10/10

Part 2 – Short Answer (10 points).

21. Discuss the major differences between classical and Keynesian economists. Be sure to explain how they differ with regard to how quickly equilibrium is restored in the economy as well as what role they see for government action in restoring equilibrium.

5

a. Classical and Keynesian economist differ in the way they think wages and prices adjust during equilibrium. Classical economists think that during times out of equilibrium, prices and ways will adjust quickly back to equilibrium. They believe the economy will not experionce high enemployment for long periods of time, therefore no government action should be taken. Keynesian Economists believe that during times out of equilibrium, prices

22. What is the marginal propensity to consume, and why is it always less than one?

5

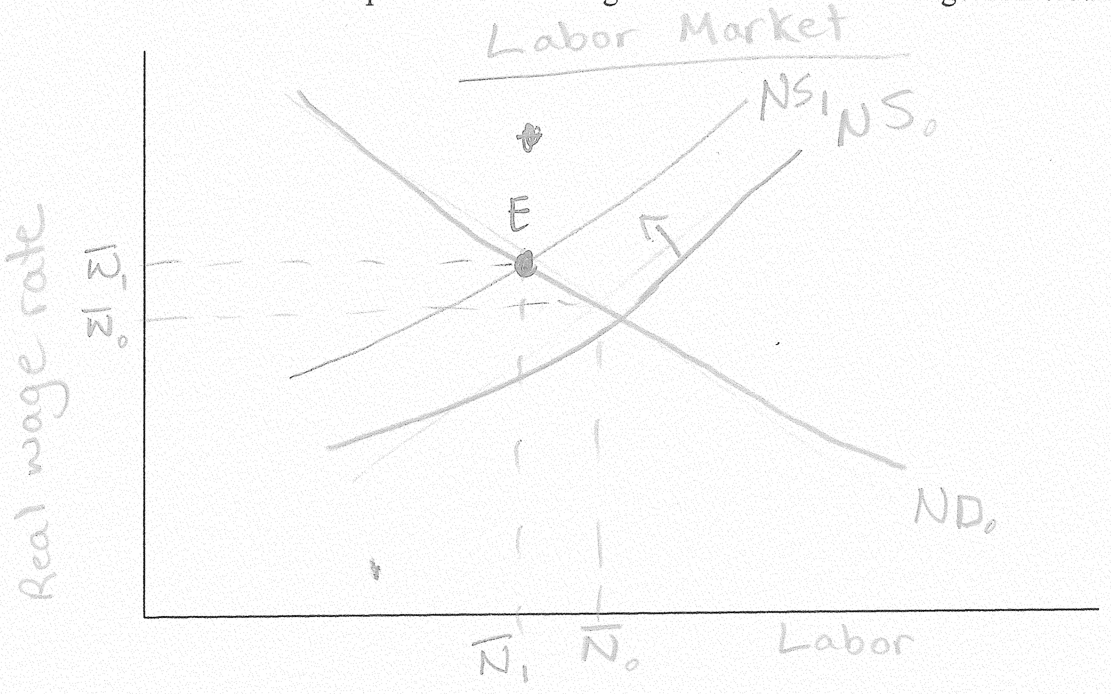
a. The marginal propensity to Consume is the amount of consumption when income is increased by one unit. The marginal propensity to consume is always less than one because at any part of an increase that savings will always increase by atleat by one unit.

and wages will not adjust quickly and that the economy may have long periods of high unemployment. They believe that during these times that there is a need for government action.

30/30

Part 2 – Application (30 points).

23. Use the following space to draw equilibrium in the labor or the goods market. Be sure to label and explain all of the diagram elements in order to get full credit.



The labor market diagram displays the interaction between labor supply and labor demand. ND_0 is the labor demand curve, and NS_0 is the labor supply curve. Both curves are determined by the relationship between the real wage rate on the vertical axis and the quantity of labor on the horizontal axis. The equilibrium point on this graph occurs where $NS_0 = ND_0$ which is at the ~~$\overline{W}_0$~~ real wage rate and the $\overline{N}_0$ quantity of labor. The real wage rate is the wage rate adjusted for inflation.

What about the slopes of each curve?

24. Give a detailed explanation of how equilibrium occurs in this market.

a. Equilibrium occurs where the labor demand curve equals the labor supply curve. If the real wage rate is too low or too high, either too many or too few workers will be available for the positions needed in the economy. Therefore, businesses will continue to adjust their standard wage until they have reached the minimum value they can pay their workers while obtaining the quantity of labor they desire.

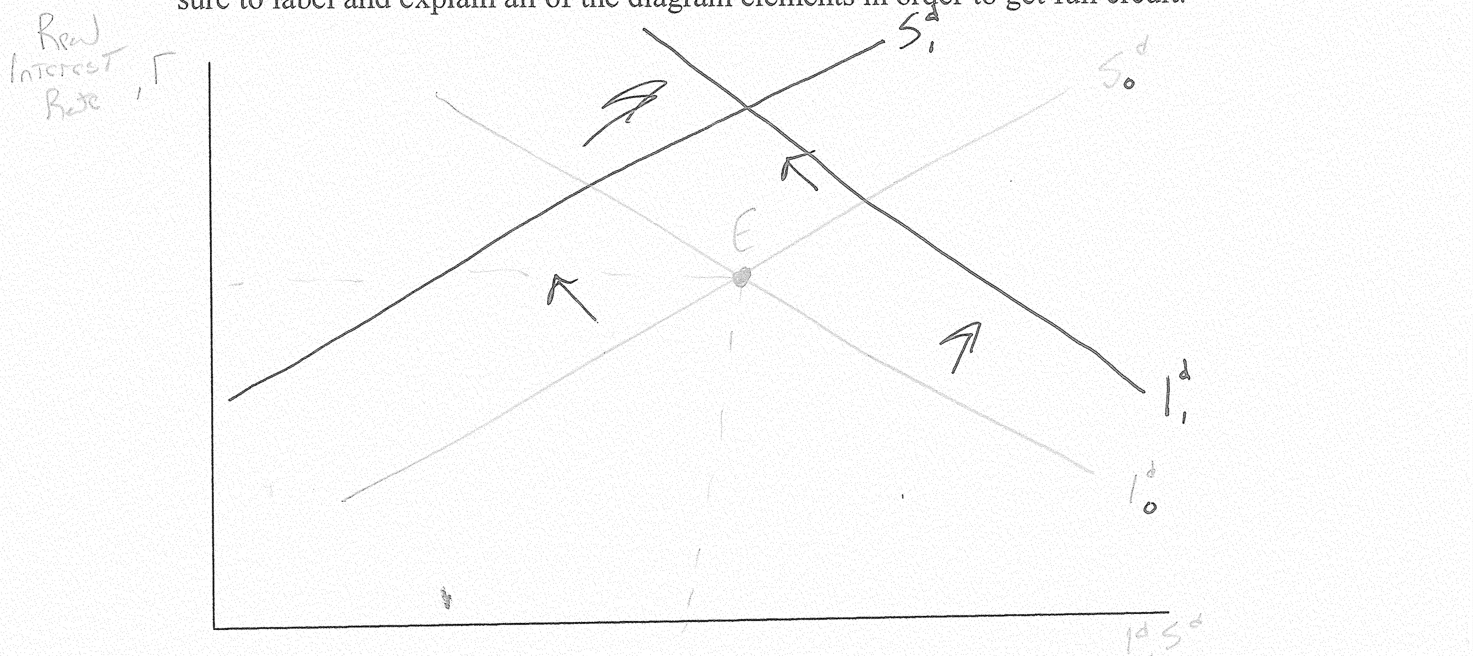
25. Describe the type of scenario that would change equilibrium in this market and show these changes in your graph.

a. An increase in the expected real wage rate would decrease labor supply because workers would not be willing to work as much because they would be able or expect to be able to afford more leisure time. This change would increase the real wage rate and decrease the quantity of labor.

27/30

Part 2 – Application (30 points).

23. Use the following space to draw equilibrium in the labor or the goods market. Be sure to label and explain all of the diagram elements in order to get full credit.



- I^d = desired Investment relative to each real interest rate
- r is the y axis, while desired Investment & desired savings are on x-axis
- S^d = desired savings relative to each real interest rate
- S^d is upward sloping bc the higher the Interest rate, the more reward individuals recieve from saving. So, the higher the Interest Rate, the more you save. I^d is negative sloping because the higher the Interest Rate, means the higher the user cost of capital.

9

Equilibrium point? -1

24. Give a detailed explanation of how equilibrium occurs in this market.

a. Equilibrim occurs because the real interest
rate rises or falls to ensure desired
savings and investment remain equal. The
crossing point of the savings and investment
curves is always equilibrim. The slopes of
the curves assure that any shift of one
curve changes equilibrim real interest rate
and desired savings & investments. $S^d = I^d$

25. Describe the type of scenario that would change equilibrium in this market and show these changes in your graph.

a. (a) Temporary increase in G (go to war)
(b) Savings curve shifts left
(c) Equilibrim point moves from point A to B
(d) Real interest rate increases to 6%
and desired savings & investments lower from
1000 to 700.