

S1 d) (3 points) If the Fed did nothing, explain how exactly the economy will return to full employment.

SINCE AS > AD PRICES MUST FALL

S1 e) (4 points) Assuming that the Fed did nothing, find the new price level associated with the long run general equilibrium.

LONG RUN IS WHEN $r = .01$, $Y = 250$

$$\frac{400}{P} = 105 + .5(250) - 1000(.01)$$

$$P = 1.818$$

← recall - its changes in P that gets us BACK TO LR

Please label this long run equilibrium on your FE, IS, LM diagrams as point C. Be sure to label diagram completely with the inclusion of all the relevant shift variables like we did numerous times in class.

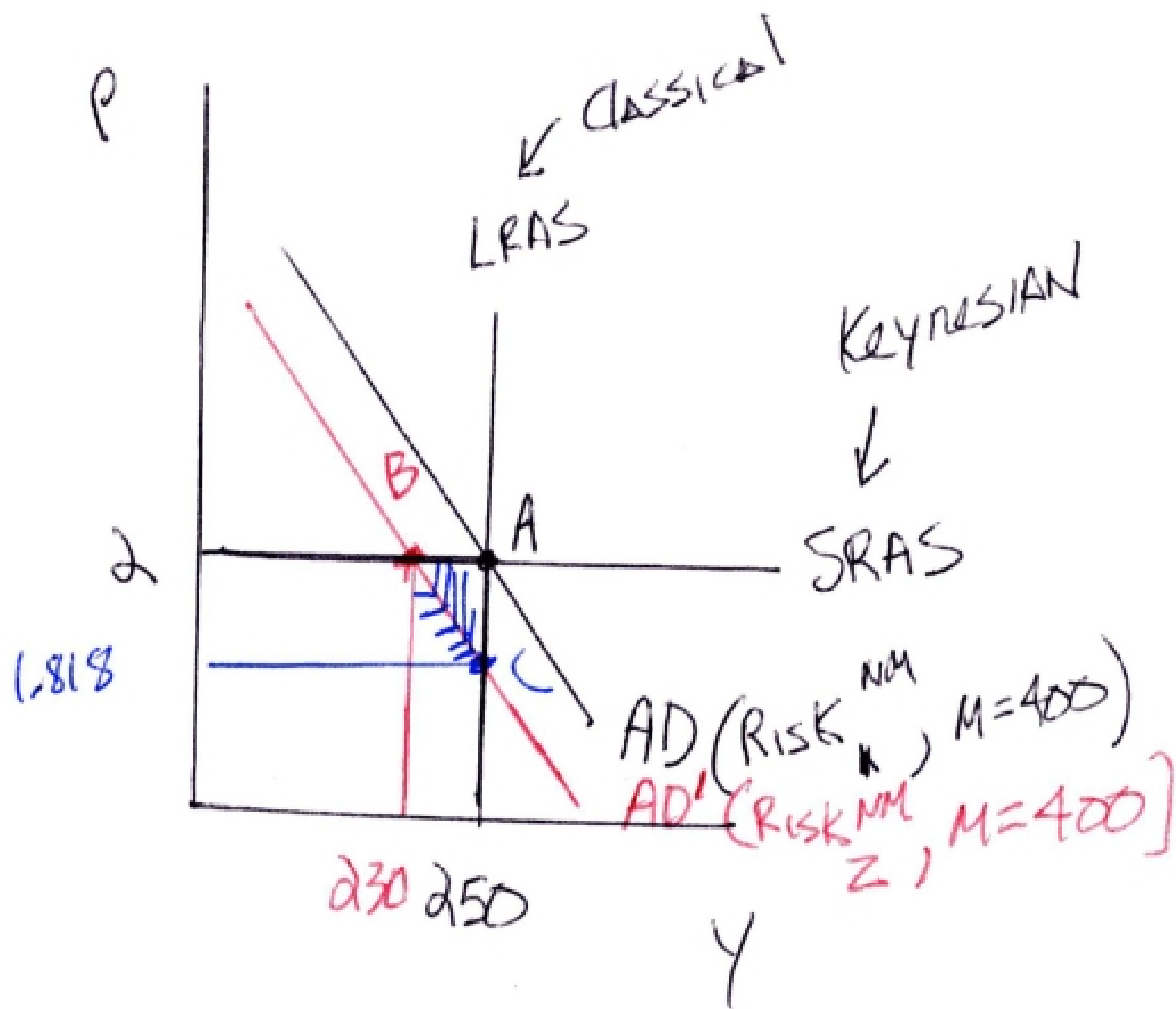
S1 f) (5 points) Is this result desirable? That is, with perfect information, would the Fed allow this long run adjustment to take place? Why or why not? Explain in as much detail as possible using a real world event (hint, it's a central banking nightmare!).

NO! EXPLAIN!

S1 g) (5 points) Suppose otherwise and that the Fed wanted to keep prices constant at their original level at points A and B. What would the Fed have to do exactly, as in open market operations? Assume that the money multiplier is 1. Be specific and show work.

$$\frac{M}{Z} = 105 + .5(250) - 1000(.01)$$

$M = 440 \rightarrow$ 40 IN OPEN MKT PURCHASES



In the scenario 12, we let these wonderful elected officials of ours increase G to 80 (from 50)

32 a) (4 points) (4 points) Derive a 'new' expression for the IS curve (r in terms of Y). Please show all work

$$S^d = Y - [85 + .5(Y - 100) - 500r] - 80$$

$$S^d = -115 + .5Y + 500r$$

$$-115 + .5Y + 500r = 50 - 500r$$

$$1000r = 165 - .5Y$$

$$r = .165 - .0005Y \quad \text{--- 'new' IS}$$

32 b) (4 points) Now solve for the short-run equilibrium output (Keynesian) and the corresponding real rate of interest. Please show all work. Please label this short-run (fixed price) equilibrium as point B.

Set 'new' IS = LM

$$.165 - .0005Y = .115 + .0005Y$$

$$Y = 280$$

$$r = .025$$

32 c) (4 points) In the short run, what is the "Keynesian" government spending multiplier? Please show all work

$$\text{Keynesian Multiplier} = \frac{\Delta Y}{\Delta G} = \frac{30}{30} = 1$$

32 d) (4 points) Solve for the real rate of interest in the long-run equilibrium.

We know in LR $Y = 250$, Plug into new 'IS'

$$r = .165 - .0005(250)$$

$$r = .04$$

32 e) (4 points) We now consider the long run when prices adjust. Find the new price level associated with the long-run equilibrium. Please show all work

$$\frac{400}{P} = 85 + .5(250) - 1000(.04)$$

$$P = 2.35$$