Problem Set #5

Due Tuesday, October 31, 2006

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

QUESTIONS

1. According to the “q” theory of investment, a fall in interest rates raises equity prices, which causes business firms to issue more stock and hence to raise investment. Assuming that this theory is correct, use an IS-LM model diagram with an Okun’s Law diagram to clearly show the effects of a monetary expansion on equilibrium income, interest rates, and the unemployment rate. Be sure to provide a brief economic explanation of the adjustment process as the economy moves from its initial equilibrium position to its final equilibrium position.

2. The ‘expansionary fiscal contraction” theory claims that when the government reduces the budget deficit, consumer confidence improves. Assuming that this theory is correct, use an IS-LM model diagram with a Budget Balance diagram to clearly show the effects of an increase in tax rates on equilibrium income, interest rates, the actual budget balance, and the structural budget balance. Be sure to provide a brief economic explanation of the adjustment process as the economy moves from its initial equilibrium position to its final equilibrium position.