

Macroeconomics - Homework #2

1. Computational part - 4 points:

Problem 1 - Multiplication effect

In the closed economy with no external trade the autonomous consumption is 200 bil.USD, the marginal propensity to consume is 90%, planned investment is 400 bil.USD, government expenditures are 300 bil.USD and taxes are 250 bil.USD. What is the equilibrium level of output which puts the market for goods and services into balance?

How big will be the change in the national product if the government

- increases expenditures on the construction of highways by 20 bil.USD?
- decreases the property tax by 20 bil.USD?
- increase expenditures on health care by 20 bil.USD and finances it by increasing the property tax also by 20 bil.USD.

(Hint: use the Keynesian cross)

Problem 2 - IS-LM model and appropriate monetary policy

Use the IS-LM model to predict the effects of each of the following shocks on (a) income, (b) the interest rate, (c) consumption, and (d) investment. In each case, explain what the Fed should do to keep income at its initial level (i.e. whether he should pursue monetary restraint or monetary stimulus).

- After the invention of a new high-speed computer chip, many firms decide to upgrade their computer systems (i.e. we observe higher investment at the same level of interest rate).
- A wave of credit-card fraud increases the frequency with which people make transactions in cash (i.e. people demand more money at the same interest rate)
- A best-seller titled Retire Rich convinces the public to increase the percentage of their income devoted to saving (i.e. the consumption has decreased).

(Hint: Draw 3 pictures - Keynesian cross, Money market as well as IS-LM model. Show how the shock affected all of them. Show how the CB should respond to the shock - i.e. how it should adjust the money supply and thus move the LM curve).

2. Reading part - 2 points:

On the website, I posted an opinion piece by Paul Krugman (Nobel prize for economics, 2008) "How Did Economists Get It So Wrong?", published on September 2, 2009 in New York Times. This article has started a heated debate on the usefulness of macroeconomics in the view of the current events in the global economy. In your essay (max 2 pages) I would like you to answer these questions

1. What is the main postulate of Mr. Krugman? How does he support his opinion?
2. What part of his argumentation do you agree with, and why? Support your opinion.
3. What part of his argumentation don't you agree and why? Support your opinion.
4. In general, what is your opinion on the failure of macroeconomics in predicting the crisis?

Remember that the original article is an opinion piece. Thus, the author, though he can write very persuasively, doesn't have to be right :-).

Rules:

- For the computational part, you can work in groups - max 3 people in the group, 1 solution with all the names on it.
- For the reading part, everybody has to hand in his own essay (max 2 pages, 12pt, Times New Roman).
- Submission deadline - by email or on paper before the class - i.e. before April 26, 14:45. For every day of delay (either computational or reading part not submitted), I subtract 1 point.

Good luck!