  
b) Assuming the increase in inflation is expected, then in the AD-AS model, the SRAS shifts up and the new equilibrium is a higher P and the same Y. In the Phillips curve, the SRPC shifts up and the new equilibrium is higher inflation and the same unemployment.

**Ch 14.**

***Questions***

3. In the short run, nominal and real interest rates will fall. In the long run,  $i$  will rise and  $r$  will return to its original level.
4. Increasing the response of  $\Delta i$  to  $\Delta P$  implies that the monetary authority will be less accommodative of an adverse supply shock and as a result prices will rise less and output will fall more in the short run.

***Problems and Applications***

3. To lower  $i$  in the long run, inflation must be reduced. This requires reducing money growth which in the short run will raise  $i$ .