Economics Assignment #4

1. There is a fall in investment in the US (which is a large country). Using diagrams, explain how this will affect the world interest rate, Canadian saving and investment, the Canadian real exchange rate and net exports.

Since the United States is a large country, that means that the world's market for loanable funds will trend in the same fashion as the United States (but, to a lesser extent). Therefore, the world's market for loanable funds will have a left-ward shift in the supply of loanable funds, as shown in the below graph:

Graph #1:



This graph illustrates that, if there is a decrease in the desired saving, then the interest rate will trend up. In short, the world's interest rate trends up with the United States'.

So, how does this affect Canada's economy?

Graph #2:



We can see that there will be an increase in the world interest rate, as illustrated by . This will cause the desired savings in canada to rise, as people turn away from Canadian investments. This also causes the investment in Canadian goods to fall, creating the gap in the middle, representative of the net-capital outflow, which has grown since the increased world interest rate. In short, the Canadian desired saving rises, Canada's investment demand falls, and the net capital outflow (net exports) increase.

But, what does this do to the Canadian dollar?

Graph #3:



As we can see, these circumstances do have an effect on the Canadian exchange rate. Since the supply of NCO has increased, we trend forward on the downward-sloping net-export demand curve. This causes the relative value of Canadian dollars to fall, in relation to other currencies.

2. Using the AD-AS framework, assuming sticky wages, explain the short run and long run effects of a fall in AD on: output, employment, real wages, and the price level.

Given sticky wages, and a fall in the aggregate demand, we can produce the following graph:

Graph #4:



As we can see, the AD curve shifts down, changing from the initial to being . This change illicits two changes within the graph: one affecting the short-run, and one effecting the long-run.

In the short-run, we can see that the SRAS curve stays at . The intersection between this curve and the curve represent the short-run fluctuation to the price level and the real GDP. Both shift lower, causing a decrease in real GDP. We can see that the price level lowers, in the short-run, but not by enough.

So, what is happening with the labour market?

Graph #5:



In this graph, we show the supply of labour on the x, and real wages on the y. We noticed before that, in the short-run, there is a decrease in the price level. As a result of this, W/P will grow larger, forcing our real wage to rise. This is because of the sticky-wages, which force W to maintain constant, in the short-run. As illustrated on the graph, we can see that this creates a large unemployment gap. These are the people that want to work at the new wage level, but cannot.

Thus, we can see that in the short-run, overall, output (real GDP) falls, employment falls and unemployment rises, price level falls, and real wages increase (due to the fall in the real price level).

However, this does not hold in the long run. In the long run, we know that sticky wages will not apply. As such, the recession will eventually end (as the AD slopes down). The nominal wage level will adjust, bringing price levels down even further. This will, in the end, make it so that there was no real affect on output, employment, or wages. All real variables will maintain being the same. However, price level, and nominal wages will fall, compared to the initial price levels.