

Problem Set 9
"Macroeconomics 1"
ECON 1102/7074

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1 Question

Consider the following changes in the macroeconomy. Show how to think about them using the IS curve, and explain how and why GDP is affected in the short run.

(a) The government offers a temporary investment tax credit: for each dollar of investment that firms undertake, they receive a credit that reduces the taxes they pay on corporate income.

(b) A booming economy in Europe this year leads to an unexpected increase in the demand by European consumers for Australian goods.

(c) Australian consumers develop an infatuation with all things made in Indonesia and sharply increase their imports from that country.

(d) A housing bubble bursts so that housing prices fall by 20% and new home sales drop sharply.

2 Question

Suppose the government decides to increase government purchases today, say on bridges, to stimulate the economy. Explain how this affects the IS curve. How does your answer depend on the way in which the spending is financed and on the extent to which Ricardian equivalence holds?

3 Question

Suppose a large cyclone destroys many houses and buildings in Queensland but fortunately results in little loss of life. Show how to think about this event using the

IS curve. Explain how actual output, potential output, and short-run output are affected in the short run and why.

4 Question

The amount of goods the Australian economy imports might depend on the current state of the economy as well as one potential GDP: for example, when the economy is booming, imports usually rise. To incorporate this channel into the model, suppose the import equation is given by

$$\frac{IM_t}{\bar{Y}_t} = \bar{a}_{im} + \bar{n}\tilde{Y}_t.$$

Assume the remainder of the model is unchanged from the original setup, as in table 10.1 in the Jones textbook.

- (a) Derive the IS curve for this new specification.
- (b) What happens when there is an aggregate demand shock that increases \bar{a} by 1 percentage point? Explain!