

Problem 11-2

Use the IS-LM model to predict the effects of each of the following shocks on income, the interest rate, consumption, and investment. In each case, explain what the Fed should do to keep income at its initial level.

- After the invention of a new high-speed computer chip, many firms decide to upgrade their computer systems.
- A wave of credit-card fraud increases the frequency with which people make transactions in cash.
- A best-seller titled *Retire Rich* convinces the public to increase the percentage of their income devoted to saving.

Problem 11-4

Explain why each of the following statements is true.

Discuss the impact of monetary and fiscal policy in each of these special cases.

- If investment does not depend on the interest rate, the IS curve is vertical.
- If money demand does not depend on the interest rate, the LM is vertical.
- If money demand does not depend on income, the LM is horizontal.
- If money demand is extremely sensitive to the interest rate, the LM is horizontal.

Problem 11-3

Problem 10.3

Let' represent the tax system by writing tax revenue as $T = \bar{T} + tY$ where \bar{T} and t are parameters of the tax code. t is called the marginal tax rate.

- How does this tax system change the way consumption responds to changes in GDP?
- In the Keynesian cross, how does this tax system alter the government-purchases multiplier?
- In the IS-LM model, how does this tax system alter the slope of the IS curve?

Problem 10.4

Consider the impact of an increase in thriftiness in the Keynesian cross. Suppose the consumption function is $C = \bar{C} + c(Y - T)$ where \bar{C} is called *autonomous consumption* and c is the MPC.

- What happens to equilibrium income when the society becomes more thrifty, as represented by a decline in \bar{C} ?
- What happens to equilibrium saving?
- Why do you suppose this result is called the *paradox of thrift*?
- Does this paradox arise in the classical model of Ch 3? Why or why not?
