1. Explain why an increased desire to save (implying less desired consumption spending) would not generate unemployment according to classical economists.

An increase in Supply puts downward pressure on the interest rate.
Lower interest rate causes an increase in Investment, restoring equilibrium @full employment.
Where desired Savings = desired Investment.
Changing interest rate is the key.

2. Why do classical economists maintain that prices would double if the money supply doubles?

Velocity assumed to be fixed.
Output fixed at full employment level.
So in \( MV = PY \) the \( \% \Delta M = \% \Delta P \).

3. What condition must be satisfied for Say’s Law to remain valid?
The loanable funds market must clear to that Saving = Investment.

4. Use an aggregate supply and demand graph to show why classical economists contend that inflation is a monetary phenomenon.

Changes in \( M^S \) cause shifts in AD which only causes changes in Price \( (P) \), NOT in \( Y \).

5. In the Keynesian model, what determines the equilibrium rate of interest?

Interest rate determined by the intersection of \( M^p \) and \( M^S \).
6. Demonstrate with a graph and then explain in words what is meant by the Keynesian Liquidity Trap.

@low levels of interest, the liquidity preference of consumers is infinite which makes monetary policy ineffective (because expect r to increase so don’t want to hold bonds)

7. What does Keynesian analysis assume about the shape of the aggregate supply schedule? How does this assumption produce different results from those of classical economics?

Keynes thought that AS was kinked @ full employment

This means that up to the kink @full employment, monetary and fiscal policy is effective in changing the level of output

8. A. Explain in words what the LM curve represents.

The LM curve shows all the various combinations of interest and income which make $M^S = M^D$.

B. Explain in words what the IS curve represents.

The IS curve shows all the various combinations of interest and income which equate I and S.