

### Problem on IS/LM and IS/MP

I) Describe how, if at all, each of the following developments affects the IS and/or MP curves:

- a) Taxes fall.
- b) Government purchases fall, and at the same time the Federal Reserve changes its policy rule to set a higher real interest rate at a given level of output than before.
- c) The demand for money increases (that is, consumer's preferences change so that at a given level of  $i$  and  $Y$  they want to hold more real balances than before).
- d) Investment demand becomes less sensitive to the interest rate.

II) Describe how, if at all, the same developments affect the IS and/or LM curves:

- a) Taxes fall.
- b) Government purchases fall, and at the same time the Federal Reserve reduces the money supply.
- c) The demand for money increases (that is, consumer's preferences change so that at a given level of  $i$  and  $Y$  they want to hold more real balances than before).
- d) Investment demand becomes less sensitive to the interest rate.

III) What happens if there is a decrease in expected inflation

- a) in the IS/MP model, assuming that  $\pi = \pi^e + \alpha(Y - \bar{Y})$ ? Show on a graph.
- b) in the IS/LM model? Show on a graph.