1. Read Hubbard and O’Brien chapters 26 and 27.


3. Explain to your brother, who is clueless about economics, how the central bank can stimulate the economy. That is, describe the process that begins with increased money supply and results in increased aggregate demand. Start with describing how the money supply is increased and pay particular attention to explaining the inverse relationship between bond prices and yields. Do these in your own words.

4. What is a bond? Why are the bond prices and interest rates inversely proportional?

5. What is investment? Why is it affected by interest rates?

6. Think about the following model where aggregate supply is given by

\[ Y = 250 + 25P \]

and the components of aggregate demand are

\[ C = 209 + 0.9DI - 10P \]
\[ I = 150 \]
\[ G = 100 \]
\[ T = 10 \]
\[ X = 100 \]
\[ IM = 51 + 0.1DI \]

(a) Characterize the AD curve. Find the equilibrium GDP. How much does the AD curve shift if G increases by 50 (use the multiplier to answer)? What happens to equilibrium GDP if G increases by 50?
In the remainder of the question numbers will not be pretty, don’t be alarmed.

(b) Assume now that investment is given by
\[ I = 290 - 2i \]
Money supply is 100
Money demand is 600 - 25i + 2.5Y

Why is money demand increasing in Y and decreasing in i? Why is investment decreasing in the interest rate, i? Solve for the equilibrium condition in the money market in terms of i and Y. Express i in terms of Y and substitute in the investment equation. Then characterize the AD curve (assuming G=100). What is the simple multiplier? Why is it smaller/larger than in (a)? What is equilibrium GDP? What is I? What happens to equilibrium GDP if G increases by 50? What happens to investment? Discuss using the crowding out concept.

(c) Now assume investment is given by
\[ I = 290 - 2i + 0.1Y \]
With other equations, including the money market, the same.

Characterize the AD curve (assuming G=100). What is the simple multiplier? Why is it smaller/larger than in (a)? Why is it smaller/larger than in (b)? What is equilibrium GDP? What is I? What happens to equilibrium GDP if G increases by 50? What happens to investment? How do these compare with (b) Discuss using the crowding out and crowding in concepts.

(d) Assume that investment is as in (c) and G=100. What happens to GDP and I if money supply increases by 100?

7. Read “The Economist” of the week of March 20-26, 2010. Write a paragraph or two on the piece “It wasn’t us” (p.72) as part of your homework—not as a separate essay. Your paragraph(s) should contain your comments on the piece where you use your knowledge of economics. You should not be summarizing The Economist.