IS-LM model and expectations

Exercises

Economics II – Lecture 5

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Exercise 1:

Suppose that a country is experiencing a recession period and this makes individuals' fear about their solvency on housing mortgages. In order to revive the economy, helping mortgage subscribers, the government proposes a temporary expansionary fiscal policy in time t. In contradiction, the opposing parties, claim that a temporary expansionary monetary policy is what the country needs in such a situation.

a) In your opinion, which is the most appropriate policy to be applied? Explain your answer using the IS-LM model with expectations and graph the outcomes of both policies.
b) Let's figure out that individuals interpret the proposal of the opposing parties as an expansionary intervention today plus the commitment to an additional expansionary maneuver in the future. Discuss the effects on current income and interest rates.

Exercise number 2:

Assume that the yield curve is downward sloping. Supposing that a country is exiting a recession period and hence financial markets are expecting consumer confidence to rise in the future, answer to the following questions:

a) If the financial markets are right, how will interest rates and production level change?
b) Let's assume now that financial markets are also expecting that the central bank would intervene with a contractionary intervention to quell the excessive surge of the economy: how interest rate level and production would vary in this case?
c) Given your answers in points a and b, how would the yield curve change according to the shocks described in those questions if financial market expectations are good? And what if they are not?

Exercise number 3:

Assume that the yield curve is initially flat. Explain and represent graphically how it is bound to change after the following shocks:

a) Financial markets are expecting a drop in consumer confidence and, hence, in household expenditure in t+1;
b) Financial markets are expecting a future contractionary monetary policy shock;
c) Financial markets are expecting a future contraction in government expenditure together with an expansionary monetary policy intervention;
d) Financial markets are expecting a future tax cut;

Exercise number 4:

Explain how the following events affect stock prices:

a) Financial markets expect the central bank to implement an expansionary monetary policy in t+1;
b) The central bank in time t increases the policy rate more than expected;

c) The government operates an unexpected tax increase in time t;
d) Following an increase in consumer confidence and household expenditure, the central bank decides to operate a policy rate increase in time t;