1. Problem 2, chapter 15, page 436 K&W

a. in the interest rate will lead to an increase in the quantity of money demanded (a movement down the money demand curve) but no shift in the money demand curve.

b. When the holiday shopping season starts, consumers anticipate an increase in expenditures and so, at each income level, increase the demand for money. The money demand curve shifts to the right.

c. As McDonald’s and other fast-food restaurants begin to accept credit cards, it reduces the demand for money, assuming that households put more money in savings instead of holding currency. The money demand curve shifts to the left.

d. When the Fed engages in open-market operations, it will change the money supply (the money supply curve will shift). This will affect the interest rate and consequently the quantity of money demanded. An open-market purchase of U.S. Treasury bills by the Fed will increase the money supply, lowering the interest rate and increasing the quantity of money demanded. This is a downward movement along the money demand curve.

2. Problem 5, chapter 15, page 437 K&W

a. The central bank can use expansionary monetary policy to eliminate the recessionary gap. The central bank could engage in an open-market purchase of U.S. Treasury bills. This would increase the money supply, lowering the interest rate and encouraging an increase in investment spending. The increase in investment spending will kick off the multiplier process, leading consumers to increase their spending. The final situation is illustrated in the accompanying diagram by the movement of the AD curve from its initial position, AD1, to its new location, AD2. Real GDP and the aggregate price level will rise.
3. Problem 7, chapter 15, page 437 K&W

a. Beginning at equilibrium point E1 in the accompanying money market diagram, when the economy of Eastlandia goes into recession, aggregate spending will fall and the money demand curve will shift to the left, from MD1 to MD2, moving the money market from its initial equilibrium, E1, to a new equilibrium at E2. If the central bank keeps the quantity of money constant, the interest rate will decrease to r2, shown at the new equilibrium point, E2. The decrease in the interest rate would encourage investment spending and would help close the recessionary gap.

b. If the central bank is committed to maintaining an interest rate target of r1, then the central bank will reduce the money supply as the economy goes into recession, from MS1 to MS2 in the accompanying diagram, eliminating the potential for interest rates to fall. The new equilibrium in the money market is at E3, with the interest rate at its target rate, r1.

4. Problem 9, chapter 15, page 437 K&W

If the economy is in long-run macroeconomic equilibrium with an unemployment rate of 5%, then the long-run aggregate supply curve must be vertical at a real GDP that is associated with a 5% unemployment rate. This long-run macroeconomic equilibrium is E1 in the accompanying diagram. In the short run, the central bank can engage in expansionary monetary policy to shift the aggregate demand curve to the right (from AD1 to AD2) and reduce the unemployment rate to 3%. Over time, because real GDP exceeds potential output, the short-run aggregate supply curve
will shift to the left (from SRAS1 to SRAS2). So to keep the unemployment rate at 3% in the short run, the central bank would have to engage in continuous increases in the money supply, shifting the aggregate demand curve to the right as the short-run aggregate supply curve shifts to the left, and the aggregate price level will go higher and higher. However, the central bank cannot keep the unemployment rate at 3% in the long run, since, in the long run, money is neutral. In the long run, output will return to its potential level and the unemployment rate will return to 5%.

5. Problem 13 chapter 15, page 438 K&W

a. The Federal Reserve increases the money supply, which shifts the money supply curve to the right, from MS1 to MS2. An increase in the money supply drives the interest rate down, from r1 to r2.

b. Because aggregate prices are sticky in the short run, a fall in the interest rate leads to a rise in investment and consumer spending. This increase in investment and consumer spending leads to a rightward shift of the aggregate demand curve.

c. Although in the short run a rise in the interest rate leads to an increase in the quantity of goods and services demanded, in the long run nominal wages will rise. This will cause the economy to end up at E2, at a higher price level.
In 2005, the merchandise trade balance was −$100 billion ($400 billion − $500 billion). The balance of payments on current account was −$150 billion [($400 billion + $300 billion) − ($500 billion + $350 billion)]. Since the balance of payments on financial account plus the balance of payments on current account must sum to zero, the balance of payments on financial account must have been +$150 billion. If the rest of the world bought $250 billion of Scottopia’s assets, Scottopia must have bought $100 billion of assets from the rest of the world.

Since the interest rate is 10% in Northlandia and 6% in Southlandia, demanders of loanable funds in Northlandia will want to borrow in Southlandia and suppliers of loanable funds in Southlandia will want to lend in Northlandia. As the supply of loanable funds falls in Southlandia, the interest rate in Southlandia will rise; as the supply of loanable funds rises in Northlandia, the interest rate in Northlandia will fall. This will narrow the gap between interest rates in the two countries. Since no one distinguishes between the assets in the two countries, interest rates will change in both countries until they are equal; as a result, there is no additional incentive for suppliers of loanable funds in Southlandia to lend in Northlandia and for demanders of loanable funds in Northlandia to borrow in Southlandia. In the accompanying diagrams, you can see that at an interest rate of 8% there is an excess supply of loanable funds in Southlandia equal to 250 and an excess demand for loanable funds in Northlandia equal to 250. So the two countries will both end up with an interest rate of 8%. Northlandia will run a surplus of 250 in the financial account and a deficit of 250 in the current account; Southlandia will run a deficit of 250 in the financial account and a surplus of 250 in the current account.
8. Problem 8 chapter 18, page 523 K&W

a. If Japan relaxes import restrictions, Japanese residents will demand more U.S. goods and more U.S. dollars to buy those goods. The U.S. dollar will appreciate due to the increase in the demand for U.S. dollars.

b. If the United States imposes import restrictions, Americans will buy fewer Japanese goods. Americans will want to exchange fewer U.S. dollars for yen, so the supply of U.S. dollars will decrease and the U.S. dollar will appreciate.

c. A dramatic rise in U.S. interest rates will attract Japanese buyers of American assets as well as discourage Americans from buying Japanese assets. There will be an increase in the demand for U.S. dollars and a decrease in the supply of U.S. dollars; the U.S. dollar will appreciate.

d. A report indicating that Japanese cars last much longer than previously thought, especially when compared with American cars, will increase the demand for Japanese cars and the demand for Japanese yen. The yen will appreciate and the U.S. dollar will depreciate.

9. Problem 10 chapter 18, page 523 K&W

a. If inflation is 10% in the United States and 5% in Japan, and the U.S. dollar–Japanese yen exchange rate remains the same, Japanese goods and services will be more attractive than U.S. ones.

b. If inflation is 3% in the United States and 8% in Mexico, and the price of the U.S. dollar falls from 12.50 to 10.25 Mexican pesos, both the lower inflation and the depreciation of the dollar (appreciation of the peso) make American goods more attractive.

c. If inflation is 5% in the United States and 3% in the eurozone, and the price of the euro falls from $1.30 to $1.20, both the lower inflation in the eurozone and the appreciation of the dollar (depreciation of the euro) make eurozone goods more attractive.

d. If inflation in the United States is higher than in Canada, this makes Canadian goods more attractive. However, if the U.S. dollar depreciates against the Canadian dollar, this makes American goods more attractive. In this case, the depreciation of the U.S. dollar is so dramatic that it overwhelms the difference in inflation rates. American goods are more attractive.