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Question 2

1. Introduction

Own price elasticity, cross-price elasticity and income elasticity are various measures to see how consumers change their spending pattern with a change in various factors. They help assess the change in government policies impact on the consumers. Firms are also able to decide how a change in policy will impact the consumers and affecting their total revenue.

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2. Elaborate the own-price, cross-price and income elasticity theoretically and empirically.

1 Own price elasticity

Refers to the percentage change in price quantity demanded of a good and its impact or due to the percentage change in price

Formula

$$PED = - \frac{\% \text{ change in Quantity demanded}}{\% \text{ change in price}}$$

e.g. if price increase by 2 percent and quantity demand decreased by 1% then

$$PED = 0.5 \text{ - inelastic}$$

This means a change in price creates a decrease in quantity demanded

2. Income elasticity

This refers to the change in quantity demanded due to a change in income

$$IEM = \frac{\% \text{ change in Quantity demanded}}{\% \text{ change in income}}$$

e.g. a 2% increase in income leads to a 1% increase in quantity demanded

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This means a %
change in price
creates a lesser
~~decrease~~ impact on
quantity demanded.

2. Income elasticity demand

This refers to the
change in quantity
demanded and its
impact due to a change
in income

Quantity demanded
price

$$IEd = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in income}}$$

e.g. a 2% increase in income
leads to a 4% increase
in quantity demanded

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the demand is ^{income} elasticity of demand of this good is elastic - a % change in income leads to a greater change in quantity demanded

→ This good is also a normal good as positive relationship between income and ~~demanded~~ quantity demanded.

→ Negative relationship when good inferior an increase leads to decrease in demand.

3. Cross - elasticity of demand

Cross elasticity of demand refers to the change in quantity demanded of a good with

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due to a change in
price of another good

$$CED = \frac{\% \text{ in quantity demanded of good A}}{\% \text{ in price of good B}}$$

if $CED > 0$ goods are complements

that means goods are
purchased together
e.g. Tires and Cars

if $CED < 0$ goods are substitutes

that means goods are
competing with each
other

e.g. Coca Cola and Pepsi

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2. Relationship of own price elasticity with total revenue

Inelastic

A. $PE < 1$

Price	Quantity	Marginal revenue M.R	Total revenue T.R
5	25 $PE < 1$	-	125
10	20	50	200
15	15	25	225

B. $PE > 1$ - Elastic

Price	Quantity demanded	Marginal revenue	Total revenue
5	25		125
10	10	-25	100
15	5	-25	75

Comparing both cases it is easy for any business to see if their product has elastic demand

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they gain more total
revenue from increasing
prices - **Case 1**
revenue keeps increasing
with increase in price
e.g. from 10 to 15 is 200 and
15 total revenue 225
increase of 25.

In the **Case 2** elastic
demand if ~~consumer~~^{business}
decreased price from
15 to 10 gains
in marginal revenue
of 25 25 total
revenue increases from
75 to 100.

Conclusion

Price elasticity, income
elasticity and cross
elasticity are important
measures to show
business and government
to determine the pr-
cessing impact of
various factors.

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Question 3

1. Introduction

IS-LM model is a useful tool for macro-economic stabilization it allows the policy makers to see the impact of policy changes on goods - IS - and money market LM. It addresses some of the things left in the typical Keynesian model of aggregate demand and aggregate supply.

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2. Critically evaluate the IS-LM model as a tool for macroeconomic stabilization in developing countries

IS - good market

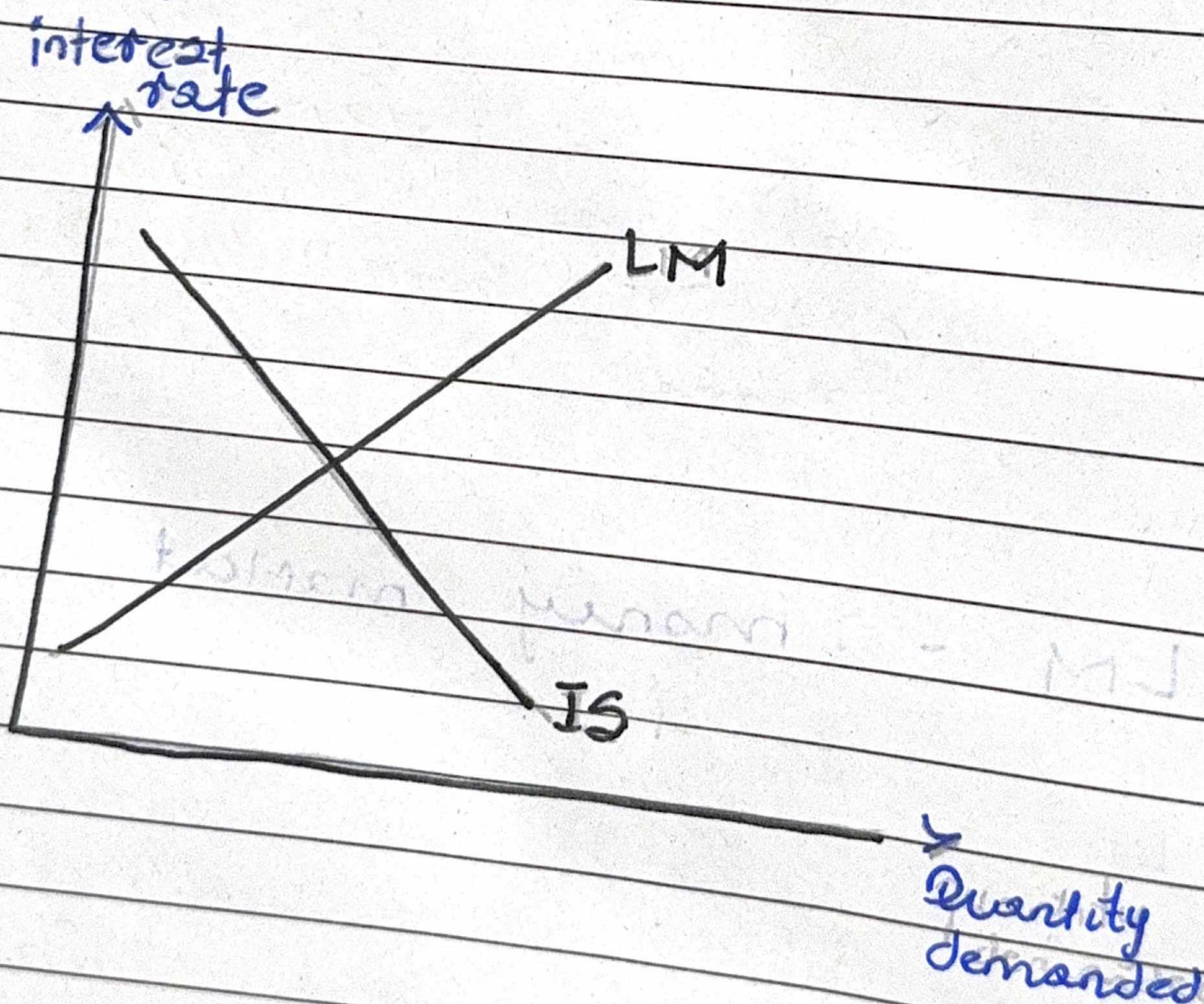
IS - I for investment and S for savings shows how both these react to changes

LM - money market

LM - liquidity for L and M for money illustrates how the financial-money market reacts to changes in interest rate

ISLM framework

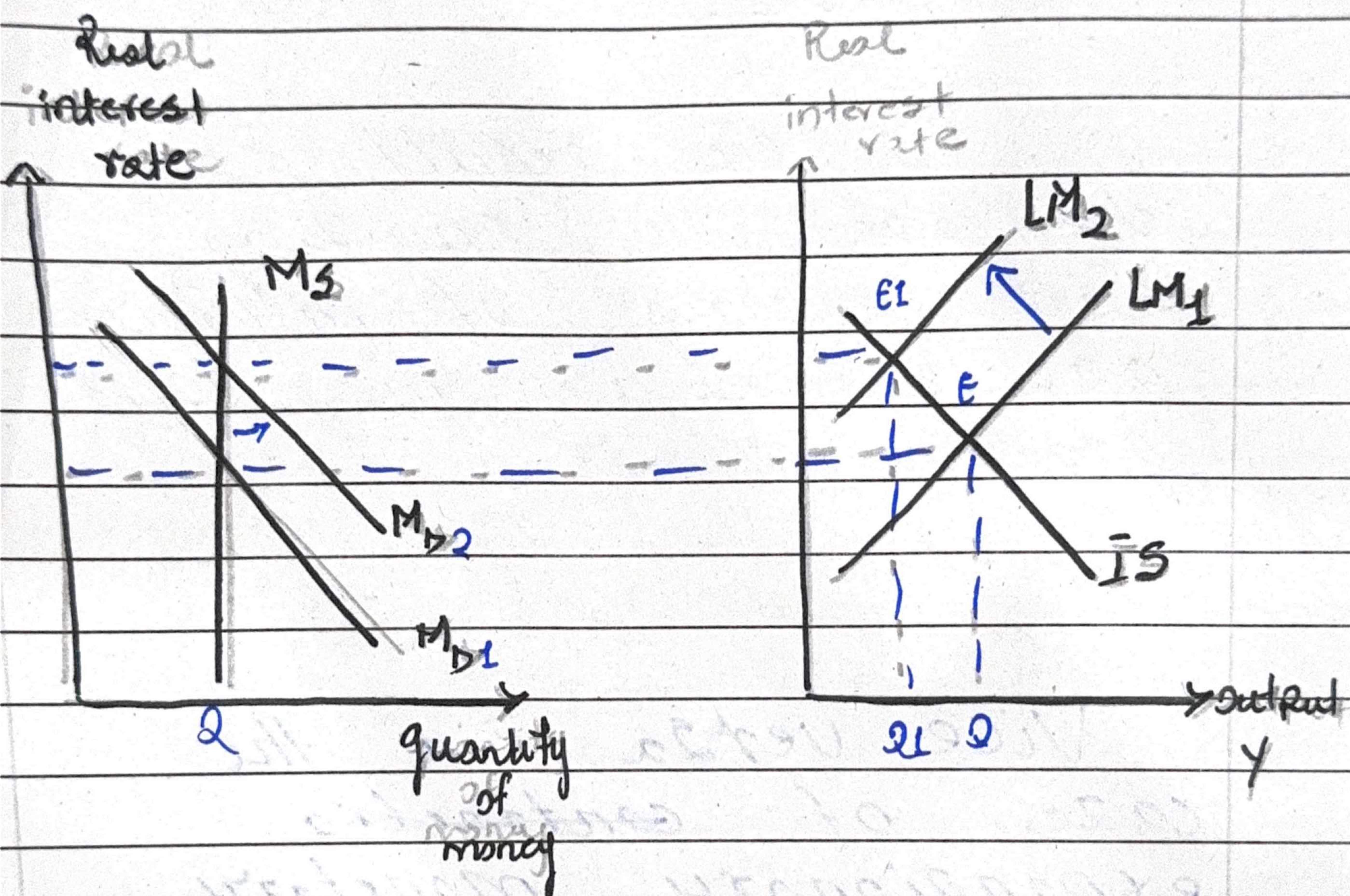
Together they represent the ISLM which shows how changes in interest rate & monetary policy impacts the goods and money markets



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Developing countries cases

1 Contractionary monetary policy



As the graph above illustrate, the government to decrease inflation in the developing country will try to follow a contractionary monetary policy. This will lead to an increase in policy rate from r_1 to r_2 .

As a result,

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people in the economy will be encouraged to save more and spend less as saving becomes attractive.

The end result, a decrease in spending and easing of inflation as shown in IS-LM graph

Vice versa in the case of ~~contractionary~~ expansionary monetary policy if the developing country is experiencing a recession and low inflation.

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3. Compare its usefulness with AD-AS analysis, highlighting strengths and limitations.

Aggregate demand and aggregate supply analysis shows the impact of shifts in either demand or supply side and their impact of output.

Strengths & Limitations

1.

Strengths

the role of central bank highlighted

interest rate impact comprehensively illustrated

joins goods and money markets

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1. Combined goods and money market - comprehensive

The goods and money markets role is explained and highlighted how each responds when changes in the economy takes place. Unlike AD-AS approach that fails to explain both these markets

2. impact of interest rate highlighted

The impact of interest rate is explained in depth, which is linked upon at the higher level in AD-AS model.

3. Investment and Savings decision profoundly explained

How investment and saving decision changes when there is a change in government policy is explained in-depth and the rational of how these changes ensue. Unlike the AD-AS model.

4. The desire to hold liquidity and money comprehensively showed

Why people hold money and when they prefer liquidity is explained in the model. The typical AD-AS model lacks this.

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Limitations

1. Supply side factors ignored

The supply side factors ignored, such as what happens when their is rise in the cost of raw materials
e.g. OPEC crisis

2. Overemphasis on role of central bank -

The central bank at times cannot influence decisions of people.

e.g. Volcker disinflation

3. role of expectations not explained

The role of expectations ignored in the model that people take into account future uncertainty as well when making decisions.

4. Rigidity in the economy not highlighted

Sticky wages - firms are in contract cannot change prices immediately.

Sticky prices
menu costs

the business have cost and cannot instantly change their cost of items.

Delay to
internalize
changes

it takes a while
for consumers and
business to internalize
changes.

Conclusion

The IS-LM model
comprehensively explains
how changes in the
economy take place
given certain factors
and the role of
central banks monetary
policy. It is more
comprehensive with
the comparison to
AD/AS model but
ignores some important
factors like all
economic models.

Question 4

1. Introduction

Kynesian framework and the classical school are both pivotal in seeing how economy resets as a whole to various factors and different approaches that can be taken. Whereas the Keynesian approach is about taking an active role in running of the economy, the classical approach is a more passive approach in dealing with the economy as a whole.

2. Critical evaluation of Keynesian framework and classical school in addressing inflation, unemployment.

A. Keynesian approach

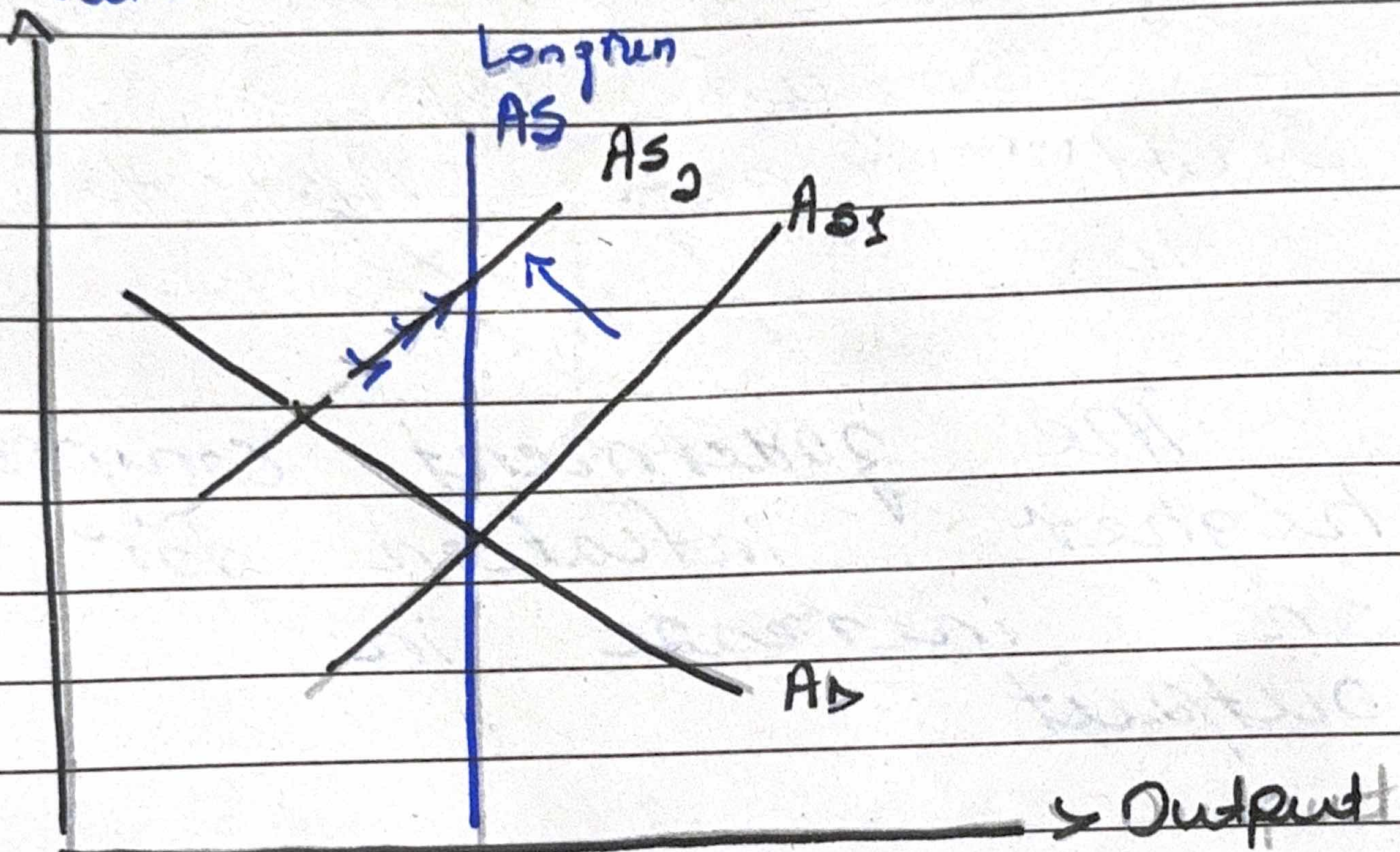
The Keynesian approach sees that economy is free by less constraints in the long-run than in the short-run.

→ The aggregate supply according to Keynesian theory is vertical in the ~~short-run~~ long-run

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$$\text{unemployment} = \text{natural rate} + 2 (\text{current} - \text{expected inflation})$$

inflation - price
rate



As the graph above illustrates, A shift in short-run aggregate supply from AS_1 to AS_2 will increase inflation and unemployment as less demand for workers - (raw materials price increases). Due to rising costs.

Keynesian approach states that the

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the government should intervene and increase output by following an expansionary fiscal policy increase.

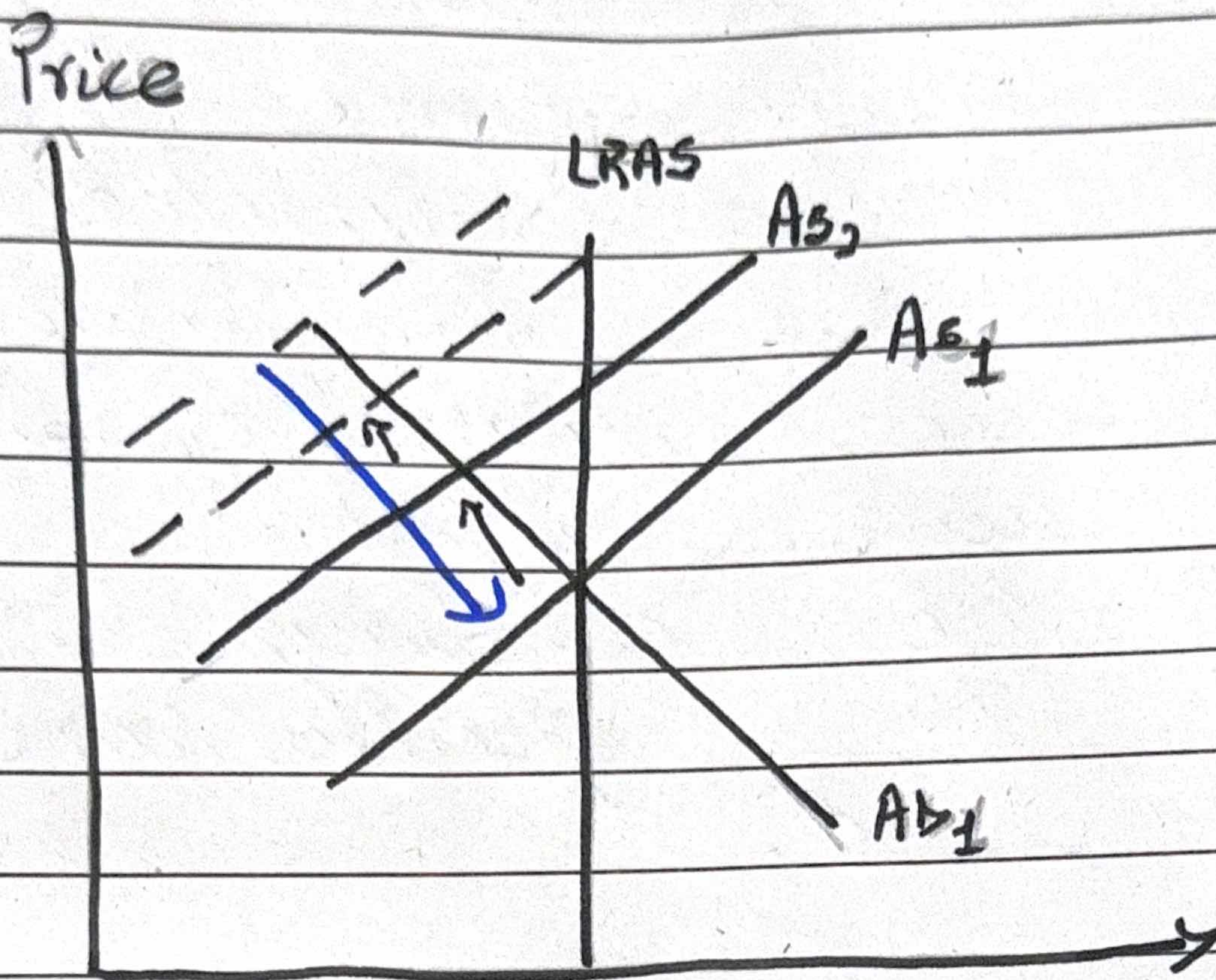
Aggregate demand this is shown by a shift from AD_1 to AD_2

The government compromises higher inflation for an increase in output

Classical view

The unemployment will decrease as a result due to an increase in output. This expansionary policy ensures that government does not stay complacent. In the long run, government has compromised higher inflation for higher output

Classical view



According to classical view the government should not intervene.

The economy will come back to its natural level of output.

Rational is that as firms hire workers in the economy in the short run workers will refuse to work at lower wages but in the long run as higher inflation but as

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Firms close down or keep firing workers - AS_1 to AS_4 their unit come a point when workers will begin to work at low wages (AS_4 and AS_1) and this will bring back the economy back to equilibrium level E .

The government without intervention achieved low inflation and unemployment.

Critical evaluation

The classical view was misguided. In the 1930s great depression as markets failed to self correct due to unions - wage stickiness. A period of stagflation high unemployment and inflation. Keynes suggested governments need to follow

expansionary ^{fixed} monetary
policy. This is
why Keynes is called
Saviour of Capitalism.

Conclusion

As shown above,
Keynes called the
Saviour of Capitalism
as the Keynesian
theory gives government
an active role.

Markets do not always
correct themselves and
governments need to
intervene to bring
economy to an
optimal equilibrium.

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Question 5

1. Introduction

Monetarists, such as Milton Friedman, have highlighted the importance of central bank in a economy. However it is a lender of last resort and ensures commercial banks do not practice predatory practices that jeopardize the effective functioning of the economy.

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2. Theoretical and practical arguments to assess the role of central bank as a ^{regulator of} commercial lender banks and lender of last resort

1. Printing of currency

Central bank plays a pivotal role of issuing currency.

It ensures that there is adequate available cash in the economy through which people can maintain a sufficient level of liquidity.

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2. Reserve ratio

The reserve ratio is the amount of lending that banks can do. A higher reserve ratio means less lending. If banks given reserve ratio of 10% can lend 90% of deposits - credit creation

3. Prevents bankruptcy

Central bank ensure that major State owned enterprise, commercial banks and government itself does not go bankrupt and actively monitors the credit risk in the economy.

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4. Issues bonds

Central bank issues bond for the government that allow it to borrow from the people

5. Decides interest rates - Policy rate

A. impact on investment - borrowing

Central bank sets the interest rate on which basis people can borrow from each other. The private sector borrows when interests low & vice versa.

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B. impact on savings - lending

The savings reduce when central bank ~~but~~ decides a higher ^{lower} interest rate when people are discouraged to save more and the spending increases in the economy.

→ This gives boost to the economy.

→ on the other hand when interest rate increased people start to get higher return on savings.

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3. How effective are these functions in preventing financial crisis in weak institutional settings?

1. Stabilize currency
- exchange rate

The central bank stabilizes currency when there is excessive depreciation by increasing the interest rate. People prefer the domestic currency to foreign currency. This increases the value of currency and stabilizes it.

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2. Prevents bank runs

The central bank
by ensuring banks
stay liquid and
guaranteeing people
their deposits
ensures that
people do not go
for depositing out
all their cash in
crisis.

3. Eases inflation - Store of value of currency maintained

Fisher equation = $MV = PQ$

if prices are increasing
the central bank
increases the
policy rate and
issues securities in
the market to suppress spending.

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4. Government liquidity maintained can borrow

Government can borrow from the central bank if it has low liquidity and this ensures effective working of the governments projects.

5. Line of credits - LCs for business

The central bank gives Line of credits through which businesses can import from the foreign countries and import goods and capital. The central bank guarantees to payback in dollars on behalf of local business.

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6. Reserves of government maintained with central bank

The foreign reserves of the country are held with the central bank and it ensures that the country is maintaining sufficient reserves to pay creditors.

Conclusion

The central bank ensures that the country's financial system works effectively and there is trust in the financial system of the country. It ensures that the economy does not go of complete chaos.