Homework #5, Economics 362, Due Thursday, February 16.

1. The DD curve.

    (a) Construct it carefully, by suitably shifting the aggregate demand curve in the graph with Y, D on the vertical axis and Y on the horizontal. Explain in words why the DD curve is upward sloping.

    (b) How does it shift when ρ increases? Explain.

    (c) Explain carefully the condition of the goods market (whether $D > Y$ or $D < Y$) for points above and below the DD curve.

2. The AA curve

    (a) Construct it carefully, by suitably shifting curves in our diagram system that summarizes the UIP and MM curves. Explain in words why it is downward sloping.

    (b) Suppose the money demand equation is modified so that real money demand is $L(R, Y, a)$, where a is a variable that shifts money demand. When a is higher, then L moves up. Movements in a capture the idea that people may decide to reallocate their financial assets from bonds into money for reasons having nothing to do with the current value of Y or of R. The variable, a, is an exogenous variable. Explain carefully what an increase in a does to the AA curve. Can you think of a concrete reason why people might want to shift out of bonds and equity and into cash (this is what a jump in a means)?

    (c) Explain carefully the condition of asset markets for points above and below the AA curve.

3. Consider the following disequilibrium dynamics. When $D > (<)Y$ then Y increases (decreases) slowly. The exchange rate and interest rate adjust instantly to ensure the economy is constantly on the AA curve.

    (a) Suppose ρ decreases temporarily. Explain what happens to output, consumption, investment, R, and E in the short run, as the

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economy moves to short run equilibrium. Do this in two steps. First, work things out carefully using a graphical analysis. Then, talk through the results as though you were a journalist making a presentation to a general audience of non-economists.

(b) Redo (a) for the case when a decreases temporarily.

(c) Redo (a) for the case in which there is a temporary drop in I.

(d) Redo (a) for the case in which there is a temporary jump in R^f.