Homework 9

1. Consider the usual IS-LM model:

$$Y = C(Y - T) + I(r) + G,$$

$$\frac{M}{P} = L(r, Y).$$

   a) If the government increases spending by ΔG and the central bank attempts to keep the interest rate unchanged, then how should the central bank do? (Do a quantitative analysis.)
   b) If the central bank manages to do this, what would be the government spending multiplier in this case?

2. Consider a small open economy with flexible exchange rate, and assume that the net export depends on not only the exchange rate but also the total income,

$$X = X(e, Y).$$

Note that X is decreasing in Y. More income leads to more consumption of imported goods. Analyze the effect of a fiscal stimulus on the economy.