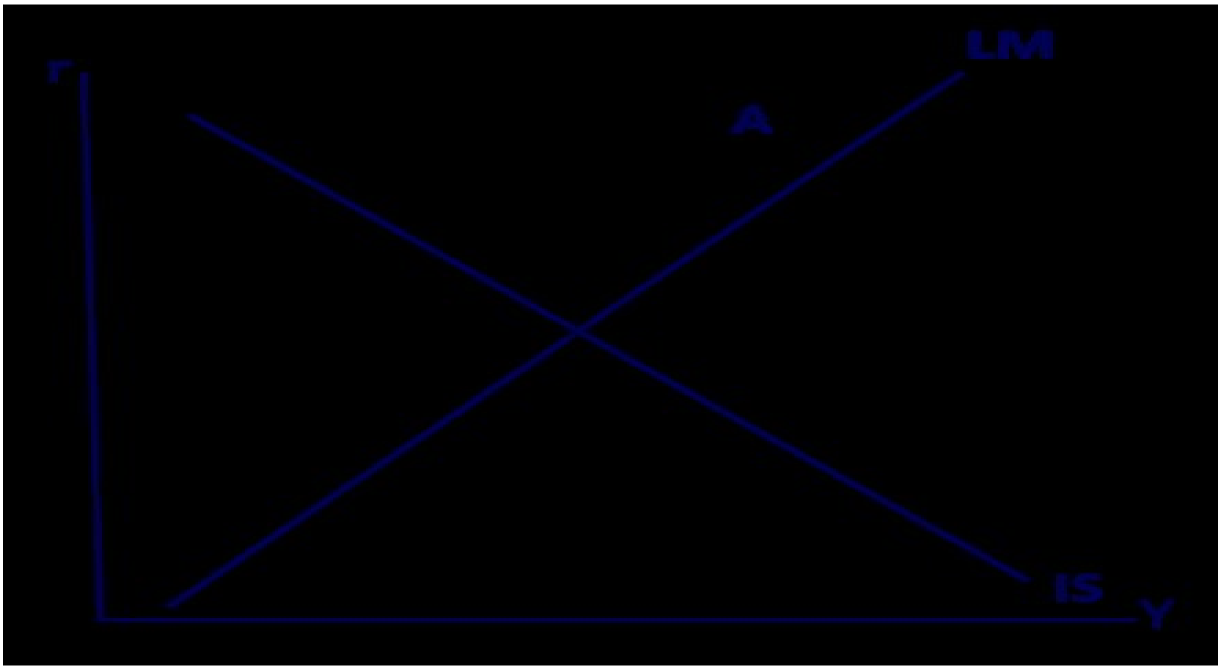
Problem 3

Consider the following economy operating at point A:



Part (a)

What are the conditions that prevail in each market if the economy is positioned at point A? (2 marks)

Part (b)

Briefly describe how will this economy will adjust to achieve simultaneous equilibrium. (2 marks)

Part (c)

Assume that the economy is now in equilibrium, but that equilibrium is associated with the actual level of output in the economy, well below the natural level of output.

(i) If you are a policy activism advocate, what would you recommend the government do? Why? (1.5 marks)

(ii) If you are a policy rules advocate, what would you recommend the government do? Why? (1.5 marks)

(iii) For the most effective fiscal policy possible, should the IS curve be relatively flat or relatively steep? Should the LM curve be relative flat or relatively steep? (1 mark)

Part (d)

Briefly explain why fiscal policy may be more effective than monetary policy when the economy is in a recession. (2 marks)

Problem 5

Part (a)

Briefly contrast the difference between the development of the Global Financial Crisis and the Great Depression. (2 marks)

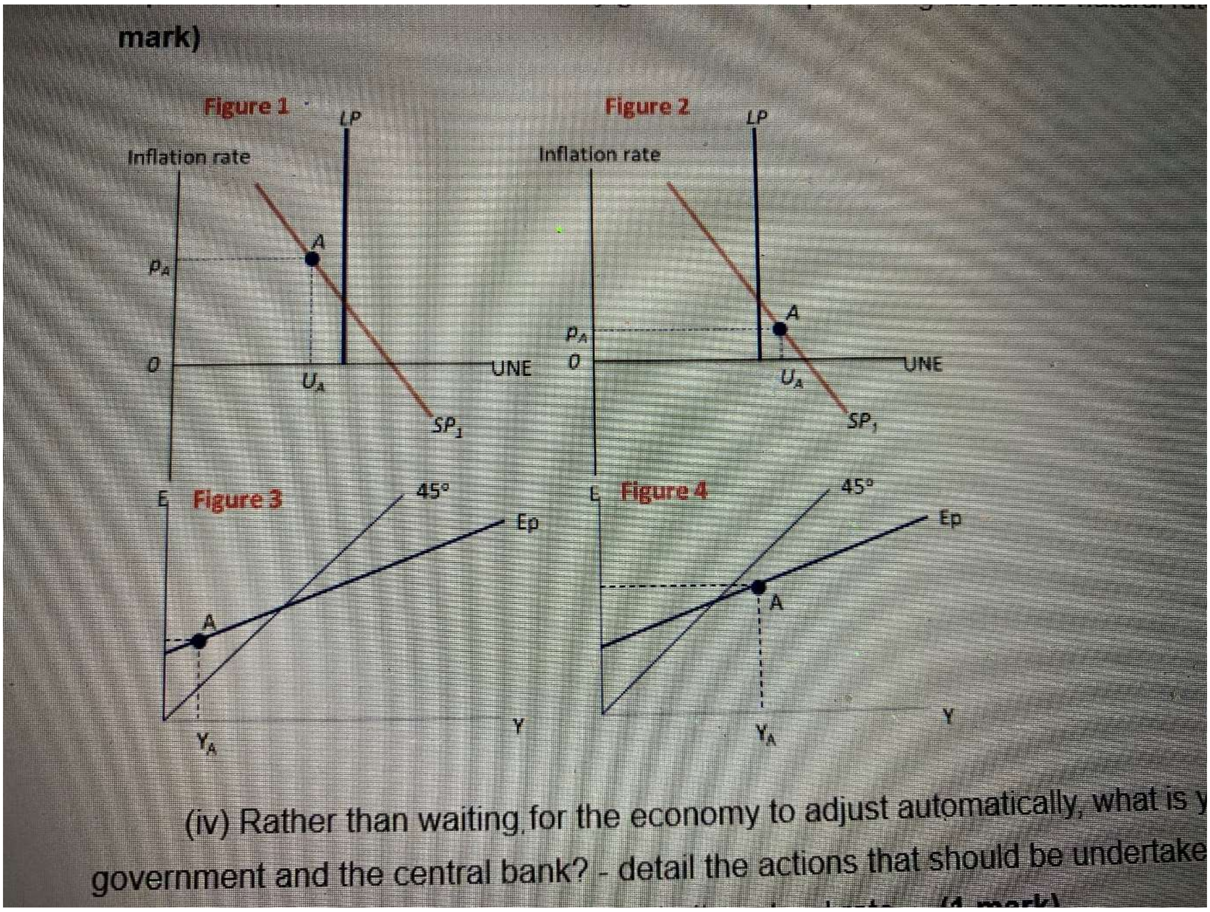
Part (b)

Imagine that the government determines that the economy is currently producing above the natural rate of output.

(i) Would the economy be facing a recessionary or inflationary gap? (0.5 mark)

(ii) Would the output ratio for this economy be equal to 100%, above 100% or below 100%? (0.5 mark)

(iii) Consider the diagram below and identify which diagram correctly represents the current equilibrium position for this economy given that it is producing above the natural rate of output. (0.5 mark)



(iv) Rather than waiting for the economy to adjust automatically, what is your policy advice for the government and the central bank? - detail the actions that should be undertaken by the government and the central bank to move the economy to its natural rate. (1 mark)

(v) Refer to the diagram you selected for part (iii) above and explain how the economy will move to its natural rate following your advice from part (iv) above on your model. Is there a shift or movement of the curve? Which curve and in which direction? (3 marks)

Part (c)

Classical economists (and monetarists) believe the excessive growth of the money supply causes inflation in the economy. State the Quantity Equation from the Quantity Theory of Money and using the quantity equation, briefly explain why an increase in the money supply causes inflation. (2.5 marks)