

Homework 4
Principles of Macroeconomics: ECO 212
Due: Thursday, April 20, 2006

Question 1.

Carefully explain what happens to exports, imports, net export spending, and the nominal exchange rate after a decrease in interest rates.

Question 2.

The most recent tax rate cut in the US is phased in slowly over 2004-2006 and expires in 2010. Congress has debated making the tax cuts permanent.

- a. After the tax rate cut, what happens to consumption and savings according to the model with a constant MPC? Explain. If the tax cuts are made permanent, what will be the effect (if any) on *today's* consumption and savings?
- b. After the tax rate cut, what happens to consumption and savings according to the permanent income hypothesis? Explain. If the tax cuts are made permanent, what will be the effect (if any) on *today's* consumption and savings?
- c. After the tax rate cut, what happens to consumption and savings according to the life cycle hypothesis for a student, worker, and a retiree? Explain. If the bill to make the tax cuts permanent passes, what will be the effect (if any) on *today's* consumption and savings of a student, worker, and a retiree?

Question 3.

Carefully explain the effect of an decrease in inflation on aggregate demand, interest rates, consumption, investment spending, net export spending, and income, according to both the Taylor rule.

Question 4.

Suppose that households begin to feel that the economy will not do well in the next year.

- a. Graphically show the effect on the spending balance graph and the AD-AS graph. Number each movement on the spending balance graph and explain.
- b. What happens to consumption, investment spending, net exports, spending, and income in the short and long run?
- c. Is the expectation self-fulfilling? That is, does the expectation of the investors come true? Explain.