

Liquidity

1. Write short definitions for the following terms: borrowing constraint; incomes policy; stagflation; a short-run and long-run production function; voluntary unemployment; intertemporal budget constraint; transitory income.

2. (a) A utility maximizing household reduces its supply of labor in the market. Given a short-run production function and competitive markets, use a diagram to explain what changes are predicted for output on the production function and changes in supply curve.

(b) If there is technical improvement that increases capital efficiency, explain what effect this will have on employment, output and the supply curve.

3. (a) If government wishes to stimulate the economy would a cut in taxes be better than an increase in government spending? Which of these options will be more effective in stimulating the economy? Explain.

(b) What is the liquidity trap? Describe the conditions under which this condition exists and explain under what conditions this outcome no longer holds.

(c) How does the Keynesian consumption function differ from the Friedman consumption function.

4. A worker utility function is defined as: $U = Y^{\frac{1}{5}} S^{\frac{4}{5}}$ where Y^e is expected income, S is leisure time in hours. The income constraint is defined as: $Y^e = \$100.00 + W^e(n)$, where W^e is the expected wage rate and n is labor, such that $n = 50 - 0.5S$.

(a) Find the optimal values for the number of hours worked and the number of hours taken as leisure. Draw a diagram to show your results.

(b) If the wage rate is \$40.00 what is his optimal expected income?

(c) If the worker was to work 40 hours per week, what would be the value of his extra income?

5. The following equation describes the IS/LM model and aggregate supply in the short-run:

1. IS: $Y = c(Y - t(Y) + M/P) + I(r) + G$

2. LM: $M/P = k(Y) + L(r)$

3. AS: $Y = P/w$

with the variables defined in their traditional manner.

(a) Find dY/dG and dr/dG .

(b) Find dY/dw and dr/dw