Section Exercise for April 11/12: Aggregate Demand with Answers

1) The Berkeley Chair Store plans to spend $100 on saws in the coming year. It also plans to sell 9 of the 10 chairs it will produce at $100 each. At the end of the year, it finds is has only sold 6 chairs. What is Berkeley Chair Store's planned and actual investment?

Planned investment is $100 new saws + (1 unsold chair * $100)=$200
Actual investment is $100 new saws + (4 unsold chair * $100)=$500

2) Sarah has decided to spend $40K of her 50K salary this year. She only considers her year-end bonus to be disposable income. At the end of the year she gets a bonus of $10K and spends $5K of it. What is Sarah's marginal propensity to consumer?

Consumption=Autonomous consumption+ mpc*disposable income.
40+5=45k=40+mpc*10K
5K=mpc*10k
mpc=1/2 or 50%

3) Sarah (from the previous problem) has always felt rich because she owns a Monet in her attic. Unfortunately, an authenticator has just told her it's a fraud. How is her spending likely to change?

Sarah will probably spend less because she has just discovered she is much less wealthy than she believed. This is an example of the wealth effect.

4) If PAE= 500+.7Y, graph the expenditure line. If consumers become pessimistic, how might this line change?

The expenditure line will have a lower intercept but same slope.

5) If a country is in recession, should the government raise or cut taxes? Raise or cut spending? Why might the government hesitate to do these things?

Should cut taxes and raise spending. Might be politically unpopular. Might take too long to change policies. Might discuss how some taxes are automatic stabilizers- incomes fall reducing taxed income, etc.