Macroeconomic Policy
Exercise set 2

1. Suppose all firms are identical and have the same menu cost. Write down the aggregate supply in the case of small and large nominal shocks.

   All other functions have the usual form.

   Define the economic equilibrium and be clear about what variables are determined on what markets when shocks are large and small. Does the Classical dichotomy holds?

2. Suppose that the menu cost takes the form of losing all customers if prices are changed at unusual times. The convention is that a proportion 0.5 of firms change prices in December and the remaining proportion in June. Write down the short run and long run aggregate supply equations in the case in which firms set prices according to the rule in the lecture notes. Would the aggregate supply function be different if shocks were small rather than large (hint: how large is the cost of changing prices at an unusual time)? How long would the effect on output of an unanticipated nominal shock last?