

Do not write your name on the assignment. Write your name only on the back of this sheet of paper and staple your answers on the front of this sheet of paper. Failure to follow these directions will cost you 1 point on the assignment.

1) (25 points) Draw the IS/LM/BP diagram with the BP curve **flatter** than the LM curve and a **flexible** exchange rate. Illustrate an increase in the money supply. Explain why the curve(s) moved as drawn. Make sure that the diagram starts and ends in equilibrium in all three markets. Given your diagram, is monetary policy effective? Explain your logic.

2A) (20 points) Draw the line with interest rates and government spending on the two axes. Explain why the EB line slopes up and why the IB line also slopes up.

B) (20 points) As the book describes the diagram, it is hard to understand why the IB line must be steeper than the EB line. So I am going to have you work through an alternative proof. Start at the equilibrium and move to the right. As described in part A, both lines need to have interest rates increase. Two variables, one for internal balance and one for external balance, will be affected by the interest rate increase. Which one is affected more? Explain your logic.

3A) (15 points) In the *Intermediate Macroeconomic* textbook that you had, and in the *Principles of Macroeconomics* textbook that I believe you used, they explain the downward sloping AD curve using the *Real Balance Effect*, *Interest Rate Effect*, and the *Open Economy Effect*. Which one of them is used by this textbook to explain the slope of the AD curve for a closed economy? Explain that effect.

B) (20 points) Is the AD curve is flatter for an open economy with a fixed exchange rate or for a closed economy? Explain why