AS/AD: Key

1. Now, changes to inflation do not affect output. The AD curve is thus vertical.

2. Now, any change in inflation affects not only consumption and investment, but government spending as well. Thus, changes in the inflation have larger changes on the output. 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. There are many potential reasons. In class, we focused on how inflation increases the level of risk that households and firms face. Because they are risk averse, they respond to increased risk by reducing their consumption and investment. Higher inflation thus leads to lower output.

6. It will be vertical. Changing π 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. 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.

11. 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.

12. False. We change the price level and consider the 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 the AD curve. It does not cause the AD curve to shift.