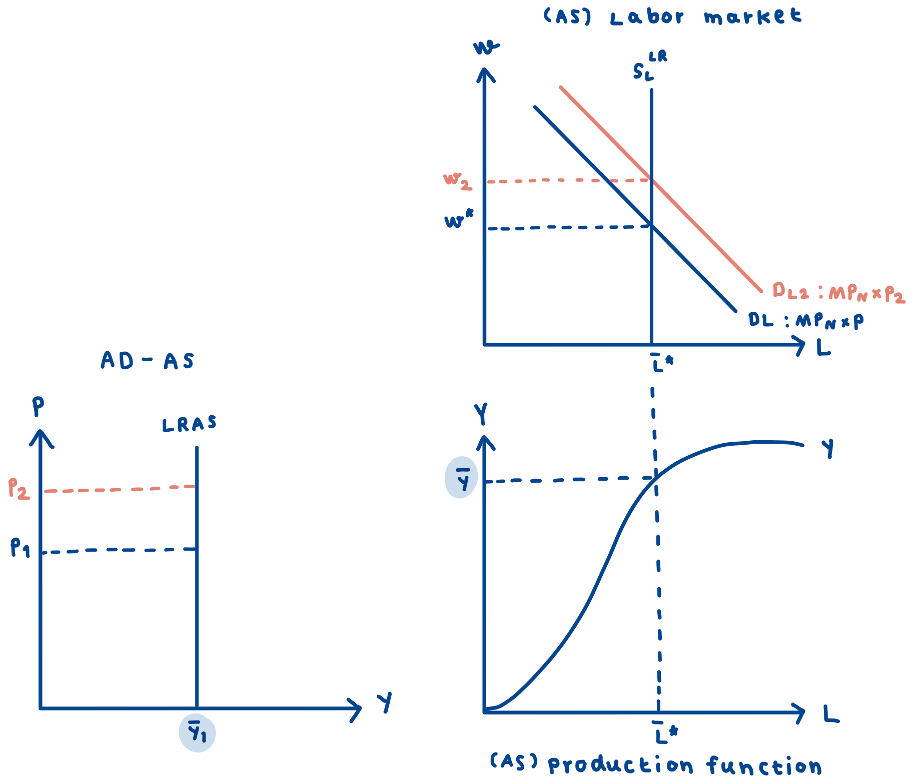
GROUP 11

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?



With long-run aggregate supply, nation of aggregate supply when boht prices and wages are perfectly adjusted. That is there is no nominal frictions about labor market and good market. The aggregate supply is represented relationship between price level (P) and real national income (Y) at full-employment rate and aggregate supply is represented by vertical line at Y^* level because no matter how much the level of price change ($P\uparrow$), the real national income will remain the same ($\bar{Y}$), $P\uparrow \Rightarrow W\uparrow \Rightarrow \frac{W}{P}$ back to original equilibrium $\Rightarrow Y$ also back to original equilibrium too. Vertical line of long run aggregate supply caused by mechanisms that adjust economy to the potential output level which the mechanisms that ensure continued full-employment of labor in the classical case is improvement in technology more resources.

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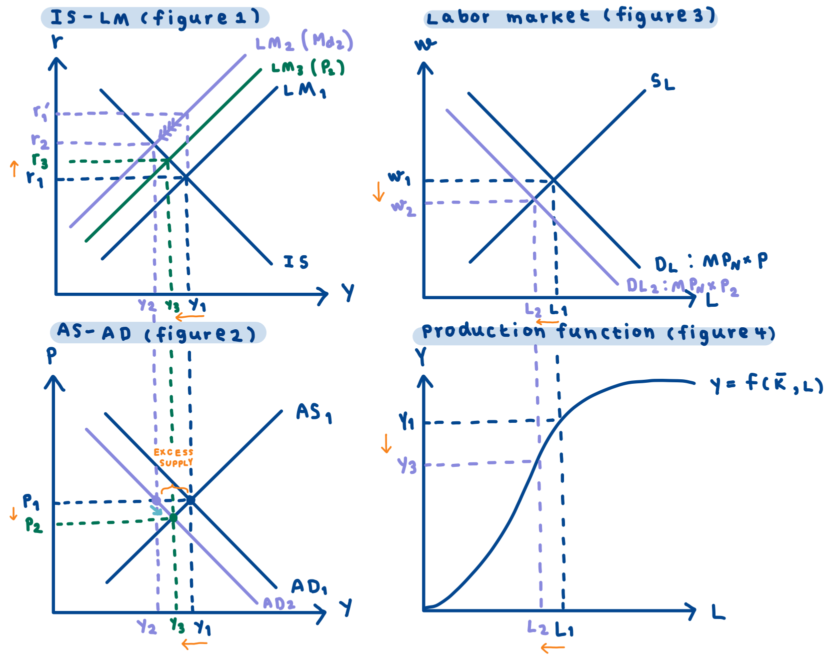
1.3) Within the core AD-AS model (4 diagrams), analyze the effects of a loss of confidence in risky stocks and bonds such as occurred in the 2007–09 financial crisis. What would likely be happening to output, interest rate, price, employment, consumption and investment?



As we loss of confidence in risky stock and bonds, people don't want to buy more stocks and bonds then they will sell stock and bond because they don't want to hold stocks and bonds anymore in hand. So, when they sell stocks and bonds it means that they have more money in hand and money demand increase (Md↑).

- As Md increase (Md↑), it affects interest rate increase (r↑) from r_1 to r_1' and then LM curve shift upward to LM_2
- As interest rate increase (r↑), investment decrease (I↓) and then national income decrease (Y↓) from Y_1 to Y_2 at equilibrium IS-LM
- As national income decrease (Y↓) it impact money demand decrease (Md↓) and then interest rate decrease (r↓) from r_1' to r_2 at equilibrium IS-LM
- As national income decrease (Y↓) from Y_1 to Y_2 then AD shift to the left at Y_2, P_1 and it cause excess supply. So, price decrease (P↓) from P_1 to P_2
- As price decrease (P↓) it made $\frac{Ms}{P}$ increase ($\frac{Ms}{P}$↑) and interest rate decrease (r↓) from r_2 to r_3 and then interest rate increase (I↑). when interest rate increase national income also increase (Y_3) at equilibrium AD-AS
- As price decrease (P↓), Labor demand which is $MP_N \times P$ also decrease (D_L↓) means that labor demand curve shift to the left and it affects labor decrease (L↓) from L_1 to L_2 and wage also decrease w↓) from W_1 to W_2
- As labor decrease (L↓), in production function, labor also decrease (L↓) from L_1 to L_2 and output decrease (Y↓) from Y_1 to Y_3.

In conclusion, with this situation it affects output decrease from Y_1 to Y_3 as figure 4, interest rate increase from r_1 to r_3 as figure 1, price decrease from P_1 to P_2 as figure 2, employment decrease from L_1 to L_2 as figure 2,3, consumption not change because IS curve not shift, and investment decrease caused by interest rate increase.

2) **Question** Against the backdrop of the information provided above, economists attempt to seek for possible reasons that account for the cross-country empirical regularities. In lights of the discussion we had in class about the theory of business cycle fluctuations, explain the possible reasons that could account for the observed differences of business cycle volatilities.

The business volatility is the deviation of GDP out of the trend line. According to the graph (Exhibit A), Emerging market economies (EMEs) seems to have stronger business cycle volatility than advanced economy (AE). There are many reasons affecting this volatility which will be dicussed in this essay.

One is the possible reason is the shock management. The advanced economy tends to have greater respond to the shock rather than Emerging market economies. Moreover, Advanced economy use less time to apply the policy throughout the government. To be clarify, AE have more precise prediction of expected shock that will be happen and able to adjust back to the trend line on time. Unlike the emerging market economies, They may not have ability to predict well and when the time that the shock comes, They consume the time for application of the policy much more than advanced economy So, they are not able to fix the problem on time and when market adjust itself back to the trend line, the policy have just been used. The policy are not help but jerk the trend off causing inflation or deflation.

Apart from that, the other reason is market stability or policy stability. The advanced economy is more stabilize than EMEs as you could notice on the graph. Take a closer look on the graph, Agentina's GDP is more fluctuate than US. one of the reason is market engagement or investment, when the trend is upward, the investors tend to invest more and when the trend reach the inflection point and turn to downward trend, investors will withdraw from the market

These actions will cause the fluctuation by driving the trend out of the line than what it could be which can be says that standard deviation will rise from these actions.