Problem Set #5
14.02
Due 10/ 30/96

1.) A credible, phased-in deficit reduction, with no anticipated change in Fed policy, will certainly cause a decrease in

a. current output
b. the current interest rate
c. the expected future interest rate
d. all of the above
e. none of the above

2.) A phased-in deficit reduction package is more likely to be expansionary if:

a. the policy is front-loaded, i.e. most of the increase in taxes comes in the current period
b. current private spending is not very sensitive to the expected future interest rate
c. financial markets believe the Fed will lower interest rates
d. all of the above
e. none of the above

3.) In the few years after the Clinton deficit reduction package of 1993, the US economy experienced:

a. an increase in output
b. a decrease in interest rates
c. a decrease in the actual deficit
d. all of the above
e. none of the above

4.) Which of the following will shift the IS curve rightward?

a. an increase in current taxes
b. an increase in expected future taxes
c. an increase in expected future output
d. all of the above

5.) An increase in the nominal interest rate expected in the future will cause

a. a rightward shift of the LM curve
b. a leftward shift of the LM curve
c. the LM curve to become flatter
d. the LM curve to become steeper
e. no change in the LM curve

7.) Recently, President Clinton passed the Welfare Reform Bill which, in essence, decreases the total amount of federal welfare payments. Illustrate the potential impact of this legislation in the ISLM context. Describe what happens in terms of current variables and expectations.

8.) Assume, for a moment, that Bob Dole is leading in the polls due to growing support for his 15% tax cut. Illustrate the impact of this expectation in the ISLM context. (Take both the expected tax cut and the effect on interest rates into account).

9.) The Central Bank of Country A promises to increase nominal interest rates next year, despite a constant rate of future expected inflation.

a.) Illustrate the impact of such a promise in the ISLM context.

b.) How does the composition of GDP change? Is it composed of more or less consumption or investment?

c.) Repeat a and b under the assumption that expected future inflation rises by the same amount as the expected future nominal interest rate. Do not use this assumption for part d.

d.) If the Central Bank instead increases interest rates today by contracting the money supply, what happens to equilibrium output?Be explicit about the assumptions you make and the time frame to which you refer.

10.) True, False, Uncertain: Explain. Do both and explain regardless of the answer.

a.) The IS curve will tend to be steeper when expected future taxes are relatively small.

b.) The demand for money depends on the expected future real interest rate.

11.) In the last problem set, you were given a question about the impact of the recent "good" unemployment numbers on stock prices. The fear was that the Fed would increase interest rates to fight off inflationary pressures, thereby causing stock prices to fall. The Fed, however, opted not to increase the interest rates. Suppose that, today, new unemployment figures show a .5% further drop in the unemployment rate. What do you think would happen to stock prices? Draw the impact of the lower unemployment figures in the ISLM context. State which expectations are changing and in which directions these changes may shift either the IS or LM curves?

12.) Do anticipated increases in government spending impact the economy differently that unanticipated increases? Why or why not? Show graphically. Would your answers changed if the anticipated increase in government spending was not a credible one (people do not believe the government will actually spend more)?

13.) Go find or buy a recent issue of the Economist (We will rely on the October 19th issue, but any week should be fine.) Look at a page near the end of the magazine with the title "Emerging-Market Indicators." Compute the real interest rate for Mexico, Brazil, Argentina, Chile and Venezuela. This page will contain all the information you need in your calculations. Indicate how you compute the real interest rates and what assumptions you need to make. In which country is the real interest rate the highest? lowest?