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Principles of Economics

Study Questions – Model 3

Suppose that major Presidential candidates propose cutting taxes and raising government spending.

- a) Use two graphs to illustrate the short run effects of these policies on output and interest rates.
- b) Forecast the effects of these policies on the budget deficit, net exports, and investment.

Answers to Study Questions – Model 3

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(Graphs on next page) Interest rates rise and the GDP grows.

The budget deficit will increase; government is spending more but taking in less tax revenue, meaning that it will have to borrow more. More government borrowing is the definition of a larger budget deficit.

Higher interest rates make it more expensive to borrow to buy a house or to buy physical capital, so there will be fewer of such purchases. So investment is lower.

Higher interest rates cause the dollar to appreciate (get stronger) on foreign exchange markets. This means that exports will fall and imports will rise, so net exports (exports minus imports) will fall.

