Section B

4. (a) With the aid of the AS-AD model, explain how the depreciation of the currency of Economy A against the currencies of its trading partners affect the general price level and the aggregate output in the short run and in the long run. (11 marks)

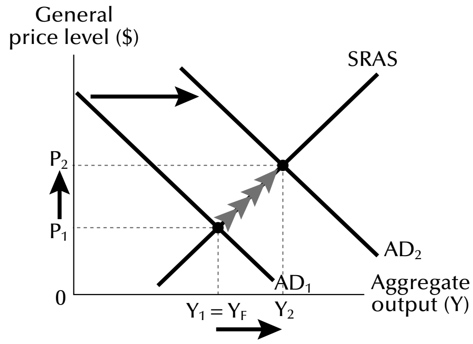
Strategies

Consider the short-run and long-run equilibrium conditions. Analyze how depreciation affects the aggregate demand, and eventually how the labour market adjusts to attain long-run equilibrium. Draw both the short-run and long-run equilibrium points in the AS-AD model.

Level Boosting Examples

Ans. Level 2 answer

(a)



Level Analysis

The long-run aggregate supply curve should be drawn.

<u>Mark allocation for the diagram:</u>

- AD_1 shifts right to AD_2 1

In the short run, the general price level increases. 1

In the long run, the general price level increases, 0

and the aggregate output increases. 0

Level Analysis

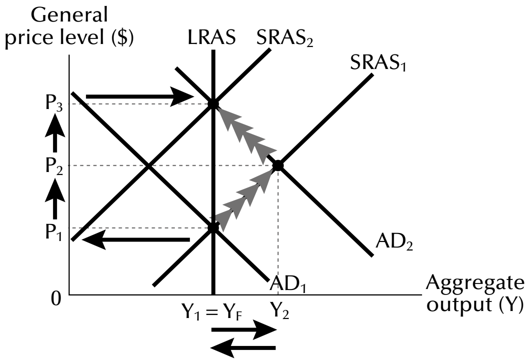
The short-run change in the aggregate output produced should be analyzed. The change in the short-run aggregate supply should also be considered.

Boost Your Level

Draw the long-run aggregate supply curve to show both the short-run and long-run equilibrium points. The short-run increase in aggregate output should be analyzed with the reasons explaining why the short-run aggregate supply curve is upward sloping. The adjustment to the long-run equilibrium point should be explained with a shift of the short-run aggregate supply curve.

Level 5 answer

(a)



<u>Marks allocation for the diagram:</u>

- AD_1 shifts right to AD_2 1
- P_1 increases to P_2 and Y_1 increases to Y_2 1
- $SRAS_1$ shifts left to $SRAS_2$ 1
- P_2 increases to P_3 and Y_2 decreases to Y_1 1

A depreciation of the currency of Economy A makes its exports cheaper in terms of the currencies of its trading partners. 1

This increases Economy A's net exports and aggregate demand. 1

In the short run, the general price level increases. 1

The aggregate output also increases due to sticky prices, sticky wages and misperceptions about the general price level. 1

In the long run, all prices and nominal wages are perfectly flexible, and misperceptions about the general price level are corrected. 1

As the aggregate output is greater than the potential output, the shortage in the factor market increases the nominal wage rate and decreases the short-run aggregate supply. 1

Eventually the general price level further increases to P_3, while the aggregate output reduces back to the potential output. 1

Level Analysis

Both the short-run and long-run equilibrium points are shown with the short-run and long-run aggregate supply curves.

Level Analysis

The short-run increase in aggregate output is analyzed with the sticky-price, sticky-wage and misperceptions theories. The adjustment to the long-run equilibrium point is explained with a leftward shift of the short-run aggregate supply curve.

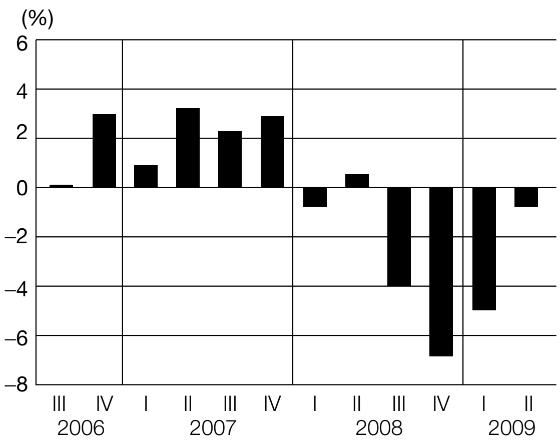
- To dampen the inflation, a contractionary policy should be carried out. But this will worsen the recession.
- This shows that even without misjudgement or time lags, macroeconomic policy does not always successfully achieve its economic objectives.

News Express

C01 World news | **DAILY NEWS** | 30 August 2009

Worldwide financial tsunami in late 2008

The bankruptcy of Lehman Brothers in late 2008 formally marked the beginning of the worldwide financial tsunami, which was rooted in the sub-prime mortgage crisis in the US in the late 2000s. The collapse of the US stock markets and the liquidation of many financial institutions in the US made the US economy suffer from recession. Many financial institutions tightened their lending policies, making it more difficult for firms and property buyers to obtain credit in the capital markets. Most US people also have a gloomy expectation of the future economy.



Quarter-to-quarter growth in US real GDP.
Source: US Bureau of Economic Analysis.

Analysis: Refer to Fig 11.29. The tightening of the lending policies of the financial institutions reduced the financial ability of households to consume and firms to invest. The gloomy expectation of the future US economy further lead to a decrease in private consumption and investment. These would make the aggregate demand curve shift leftward from AD_1 to AD_2, resulting in a decrease in the equilibrium general price level from P_1 to P_2, and also a decrease in the equilibrium aggregate output from Y_1 to Y_2 in the short run. The economy would move from point A to point B.

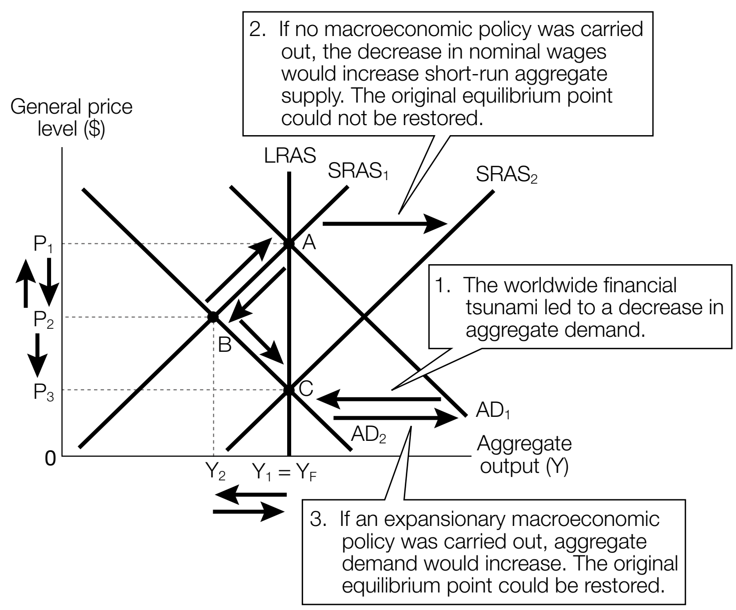


Fig 11.29 When aggregate demand decreases, an expansionary macroeconomic policy can stabilize both the general price level and aggregate output. Letting the economy adjust can only stabilize aggregate output but not the general price level.