EC1B5 Winter Term 2023-24
Answer Key to Discussion Question 7 (Week 9 Class)

Week 9 class: We have learnt about economic fluctuations and the economic theories behind it.

a. What are the characteristics of economic fluctuations?

b. Suppose the economy is in an expansion. What would be the reasons and mechanisms provided by the three different schools of thought, namely, real business cycle, Keynesian and monetary?

Answer key:

a. Economic Fluctuation: Short-run changes in the growth of GDP. A recession is defined as episodes of negative growth in real GDP. Economic expansions are periods between recessions. Variables such as real consumption, real investment, and employment move positively (or together) with real GDP – pro-cyclical. Variables such as unemployment move negatively (or opposite) with real GDP – counter-cyclical.
b. All three provide a reason why labour demand shifts to the right during an expansion.

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RBC: A technological improvement will be the source; higher marginal product of labour shifts LD to the right so wage goes up and employment goes up. As the marginal productivity of capital rises too, investment will grow as well, and output will rise accordingly.

Keynesian: Optimism about business and consumer expectations of the future leads to an increase in demand for consumption and investment, which in turn leads to an increase in output and labour demand.

Monetary theory: An increase in money supply puts pressure on prices to go up. Due to menu costs, however, prices do not adjust immediately so the “real cost” is lower, which increases demand and shifts LD to the right. Investment will rise, too, as an increase in the money supply will lower interest rates.