Problem Set #7

Due Tuesday, December 5, 2006

Problem Sets MUST be word-processed except for graphs and equations.

QUESTIONS

1. Suppose that rising inflation causes increased uncertainty which, in turn, motivates people to permanently increase their average propensity to save. Now suppose that the economy is at its NAIRU and there is a sudden increase in the price of oil.

   a. Based only on this information, use a DAD – SAS model diagram to clearly show the effects of these events on equilibrium output and the inflation rate and during the first 2 years of the adjustment process. Also be sure to identify where the economy and inflation settle when the adjustment process is complete.

   b. Provide a brief economic explanation for what happened to economic output and inflation because of the events described above and during the first 2 years of the adjustment process. Also be sure to discuss where economic output and inflation finally settle at the end of the adjustment process.

2. In the late 1990s, there was a large increase in autonomous investment because many firms developed new business applications, including electronic job searches, using the Internet. Suppose that the economy was at potential output and that the introduction of Internet job searches causes the NAIRU to decline because of more efficient labor market matching.

   a. Based only on this information, use a DAD – SAS model diagram to clearly show the effects of these events on equilibrium output and the inflation rate and during the first 2 years of the adjustment process. Also be sure to identify where the economy and inflation settle when the adjustment process is complete.

   b. Provide a brief economic explanation for what happened to economic output and inflation because of the events described above and during the first 2 years of the adjustment process. Also be sure to discuss where economic output and inflation finally settle at the end of the adjustment process.