Assignment 1

Econ520. Fall 2025

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Name:	PID:

Financial innovation has made **money demand more interest elastic**. Your task is to assess whether this change makes monetary and fiscal policy more or less effective.

Specifically, assume that the slope of the $L(i)$ function gets steeper in the LM curve $M/P = Y \times L(i)$. It may help to assume a linear money demand function, so that LM becomes $M/P = Y + L_0 - b_L \times i$. Financial innovation increases the value of the parameter b_L.

Determine the effects of a given increase in M/P or G on equilibrium output for large and small values of b_L. Illustrate your answer in **graphs** (with explanations). **Explain** the economic intuition for what you find.

For this question, I want you stay "inside the model." The IS/LM assumption of fixed prices is an obvious limitation, but we will live with it for now. There is no need to discuss what the model misses for this case.

Hints:

- Be careful about how much the curves shift due to the shock. This may change with the slope parameter.
- Start with the fiscal expansion. It is the easier case.