

## Homework #4- Fall 2001

- A) During a recession a decline in unemployment benefits greatly affects economic activity. During a recession when a large portion of the country's labor force is unemployed, and we assume that there are unemployment benefits, economic activity falls because consumers have a limited income from benefits. Consumers will save more and spend less due to the uncertainty of the job market. But without unemployment benefits an unemployed labor force has no source of income. Therefore, consumers will be consuming nothing, only trying to hold on to what they already have. This lack of consumption, due to a lack of unemployment benefits, increases the severity of a recession. I would consider the unemployment benefits by government as a "stabilizer" of economic cycles because by providing a small amount of income for the unemployed they keep consumer spending from crashing. With benefits spending may still decrease but it will not completely crash. Consumer consumption is a significant determinant of economic cycles therefore if unemployment benefits help stabilize consumption they will in turn stabilize the economy.
- B) The service sector includes such industries like hotels, restaurants, airlines and auto rental agencies. The service sector helps to stabilize economic cycles because the demand for service activities is less volatile and independent from the demand of physical products (manufactured goods). In the past the service sector has been more stable than the manufacturing sector because its profits are less volatile and it has grown significantly more than the manufacturing sector. The terrorist attacks have hit the services sector hard and since the service sector is such a major source of income for our economy, larger than the manufacturing sector, I think it will take us longer than usual to end this recession.

2.

A) When output falls so will the number of home mortgages. The number of home mortgages is a pro-cyclical economic variable. Banks will not be eager to issue home mortgages when income is drastically decreased during a recession. Households are a higher credit risk to banks.

B) During an economic downturn I would expect banks to tighten their terms for lending to households because a decrease in income makes them a higher credit risk. This behavior will decrease the effectiveness of the Fed's "expansionary" monetary policy because with less loans/mortgages being issued households are left with no breathing room. The money supply is not expanded and consumers cannot borrow, therefore they cannot return to their normal consumption levels. This furthers a recession rather than ending it.