

## Homework Set Five

1. (5% )Explain whether you agree or disagree with the following statement:  
We ought to strive to keep unemployment at least 1 percentage point below the natural rate.
2. (5%)Explain whether you agree or disagree with the following statement: If potential GDP is below actual GDP, then we have succeeded in reducing the natural rate of unemployment.
3. (15%)Joe Petrovich is a butcher. He started last year off with \$5,000 in his checking account, and with a \$100,000 bank loan, on which he pays 8% interest. Last year Joe grossed \$250,000 from butchering. He put \$10,000 in a mutual fund, and received a \$12,000 bequest from his beloved Aunt Sally. His expenses were as follows:

Purchases of Meat for Resale	\$160,000
Food	\$10,000
Clothing	\$5,000
Donation to KSU	\$5,000
Rent	\$32,000
Purchase of New Equipment for the Butcher Shop	\$25,000

At the end of the year, he had \$12,000 in his bank account. He paid off none of the loan, though he did pay the interest. If Joe is a nation unto himself, construct a table showing his trade balance. (Note: if your answer shows a statistical discrepancy, it is incorrect).

4. (20%) These statements relate to some statements recently made by Senator F. Untermeyer Jones. Senator Jones has been reading the recent financial news, and has made a number of statements about the balance of payments. For each of the statements, explain why you agree or disagree with Senator.
  - The statistical discrepancy is quite large. If we can spend more on researching international flows, we can reduce that statistical discrepancy and cut our deficit on current account.
  - The deficit on current account is quite large, and needs to be reduced. But the reduction should be effected in such a manner as does not lead to a lower standard of living, less investment, reduction in government services, etc.

- I understand that the deficit on current account is financing new investment in this country. But that borrowing will ultimately have to be paid back by average citizens, so future generations will be worse off.
  - If people become more confident about the future, the current deficit on current account will decrease.
  - If people loved their children more, the current deficit on current account will decrease.
5. (25%) Assume that there is no world capital market, and that interest rates are determined by the domestic supply and demand for loans, the government's demand included. What would be the effect on the interest rate of each of the following?
- People become more confident about the future
  - A sudden – but fortunately one time – plague hits senior citizens, who die with assets they planned to consume during their lifetime. Their wealth is distributed to their children.
  - The government gives everyone a \$1,000 tax cut; the resultant borrowing is to be paid back by future taxpayers.
  - There is a sharp temporary recession.
  - The government decides to build a monument to Irving Fisher, and sends taxpayers a one time bill.
6. (25%) Now assume that there is a world capital market, and that we face an upward sloping supply curve of loans. What would be the effect on balance on current account of each of the following?
- People become more confident about the future
  - The government gives everyone a \$1,000 tax cut; the resultant borrowing is to be paid back by future taxpayers.
  - There is a sharp temporary recession.
  - A country from whom we buy and sell a lot of goods and services devalues its currency.
  - Europeans are suddenly hit with a desire to visit the United States and see our scenic wonders.
  - Much of the underdeveloped world shakes off its lethargy, leading to a significant rise in the world-wide demand for loans.