Chapter 12:
1. Questions For Review numbers 1,4 (p. 352).
2. Problems and Applications number 3c–g, 5–7 (p. 352–53).

Chapter 12,13 (appendix):
3. Suppose that we generalize our IS-LM model in the following way. Suppose that consumption depends positively on disposable income and negatively on interest rates, investment spending depends positively on national income and negatively on interest rates, and net exports depends negatively on both national income and interest rates. The rationale is as follows.

For each extra dollar of income and production Y in the economy, consumption and investment spending increase by the marginal propensity to consume (MPC) and invest (MPI) respectively (consumers spend some of their extra income and businesses buy equipment in order to sustain high production levels), and net exports falls by the marginal propensity to import (MPIM). The MPIM is the part of the extra consumption and investment spending that is on imports rather than on domestically produced goods, so we will assume that MPIM < MPC + MPI, i.e., that not all of our extra spending is on imports.

As interest rates rise, consumers and businesses reduce their spending. Further, assume that there is (imperfect) international capital mobility, so that, as domestic interest rates increase, foreign capital flows into the country (foreigners find it more attractive to buy our assets), driving the exchange rate up and thus net exports down.

a. Hold interest rates constant. What is the slope of the planned expenditure line in the Keynesian Cross model? If the MPC, MPI, and MPIM are .8, .1, and .15 respectively, what is the value of the multiplier in the Keynesian Cross model?

b. Now let interest rates be flexible. Use the Keynesian Cross diagram to show that the IS curve is still downward sloping in this model.

c. Suppose that the economy starts in long run equilibrium. Suppose that Congress passes a tax cut. In what directions do the components of spending (C,I,G,NX) move in short run equilibrium? In long run equilibrium?