Nanyang Technological University
School of Social Sciences

HE2002 Macroeconomics II AY23-24 SEMESTER 2

Solution to Tutorial 4

1. **Chapter 5, Q7. The fiscal-monetary policy mix in the aftermath of the Great Financial Crisis**

   (a) Most governments used generous fiscal stimulus packages to stimulate growth. Other governments suffering from huge fiscal budget deficits found it difficult to raise funds to finance government spending, and so they simply resorted to cutting taxes in the hope of boosting household consumption and investment spending. Both reduction in taxes and fiscal spending shift the IS curve to the right. The increase in M shifts the LM curve down. Output increases in both cases, but the impact is higher on government spending than on tax cuts due to the high multiplier effect.

   (b) The Great Financial Crisis was probably the worst recession encountered by the global economy in modern times. The policy mix differed among countries. Many nations realized that the severity of the crisis required their central banks to step in with expansionary monetary policies and that their governments should borrow to increase their spending. If fiscal budgets did not allow for this, the governments had to cut taxes. Some central banks that had their interest rates close to zero were unable to lower interest rates drastically and resorted to excessive fiscal spending in addition to using unconventional tools of expansionary monetary policy. The expansionary monetary and fiscal policies tried to steer global the economy out of the recession, but the severity of the crisis and the contagion effects made the recovery process slow.

2. **Chapter 5, Q8.**

   (a) The central bank keeps the interest rate constant. Fiscal policy is expansionary as either G is increased or T is decreased. Investment will increase as output rises.

   (b) The central bank will cut interest rates as the fiscal authorities either reduces G or raises T (or both).

3. **Chapter 6, Q1.**

   (a) False. Nominal interest rates are expressed in dollars; real rates in goods.

   (b) True.

   (c) Uncertain. The statement is true when the nominal rate of interest does not change.

   (d) False. Bonds vary significantly in terms of default risk.

   (e) True.

4. **Chapter 6, Q2.**

(a) The exact real interest rate in France $= 1.017/1.008 - 1 = 0.89\%$. The exact real rate in Switzerland $= 1.017/1.005 - 1 = 1.19\%$.

(b) The approximate real interest rate in France $= 1.7\% - 0.8\% \approx 0.9\%$. The approximate real interest rate in Switzerland $= 1.7\% - 0.5\% \approx 1.2\%$.

(c) The real interest rates in both countries differ due to higher inflation risk components in the French real interest rate. Other possibilities include the effects of the currency risk of the euro compared to that of the Swiss franc in addition to the transaction costs involved in currency arbitrage.