Chapter 33

1. For the following four cases, trace the impact of each shock in the aggregate demand and aggregate supply model by answering the following three questions for each: What happens to prices and output in the short run? What happens to prices and output in the long run if the economy is allowed to adjust to long-run equilibrium on its own? If policy makers had intervened to move output back to the natural rate instead of allowing the economy to self-correct, in which direction should they have moved aggregate demand?

a. aggregate demand shifts left

b. aggregate demand shifts right

c. short-run aggregate supply shifts left

d. short-run aggregate supply shifts right

2. The following events have their *initial* impact on which of the following: aggregate demand, short-run aggregate supply, long-run aggregate supply, or both short-run and long-run aggregate supply? Do the curves shift to the right or left?

a. The government repairs aging roads and bridges.

b. OPEC raises oil prices.

c. The government raises unemployment benefits, which raises the natural rate of unemployment.

d. People feel more secure in their jobs and become more optimistic.

e. A technological advance takes place in the application of computers to the manufacture of steel.

f. The government increases the minimum wage.

g. Because price expectations are reduced, wage demands of new university graduates fall.

h. The central bank decreases the money supply.

i. A drought dramatically reduces the country's agricultural output.

3. Suppose the economy is in long-run equilibrium. Then, suppose the central bank suddenly increases the money supply.

a. Describe the initial impact of this event in the model of aggregate demand and aggregate supply by explaining which curve shifts which way.

b. What happens to the price level and real output in the short run?

c. If the economy is allowed to adjust to the increase in the money supply, what happens to the price level and real output in the long run? (compared to their original levels)

d. Does an increase in the money supply move output above the natural rate indefinitely? Why?

4. Suppose the economy is in long-run equilibrium. Then, suppose workers and firms suddenly come to expect higher prices in the future and agree to an increase in wages.

a. Describe the initial impact of this event in the model of aggregate demand and aggregate supply by explaining which curve shifts which way.

b. What happens to the price level and real output in the short run?

c. What name do we have for this combination of movements in output and prices?

d. If policy makers wanted to move output back to the natural rate of output, what should they do?

e. If policy makers were able to move output back to the natural rate of output, what would the policy do to prices?

f. If policy makers had done nothing at all, what would have happened to the wage rate as the economy self-corrected or adjusted back to the natural rate of output on its own?

g. Is it likely that an increase in price expectations and wages alone can cause a permanent increase in the price level? Why?

5. Suppose the economy is at a point such as point B in Exhibit 2. That is, aggregate demand has decreased and the economy is in a recession. Describe the adjustment process necessary for the economy to adjust on its own to point C for each of the three theoretical short-run aggregate-supply curves.

a. the sticky wage theory:

b. the sticky price theory:

c. the misperceptions theory:

d. Do you think the type of adjustments described above would take place more quickly from a recession or from a period when output was above the long-run natural rate? Why?