EC1B5 | Chapter 12

Economic Fluctuations

<u>Additional Practice Questions:</u>

Book Question 4

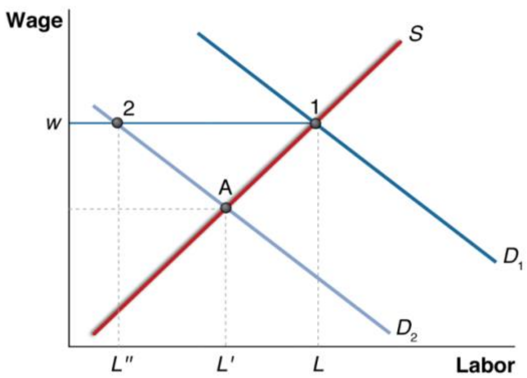
Suppose that the mythical country Moricana has a downward rigid wage. Moricana is in a recession; capacity utilization in the economy is at an all-time low, and surveys show that firms do not expect economic conditions to improve in the coming year.

a. Firms in the country are cutting back on capital spending and investment. Use a graph to show how this would affect the labor demand curve (ignore the effects of multipliers).

b. Is unemployment in Moricana likely to be classified as voluntary or involuntary? Explain your answer.

Answer:

a. Given the information in the question, wages in Moricana are likely to be rigid. When firms cut back on capital spending and investment, the demand for labor will fall. This shifts the labor demand curve to the left. As shown in the following graph, the economy is initially in equilibrium at point 1, where the level of employment is *L*. The demand curve for labor shifts from D_1 to D_2. Because wages are rigid and cannot adjust, the economy moves to point 2 on D_2. The level of employment falls from *L* to *L*". Had wages been flexible, employment would have only fallen to *L*'.



b. When wages are rigid, a left shift of the demand curve leads to involuntary unemployment. At the going wage *W* in the graph, the number of workers who are willing to work at the going wage exceeds the number of jobs that firms are willing to fill. The number of workers who would like to work at the market wage but can’t find a job is equal to the gap between *L* and *L*" in the graph from part a.

Book Question 5

Answer the following and illustrate your answers on a graph.

a. Assuming flexible wages, how will wages react to a fall in labor demand?

b. What options do workers have in this case?

Answer:

a. Labor demand can fall significantly during a period of recession. There is a decreased demand for workers, and companies can choose among the best workers. Therefore, companies are in a good negotiating position to lower wages.

b. The choices for workers are limited. They can remain unemployed, or they can retrain themselves if they have money to spare. If workers decide to increase their labor supply, for instance, by working extra hours, that will further reduce the wages. However, if workers can go on strike effectively and threaten to decrease their labor supply, which on its own might increase wages, then companies will be forced to reconsider their labor demand and increase wages for more people.

Book Question 7

In 1973, the major oil-producing nations of the world declared an oil embargo. The price of oil, a key source of energy, increased. In many countries, this led to a fall in real GDP and employment. Which of the three business cycle theories explained in the chapter – real business cycle theory, Keynesian theory, and monetary theory – would best fit this explanation of the 1973 recession?

Answer: Real business cycle theory emphasizes the role of technology in causing economic fluctuations. Proponents of real business cycle theory tend to emphasize the importance of changing input prices on aggregate output. Because almost all firms use oil in one form or another, oil price changes function like technology changes. An increase in the price of oil in 1973 led to a decrease in the productivity of firms that used oil. Large and abrupt increases in oil prices can cause a recession. Thus, the real business cycle theory best fits the explanation given in the problem.

Book Question 11

The global outbreak of COVID-19 in 2020 wreaked havoc on most economies. The containment efforts of the pandemic were proving to be detrimental to economic activity leading many countries to relax the lockdown even when the objective of the containment was not reached. How do you think the labor demand curve was affected because of the pandemic? How do you imagine countries are reacting to cushion the effect of the fall in economic activity on businesses and household incomes? Use a graph to illustrate your answer.

Answer: The COVID-19 outbreak constituted a negative shock on the labor demand curve in any economy that was affected by this virus. Many lost their jobs due to the pandemic. As shown in the figure, the labor demand curve moved from D_1 to D_3, and employment accordingly decreased from L to L'' (if wages are assumed to be rigid) or to L_B (if wages are flexible). To counter the ensuing unemployment and business closures, governments should implement expansionary fiscal policies like tax exemption, fiscal packages to failing businesses, and targeted support to families. Monetary policies should also support the fiscal policies. If successful and if the negative effects of the pandemic stabilize, such policies would move the employment from L'' to L' (if wages are rigid) or from L_B to L_A (if wages are flexible); if not, then the magnitude of the negative shock will be more severe, which governments can combat by implementing more acute expansionary measures.