EXERCISES SET 8
EXPECTATIONS
EXERCIZES FORM CHAPTER 19 OF BLANCHARD

2) Use equation (19.6) to answer this.

a) $i_{3t} = \left(\frac{1000}{800}\right)^{1/3} - 1 = 7.7\%$.
b) $i_{4t} = \left(\frac{1000}{800}\right)^{1/4} - 1 = 5.7\%$.
c) $i_{4t} = \left(\frac{1000}{850}\right)^{1/3} - 1 = 4.1\%$.

3) Use the second equation at the top of page 377 to answer.

a) $i_{1t} = 5\%$.
b) $i_{2t} = [(1.05)(1.055)]^{1/2} - 1 = 5.25\%$.
c) $i_{3t} = [(1.05)(1.055)(1.06)]^{1/3} - 1 = 5.5\%$.

5)

a) An expansionary monetary policy results in *both* lower interest rates and higher output. (NB Higher output will normally lead to higher profits and thus higher dividends, at least in the short run.) This unambiguously increases stock prices as the numerator increases and the denominator decreases in the expression (19.9) for stock prices. This increase occurs suddenly the day of the announcement.
b) Since the expansion is anticipated, there will be a *gradual* increase of stock prices *before* the lower interest rates become effective.
c) An expansionary fiscal policy shifts the *IS* curve to the right. When both the *IS* and *LM* curves shift right, we have:
   i) Higher output leading to higher dividends;
   ii) An ambiguous effect on the interest rate.

   So the net effect on stock prices is ambiguous. A large shift of the *IS* curve or a steep LM curve may cause a large increase in the rate of interest which leads to a drop in stock prices even though expected dividends go up. Note that since the policies are fully anticipated, then the change in stock prices will occur gradually before the policies come into effect; there will not be any sudden change in stock prices.