EE212 Principles of Macroeconomics, 2/2015 (Sec. 046401)

Problem Sets 3 :

Chapter 6. ISLM Model

Please submit at the BE office, 5th floor department of Economics building.
Deadline of submission : Thursday 21, April 2016, before 15.00 hrs.
Late submission will not be accepted.
* Note that when there are many parts in one question, please **indicate clearly** the part you are answering. For example, **(a)** Answer. — **(b)** Answer. —. This way applies to exam as well.
* If the space provided is not enough, you may attach a separate sheet.

1. Consider an economy where the money demand is not sensitive to income while investments are not very sensitive to the interest rate.

   (a) Using diagrams to illustrate your answer discuss the effectiveness of fiscal and monetary policy in such a case using the IS-LM model.

   (b) Suppose you're an economic advisor to this economy which was facing a deflationary gap. Please explain whether you'll suggest the use fiscal or monetary policy to eliminate the deflationary gap.

2. We normally draw the IS curve as downward sloping and the LM curve as upward sloping, as appropriate for our usual assumptions about behavior. How would either or both of these curves look different if the following unusual assumptions were made? Describe and draw your answers.

   (a) Investment does not depend on the interest rate.

   (b) The MPC is zero.

   (c) Demand for money does not depend on income.

3. In each case of Question 2 (listed below), draw aggregate demand curve (AD).

   (a) Investment does not depend on the interest rate.

   (b) The MPC is zero.

   (c) Demand for money does not depend on income.

4. In each case below, show how one or both of the IS-LM curves change for the following exogenous changes in the model. Then, from that, determine how output (Y), consumption (C), interest rate (r), money supply (MS), Investment (I) would change. Graphically illutrate and give reasons for your results.

   (a) A reduction in government purchases

   (b) An increase in the money supply

   (c) A downward shift in the consumption function (less consumed at each Y–T).