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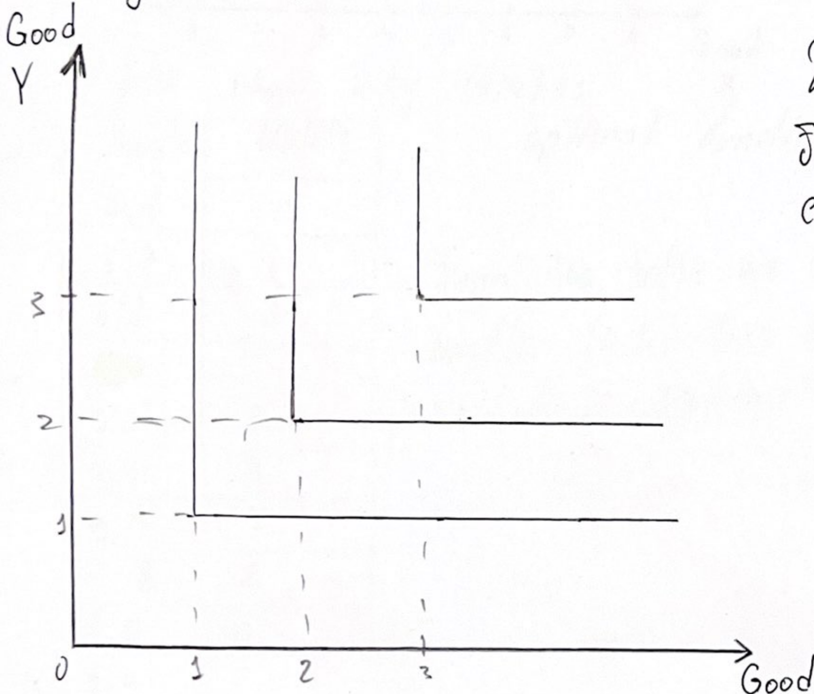
Section B

N 11

$P_X = P_Y = 10$ pounds

a) We know that good X (packet of cheese) and good Y (bottle of wine) are perfect complements. This means that good X and good Y are always consumed together. Also proportions of consumption of them are fixed (and it is not always 1:1)



Due to the fact that Good X and Good Y are perfect complements, the indifference curves will look like this

The shape of the curves can be explained by the fact that Sam's utility from the new unit of X or Y will increase only if both X and Y will increase. If the is the new unit of <u>only one</u> good, Sam's utility will stay the same

$U = \min\{X, Y\}$

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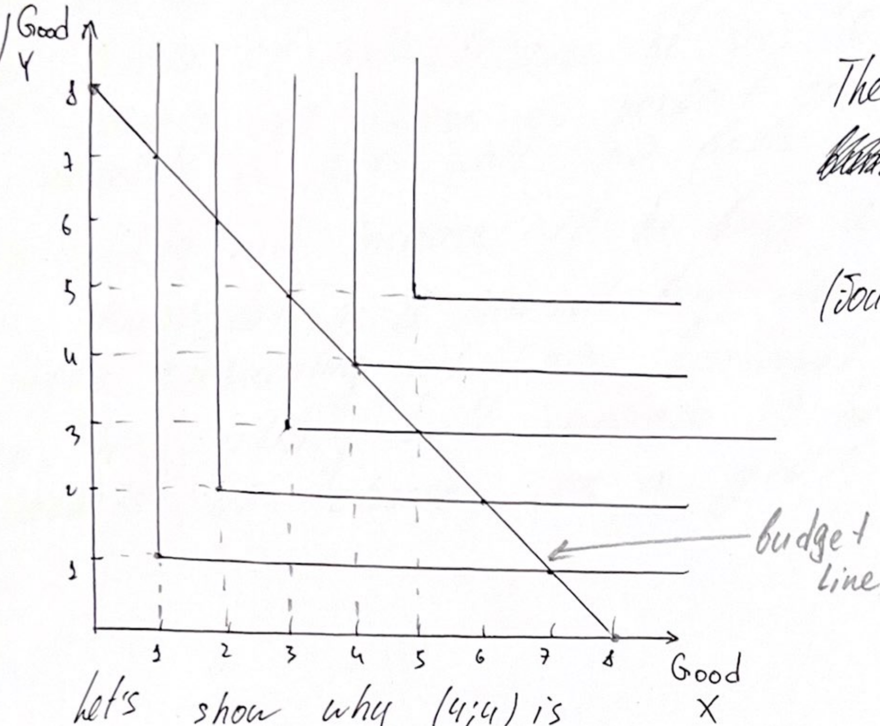
b)



The optimal ~~bundle~~ bundle is (4;4) (found graphically)

Let's show why (4;4) is optimal bundle

Bundle	Utility
0;8	0
1;7	1
6;2	2
5;3	3
4;4	4
3;5	3
2;6	2
8;0	0
1;7	1

From the table we can see that bundle (4;4) has the biggest utility, so it is optimal bundle.

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c) He will not benefit from receiving the gift of two bottles of wine, because he sees bottles of wine and packets of cheese as perfect complements and he benefits if gets units of both of them.

His utility will increase if he buys 2 more packets of cheese, but, as he can not buy more, because he is already consuming at his optimal bundle, so his utility will increase if he gets 2 more packets of cheese as a gift.

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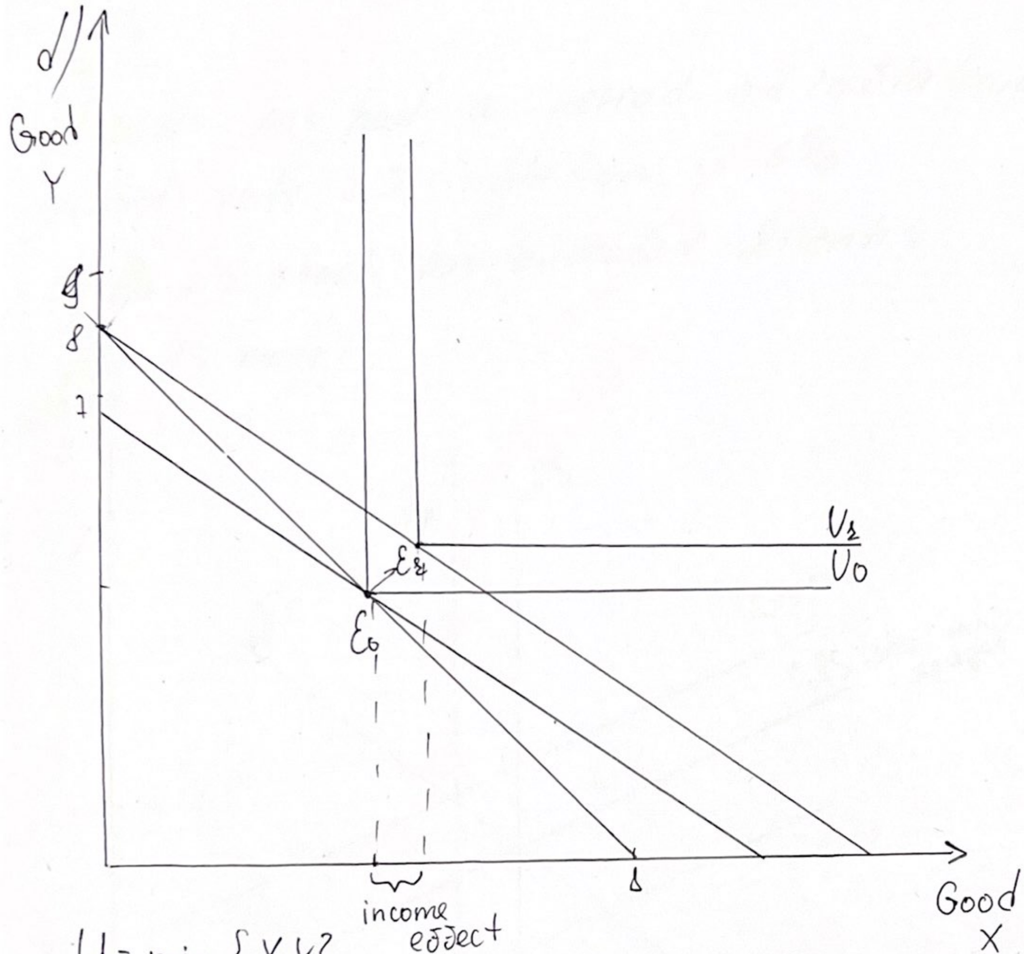

$U = \min\{X, Y\}$

As X and Y are still perfect complements Sam's
After the fall in the price of cheese ~~the~~ optimal
bundle will either not change (if the difference between
old cost and new cost is not very big) or X and Y in optimal
bundle will become bigger (if the difference between
old cost and new cost is big enough)
Also the will be <u>no</u> substitution effect.

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Section C

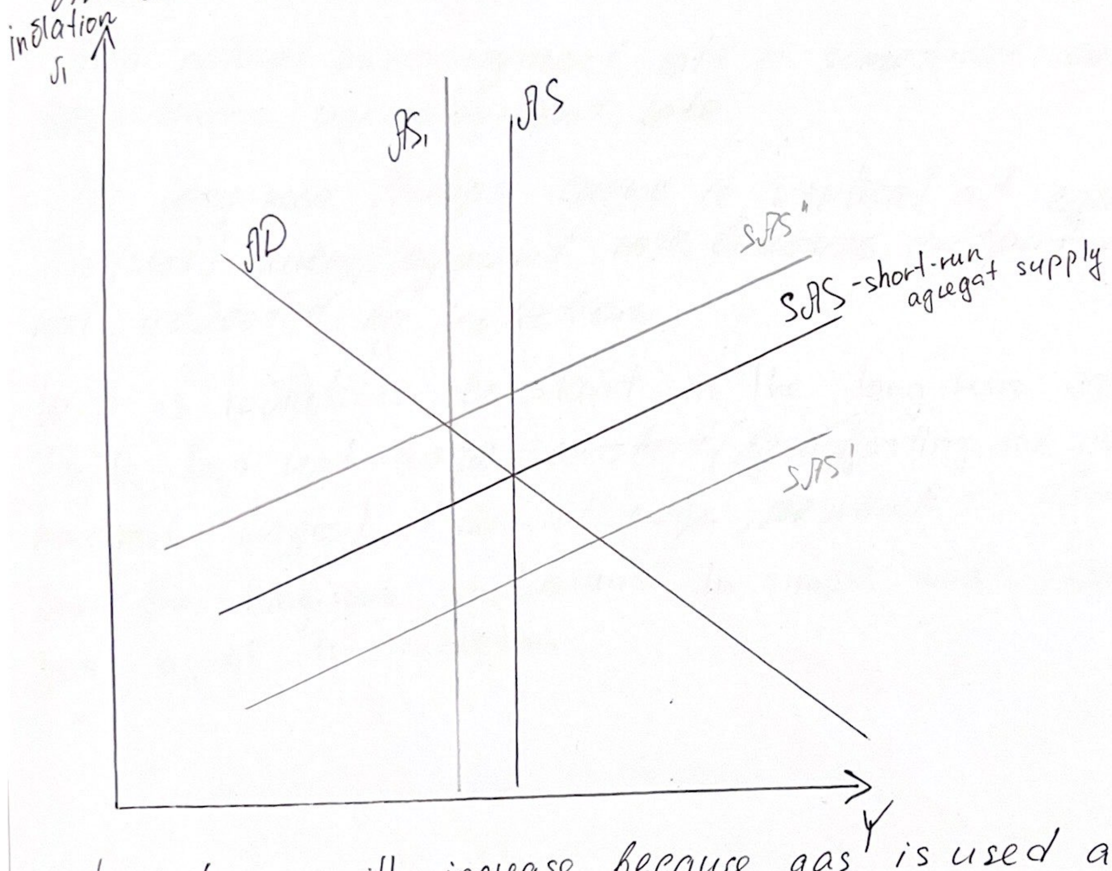
N 13

Atlantis has had a period of inflation aroud 2%

Current rate of inflation is 6%

a) ~~As~~ AS shock has affected Atlantis

AD-AS model



Inflation will increase, because gas is used as intermediate good in production of lots of ~~things~~ other goods, so the increase in price of gas will lead to the increase in price of other goods, which will lead to the increase of inflation rate.

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N13

b) ~~The natural rate of unemployment~~

Natural unemployment occurs if all unemployment is voluntary (meaning that people, who are unemployed, do not want to be employed).

Usually (<u>not always</u>) natural unemployment is equal to frictional unemployment + structural unemployment.

Also natural unemployment rate is sometimes called equilibrium unemployment rate.

The long-run Phillips curve is vertical at equilibrium (natural) unemployment rate, because output is not affected by inflation

Why is inflation constant in the long-run equelibrium?
People keep real wages constant (by adjusting the groth of nominal wages) at the ral wage, ~~we~~ which is required for the long-run equilibrium. In simple words, people just ajust to inflation.

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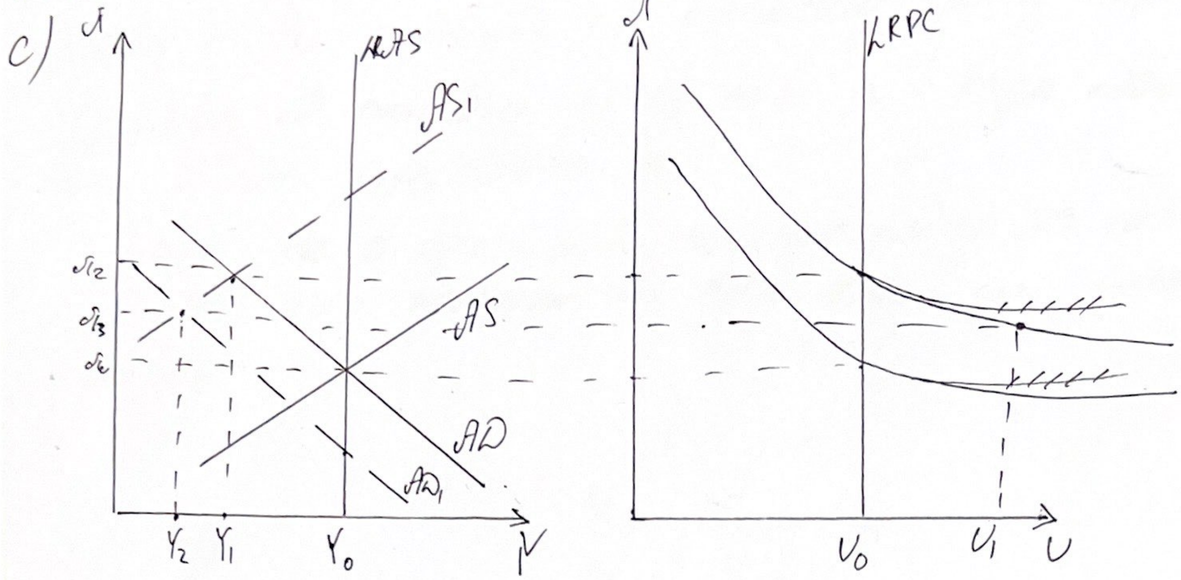
c)



AS shifts left
PC shifts right
Central Bank has two ways to react in this situation

1) It can decrease aggregate demand (using monetary policy) (so AD shifts left) to decrease unemployment and inflation

2) It can increase aggregate demand to increase output (AD shifts right)

I think that Central Bank will choose to try to hold inflation on the same level (decrease to the level before shock) (because it was stable for several previous years), so in my opinion Central Bank will stick with the 1st way of behaviour in this situation

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N13

d) Why is the credibility of monetary policy important?

Credibility of monetary policy has a huge effect on interest rate, inflation, ect.

If people like (or agree) with monetary policy, it's effect is better and ~~[illegible]~~ has more effect on current situation.

I can say that credibility of monetary policy has a big effect on inflation.