

Econ 116b
Problem Set 5

More on the AS-AD Model

1. What happens to the interest rate when the AD curve shifts to the right because government spending (G) increases? Explain using the IS-LM model. What happens to investment (I) and why?
2. What happens to the interest rate when the AD curve shifts to the right because the money supply (M) increases? Explain using the IS-LM model. What happens to investment (I) and why?
3. What happens to the interest rate when the AS curve shifts to the left because the price of imports (PM) increases? Explain using the IS-LM model. What happens to investment (I) and why?

The Stimulus Bill

1. Read about the stimulus bill that just passed Congress. From your reading estimate how much of the \$787 billion is in the form of tax cuts and transfer payment increases (decreases in T) versus increases in government purchases of goods and services (increases in G). Also, estimate how much of the decrease in T will take place in 2009, in 2010, and in 2011. Similarly, estimate how much of the increase in G will take place in 2009, in 2010, and in 2011. Most people do not think the bill will lead to large increases in inflation. Why?

The Phillips Curve

1. “The Phillips Curve broke down in the 1970’s.” What does this mean and why is it perhaps a misleading statement? Explain the “breakdown” using the AS-AD model.