

Cooleconomics
Macroeconomics

Study Questions: (Short run closed economy IS-LM Model)

1. Congressman Biff Flatt says “government must act to rid of our budget deficit if we want to get out of this recession!”

Is Biff correct? Explain and illustrate using a closed economy IS-LM graph

2. A closed economy is characterized as follows:

$$C = 2000 + .9(Y-T) - 20r$$

$$I = 5000 - 10r$$

$$G = 2000$$

$$T = 2000$$

$$M_s = 600$$

$$M_d = .1Y - 5r$$

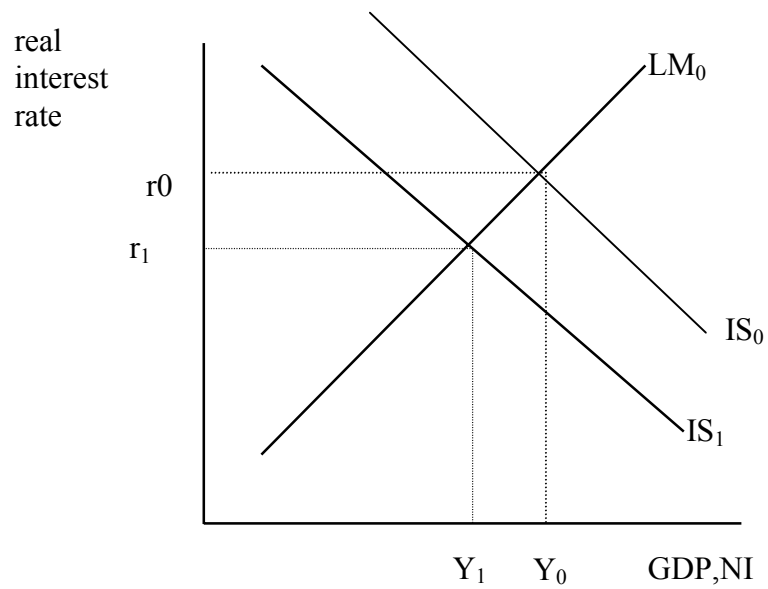
$$P = 1$$

A) Calculate equilibrium values for Y , C , I , budget deficit, and private savings.

B) Now the government cuts taxes by 1000.

Calculate new equilibrium values for Y , C , I , budget deficit, and private savings.

1. No. One must stimulate spending to get out of a recession. If government wants to get rid of the deficit then it must cut its own spending or raise taxes; either of these things reduces spending—not stimulates it! The Congressman is a bonehead! His deficit reduction plan would affect r and Y thusly:



2a

$$AD = 9000 + .9(Y - 2000) - 30r$$

$$AD = 7200 + .9Y - 30r$$

$$Y = 7200 + .9Y - 30r$$

$$30r = 7200 - .1Y$$

$$r = 240 - .003333333Y$$

$$600 = .1Y - 5r$$

$$5r = -600 + .1Y$$

$$r = -120 + .02Y$$

$$240 - .003333333Y = -120 + .02Y$$

$$360 = .023333333Y$$

Y	15428.57143
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r	188.5714286
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I	3114.285714
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C	10314.28571
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C	10314.28571
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private Savings	3114.285714
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2b

$$AD = 9000 + .9(Y - 1000) - 30r$$

$$AD = 8100 + .9Y - 30r$$

$$Y = 8100 + .9Y - 30r$$

$$30r = 8100 - .1Y$$

$$r = 270 - .003333333Y$$

$$600 = .1Y - 5r$$

$$5r = -600 + .1Y$$

$$r = -120 + .02Y$$

$$270 - .003333333Y = -120 + .02Y$$

$$390 = .023333333Y$$

Y	16714.29
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r	214.2857
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I	2857.143
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C	11857.14
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C	11857.14
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private Savings	3857.143
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The budget deficit rose from 0 to 1000.