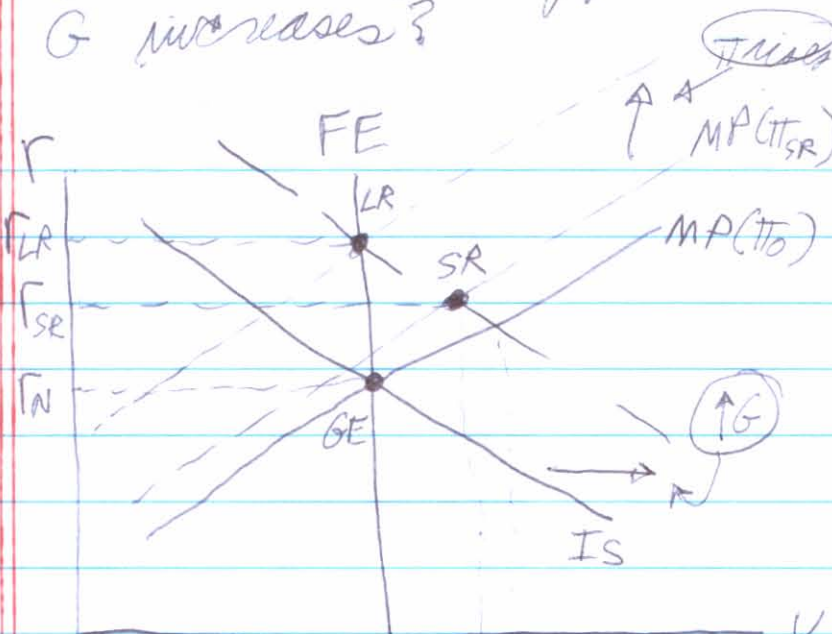
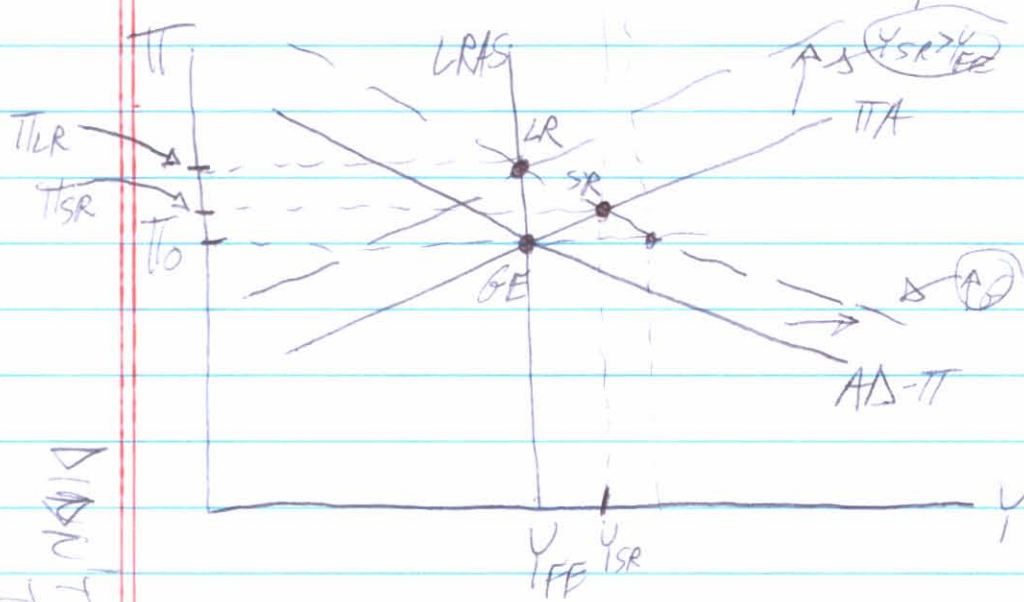


HW Question: What happens in SR + LR when  $G$  increases?



$\uparrow G$  shifts IS and AD- $\pi$  RIGHT.  
 In SR,  $\pi$  rises as we move along  $\pi$  curve + with  $\uparrow \pi$ , Fed raises MP curve upward

Now,  $Y_{SR} > Y_{FE}$  which causes  $\pi$  to shift UP raising  $\pi$ , causing Fed to raise real rate by shifting MP UP.



DIDN'T ASK FOR THIS BUT THOUGHT YOU MIGHT LIKE TO KNOW

Note that  $Y$  rises,  $r$  rises +  $\pi$  rises in the short run  
 In LR,  $Y$  returns to  $Y_{FE}$ ,  $r$  rises even more +  $\pi$  rises even more

In the very long run, the  $\uparrow G$  means there is less savings to finance  $I$  and so capital falls. Hence  $Y_{FE} = K^{\alpha} (AN_{FE})^{1-\alpha}$  will fall, unless foreign savings flows in to keep  $I$  from falling.