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Principles of Economics

Model 4 Study Questions

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

- a) Households become more optimistic.
- b) The government decreases defense spending.
- c) The Central Bank raises the required reserve ratio.

i) On 3 separate graphs (1 each for a through c), illustrate what would happen to equilibrium GDP and the equilibrium price level if events (a)-(c) were to (separately) occur, using model #4 of an economy.

ii) In 12 separate responses (4 each for a through c), indicate what happens to total investment, total consumption, the trade deficit, and the budget deficit if (a)-(c) were to (separately) occur, and explain why each changes.

Answers to Model 4 Study Questions

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

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ii) In 12 separate responses (4 each for a through c), indicate what happens to total investment, total consumption, the trade deficit, and the budget deficit if (a)-(c) were to (separately) occur, and explain why each changes.

a) The higher price level increases money demand. (Meanwhile, the Central bank has NOT changed the money supply.) Higher money demand along with a constant money supply results in higher interest rates. And:

Higher interest rates mean it is more expensive to borrow to buy houses or physical capital, so investment falls.

Higher interest rates also cause the dollar to appreciate vs. foreign currency, causing U.S. imports to rise and exports to fall → Net exports fall → the trade deficit rises.

Real national income has risen; this is a larger amount of income for the government to tax. (Meanwhile, government has not changed tax rates or its level of spending.) Since government is taking in more tax revenue and keeping its spending constant, it can borrow less → the budget deficit falls.

b) The lower price level reduces money demand. (Meanwhile, the Central bank has NOT changed the money supply.) Lower money demand along with a constant money supply results in lower interest rates. And:

Lower interest rates mean it is less expensive to borrow to buy houses or physical capital, so investment rises.

Lower interest rates also cause the dollar to depreciate vs. foreign currency, causing U.S. imports to fall and exports to rise → Net exports rise → the trade deficit falls.

Since government is spending less, it can borrow less → the budget deficit falls.

c) The Central bank policy reduces the money supply, causing interest rates to rise.

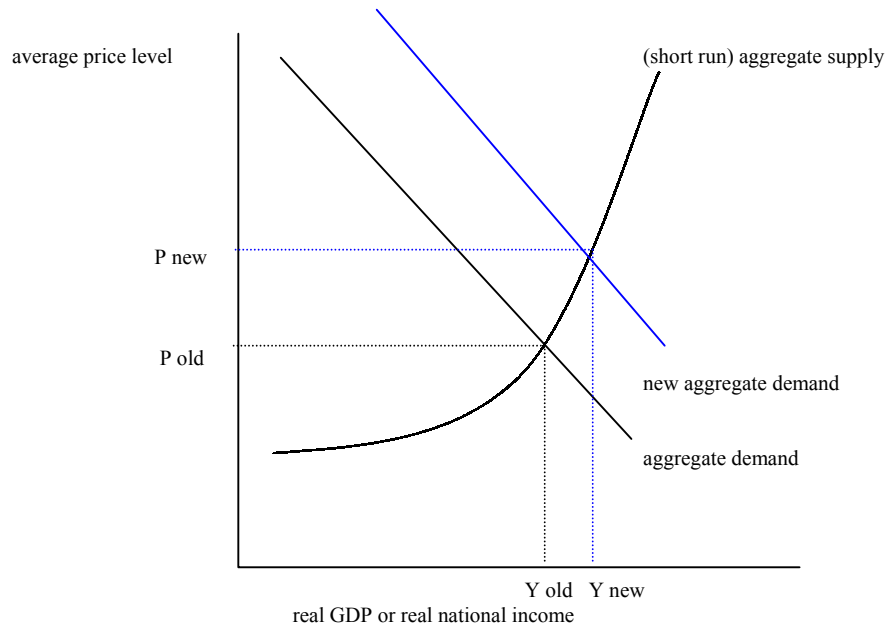
Higher interest rates mean it is more expensive to borrow to buy houses or physical capital, so investment falls.

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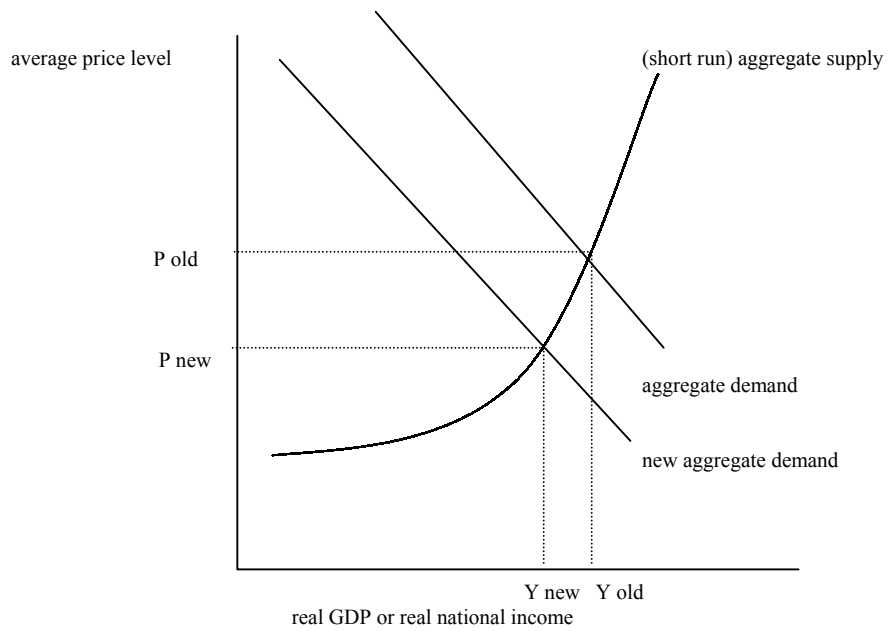
Real national income has fallen; this is a smaller amount of income for the government to tax. (Meanwhile, government has not changed tax rates or its level of spending.) Since government is taking in less tax revenue and keeping its spending constant, it must borrow more → the budget deficit rises.

graphs:

a)



b)



c)

