Problem Set 4

Money market and Monetary Policy

Problem set is due to Wednesday May 10 in class

5. In 1982 Mexico was the first Latin American country that declared its bankruptcy. Argentina, Brazil and the rest of the Latin American countries followed. The average rate of inflation during the 80´s reached the 65.2% for Mexico, 724.6% for Argentina, and 613.8% for Brazil. Explain how the Government can contribute to this situation and explain the economic consequences and costs of a high inflation rate (hyperinflation).

2. Let's assume that the economy suffers from unemployment. How can monetary policy help to combat it? Explain. Use the real money balances market, the IS-LM function, and the Cobb-Douglas production function. Will this policy have any effect on prices?

3. Since 2016 reserve requirement for EU banks was lowered to 1%. If an EU bank receives 100,000 euros deposit, how much can the bank lend? What is the value of the money multiplier? What is going to happen with the money supply in the EU-zone? Explain how it works and use all the markets involved. Including IS-LM. Why do you think the ECB took that decision? Explain

4. Let's suppose that b coefficient in the investment function is small. Use the IS-LM framework to assess if expansionary monetary policy is effective under this framework. Explain. Hint: if b is small that will have an effect on the slope of the IS function.

5. Let's assume the country suffers from a liquidity trap (people prefer to hold cash than any other asset). Then the central bank of this economy decides to expand money supply. How effective is this policy? Explain and use the IS-LM functions. What about expansionary fiscal policy? Will it be effective in achieving its goal? Explain and use the graphs.

6. Japan has been suffering from deflation since the 90s. How does deflation affect the economy? And what are the Central Bank policies that could help to ease this burden? Explain and use graphs if necessary.