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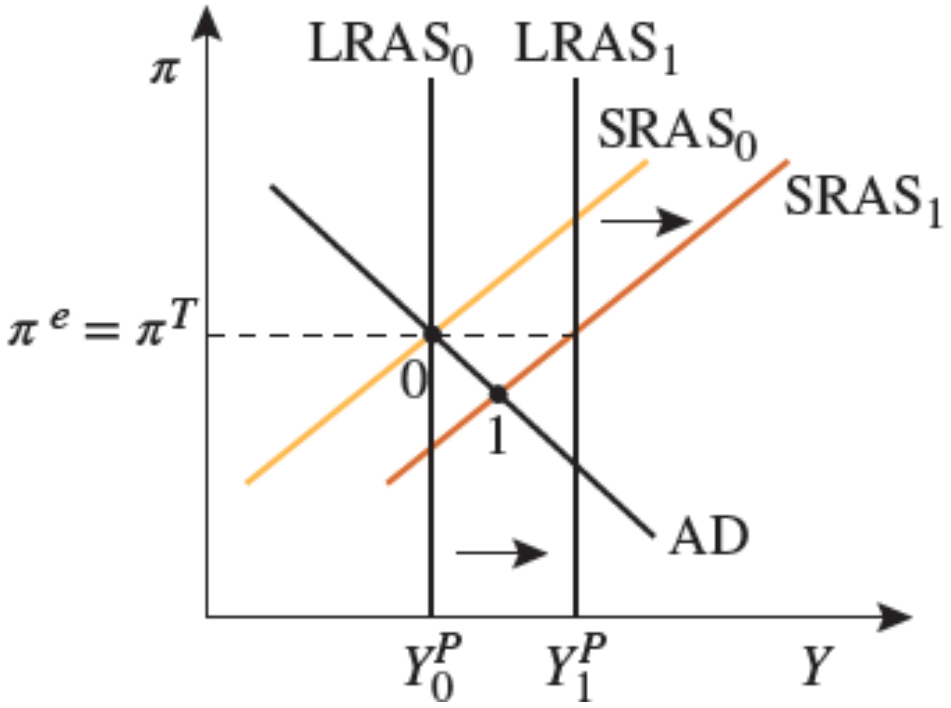
- *In the short-run*, **output** *and* **inflation** are <u>determined by</u> the **intersection** of **SRAS** and **AD**.
- Since **AD** is **unchanged**, the ***economy is at <u>point 1</u>*** in the short-run.

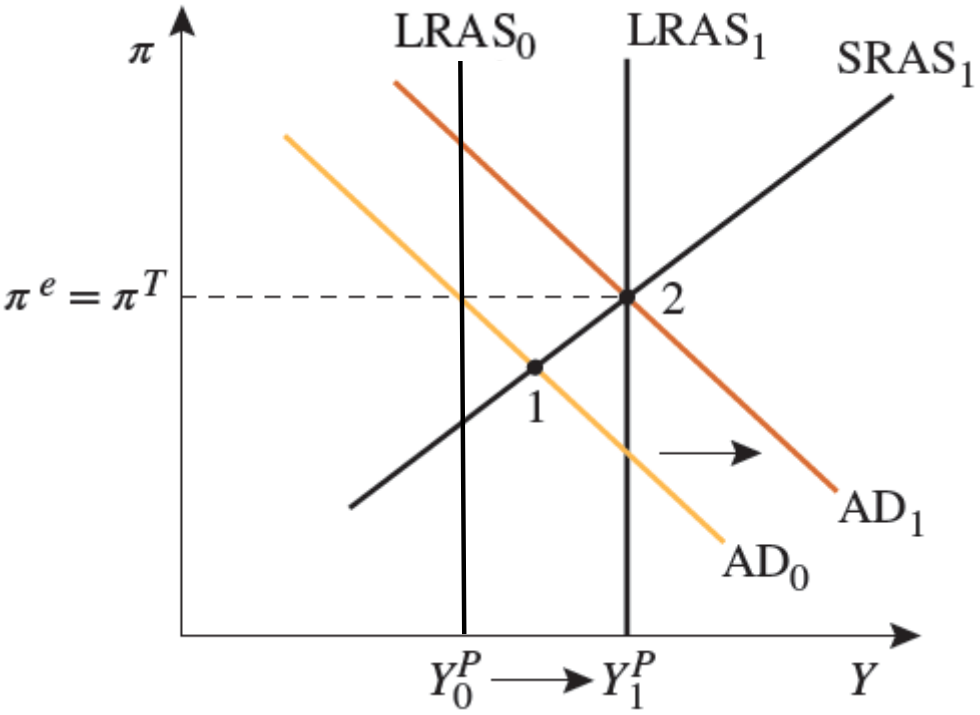


Monetary Policy Response

- In the **long run**, **output** must *go to the* ***new*** *level of* **potential output**, $\mathbf{Y^P_1}$.
- *Central Bank should respond to bring economy reaching potential output* $\boldsymbol{Y^P_1}$ *in two ways*

(1) Central bank tries to keep inflation remain on target

- Central bank will ***work to move*** *the economy* to the point on the **LRAS curve *consistent with*** its **target**.
- Therefore, central bank will ***cut*** **long-run real interest rate**, *shifting* the **MPRC** to the **right.**
- **AD** curve shifts to the **right**, aiming to **return inflation** to its *target level*.
- The policy adjustment will *drive* ***output*** and ***inflation*** *up* until they **reach their new LR equilibrium level** at the ***original inflation target*** and $\mathbf{Y^P_1}$.



(2) Central bank allows the economy to reach new potential output at lower inflation

- Central bank **allows economy to reach new inflation target** at lower rate.
- *Expected inflation* given by the intersection between LARS1 and SRAS1 (point 2) is *higher than current inflation*, represented by the equilibrium (point 1), therefore, ***economic agents revised their expected inflation downward as SRAS shifting rightward to SRAS2*** so that inflation falls to π^T1
- Here, central bank **does *not* use open market operation to change reserve and money supply in order to alter its long-run real interest rate or its inflation target,** and thus *monetary policy reaction curve (MPRC)* ***stays unchanged.***