

## CHAPTER 4

### Basic Matrix Algebra and Applications

#### Topics: Economic Applications of Matrix Algebra

##### Outline:

- ▣ How to use matrix to solve system of simultaneous equations
- ▣ Partial market equilibrium
- ▣ The effect of specific tax on market equilibrium
- ▣ Simple Macroeconomic Model
- ▣ IS – LM

### How to use matrix to solve system of simultaneous equations

When we have the system of simultaneous equations:

- 1.) Identify endogenous variables, exogenous variables, parameters:

This is a system of  $m$  linear equations with  $n$  endogenous variables:

$$\begin{aligned} a_{11}x_1 + a_{12}x_2 + \cdots + a_{1n}x_n &= d_1 \\ a_{21}x_1 + a_{22}x_2 + \cdots + a_{2n}x_n &= d_2 \\ \vdots & \\ a_{m1}x_1 + a_{m2}x_2 + \cdots + a_{mn}x_n &= d_m \end{aligned}$$

- 2.) Reduce the system of equations to have number of equations equal to number of endogenous variables and to have only necessary information

That is, we need to have:

$$\text{number of equations} = \text{number of endogenous variables}$$

- 3.) Rearrange every equations in the system so that all endogenous variables are on one side and all other exogenous variables on the other side

From:

$$\begin{aligned} ax_1 &= k - bx_2 \\ dx_2 &= h - cx_1 \end{aligned}$$

To:

$$\begin{aligned} ax_1 + bx_2 &= k \\ cx_1 + dx_2 &= h \end{aligned}$$

- 4.) Rewrite the system into matrix form:

$$\begin{aligned} ax_1 + bx_2 &= k \\ cx_1 + dx_2 &= h \end{aligned}$$

$$\begin{bmatrix} ax_1 + bx_2 \\ cx_1 + dx_2 \end{bmatrix} = \begin{bmatrix} k \\ h \end{bmatrix}$$

$$\begin{bmatrix} a & b \\ c & d \end{bmatrix}_{2 \times 2} \begin{bmatrix} x_1 \\ x_2 \end{bmatrix}_{2 \times 1} = \begin{bmatrix} k \\ h \end{bmatrix}_{2 \times 1}$$

$$A_{n \times n} x_{n \times 1} = d_{n \times 1}$$

$A$  is matrix of parameters that are in front of endogenous variables.

$x$  is column vector of endogenous variables to solve for its final values as a function of exogenous variables and parameters

$d$  is column vector of parameters that don't multiply with endogenous variables and exogenous variables

5.) Check that  $\det A$  must not equal to 0, so that  $A^{-1}$  exists.

$$|A| \neq 0$$

,where  $\det A$  can be computed by:

- If a square matrix  $A$  is a 2 by 2 matrix, then  $\det A$  is equal to:

$$|A| = \begin{vmatrix} a_{11} & a_{12} \\ a_{21} & a_{22} \end{vmatrix} = a_{11}a_{22} - a_{21}a_{12}$$

- If a square matrix  $A$  is a 3 by 3 matrix, then  $\det A$  is equal to:

$$|A|$$

$$= \begin{vmatrix} a_{11} & a_{12} & a_{13} \\ a_{21} & a_{22} & a_{23} \\ a_{31} & a_{32} & a_{33} \end{vmatrix}$$

$$= a_{11}a_{22}a_{33} + a_{12}a_{23}a_{31} + a_{13}a_{32}a_{21} \\ - a_{31}a_{22}a_{13} - a_{32}a_{23}a_{11} - a_{33}a_{21}a_{12}$$

- $n^{\text{th}}$ -order determinant by Laplace Expansion

Let  $A$  be a matrix in  $R^{n \times n}$ . The determinant of  $A$  or  $\det A$  is given by  $|A|$ .

$$|A| = \begin{cases} \sum_{j=1}^n a_{ij} C_{ij} & i = 1, 2, \dots, n \text{ (expansion by } i^{\text{th}} \text{ row)} \\ \sum_{i=1}^n a_{ij} C_{ij} & j = 1, 2, \dots, n \text{ (expansion by } j^{\text{th}} \text{ column)} \end{cases}$$

We call  $C_{ij}$ , Cofactor of *element*  $a_{ij}$ .

$$C_{ij} = (-1)^{i+j}M_{ij}$$

The minor of element  $a_{ij}$ ,  $M_{ij}$ , is the determinant of the matrix resulting from deleting row  $i$  and column  $j$  of matrix  $A_{n \times n}$ . In other words, a "minor" is the determinant of the square matrix formed by deleting one row and one column from some larger square matrix.

Note: If determinant is found by using Cofactor for elements from the WRONG row or column, the determinant will be zero!!!!

$$\begin{vmatrix} 4 & 1 & 2 \\ 5 & 2 & 1 \\ 1 & 0 & 3 \end{vmatrix} \quad |C_{21}| = -\begin{vmatrix} 1 & 2 \\ 0 & 3 \end{vmatrix} = -3 \quad |C_{22}| = \begin{vmatrix} 4 & 2 \\ 1 & 3 \end{vmatrix} = 10 \quad |C_{23}| = -\begin{vmatrix} 4 & 1 \\ 0 & 1 \end{vmatrix} = 1$$

$$|A| = 4(-3) + 1(10) + 2(1) = 0$$

6.) Use inverse matrix **or** Cramer's rule to find the solution of the system of simultaneous equations:

6.1) Inverse matrix:

$$\begin{aligned} Ax &= d \\ A^{-1}Ax &= A^{-1}d \\ Ix &= A^{-1}d \end{aligned}$$

$$x = A^{-1}d$$

,where we can find  $A^{-1}$  by

$$A^{-1} = \frac{1}{|A|} \cdot adjA$$

$$adjA = [C_{ij}]^T$$

6.2) Cramer's rule:

$$x_k = \frac{|A_k|}{|A|}$$

$|A_k|$  is the determinant of matrix A when replacing column  $k$  of matrix A by vector  $d$ .

### Partial market equilibrium

**Demand:**  $Q^D = a - bP$

**Supply:**  $Q^S = -c + dP$

**Equilibrium:**  $Q^D = Q^S$

1.) Identify endogenous variables, exogenous variables, parameters:

Endogenous variables:.....

2.) Reduce the system of equations to have number of equations equal to number of endogenous variables

How many equations will we be working with? .....

3.) Rearrange every equations in the system so that all endogenous variables are on one side and all other exogenous variables on the other side

**Demand:**  $Q^D = a - bP$

**Supply:**  $Q^S = -c + dP$

**Equilibrium:**  $Q^D = Q^S$

**Demand:**  $\_\_\_\_\_\_ Q^D \_\_\_\_\_\_ Q^S \_\_\_\_\_\_ P = a$

**Supply:**  $\_\_\_\_\_\_ Q^D \_\_\_\_\_\_ Q^S \_\_\_\_\_\_ P = -c$

**Equilibrium:**  $\_\_\_\_\_\_ Q^D \_\_\_\_\_\_ Q^S \_\_\_\_\_\_ P = 0$

4.) Rewrite the system into matrix form:

$$\begin{bmatrix} \phantom{0} & \phantom{0} \\ \phantom{0} & \phantom{0} \end{bmatrix} \begin{bmatrix} Q^D \\ Q^S \end{bmatrix} = \begin{bmatrix} \phantom{0} \\ \phantom{0} \end{bmatrix}$$

5.) Check that  $\det A$  must not equal to 0, so that  $A^{-1}$  exists.

$$A = \begin{bmatrix} 1 & 0 & b \\ 0 & 1 & -d \\ 1 & -1 & 0 \end{bmatrix}$$

.....  
 .....  
 .....  
 .....

6.) Use inverse matrix **or** Cramer's rule to find the solution of the system of simultaneous equations:

6.1) Inverse matrix:

$$A^{-1} = \frac{1}{|A|} \cdot \text{adj}A$$

$$\text{adj}A = [C_{ij}]^T$$

$$C = \begin{bmatrix} (-1)^{1+1} \begin{vmatrix} 1 & 0 & b \\ 0 & 1 & -d \\ 1 & -1 & 0 \end{vmatrix} & (-1)^{1+2} \begin{vmatrix} 1 & 0 & b \\ 1 & -1 & 0 \\ 0 & 1 & -d \end{vmatrix} & (-1)^{1+3} \begin{vmatrix} 1 & 0 & b \\ 1 & -1 & 0 \\ 1 & 0 & b \end{vmatrix} \\ (-1)^{2+1} \begin{vmatrix} 1 & 0 & b \\ 0 & 1 & -d \\ 1 & -1 & 0 \end{vmatrix} & (-1)^{2+2} \begin{vmatrix} 1 & 0 & b \\ 1 & -1 & 0 \\ 0 & 1 & -d \end{vmatrix} & (-1)^{2+3} \begin{vmatrix} 1 & 0 & b \\ 1 & -1 & 0 \\ 0 & 1 & -d \end{vmatrix} \\ (-1)^{3+1} \begin{vmatrix} 1 & 0 & b \\ 0 & 1 & -d \\ 1 & -1 & 0 \end{vmatrix} & (-1)^{3+2} \begin{vmatrix} 1 & 0 & b \\ 0 & 1 & -d \\ 1 & -1 & 0 \end{vmatrix} & (-1)^{3+3} \begin{vmatrix} 1 & 0 & b \\ 0 & 1 & -d \\ 1 & -1 & 0 \end{vmatrix} \end{bmatrix}$$

$$C = \begin{bmatrix} (-1)^{1+1} \begin{vmatrix} 1 & -d \\ -1 & 0 \end{vmatrix} & (-1)^{1+2} \begin{vmatrix} 0 & -d \\ 1 & 0 \end{vmatrix} & (-1)^{1+3} \begin{vmatrix} 0 & 1 \\ 1 & -1 \end{vmatrix} \\ (-1)^{2+1} \begin{vmatrix} 0 & b \\ -1 & 0 \end{vmatrix} & (-1)^{2+2} \begin{vmatrix} 1 & b \\ 1 & 0 \end{vmatrix} & (-1)^{2+3} \begin{vmatrix} 1 & 0 \\ 1 & -1 \end{vmatrix} \\ (-1)^{3+1} \begin{vmatrix} 0 & b \\ 1 & -d \end{vmatrix} & (-1)^{3+2} \begin{vmatrix} 1 & b \\ 0 & -d \end{vmatrix} & (-1)^{3+3} \begin{vmatrix} 1 & 0 \\ 0 & 1 \end{vmatrix} \end{bmatrix}$$

$$C = \begin{bmatrix} (-1)^{1+1}(-d) & (-1)^{1+2}d & (-1)^{1+3}(-1) \\ (-1)^{2+1}b & (-1)^{2+2}(-b) & (-1)^{2+3}(-1) \\ (-1)^{3+1}(-b) & (-1)^{3+2}(-d) & (-1)^{3+3}(1) \end{bmatrix}$$

$$C = \begin{bmatrix} -d & -d & -1 \\ -b & -b & 1 \\ -b & d & 1 \end{bmatrix}$$

$$\text{adj}A = C^T = \begin{bmatrix} -d & -b & -b \\ -d & -b & d \\ -1 & 1 & 1 \end{bmatrix}$$

$$A^{-1} = \frac{1}{\det A} \text{adj}A = \frac{1}{-b-d} \begin{bmatrix} -d & -b & -b \\ -d & -b & d \\ -1 & 1 & 1 \end{bmatrix}$$

Therefore,

$$x = A^{-1}d$$

$$\begin{bmatrix} Q^D \\ Q^S \\ P \end{bmatrix} = \frac{1}{-b-d} \begin{bmatrix} -d & -b & -b \\ -d & -b & d \\ -1 & 1 & 1 \end{bmatrix} \begin{bmatrix} a \\ -c \\ 0 \end{bmatrix}$$

$$\begin{bmatrix} Q^D \\ Q^S \\ P \end{bmatrix} = \begin{bmatrix} \frac{ad-bc}{b+d} \\ \frac{ad-bc}{b+d} \\ \frac{a+c}{b+d} \end{bmatrix}$$

6.2) Use Cramer's rule:  $x_k = \frac{|A_k|}{|A|}$

$$\begin{bmatrix} Q^D \\ Q^S \\ P \end{bmatrix} = \begin{bmatrix} \frac{|A_1|}{|A|} \\ \frac{|A_2|}{|A|} \\ \frac{|A_3|}{|A|} \end{bmatrix}$$

$$Q^D = \frac{|A_1|}{|A|} = \frac{\begin{vmatrix} 0 & b \\ 1 & -d \\ -1 & 0 \end{vmatrix}}{-b-d}$$

$$Q^S = \frac{|A_2|}{|A|} = \frac{\begin{vmatrix} 1 & b \\ 0 & -d \\ 1 & 0 \end{vmatrix}}{-b-d}$$

$$P = \frac{|A_3|}{|A|} = \frac{\begin{vmatrix} 1 & 0 \\ 0 & 1 \\ 1 & -1 \end{vmatrix}}{-b-d}$$

☺ If we assume  $Q^D = Q^S = Q$ ,

From the model:

**Demand:**  $Q^D = a - bP$

**Supply:**  $Q^S = -c + dP$

**Equilibrium:**  $Q^D = Q^S$

If we assume  $Q^D = Q^S = Q$ , then we can reduce the system of simultaneous equations down to:

**Demand:**  $Q = a - bP$

**Supply:**  $Q = -c + dP$

Rearrange & Rewrite into matrix form:

**Demand:**  $Q + bP = a$

**Supply:**  $Q - dP = -c$

$$\begin{bmatrix} 1 & b \\ 1 & -d \end{bmatrix} \begin{bmatrix} Q \\ P \end{bmatrix} = \begin{bmatrix} a \\ -c \end{bmatrix}$$

$$\begin{bmatrix} Q \\ P \end{bmatrix} = \begin{bmatrix} \left| \begin{array}{cc} a & b \\ -c & d \end{array} \right| \\ \hline -b - d \\ \left| \begin{array}{cc} 1 & a \\ 1 & -c \end{array} \right| \\ \hline -b - d \end{bmatrix}$$

☺ If we collect specific tax from supplier  $t$  baht per unit

From the model:

**Demand:**  $Q^D = a - bP^D$

**Supply:**  $Q^S = -c + dP^S$

**Equilibrium:**  $Q^D = Q^S$

$$P^S = P^D - t$$

If we assume  $Q^D = Q^S = Q$  and  $P^D = P$ , then we can reduce the system of simultaneous equations down to:

**Demand:**  $Q = a - bP$

**Supply:**  $Q = -c + dP$  \_\_\_\_\_

Rearrange & Rewrite into matrix form:

**Demand:**  $Q + bP = a$

**Supply:**  $Q - dP = -c$  \_\_\_\_\_

$$\begin{bmatrix} \quad \\ \quad \end{bmatrix} \begin{bmatrix} \quad \\ \quad \end{bmatrix} = \begin{bmatrix} \quad \\ \quad \end{bmatrix}$$

$$\begin{bmatrix} Q \\ P \end{bmatrix} = \begin{bmatrix} \left| \begin{array}{cc} a & b \\ -c & d \end{array} \right| \\ \hline -b - d \\ \left| \begin{array}{cc} 1 & a \\ 1 & -c \end{array} \right| \\ \hline -b - d \end{bmatrix}$$

Exercise:

1.)

$$Q^D = 24 - 4P$$

$$Q^S = 13P - 27 \quad (P^* = 3, Q^* = 12)$$

$$Q^D = Q^S$$

2.) Consider a simple model in which two commodities are related to each other

Good 1

Good 2

$$Q_{d1} = Q_{s1}$$

$$Q_{d2} = Q_{s2}$$

$$Q_{d1} = a_0 + a_1P_1 + a_2P_2$$

$$Q_{d2} = c_0 + c_1P_1 + c_2P_2$$

$$Q_{s1} = b_0 + b_1P_1 + b_2P_2$$

$$Q_{s2} = d_0 + d_1P_1 + d_2P_2$$

Find the equilibrium prices and quantities in good 1 and good 2

**Simple Macroeconomic Model**

Consider simple Keynesian crossing model:

$$(1.) Y = C + I + G$$

$$(2.) C = a + bY_d$$

$$(3.) Y_d = Y - T$$

$$(4.) I = I_0$$

$$(5.) G = G_0$$

*Identify endogenous variables, exogenous variables, parameters:*

Endogenous variables:.....

*Reduce the system of equations to have number of equations equal to number of endogenous variables*

How many equations will we be working with? .....

$$Y = C + I_0 + G_0$$

$$C = a + bY^d$$

$$Y^d = Y - T$$

Rearrange every equations in the system so that all endogenous variables are on one side and all other exogenous variables on the other side

$$\text{---}Y \text{---}C \text{---}Y^d = \text{---}$$

$$\text{---}Y \text{---}C \text{---}Y^d = \text{---}$$

$$\text{---}Y \text{---}C \text{---}Y^d = \text{---}$$

Rewrite the system into matrix form:

$$\begin{bmatrix} \text{---} \\ \text{---} \\ \text{---} \end{bmatrix} \begin{bmatrix} \text{---} \\ \text{---} \\ \text{---} \end{bmatrix} = \begin{bmatrix} \text{---} \\ \text{---} \\ \text{---} \end{bmatrix}$$

$$Y^* = \frac{\begin{vmatrix} \text{---} & -1 & 0 \\ \text{---} & 1 & -b \\ \text{---} & 0 & 1 \end{vmatrix}}{1-b}$$

$$C^* = \frac{\begin{vmatrix} 1 & \text{---} & 0 \\ 0 & \text{---} & -b \\ -1 & \text{---} & 1 \end{vmatrix}}{1-b}$$

$$Y^{D*} = \frac{\begin{vmatrix} 1 & -1 & I_0 + G_0 \\ 0 & 1 & a \\ -1 & 0 & -T \end{vmatrix}}{1-b}$$

Note: We can also work with the system with two equations:

From

$$Y = C + I_0 + G_0$$

$$C = a + bY^d$$

$$Y^d = Y - T$$

To

$$Y = C + I_0 + G_0$$

$$C = a + bY - bT$$

### IS – LM

The Good Market:

$$Y = C + I + G$$

$$C = C_0 + b(1 - t)Y$$

$$I = I_0 - er$$

$$G = G_0$$

The Money Market:

$$M_d = fY - \beta r$$

$$M_s = M_0$$

$$M_d = M_s$$

*Identify endogenous variables, exogenous variables, parameters:*

Endogenous variables:  $Y, C, I, \dots$

*Reduce the system of equations to have number of equations equal to number of endogenous variables*

How many equations will we be working with? .....

$$Y = C + I + G_0$$

$$C = C_0 + b(1 - t)Y$$

$$I = I_0 - er$$

$$M_0 = fY - \beta r$$

*Rearrange*

$$\begin{aligned} Y - C - I + 0r &= G_0 \\ -b(1 - t)Y + C + 0I + 0r &= C_0 \\ 0Y + 0C + I + er &= I_0 \\ fY + 0C + 0I - \beta r &= M_0 \end{aligned}$$

*Rewrite the system into matrix form:*



