Macroeconomics: Assignment 4

(Deadline: at the beginning of Lecture 5)

Cheng Sun

1. Readings: Look at the newspapers and magazines for the past few weeks. Are there any discussions about economic fluctuations or corresponding policies? How do you interpret these discussions?
2. An economy begins in long-run equilibrium, and then a change in government regulations allows banks to start paying interest on checking accounts. Recall that the money stock is the sum of currency and demand deposits, including checking accounts, so this regulatory change makes holding money more attractive.
   a) How does this change affect the demand for money?
   b) What happens to the velocity of money?
   c) If the Fed keeps the money supply constant, what will happen to output and prices in the short run and in the long run?
   d) If the goal of Fed is to stabilize the price level, should the Fed keep the money supply constant in response to this regulatory change? If not, what should it do? Why?
   e) If the goal of Fed is to stabilize output, how would you answer to part (d) change?
3. Suppose the Fed reduces the money supply by 5 percent. Assume the velocity of money is constant.
   a) What happens to the aggregate demand curve?
   b) What happens to the level of output and the price level in the short run and the in the long run?
   c) In the light of your answer to part (b), what happens to unemployment in the short run and in the long run and according to the Okun's law?
   d) What happens to the real interest rate in the short run and in the long run? (Hint: use the model of the real interest rate in Chapter 3 to see what happens when output changes.)