Question 1:

1.1) Explain why the classical supply curve is vertical. What are the mechanisms that ensure continued full employment of labor in the classical case?

1.2) How does the Keynesian aggregate supply curve differ from the classical one? Is one of these specifications more appropriate than the other? Explain, being careful to state the time horizon to which your answer applies.

1.2) Keynesian vs. classical model

Keynesian model tells about short-term economic growth, but classical model tells the long-term economic growth.

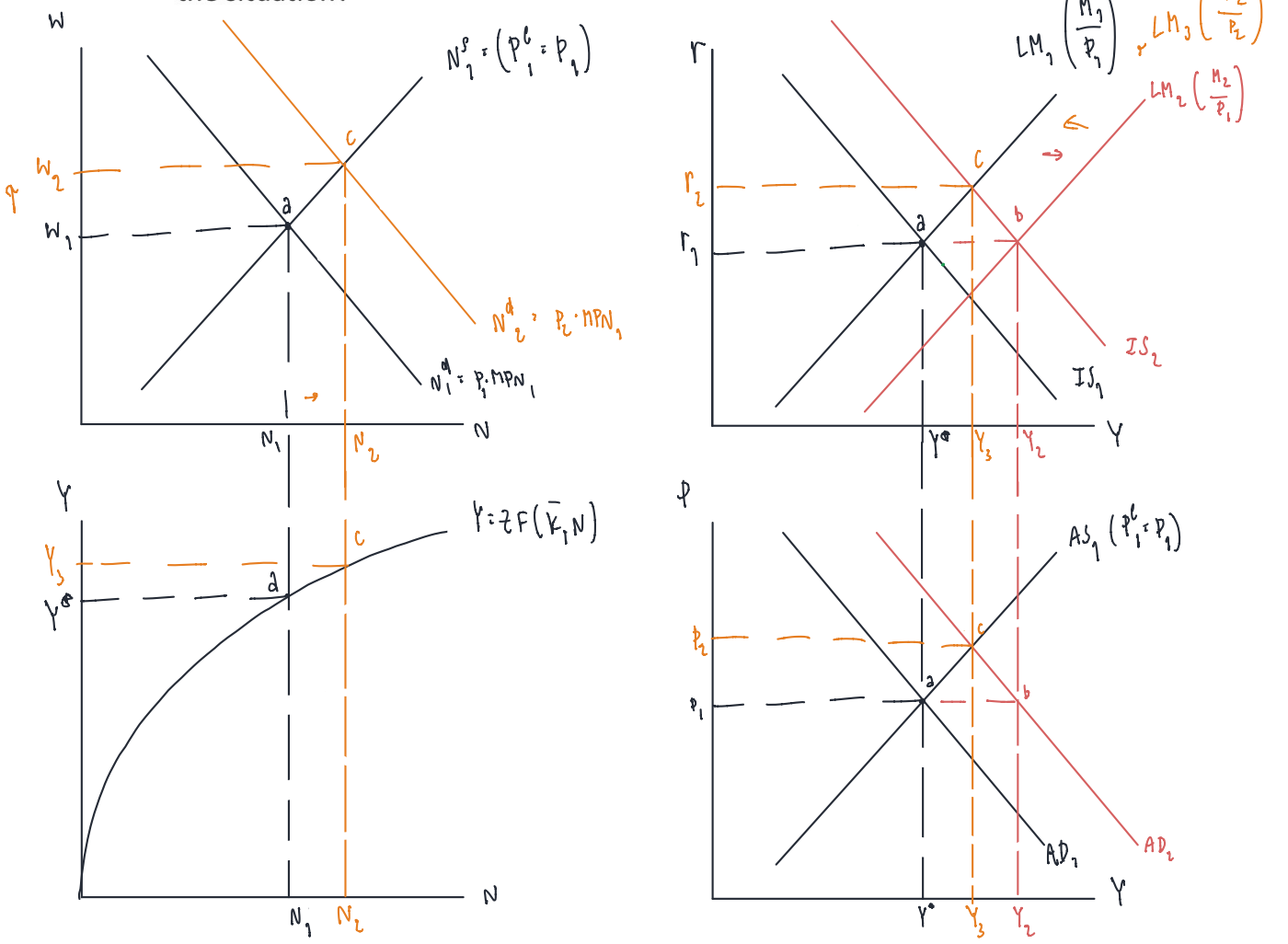
Classical model → prices & wages are freely adjusted : Competitive market creates potential output (economy is self-correcting)

Aggregate supply curve is vertical, meaning that output is fixed. Prices are flexible. Therefore, if the demand curve changes, the effect will be entirely on price level not on output.

Keynesian model : believe that economy is not always in full employment → needs an intervention from government. Aggregate supply curve is horizontal at same price level. ∴ If demand changes, the effect will be entirely on output.

∴ The main difference lies on price flexibility & the power of increasing output through aggregate demand stimulus.

1.4) Within the AD-AS model (4 diagrams), analyze the effects of fiscal expansion that is accompanied by a monetary accommodation. Is the size of fiscal multiplier large under the situation?



At point A, $Y = Y^*$, $r = r_1$, $P = P_1$, $W = W_1$, $N = N_1$. The effects of fiscal expansion create the government spending (G) increase which lead to Aggregate expenditure (AE) rise and then income (Y) increase. Hence, at r_1, IS curve shift right from IS_1 to IS_2. Plus, monetary expansion create money supply increase from M_1 to M_2 and then, $\frac{M}{P}$ rise from $\frac{M_1}{P_1}$ to $\frac{M_2}{P_1}$ which means LM curve will shift right from LM_1 to LM_2 that intersect with IS_2 at point b. r remain the same but Y increase from Y^* to Y_2. At P_1, Aggregate demand (AD) curve will shift right from AD_1 to AD_2 which create the excess demand. In order to clear market, Price level rise from P_1 to P_2. This action creates 2 impact. The first one is $\frac{M}{P}$ will decrease from $\frac{M_2}{P_1}$ to $\frac{M_2}{P_2}$. Then LM will shift left from LM_2 to LM_3 and then r rise from r_1 to r_2. Consumption and Investment will fall. As a result, Y decrease from Y_2 to Y_3. This call price effect where Y_3 more than Y^*. The second impact is that VMP increase and leads to N^d curve increase and shift right from N^d_1 to N^d_2 resulted in w increase from w_1 to w_2, N increase from N_1 to N_2, Y rise from Y^* to Y_3. Hence, new equilibrium is at point C and the outcome of this affect is P, r, w, N, C, Y increase but I decrease. The size of fiscal multiplier is smaller than under the situation

(2)

Trade composition

The emerging economy countries export more than developed countries. While the amount of import is nearly the same. We can see that in emerging economy country, the percentage of aggregate export is 71 percent and that of import is 33 percent while both import and export in the developed country are nearly the same level. So, we can conclude that emerging economy country produce goods more than they consumed. While developed country produce and consume at the same amount.

International relative price Affect economic activity in emerging economies

In emerging economies country, the change, in other words, increase in the price of commodities will increase the value of the goods that consumed and caused the economic boom. The higher value of commodities increases the amount of resources available to accumulate capital and increase consumption. Moreover the return to capital accumulation and labour hiring will rise.

In contrary with the commodities production in developed country, the change in relative price have the small impact on the value of production and economic activity.

Quantitative finding

From the information above, it implies that these effects are related to quantitative finding. Difference in pattern of production and trade among emerging and developed economies accounted for 52 percent of difference in average volatility. Moreover, we could represent the data with information that we imply. For instance, we showed that sectoral imbalances in the trade of commodities and manufactures are positively correlated with business cycle volatility. furthermore, we presented that our model was capable of accounting for a significant fraction of country relationship between business cycle volatility and the cross-sectional data.

6104641045 Paemika

6104641151 Naphut

6104641177 Napawan

6104641490 Trinath