<u>Group 4</u>

Question 1.2

In the classical aggregate supply, it is assumed that price and wage are perfectly adjusted while the economy produces at the full output which is shown by the vertical aggregate supply curve which can be implied that aggregate supply does not depend on the price. This differs from Keynesian aggregate supply curve where it is assumed price and wage are sticky and there are a lot of nominal friction. So, the aggregate supply curve is not a vertical line.

Both specifications are appropriate in different situations. The classical aggregate supply is more appropriate for the long run because they assume that the long run supply curve is inelastic and there is no nominal friction in the market. Prices are more flexible so the aggregate demand can affect the price but not the output. On the contrary, in short run, since the price and wage are hardly adjusted, Keynesian aggregate supply is more appropriate in this situation.

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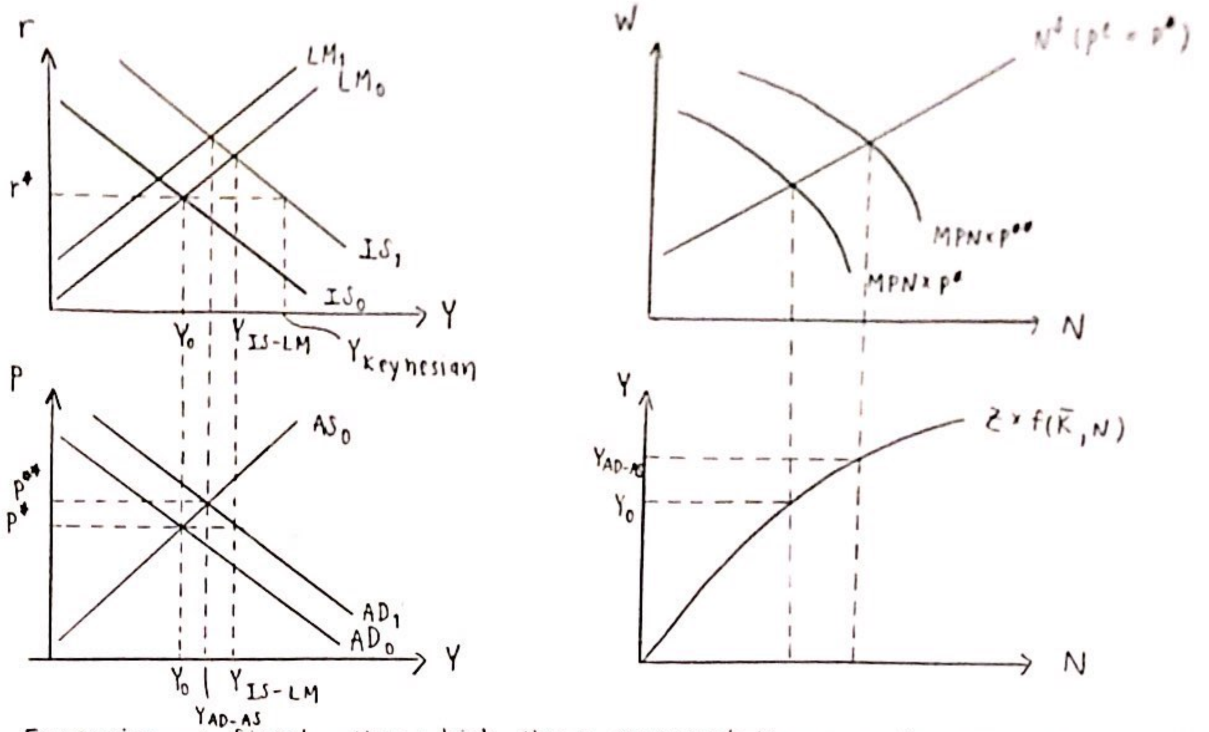
(1.4) Fiscal expansion that is accompanied by a monetary accommodation



Expansionary fiscal policy which the government increases its expenditure and tax rate is causing the IS curve to shift to the right from IS_0 to IS_1. The horizontal distance of shifting is equal to the distance between Y_0 and $Y_{Keynesian}$ which capture the traditional multiplier effect under DAE consumption. When the interest rate can be adjusted, the level of output will increase from Y_0 to Y_{IS-LM} which also cause AD to shift from AD_0 to AD_1 with the horizontal distance of Y_0 to Y_{IS-LM}. At P^* after the effect of fiscal policy, there is an excess demand in the market. Therefore, the price will rise from P^* to P^{**} and the level of output is reducing to Y_{AD-AS}.

The increasing in price causes

(1) the increase in labor demand because the increasing in price will affect the firm to produce more product and hire more people. Accordingly, the level of total output will also rise from Y_0 to Y_{AD-AS}.

(2) the shift of LM curve. The rising price affects real liquidity $\left(\frac{M}{P}\right)$ to decrease. Consequently, it causes interest rate to increase a little bit and LM curve shift to the left a little bit. Y is dropping from Y_{IS-LM} to Y_{AD-AS}.

The size of fiscal multiplier is small under the situation because price and interest rate can be adjusted.

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Question 2

One of the reasons why emerging economies have more business fluctuations is because of many reasons. Firstly, political instability and corruption leads to both domestic and foreign investment which can slow down economic growth. Political instability also causes the discontinuous work of government and each government has different policies. Consequently, the lack of decision making will be occurred and then the economy is highly volatile because the government slowly reacts to the situation. In addition, the governments of some countries that create a new policy that will boost the economy in short run would affect the fluctuation in the economy. Secondly, when a country is classified as an emerging economy, it means that the country's citizens have middle - poor income which makes them more vulnerable to changes in the market and economy. Many emerging economies are still driven by agricultural - manufacturing sectors, therefore if a negative event occurs, people in this sector are likely to be affected first which could lead to layoffs and unemployment. In comparison an advanced country, service sector tends to be the biggest contribution to a country's GDP and this sector is less vulnerable to economic changes. For example, if a negative supply shock occurs e.g. natural disasters, the sector that would be the most worse off is agriculture which tends to be the biggest sector only in emerging economies. To sum up, people with lower incomes are less prepared to negative shocks, which could lead to more business fluctuations. Thirdly, the fluctuation in currency is the cause of business cycle volatility because most of the emerging countries where their economy is driven by manufacturing sector are relying on export and import. Therefore, when the currency is fluctuating, it causes sudden upturn and downturn in an economy.