Student ID.....

EE212 Principles of Macroeconomics, 2/2017 (Sec. 046402 - A. Sicha)

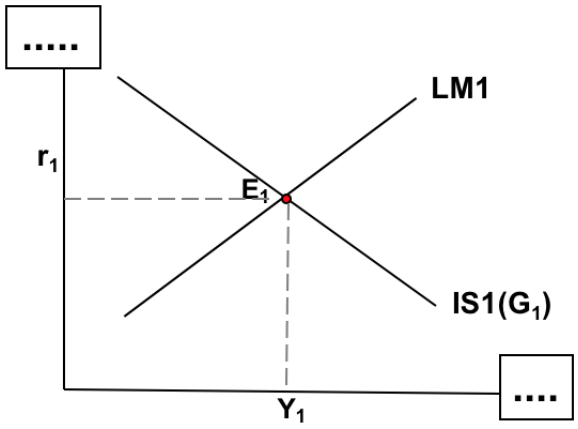
Problem Sets 8 : Chapter 6. ISLM Model

Please submit at the BE office, 5th floor department of Economics building.
Deadline of submission : May 3, 2018, before 15.00 hrs. **Late submission will not be accepted.**

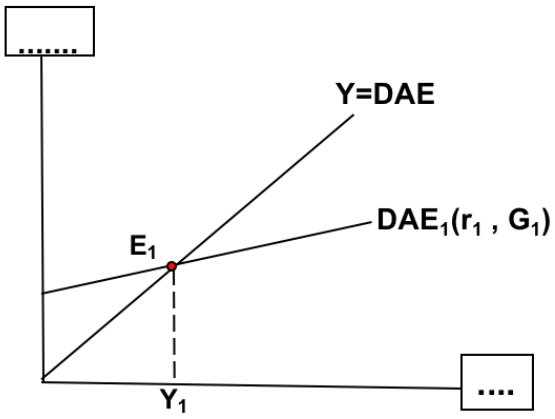
Instruction : Complete the graph. Draw additional graph necessary. Fill all the blanks to answer the question.
I do apologize, if there is any typo or mistake. Please correct it (them), if any.

1. In case of **deflationary economy**, should government increase or decrease government expenditure to solve the problem? Use IS-LM model to explain your answer. Clearly demonstrate crowding-out effect situation and adjustment process in each market in the economy (supplement necessary diagrams to illustrate the explanation).

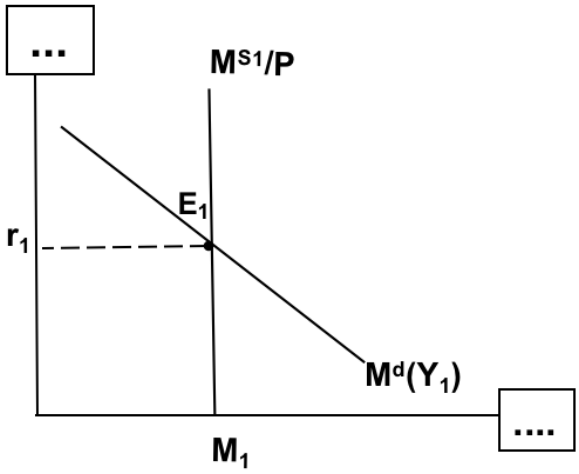
ISLM



DAE Model



Money Market



- Initially, the economy is at ISLM model equilibrium. Interest rate is at r_1. Output is at Y_1.
- The economy has a deflationary gap. This means that Y_1 is ..... (less than, greater than) potential output (Y_2).
- To solve the deflationary gap, the government should ..... (increase, decrease) government expenditure. This is called ..... (an expansionary, a contractionary) fiscal policy. Government Expenditure .....(increases, decreases) from G_1 to G_2.
  - Then, DAE shifts ..... (upward, downward) for all levels of interest rate. ..... (IS or LM) curve shifts to the ..... (left, right). [Add the new IS or LM graph to the ISLM graph provided on the previous page.]. The new equilibrium is at E_2, where the new equilibrium interest rate is r_2 and the new equilibrium output is Y_2. [Indicate E_2, r_2 and Y_2 on the ISLM graph.]
  - Interest rate (r) .....(increases, decreases) from r_1 to r_2. Output (Y) .....(increases, decreases) from Y_1 to Y_2. Y_2 is the potential output. The deflationary gap is then closed.
  - There are two effects associated with the fiscal policy.
    1. The first effect. If real interest rate remains the same ($\bar{r}$), DAE shifts ..... (upward, downward) from $DAE_1(r_1, G_1)$ to $DAE_2(r_1, G_2)$. [Add the new DAE to the DAE graph on the previous page.] $\Rightarrow$ output (Y) ..... (increases, decreases) from Y_1 to Y_3 [Indicate Y_3 on the graph.]. The size of the shift is .....(less than, equal to, greater than) ΔG.
    2. As Y ..... (increases, decreases), Real money demand .....(increases, decreases) ,
       Excess ..... (Money Demand, Money Supply), People will .....(buy, sell) bonds, Bond price .....(increases, decreases) and interest rate .....(increases, decreases)
       As r .....(increases, decreases) , investment .....(increases, decreases). DAE shifts ..... (upward, downward) from $DAE_2(r_1, G_2)$ to $DAE_3(r_2, G_2)$. Output .....(increases, decreases) from Y_3 to Y_2. This is a movement along IS curve.
       the second effect is called .....
       - Complete the money market graph. As output ..... (increases, decreases) from Y_1 to Y_2, money ..... (demand, supply) will ..... (increase, decrease). Money ..... (demand, supply) will shift to the ..... (right, left). The new equilibrium interest rate ..... (increases, decreases) from r_1 to r_2.
       - Indicate E_2 in all graphs [DAE, ISLM and Money Market.]