

Problem Set 2

Edited in length to match the earlier due date

Due: Wednesday, September 22.

1. Answer **True**, **False** or **Uncertain**. Briefly explain your answer.

- During this decade the consumption of frozen food has increased a lot. This has caused an increase in both GDP and ‘real output’¹.
- The growing importance of outsourcing—in which companies pay other companies to perform services such as cleaning, bookkeeping and so on— increases measured GDP.
- A higher propensity to save will increase investment and therefore increase GDP.
- The big problem of emerging markets is that they grow at a low and constant rate.

2. Assume that a retired person living in Florida receives, on average, a USD10,000 pension. During 1998 this money was spent in vitamins (USD4000) and food (USD6000).

During 1999 the price of vitamins went up 20% and that of food went down 10%. Under these new prices, retirees spent, on average, USD2000 in vitamins and USD8000 in food.

- Calculate the inflation rate that concerns the retirees using the basket consumed in 1998.
- Calculate the inflation rate using the basket consumed in 1999.
- Using your answers above, explain one of the problem in defining inflation.
- A positive inflation is associated with an erosion of wages while a negative inflation means a higher budget in real terms. Which answer gives a better idea of the effect that the change of prices had on retirees?

3. Assume that firms in a country produce an amount equal to the demand they had in the previous year. The economy is characterized by the following values: $c_0 = 50$, $c_1 = .7$, $I = 100$, $G = 100$ and $T = 100$.

- What is the equilibrium GDP of this economy?
- Assume that the economy is in equilibrium when they go to war. As a result, both G and T increase to 500 during that year, returning to normal after that. Show the values for Y and Z during this episode and during the following 4 years. Guess the values for Y and Z in the long run (after many many years).

¹Real output refers to total production both transacted and not transacted in the economy.