Econ 3010
Keeping-up-assignment (KUA) 11

1. Use the goods market, financial market, IS-LM, AS-AD, and uncovered interest parity (UiP) diagrams to explain in words and graphically the short run and medium run effects on GDP (Y), the unemployment rate (u), investment (I), the interest rate (i), consumption (C), the economy’s price level (P), the nominal exchange rate (E), the real exchange rate ($\varepsilon = EP/P*$) and net exports $NX = NX (Y, Y^*, e)$, of a decrease in government spending $G$. Assume the economy starts with output at its natural level and the price level equal to the expected price level ($Y = Y_n$, $P = P^e$).

2. Use the goods market, financial market, IS-LM, AS-AD, and uncovered interest parity (UiP) diagrams to explain in words and graphically the short run and medium run effects on GDP (Y), the unemployment rate (u), investment (I), the interest rate (i), consumption (C), the economy’s price level (P), the nominal exchange rate (E), the real exchange rate ($\varepsilon = EP/P*$) and net exports $NX = NX (Y, Y^*, e)$, of a decrease in the money supply $M$. Assume the economy starts with output at its natural level and the price level equal to the expected price level ($Y = Y_n$, $P = P^e$).

Some equations which might be helpful, you do not have to use them:

Goods Market/IS curve: $Y = c_0 + c_1(Y - T) + b_1Y - b_2i + G + NX (Y, Y^*, \frac{E^e_{1+i^*}}{1-i^*} P)$

Financial Market /LM curve: $i = \frac{d_1 Y - M / P}{d_2}$

Labor market/Aggregate Supply/AS curve: $P = (1+m) \frac{A^e}{A} P^e (1-u+z)$

(note that we plugged the real exchange rate $\varepsilon = \frac{E^e_{1+i^*}}{1-i^*} P$ into the NX equation. We omit the AD, but it will shift when the IS and LM shift; except when P changes, you just move along the AD curve)