Homework (Chapter 11) Due on Wednesday, The 22nd of March

Problem 1

Basic concepts: IS - LM

a) How do we derive IS and LM curves? (show full derivation)
b) Which variables are endogenous and which variables are exogenous?
c) Let's say that:
   Nominal money in the economy is 100
   Price level is 2
   Whenever interest rate increases by 1% (use 1, not 0.01!!!) money demand *changes* by 0.5, and whenever income increases by 1, money demand *changes* by 100.
   - Derive the LM curve and plot it

d) The IS equation could be written: $Y = C + I + G$.
   Lets say that, $C = 0.8(Y - T)$, $I = 100 - 0.05r$ $G = 200, T = 200$
   - If government expenditure increases by 10 units, which way IS curve shifts and by how much?
   - If taxes are decreased by 10 units, which way IS curve shifts and by how much?

Problem 2

Use the IS - LM model to analyze the effects of the following shock to the economy:

a) A banking crisis rumbles through the US. Consumers loose trust in banks and banks start taking more caution in making lending decisions.

b) The US starts a war with Iran. (Forget your political views, think like an economist ☺)

Analyze each of the shocks separately; show what happens to the endogenous variables in the short run **and** in the long run. (What are the endogenous variables in each case?)