Economics 5202  
Fall 2009  
Exercise 8

Due date: To be collected at the beginning of class on Tuesday, November 17.

Note: The usual policy on cheating and plagiarism applies for this exercise.

1. Do problem 3 of Chapter 10, on pages 401 (problems 1 in 2/e).

Illustrate your answer with the labor market, the output market, and the money market equilibrium diagrams. Explain your answer with economic reasoning, i.e., do not simply say something like “the labor demand curve shifts to the right at the same time the output supply curve shifts left”. Explain why the labor demand curve shifts right and why the output supply curve shifts left!

2. Suppose you have an economy characterized by the Keynesian coordination failure model. In this economy, suppose part of the capital stock is destroyed by an earthquake. Please note that in answering this question when you think there is an ambiguity in the answer, discuss all possible outcomes. However, when asked to demonstrate your answer in a diagram, show only one case, unless you are asked to show all possible outcomes.

   a. Start by drawing the production for this economy and an arbitrary equilibrium in the labor market.
   b. Explain how the reduction in the capital stock affects these two diagrams.
   c. What is the effort on real wage? Employment?
   d. Draw a diagram showing the output market with a low output equilibrium and a high output equilibrium. Explain how the reduction in the capital stock affect the output supply and output demand curves. Provide clear explanations and show in the diagram.
   e. Finally, show and explain carefully how the low output equilibrium and high output equilibrium are affected by the changes in output supply and/or output demand.