**Quiz 2: Keynesian macroeconomics**
**EE312: Intermediate macroeconomics**
**Semester 2/2018**
**Date: Feb, 13th 2019.**

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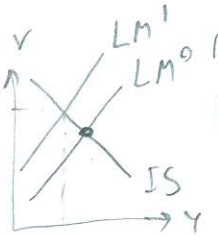
**Question 1** (15 points) True/False.

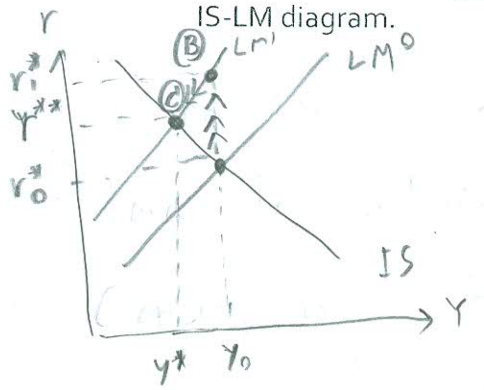
Assume for now that we are currently operating under the full-employment real GDP. Then, suppose that many public companies have started to default on their bonds, many of which are highly-rated ones. Answer the following questions

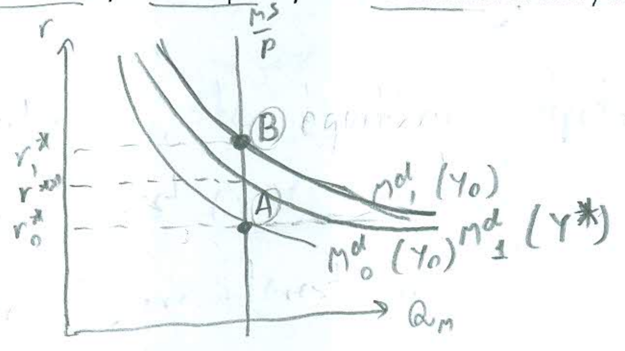
a) (5 points) How would you capture the initial impact of the hypothetical situation using the IS-LM model? Which curve do you think that it will shift? Why?




Many public companies' bond default lead to the fear of holding bond. People demand more money instead. the higher money demand increase $r^*$ in money market and shift LM to the left. This process creates new equilibrium which equilibrium Y is lower, and equilibrium r is higher.

b) (10 points) Analyze the transmission mechanism of the initial impact on key aggregate variables: output, interest rate, consumption, and investment. Link your analysis to the IS-LM diagram.




[A → B] At A, after the bond default, people demand more money. there is (excess bond supply) excess money demand. Bond issurs must give more interest rate in order to get more money sufficiently to money supply. the LM shift to the left as consequence. the general equilibrium IS-LM result in

[B → C] higher $r^{**}$, lower $Y^*$. the higher $r^{**}$ reduce incentive to invest and consumption since people rather save their money instead. the lower $Y^*$ work in the same way. It reduces I and C since people have less output (income).