

**Cooleconomics.com**  
**Principles of Economics**

**Another Model 3 Study Question**

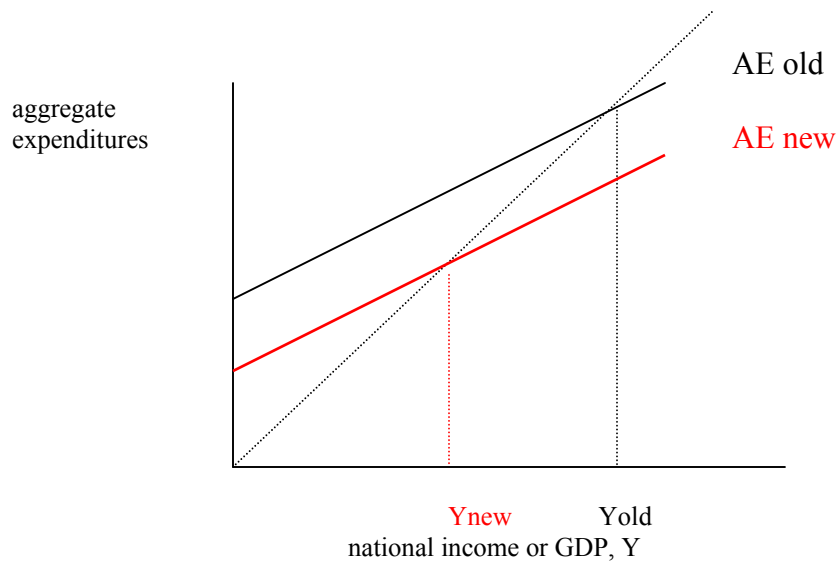
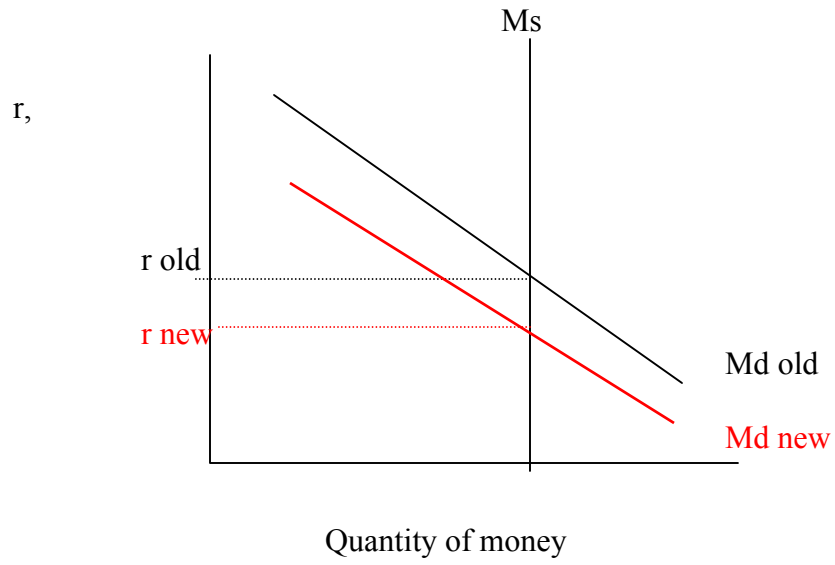
The McDonaldland economy is currently in equilibrium, but President McCheese wants to be prepared for any contingency. She asks you, Hamburglar, her economic advisor, what will happen to the economy if any of the following events were to (separately) occur:

a) Households become pessimistic.                      b) The government increases Social Security spending.  
c) The Central Bank cuts the discount rate.      d) The Fed sells "used" government securities to the public.

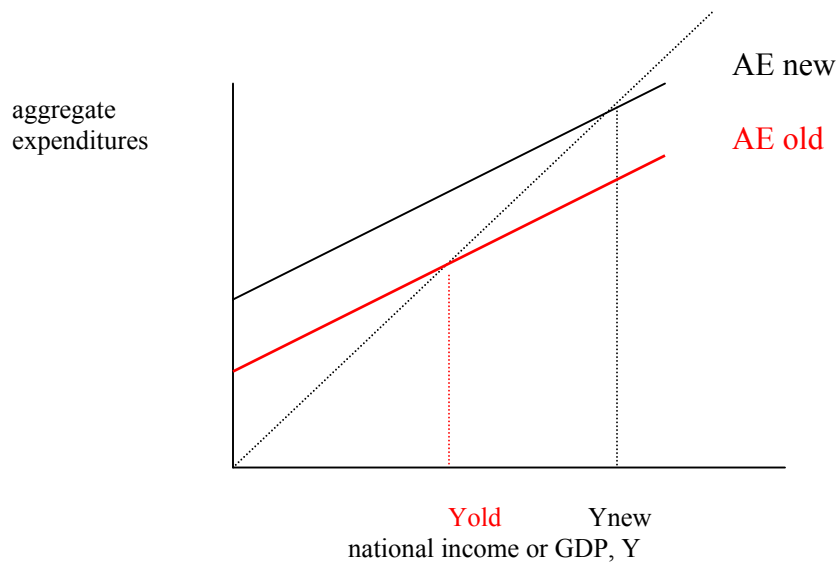
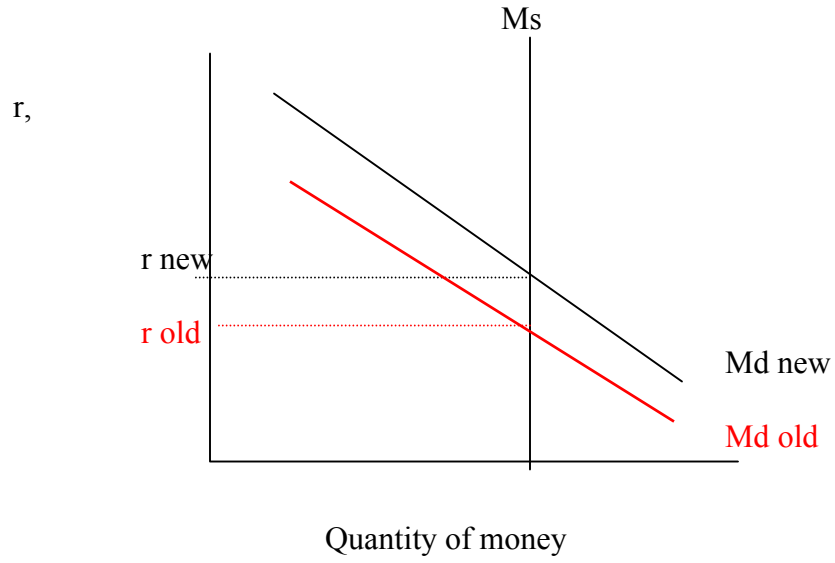
i) On 8 separate graphs (2 each for a through d), illustrate what would happen to equilibrium GDP and equilibrium interest rates if events (a)-(d) were to (separately) occur, using model #3 of an economy.

ii) In 12 separate responses (2 each for a through d), indicate what happens to total investment, net exports, and the budget deficit if (a)-(d) were to (separately) occur, and explain why each changes.

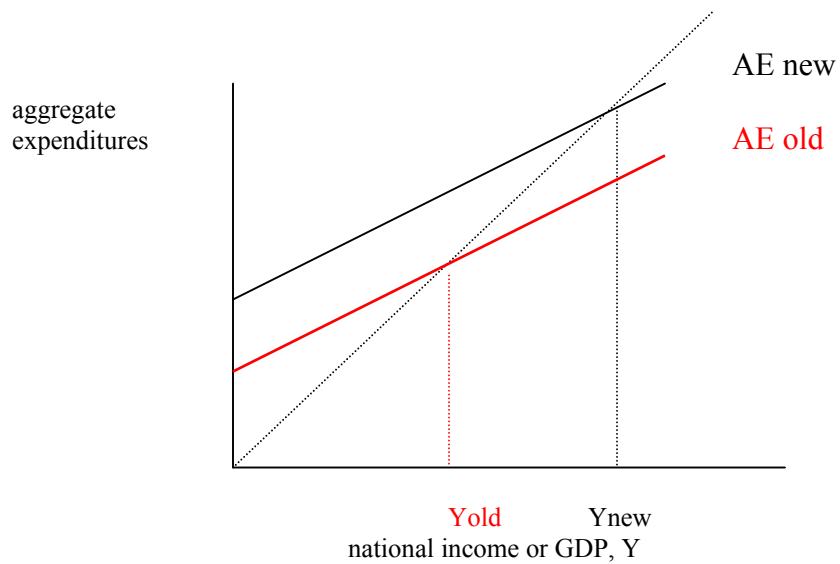
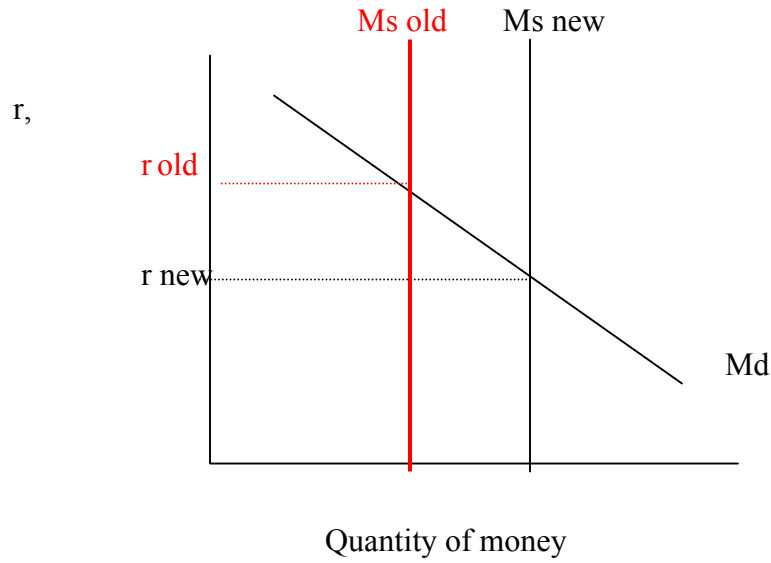
a) part (i) Pessimistic households consume less:



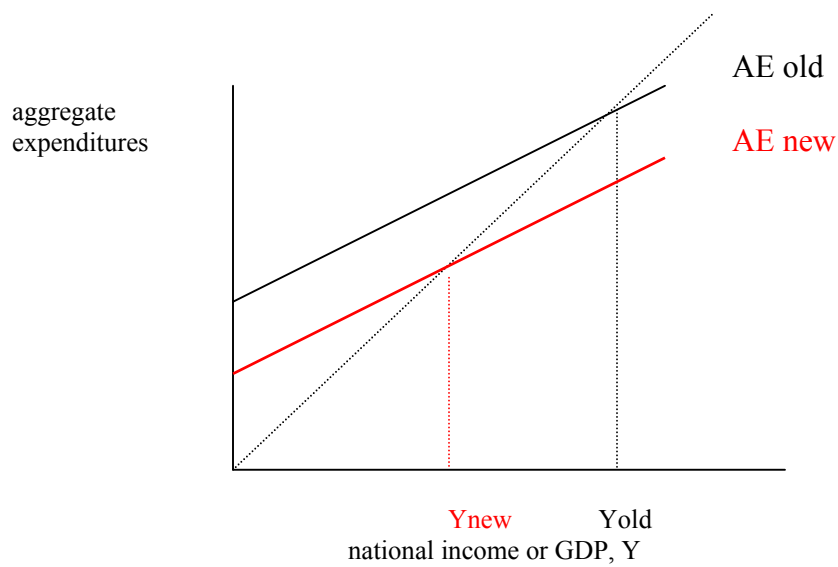
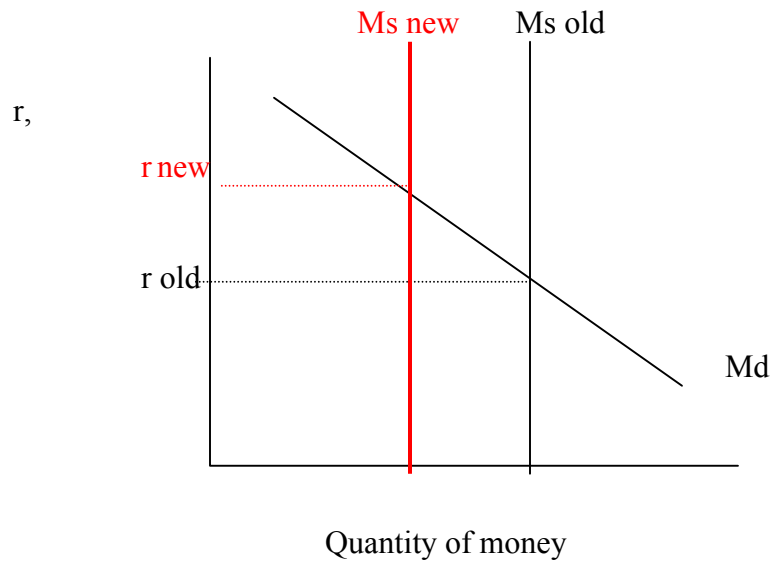
b) part (i) Higher Social Security spending causes higher consumption:



c) part (i) A lower discount rate causes a higher money supply:



d) part (i) A sale of used government securities causes a smaller money supply:



a, part ii:

Investment rises because interest rates are lower.

Net exports rise (or the trade deficit falls) because the lower interest rates cause the dollar to depreciate.

The budget deficit rises (or the budget surplus shrinks) because the smaller national income (along with no change in tax rates) causes total tax revenue to fall.

b, part ii:

Investment falls because interest rates are higher. (This is *crowding out*.)

Net exports fall (or the trade deficit rises) because the higher interest rates cause the dollar to appreciate.

The budget deficit rises (or the budget surplus shrinks) because the government is spending more money (on Social Security) without raising tax rates to pay for it.

c, part ii:

Investment rises because interest rates are lower.

Net exports rise (or the trade deficit falls) because the lower interest rates cause the dollar to depreciate.

The budget deficit falls (or the budget surplus grows) because the larger national income (along with no change in tax rates) causes total tax revenue to rise.

d, part ii:

Investment falls because interest rates are higher.

Net exports fall (or the trade deficit rises) because the higher interest rates cause the dollar to appreciate.

The budget deficit rises (or the budget surplus falls) because the smaller national income (along with no change in tax rates) causes total tax revenue to fall.