Economics 314 — Spring 2014
Daily Question #1 — January 29

Note: This "daily question" is more like a short problem set. The idea is to give you some practical experience using the simple models in coursebook Chapter 2. In your answers, focus on the economic logic, but don't go into too much detail.

1. Use the income-expenditure model to answer the following questions:
   a. If the MPC is 0.75, how much would an increase of $1 billion in government spending raise GDP?
   b. In the previous question, how much would consumption spending go up (in total, not just the first round)?
   c. Suppose that instead of lump-sum taxes, we have taxes that depend positively on the amount of income. How would introducing this positive tax rate on income affect the magnitude of the multiplier and why?
2. Use the quantity theory to answer the following question:
   a. If the money supplies in the U.S. and Brazil grow at the same rate (and velocity is constant in both countries), but real GDP grows faster in Brazil, which country will have higher inflation and why? Does this result depend on whether velocity is higher in the U.S. or in Brazil?
3. Use the *IS*/*LM* model to answer the following questions:
   a. Why does the equilibrium interest rate go up when there is an increase in spending? (Be sure to use asset equilibrium represented by the *LM* to answer this question.)
   b. If spending was not very sensitive to changes in real interest rates, would the *IS* curve be flatter or steeper? How would that change the output effects of fiscal policy and of monetary policy?
4. Use the AD/AS model to answer the following questions:
   a. If business-cycle fluctuations in year-to-year GDP growth are caused by shocks to aggregate demand, what correlation would you expect to observe between output growth and inflation (positive, negative, or zero)?
   b. If business-cycle fluctuations in year-to-year GDP growth are caused by shocks to aggregate supply, what correlation would you expect to observe between output growth and inflation (positive, negative, or zero)?