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Macro Theory

Problem Set #7

1. Consider the following version of Model 4.

(1) IS Curve $$AD = \frac{a + e + G - d*r}{1 - b*(1-t)}$$

(2) LM Curve $r = (k/h)*AD - (M - P)/h$

(3) Production $Y = s1*Ld + s2*K$

(4) Labor Supply $Ls = g0 + g1*(W/Pe) - g2*t$

(5) Labor Demand $Ld = d0 - d1*(W/P) + d2*K$

(6) Goods Market Equilibrium $Y = AD$

All of the s's, g's, and d's positive constants

Exogenous	Endogenous
a,e,G,t,M,K,W,Pe	AD,r,P,Y,Ld,Ls

a. Derive the Aggregate Demand Curve.
b. Derive the Aggregate Supply Curve.
c. How do changes in income tax rates affect each curve as well as the resulting levels of Y, W/P, Ld, and r?

Use Model 4 to address questions 2-5.

2. How would an increase in defense expenditures affect Y, W/P, P and r? (Changes in which other variables would have similar effects?)

3. If OPEC were to completely lose control of the price of oil -- say it fell to $50 per barrel, what would we expect to happen to Y, W/P, P, Ld, and r in the United States?

4. If the Federal Reserve reduced the stock of money, how would Y, Ld, P, W/P, and r be affected?

5. How well would monetary and fiscal policy work if workers have their money wages fully indexed to the cost of living?