



Problem sets 2: Keynesian business cycles

EE312: Intermediate macroeconomics

Semester 1/2019

Instructor: Assist.Prof. Dr. Kittichai Saelee

Due on Sept 20<sup>th</sup>, 2019 in class (before 11.15 am)

### **Instruction**

1. There are three parts. Part I is true/false questions. Part II has one question that requires longer answer. Part III is an essay-based question. Attempt all!
2. In part I, make it precise. The most effective way to answer True/false question is to strike to the point, and find a rebuttal case if you believe that it is incorrect. (As you may guess, the most likely answer should be either false or uncertain.)
3. In part II, the question is divided into several parts. Answer the question sequentially.
4. In part III, you have to clearly, as well as step-by-step, explain the transmission mechanism of shocks.

### **Part I:**

- 1.1 IS (random) shocks can generate a bigger volatility in real GDP under elastic money demand than under inelastic money demand.
- 1.2 The effect of fiscal policy is the strongest when monetary authority chooses to accommodate the government policy by fixing the interest rate.
- 1.3 Given the positive co-movement between price and output in the data, Thai business cycle should be dominantly driven by the supply shocks.
- 1.4 Interest rate is a counter-cyclical variable under demand shocks.

**Part 2:** Consider a two country model, namely A and B. Suppose for now that both are closed economy; that is, both A and B do not have exports and imports. The general economic structure of the two countries are identical, expect that the tax system of the two are different. *The marginal propensity to consumer (MPC) of the households in country A is higher than the MPC of those in country B.* Consider the following problems.

- 2.1) Using the IS-LM diagram, how can we capture the difference between the MPC of the two countries?
- 2.2) Based on your answer in (2.1), do you find monetary policy more effective in country A than in country B? Use the IS-LM diagram to show your analysis. Explain your answer.
- 2.3) Based on your answer in (2.1), do you find fiscal policy more effective in country A than in country B? Use the IS-LM diagram to show your analysis. Explain your answer
- 2.4) Based on your answer in (2.2) *and* (2.3), do you think the AD curve of country A is flatter or steeper than that of country B? Why? Explain your answer.
- 2.5) Based on your answer in (2.4), do you think the effect of supply shocks will be more pronounced in country A than in country B? Explain your answer.

**Part 3** Within the variable price and fixed (constant) wage version of the Keynesian model, analyze the effects of a loss of confidence in risky stocks and bonds such as occurred in the 2007–09 financial crisis. What would be likely outcome on key macroeconomic variables such as, output, interest rates, private spending, unemployment, and overall prices? Explain your answer.

(Hint: your answer should be linked to the 4 main diagrams in class.)