Problem Set #4

Due Thursday, October 19, 2006

Problem Sets MUST be word-processed except for graphs and equations.

QUESTIONS

1. In 2000, the economy was in equilibrium at its potential output level but there was a big government budget surplus. On a single IS-LM diagram, clearly show the effects on equilibrium income and interest rates of the following 2 scenarios. Be sure to provide a brief economic explanation for the different results of these 2 scenarios.

   a. Scenario #1: A large decrease in tax rates (in red).
   b. Scenario #2: A large decrease in government spending (in blue).

Now, assume that the Federal Reserve followed a stabilizing policy, i.e., it used monetary policy to keep the economy at its potential output level. On your IS-LM diagram, clearly show how this would affect equilibrium income and interest rates for the change in tax rates (in green) and the change in government spending (in orange or brown).

Finally, after both the fiscal and monetary policy changes have taken place, indicate whether each of the following variables is higher under Scenario #1 (decrease in tax rates) or Scenario #2 (increase in government spending) or whether it is the same under both scenarios:

   i. Income:
   ii. Interest rates:
   iii. Consumer spending:
   iv. Investment:
   v. Government spending:
   vi. Tax revenues:
   vii. Exports:
   viii. Imports:
   ix. Private savings:
   x. Government budget balance:
xi. Foreign savings:

xii. The demand for money:

xiii. The supply of money:

2. In 1996, the economy was below its potential output level. The government then used fiscal policy to move the economy to its potential level. However, once the economy reached potential output, consumer and business confidence surged. Starting with the initial situation in 1996, use 3 separate IS-LM diagrams to clearly show what happens to equilibrium income and interest rates in each of the following scenarios. Be sure to compare and contrast the outcomes of each of these 3 scenarios.

   a. The Federal Reserve keeps the money supply unchanged at its original 1996 level.
   b. The Federal Reserve keeps interest rates unchanged at their original 1996 level.
   c. The Federal Reserve keeps equilibrium income at its original 1996 level.