Group Work VIII

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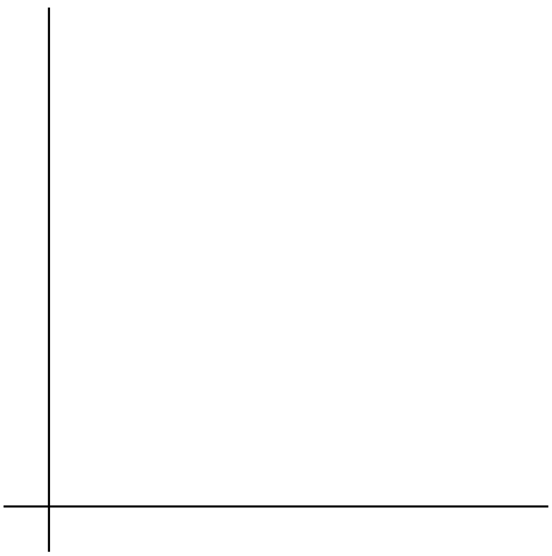
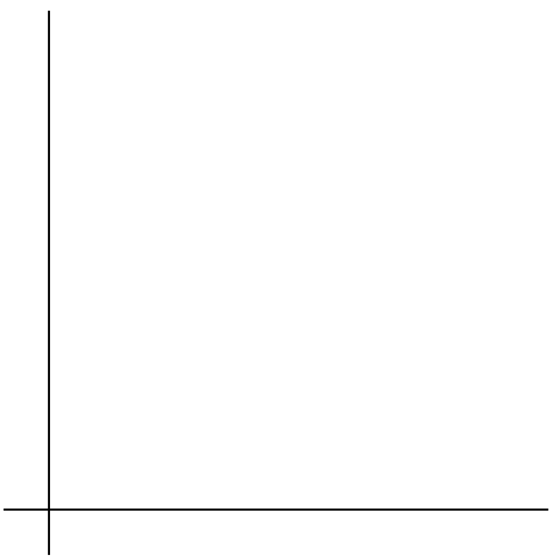
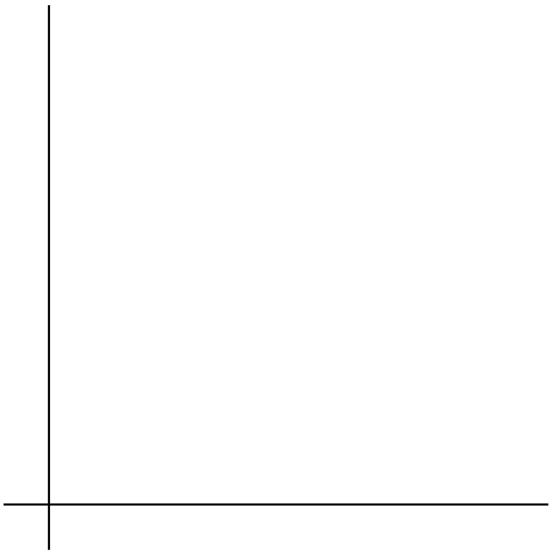
Q1: Initially, the economy is in the short-run equilibirum, i.e. output is above potential. Graphically show what would the central bank do so that there is no longer pressure on inflation.

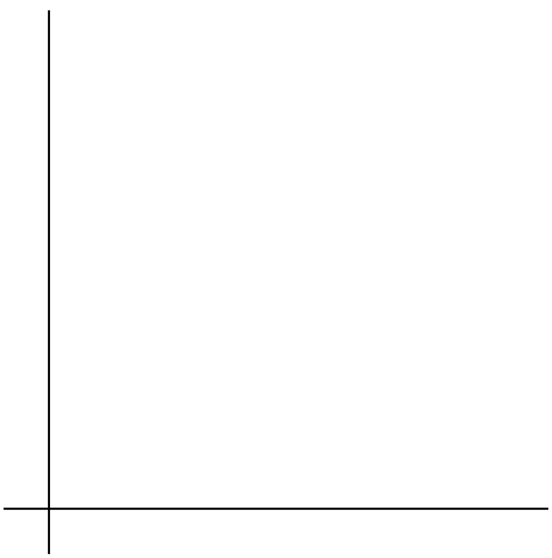




Q2: Initially, the economy is in medium run eq., i.e. output is at potential. Assume that the government, which was running a deficit, decides to reduce it by increasing taxes.

(1) Using the IS-LM-PC model, what effect does this fiscal expansion have on **short run** output, unemployment, interest rates, and inflation?





(2) How would the central bank react to bring the output back to potential?