In section II, we investigate the factors that determine income and prices in the long-run. We examine classical models of the economy where all prices are assumed to be flexible. We construct two different classical models. The first one (part A) is a static model where the levels of real GDP \( Y \), employment \( N \), the real interest rate \( R \), the price level \( P \) and the real exchange rate \( e \) are determined in the long-run. The second one (part B) is a dynamic model where the growth rates of real GDP \( Y \), employment \( N \), the stock of capital \( K \) and the price level \( P \) are determined in the long-run.

The required reading for the static model is chapters 3, 7 and 8 of the Mankiw text. While you read the material, keep in mind the following questions:

1. What are the three factors of production? How are they represented in the production function?
2. How is national income distributed to the factors of production? What does Euler's theorem imply about economic profits?
3. In the long-run, what variable brings the goods market \( Y = C + I + G \) and the loanable funds market \( S = I \) into equilibrium?
4. Using the loanable funds market, what is the effect of (i) an increase in consumption \( C \), (ii) a decrease in taxes \( T \) or (iii) a decrease in government spending \( G \) on the real interest rate \( r \) and real investment \( I \) in the long-run.
5. What is the difference between income, saving and money?
6. What are the three functions of money? What is the difference between commodity and fiat money?
7. What is the quantity theory of money? According to the quantity theory, what is the effect of money in the long-run?
8. In a small open-economy, what is the relationship between the domestic interest rate and the world interest rate? How does this relationship manifest itself in the determination of the real interest rate \( r \) and thus the saving-investment identity \( S = I \)?
9. In a small open-economy, what is the effect of (i) an increase in consumption \( C \), (ii) a decrease in taxes \( T \) or (iii) a decrease in government spending \( G \) on the real interest rate \( r \), real investment \( I \) and real net exports \( NX \) in the long-run.
10. What is the real exchange rate \( e \)? How is the real exchange rate determined in the short- and long-run?
11. In the long-run, what is the effect of (i) an increase in consumption \( C \), (ii) a decrease in taxes \( T \), (iii) a decrease in government spending \( G \) or an increase in the money supply \( M \) on the real exchange rate \( e \) and real net exports \( NX \)?