Question 1

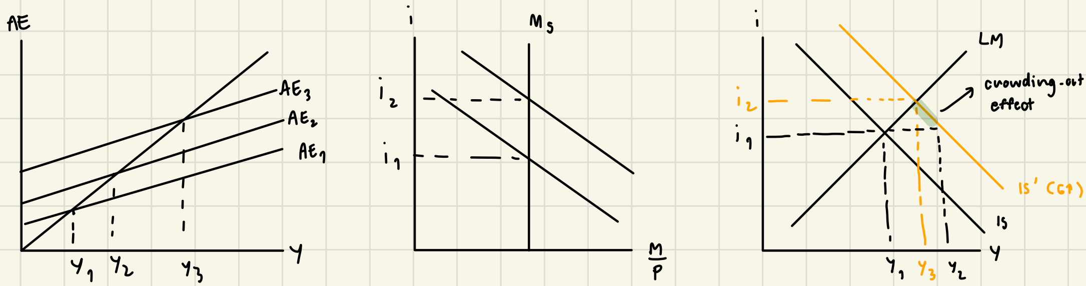
$Y = C + I + G$

$\frac{M}{P} = L(Y, i)$

Draw 3 diagrams (Keynesian Cross, Money Market, IS-LM) to **show and briefly explain** the followings:

a. The crowding-out effect when the government increases its spending
b. Another policy that can be used to avoid the crowding-out effect

a) crowding-out effect occurs when G↑ but discourage investor to investment



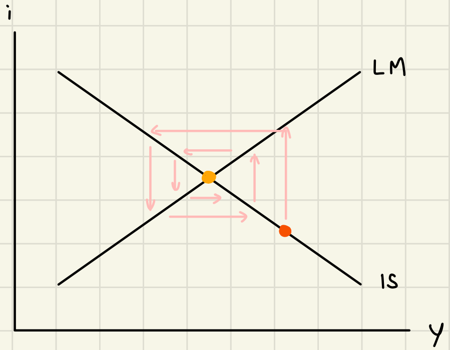
According to the graph, Government spending increase will make AE ↑ and IS curve also shift to the right and income change Y_1 to Y_2. and there will not in equilibrium to adjust to the equilibrium interest rate have to rise. So, this is a crowding out effect

b) To avoid the crowding out effect, the contractionary fiscal policy will decrease government spending that make output and income falls.
To explain in term of money market, when people have low income, they will buy less good & service.

Question 2

Draw the IS-LM diagram. **Pick ANY point on either the IS curve or the LM curve** (NOT the general equilibrium point). ย้ำว่าเลือกจุดไหนก็ได้ที่อยู่บนเส้น IS **หรือ** LM **ที่ไม่ใช่จุดตัดตรงกลางของสองกราฟ**

Use the diagram that you draw to briefly explain how the two markets at **your current point** will adjust towards the general equilibrium.



2) According to the graph, the orange point is only on the IS curve mean that it's not in the general equilibrium point.
To adjust to the general equilibrium, bank have to raise interest rate that makes investment lower and output and income will falls. Then after that the bank haveto reduce interest rate to increase investment that raise output and income so on. Finally, it will be a circle dynamic and adjust to general equilibrium of 2 markets. This process called dynamic in COB-WEB model.

<u>Question 3</u>

Assume that the liquidity preference function (real money demand) is given by the $L(Y, i) = L_0 + L_Y Y - L_i i$.

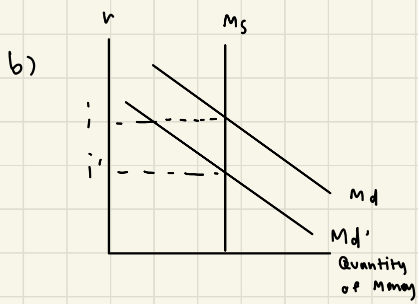
Note that **L_0 is autonomous money demand,** while other terms are the same as in the lecture slides.

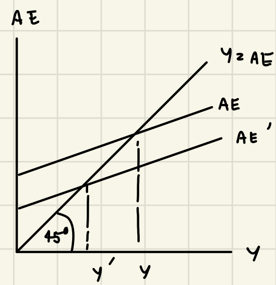
Now suppose that L_0 falls.

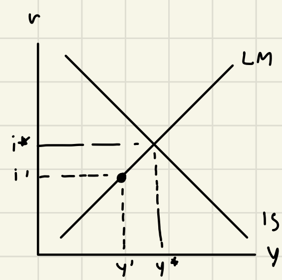
a. Give ONE reason why this may happen.
b. Show and briefly explain the effect of the fall in L_0 on the 4 diagrams (Keynesian Cross, Money Market, IS-LM, AD).

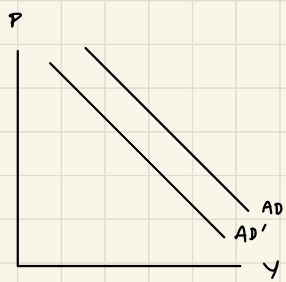
a) Price falls make less in money demand or hold cash less which make L falls.

b)









fall in liquidity (L₀) means that Money demand in the economy falls (Md shift to the left) resulting in falls in output (AE') and income (Y'). Change in Money demand cause movement along LM curve and AD will shift down.