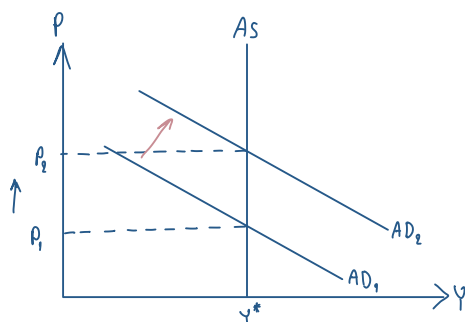
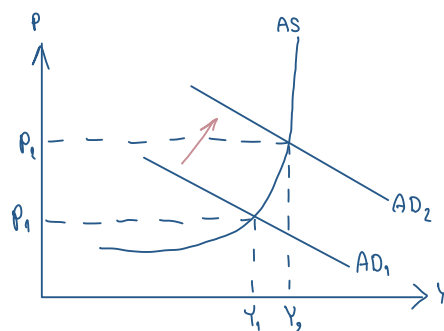


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1.2) How does the Keynesian aggregate supply curve differ from the classical one? Is one of these specifications more appropriate than the other? Explain, being careful to state the time horizon to which your answer applies.



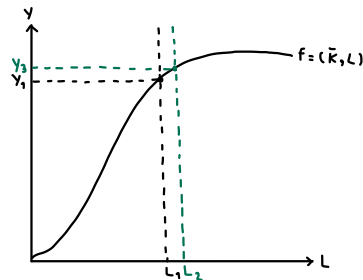
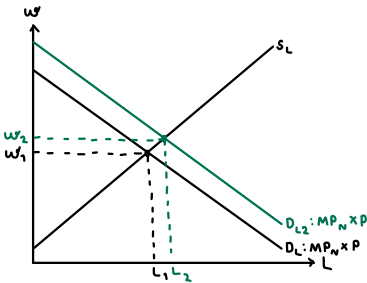
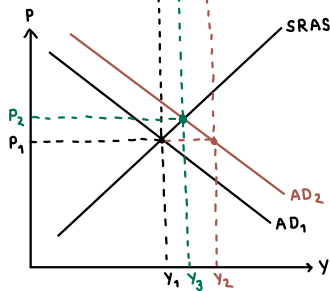
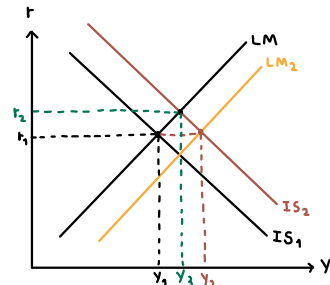
Classical aggregate supply



Keynesian aggregate supply

From the classical perspective, An increases in aggregate demand will not increase the real GDP, however, it will just cause an inflation. As it is illustrated in the graph, we will see that aggregate demand shift from  $AD_1$  to  $AD_2$ , leading to increases in price but not increase real GDP. Looking at other dimension, The Keynesian view of aggregate supply is different. They argue that the economy can be below full capacity in long term, meaning that the output will slowly adjust to the full capacity. According to the Keynesian aggregate supply curve, we can see that the increases in aggregate demand from  $AD_1$  to  $AD_2$  causing the output to rise from  $Y_1$  to  $Y_2$ . Keynesians believe that it derived from several reasons, for example, wages are sticky downwards, Negative multiplier effect etc. To answer which method are more appropriate than the other, we should consider from the real situation. The method that more appropriate to use for the reason that the market cannot adjust to equilibrium simultaneously, due to many reasons as Keynesians mentioned.

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?



Firstly, from the effects of fiscal expansion policy means that government increase their spending ( $G \uparrow$ ) its cause IS shift right from  $IS_1$  to  $IS_2$ . Apart of fiscal expansion it also has monetary expansion too then money supply  $\uparrow$  and LM will shift to the right too. There is no crowding out effects in this case because it was substitute by monetary policy.

As LM and IS shift to the right the aggregate demand also shift to the right. when AD shift right it has an excess demand. when excess demand price will increasing until AD-AS model adjust to the equilibrium point.

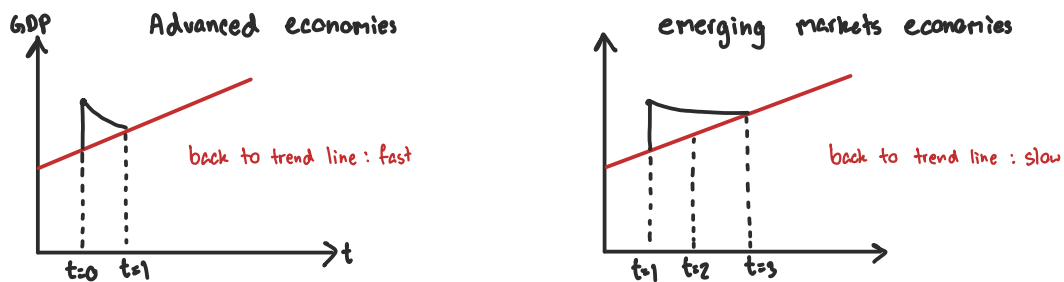
As price increase  $\rightarrow \frac{M_s}{P}$  will decrease  $\rightarrow$  interest rate  $\uparrow$  then investment decrease and national income also decrease too from  $Y_2$  to  $Y_3$ . Moreover, when  $\frac{M_s}{P}$  decrease it will cause LM to decrease again.

Now focusing on Labor market and production function. Demand of labor increase due to the price effects. Then wage  $\uparrow$  and hiring labor  $\uparrow$ . As hiring labor increase outputs will also increase too.

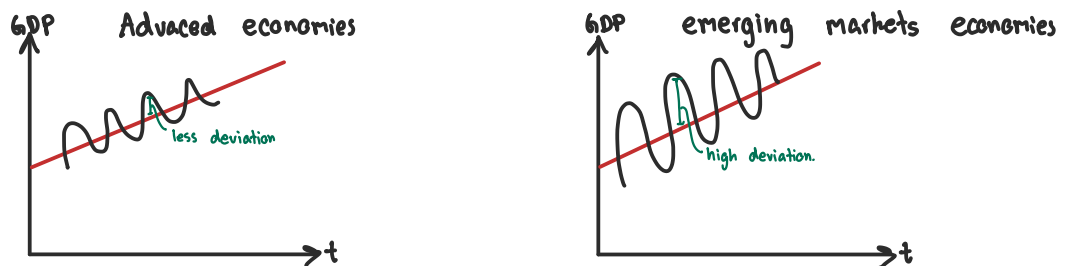
To conclude, at firstly the size of fiscal multiplier is large ( $Y_1 \rightarrow Y_2$ ). But due to the price effects  $Y$  decrease from  $Y_2 \rightarrow Y_3$ .

## Question 2

The business cycles volatility is the deviation of the actual GDP that diverge out of the trend line. According to the information, the emerging markets economies seems to have higher business cycles volatility than the advanced economies. The possible reasons are going to be discussed in the following paragraphs.



To begin with, the emerging markets economies are less stable than the advanced economies. Therefore when the GDP deviate out of the trend line, the GDP of advanced economies are quickly adjusted back to the trend line faster than the emerging markets economies. Apart from that, the interest elasticity to investment is also the possible reason. From my perspective, emerging markets economies could have higher interest elasticity to investment than advanced economies. To illustrate, in emerging markets economies, if interest increase, investment will decrease a lot; then, output ( $Y$ ) decrease a lot. Therefore, the deviation is high because output would drop a lot below the trend line. Moreover, in the advanced economies, if interest increase, investment will decrease a little; then, output ( $Y$ ) decrease a little. Therefore, the deviation is low because output dropped just a little below the trend line.



Not only the previous possible reasons, but also the shock in economies. In emerging markets economies, the shock would more affect the deviation of GDP out of the trend line compared with the advanced economies. Lastly, the possible reasons is the inflation and output gap. According to the Phillips relation, there exists the positive relationship between inflation and output gap. To clarify, the deviation of actual GDP that diverge out of the trend line is the output gap of economies. It can be positive output gap if GDP is above the trend line and it can be negative output gap if GDP is below the trend line. Therefore, high business cycles volatility lead to high output gap. Then, emerging markets economies would have higher inflation than advanced economies. Notice that the inflation can be both positive inflation and negative inflation (deflation).

To summarize, our group came up with four possible reasons. Firstly, there is the time that take the actual GDP back to the trend line (economies stabilization). Secondly, it is interest elasticity to investment. The third is the effectiveness of the shock in economies. The last is the inflation and output gap in the economies.