Macroeconomics closing a recessionary gap assignment

Economics

a. The Policy that the Fed will implement to close the recessionary gap is called the Expansionary Fiscal policy. The Federal bank in the United States has the power to both make the laws and pass them too. If the economy is operating at a capacity lower than its optimum output, there is a recessionary gap in the economy. Thus if the general level of employment in the economy is lower than its optimum level, the output generated will also be lower. The Fed can influence the supply of money in the economy which is instrumental in dealing with recession or inflation for that matter.

To take care of this gap, the Fed has various means available on hand. The Fed can take any or all of the following actions to tackle the recessionary gap: ??? Open market operations: These refer to purchase of Government securities such as bonds and treasury bills to control recession. ??? Interest Rate: This is the rate of interest that the Fed charges commercial banks for borrowing. In a recession, the Fed would reduce the interest rates at which it lends money to the commercial banks. The banks are expected to pass on this benefit further to the general public and thus it in effect reduces the market interest rate. Reserve requirement: This refers to the proportion of deposits that commercial banks have to maintain as reserves. The banks are required to keep a certain portion of the funds deposited with them as liquid cash. This should be kept idle in the vaults of the banks and this amount is not available for further lending. For dealing with recession, the Fed would reduce the reserve requirement. b. The above steps taken by the Federal Bank would result in reducing the recessionary gap. This can be explained as follows. ??? Open market operations: Purchase of Government securities and bonds would increase the money supply in the market.

When the Fed starts purchasing bonds, the demand for bonds will increase leading to a hike in their prices. The money supply in the hands of the general public who will be selling these bonds will thereby increase. This will increase their purchasing power and gradually reduce recession. Also, the higher price of bonds reduces the interest rates, which will further stimulate investment. ??? Interest Rates: By reducing the interest rate at which commercial banks borrow from the Fed, the Fed ensures that banks would borrow more funds. In that scenario, the banks would in turn have more funds to lend out to the general public in the conomy. This will result in a lowering of the market rates and thus spruce up investment in the economy. ??? Reserve requirement: By reducing the reserve requirement, again the same purpose will be solved. The Banks will have more amount of money to lend for various purposes. In that scenario, the money supply in the market will increase and the interest rates will reduce again boosting more investment. Another effect of reduced interest rate is that the reduced interest rate will increase supply of dollars and reduce demand for it. This results in reducing the rate of exchange of dollars thereby boosting exports.

This will increase investment and a shift in Aggregate demand curve to the right thereby closing the recession gap. ??? The effect can be illustrated with the help of the following diagrams In the above graph, we can see that by reducing the reserve ratio, the money supply increases from M to M1. Thus, the market rate of interest reduces from r1 to r2. The effect of the drop in market interest rate can be seen in the next graph The above diagram, shows the increase in supply of dollars and a corresponding drop in demand for dollars. This leads to lowering of Exchange rate of dollars in international economy from E1 to E2. c.

As we have already discussed, the lower interest rate and higher money supply in the hands of the public will increase investment. This will also increase their spending since their purchasing power will increase. Not surprisingly, the aggregate demand of the economy will increase. The natural effect of the increase in aggregate demand will be an increase in the general price level. This will result in bailing out the economy from recession. This can be explained in detail with the help of the following graph: The recessionary gap is Y2-Y1 which means that the economy is performing at Y1 capacity though it has a potential to perform at Y2.

Current price level is P1 and current aggregate demand is AD1. By shifting the aggregate demand curve from AD1 to AD2, the recessionary gap is closed and the result is that the general price levels increase from P1 to P2. Also this pushes the economy to operate at level Y2. Answer 2. a. Reserve ratio is a fixed percentage of deposits made by the public that commercial banks are required to keep with themselves as liquid cash. This amount cannot be given away for further lending and has to be available with banks at all times.

If the required reserve ratio is 15%, the Worley bank will be required to keep 15% of $200 = $30 as reserve. b. The savings of $200 which is an asset for us will be recorded as a liability in the bank's accounts. This is because, a depositor has deposited the money with the Bank and it is the duty of the bank to return the amount to the depositor. Thus, it becomes a liability of the bank to return the amount and is recorded as a liability. The Bank will record an inflow of cash of $200 as an increase in its asset but the corresponding double entry will record a liability of $200 as deposits made by public which is repayable.