Econ 102 –Spring 2014 – Week 16

Exercise 1

The economy of River Plate is characterized by the following equations:

$C = 100 + .75(Y - T) - P$	(consumption)
$T\text{-}TR = 200$	(net taxes)
$G = 240$	(government spending)
$X - M = -40$	(net exports)
$I = 1000 - 1600r$	(investment)
$Ms=2000$	(money supply)
$Md=3500 - 6000r$	(money demand)
AD: $Y = C + I + G + (X - M)$	(aggregate demand)
AS: $Y = 4P-3W-2Q$	(aggregate supply)

where r is the nominal interest rate, P is the GDP Deflator, W is the average wage, and Q is the oil price. Suppose that W=50, and Q=25. Answer the questions below:

a) Calculate the monetary equilibrium (find r and M that clear the money market)
b) Find the equilibrium where AD=AS
c) Assume the current reserve ratio is rr=0.40 and that people do not keep any cash (i.e. they deposit all their money in banks). If the new rr=0.333, what is the impact on the equilibrium?
d) Suppose the economy is currently operating at maximum capacity (Long Run Equilibrium). If the size of the labor force increases, what will happen to W, L and P in the new long run equilibrium? Explain using a graph.

Exercise 2

An economy is at the full employment level of output. Suppose people in this country begin purchasing more foreign cars. Answer the following questions:

a) What will happen to the domestic price level? How does the new short run equilibrium look like? Draw a graph. Explain how the economy adjusts to the LR equilibrium.
b) Suppose now that the government devaluates the domestic currency. How is the new adjustment path? Explain.

Exercise 3

A rise in productivity increases potential output, but some worry that demand for the additional output will be insufficient even in the long run. How would you respond?