

Tutorial Note 3: Investment and Financial Market

Solution to Exercises

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1. (1) D. (2) D.
2. (1) B. (2) C. Government selling bond is like borrowing money from the citizens.
3. C.
4. The answer is as in the following table.

Initial Money Demand Curve for real income Y and price level P				Final Money Demand Curve for real income Y and price level P				Action required by the Fed to maintain an interest rate at i^*
Initial M^d curve	Y	P	$\$Y$	Final M^d curve	Y	P	$\$Y$	Explanation
M^d_2	250	100	250	M^d_3	300	105	315	The Fed must increase the money supply as nominal income rises — both real income and prices rise
M^d_2	200	80	160	M^d_3	250	100	250	Increase the money supply as nominal income rises—both real income and prices rise
M^d_2	250	100	250	M^d_3	300	100	300	Increase the money supply as nominal income rises. Prices do not change but real income rises
M^d_2	250	100	250	M^d_1	200	95	190	Decrease the money supply as nominal income falls – both real income and prices fall
M^d_2	250	100	250	M^d_1	275	80	220	Here prices fall and real income rises. However, prices fall by 20% and real income rises by 10%. This combination means nominal income falls and the Fed will have to decrease the money supply to keep the interest rate the same