

Fall 2009

# Review 2 Answers

Economics 203

## PART A

1	B		6	A		11	C		16	A		21	E
2	B		7	C		12	C		17	B		22	C
3	A		8	C		13	A		18	D		23	A
4	B		9	B		14	C		19	B <sup>1</sup>		24	E
5	D		10	D		15	C		20	A		25	A <sup>1</sup>

<sup>1</sup> C is also correct.

## PART B

1. See page 2 for a sample answer.
2. See pages 3 and 4 for a sample answer.

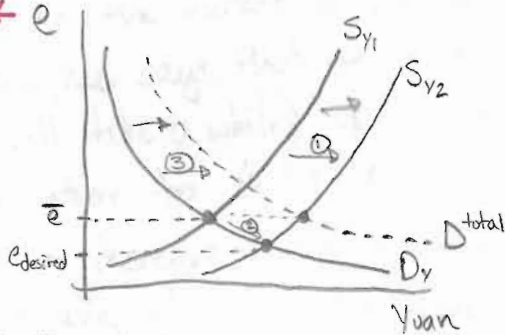
PART B: For each of the following questions, discuss your answers carefully and provide relevant graphs where useful. Use space on reverse of page as needed.

1. Assume that China keeps the exchange rate of the Yuan constant against the Dollar. If, ceteris paribus, the Chinese real GDP increases, what action(s) must it take to keep the exchange rate constant? Explain using a graph. What change, if any, results in the official reserve transactions by the Chinese central bank?

As Chinese real GDP increases, the Chinese demand for imports will increase, which increases the supply of Yuan on the international market

$$D_{\$} = f\left(e, \frac{P_{China}}{P_{Foreign}}, Y_{Foreign}, r_{China} - r_{Foreign}\right) \quad S_{\text{Yuan}} = f\left(e, \frac{P_{China}}{P_{Foreign}}, Y_{China}, r_{China} - r_{Foreign}\right)$$

how is  $e$  defined?  $\leftarrow e$



this shift in the supply of Yuan would usually bring the exchange rate down, to the  $e_{desired}$  from  $\bar{e}$ , but China wants the exchange rate to remain constant, so it needs to artificially boost demand for the Yuan (to the line marked  $D^{total}$ ) in order to keep the equilibrium  $e$  at  $\bar{e}$ . To do

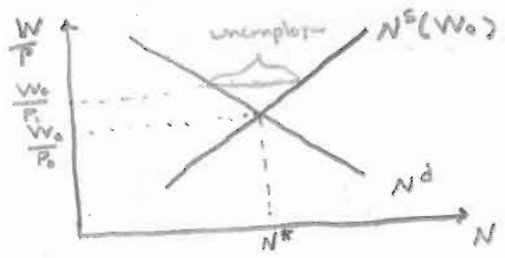
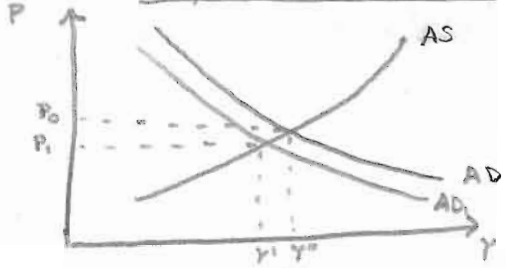
- ① Yuan shifts from  $S_{Y1}$  to  $S_{Y2}$  when  $Y_{China} \uparrow$
- ②  $e$  would naturally shift to  $e_{desired}$ , but in order to keep it at  $\bar{e}$ , China must
- ③ raise  $D_{Yuan}$  to  $D^{total}$

this, it will have to buy Yuan on the exchange market and deplete its reserves of foreign currency. This action is part of the ORT balance and is counted as a credit.

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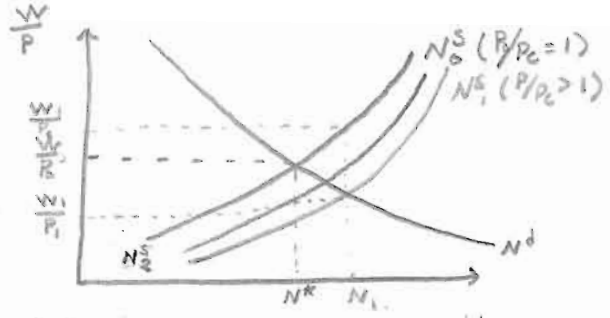
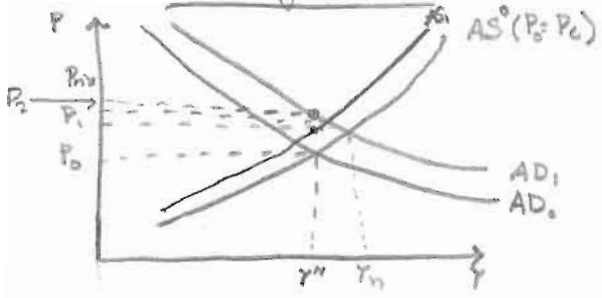
2. The Keynesian model and the Fooling model both predict output fluctuations around natural real GDP. What causes the fluctuations in each of these models? What economic policy is recommended by each of these models to attain full-employment? Discuss.

Keynesian Model



- Assume  $\exists$  a decrease in consumer confidence  $\exists$  AD shifts left. The price level decreases to  $P_1$ , GDP decreases from  $Y^n$  to  $Y_1$   $\exists$  unemployment exists b/c of the increase in the real wage following the decrease in price level. The unemployment can change from either a change in  $W$  or a change in  $P$ , however  $\exists$  no pressure on  $P$  to change since  $AS \exists AD_1$  are in equilibrium. According to Keynes wages are rigid in the SR b/c of the existence of contracts, labor unions  $\exists$  workers not being willing to take a cut in nominal wage ( $w$ ) despite the price decrease. Thus the continued unemployment  $\exists$  resulting output of  $Y_1$  which is less than  $Y^n$  occurs b/c of wage rigidity or the inability of nominal wages to move w/ change in price level. Since  $\exists$  no pressure on the price level to change  $\exists$  wage contracts are typically set for anywhere from 1 to 3 years, the unemployment  $\exists$  reduced output will exist for some time. For that reason Keynes argued this must be some form of response rather than the self-correction process. He recommended an expansionary fiscal policy, which would have the effect of shifting the AD curve to the right, raising the price level  $\exists$  bringing employment  $\exists$  GDP back into equilibrium.

Fooling Model



- The Fooling model explains fluctuations in output by the existence of asymmetry of information between workers  $\exists$  those who run firms. Workers have more prices to watch  $\exists$  thus do not have as good a notion of what the price level in the economy is. Fluctuations can occur when the price level that workers expect ( $P_c$ ) deviates from the actual price level  $P$ . The fluctuations can self-correct economy returns to full employment through a self-correction process  $\exists$  not by any economic policies.

Assume  $\exists$  a boom  $\exists$  AD shifts from  $AD_0$  to  $AD_1$ , so the price level increases to  $P_1$   $\exists$  GDP goes to  $Y_1$ . This increase in the price level is unknown to the workers so the  $N^s$  curve shifts to the right b/c workers are now under forecasting the price level. Workers get a raise of a smaller %  $\exists$   $\Delta W/P$  from  $W_0$  to  $W_1$ , so they believe their real wage is  $W_1/P_1$  when in fact it's  $W_1/P_0$   $\exists$  employment is now  $N_1$ . So the increase in employment  $\rightarrow$

that is necessary to fuel the increase in AD occurs b/c of workers' <sup>mis-</sup> ~~mis-~~ ~~esti-~~ misestimation of what the actual price level is due to the asymmetry of information between workers & those who run firms. The self-correction process plays out as workers begin to figure out the actual price level is  $P_1$ , which shifts the AS curve to the left (its centered on a point  $Y^n @ P_1$ ). ~~which~~ The shift of AS in response to price level to  $P_2$ , is b/c the feeling of workers is less the  $N^e$  curve shifts left to  $N^e_2$ . This process continues until the AS curve passes through  $Y^n @ P^n$ , at which time the price level & expected price level will be equal.

*mce*