Group 1 assignment 2

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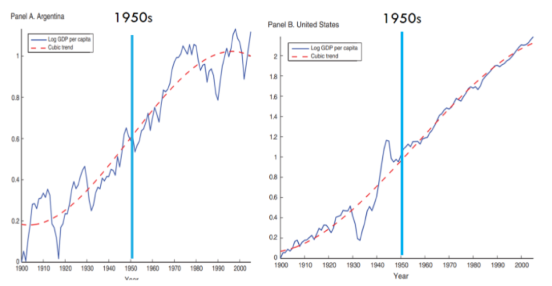
Answer Question 1

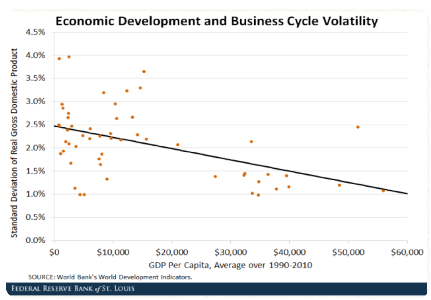
The major assumption of this model is that the economy is always at full employment, meaning that everyone who want to work is working and all resources are being fully used to their capacity. The classical economists believe that the economy is self-correcting, which means that when a recession occurs, it needs no help from anything.

Answer Question 2

As its show on the Exhibit A where the series of real GDP per capita of Agentina are way so much stronger than the trend of log real GDP per capita in the US, especially after 1950, the trend of real GDP in Agentina is cleary fluctuated compared to real GDP in the US.



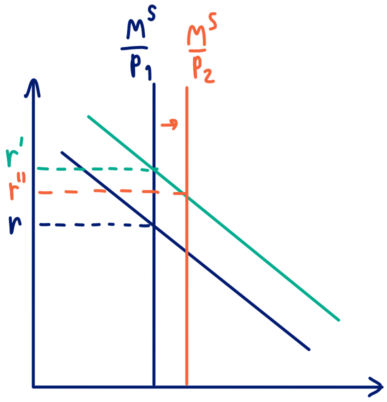
From the exhibit 2, the scattered points displays the relation between the level of development and level of business cycles. This points show the negative correlated between two variable, meaning that the higher level of economic development, the less volatile business cycle fluctuations.



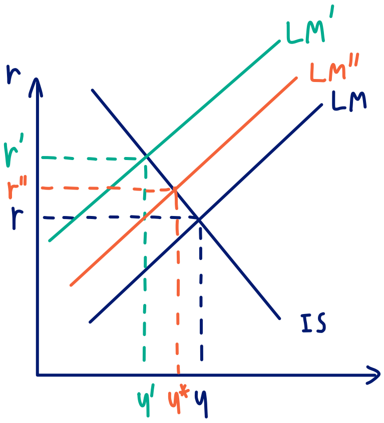
Studies using quarterly data also found that the average SD of emerging market business cycles are roughly 3 times higher than advanced economies

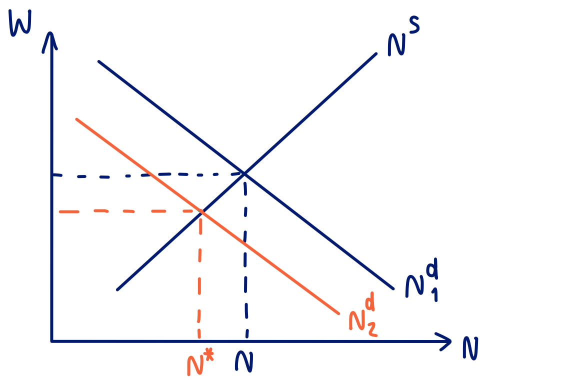
Business-Cycle Statistic	Emerging	Rich
σ_y	8.7%	3.3%

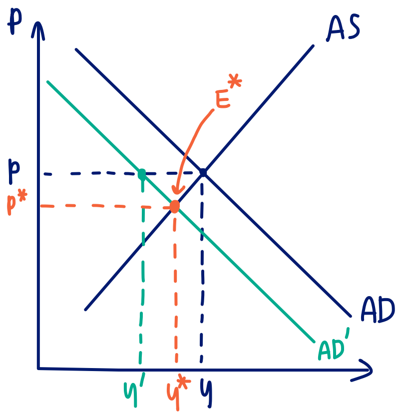
All of these 3 examples , therefore, can be sum that advanced economy tend to have lower business cycle volatilities that the emerging economies. Exhibit 2 documented that sectorial imbalance in trade of commodities , emerging economies produce and export different good more than developed economies that import and consume very similar good. Then, it leads to produce more than consumption in emerging economies, but similar production and consumption in development economies. Futhermore, manufactures are positively correlated with business cycle volatility and it also showed that the model can account for a significant fraction of country-by-country relationship between business cycle volatility and the cross-sectional characteristic. Moreover, the advanced economy country unsynchonized adjustment in price and wage across sectors and works , so firm are not be able to adjust the price whenever they want because of the specific price and wage stickiness.

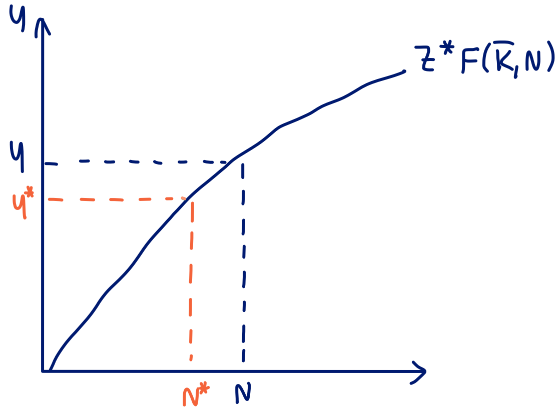


Money Market









1.3 As people loss confidence in stocks and bonds, they change their money holding behavior. People would want to hold more money, which resulted in the increase of money demand and increase in interest rate in money market. This causes a negative LM shock and shift LM curve to the left. As interest rate increase, consumption and investment drop due to higher cost of borrowing. It causes Aggregated expenditure to drop and resulted in a decrease in output. At the same price level, there is an excess supply in the market. In reality, price can be adjusted. Price will drop from P to P* because the old price is too high. For price effect, as price decrease, it lower the incentive to hire more labor of the firm. This cause a drop in labor demand and amount of labor employed. The decrease in amount of labor causes a decrease in production, which causes a drop in level of output supply a little bit. Price effect also causes the real money supply to increase. Interest rate is now being pressured to decrease a little and shift LM back to the right slightly. A drop in interest rate partially cause a rise in consumption and investment, which causes an increase in aggregated expenditure. This resulted in increase in quantity demanded and the new equilibrium in AD-AS model is at E*.