AS/AD: Key

1. Recall that we derived the AD curve by changing prices, and thus the real money supply, and thus the interest rate. This is still true. But now, the change in the interest rate produces no change in output. So the aggregate demand curve is vertical, changing the inflation gap has no affect on output.
2. Now, any change in interest rates (that was caused by a change in prices) affects not only consumption and investment, but government spending as well. Thus, changes in the inflation gap have larger changes on the output gap. In our graph, AD is flatter.

3. The AD curve shifts to the right and both the output gap and inflation gap increase.

4. The AD curve shifts to the left and both the output gap and inflation gap decrease.

5. Consider an increase in the price level. This causes inflation and the inflation gap to be bigger. This also causes the real money supply, M/P to be smaller. Now consider the market for money. Less supply raises the price, which is the interest rate. Higher interest rates make it more expensive to borrow in order to consume or invest. As consumption and investment decrease, so does output.

6. It will be vertical. Changing P now has no affect on employment which always equals one. It therefore has no effect on output. Any inflation gap yields the same level of output.

7. Suppose that nominal wages are sticky. When prices increase, so does the inflation gap. Also, real wages, W/P fall. As labor becomes cheaper, firms hire more of it and production increases.

8. AS shifts right. The output gap increases and the inflation gap decreases.

9. AS shifts left. The output gap decreases and the inflation gap increases.

10. False. Both may be either positive or negative. A negative output gap does not imply that output is negative (which would make no sense). It just means that output is less than it would be if unemployment equaled its natural rate.

11. This is an example of a shock that reduces both aggregate supply and aggregate demand. Because effects reduce output. Reduced AD decreases inflation while reduced AS increases inflation. These effects need not cancel each other out, so we cannot say that there is no change

in inflation. That effect is ambiguous; it may increase or decrease but we do not have enough information to say.

12. On the steep part of the AS curve, monetary policy has large effects on inflation, but not output. So if the goal of the policy is to change inflation, then it is relatively effective. But if the goal is to impact output, it is relatively ineffective.

13. False. We change the price level and consider teh effect on output in the markets for goods and services in order to derive the AD curve. Changes to the price level thus cause the economy to move along teh AD curve. It does not cause the AD curve to shift.

14. In the short-run, only labor demand affects employment in our model of aggregate supply. There is thus no short run effect. In the long-run, the equilibrium level of employment declines and so does potential output. LRAS shifts to the left.