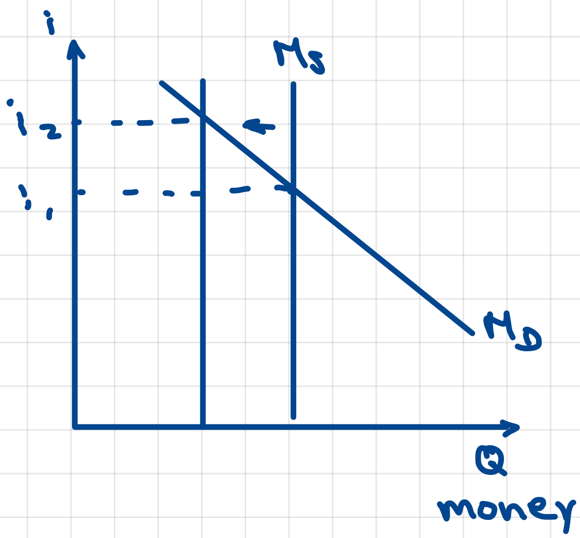
Name: Sournarabady San

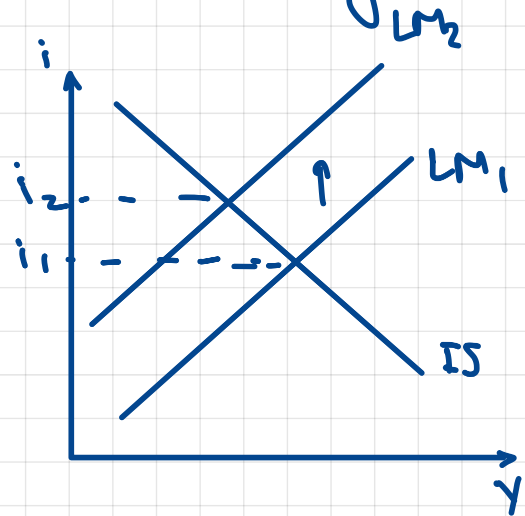
ID: 6304850032

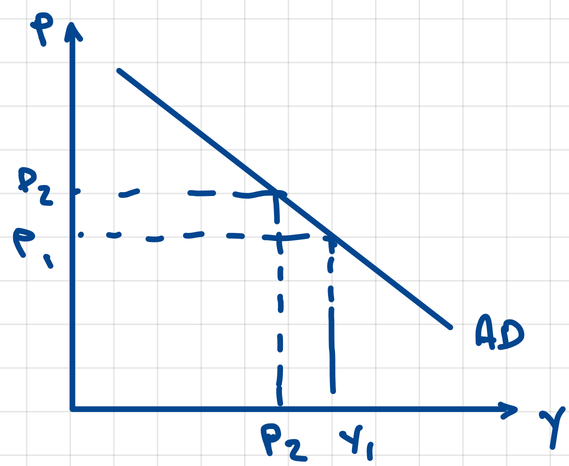
Exercise 7

Answers:

1. Explain why AD is downward sloping:



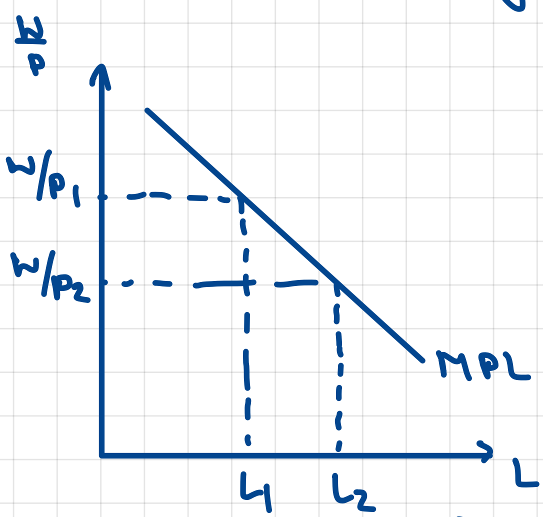


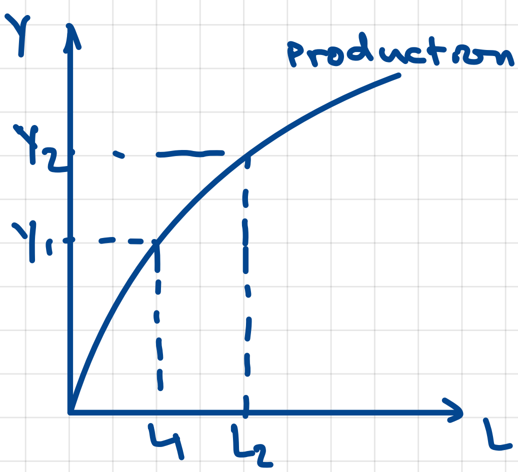


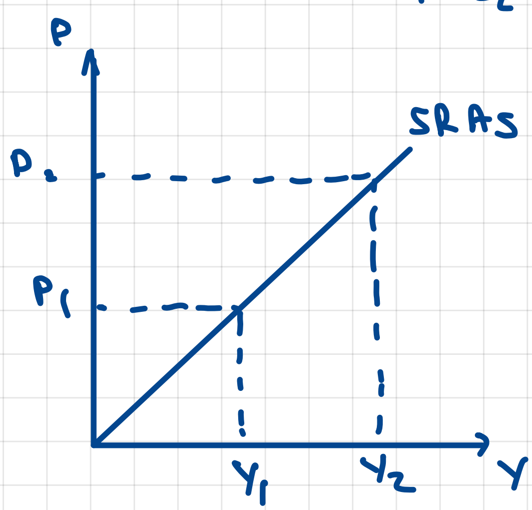
When P↑ → Ms↓ → i↑: increase in price shifts Ms to the left and increases i. When i increases there is less investment leading to lower output (Y↓). This illustrates the negative relationship between P and Y: P↑ → Y↓ and vice versa → AD is downward-sloping.

② Sticky wage refers to the inability to adjust of wage that maybe due to employment contracts, minimum wage, etc. In theory, when P↑ wage is sticky and can't adjust accordingly leading to a decrease in real wage. This encourage employer to employ more workers. More labor also means increased output.

$P\uparrow \rightarrow$ real wage $\downarrow \rightarrow$ labor $\uparrow$, $Y\uparrow$





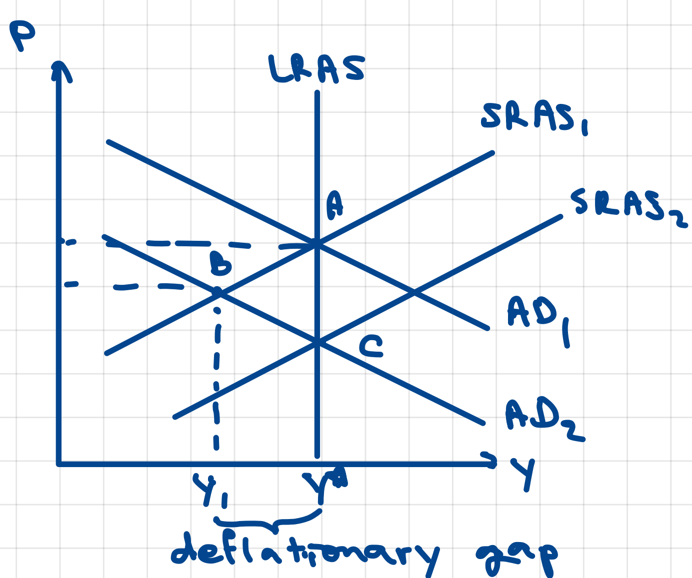


③. LRAS is vertical because in the long run, wage is no longer sticky be flexible according to price. There will be no labor demand. Thus, output won't rely on price anymore.

④.

Variable/Event	AD	SRAS	LRAS
P↑	down	up	no effect
G↓	down	no effect	no effect
T↓	up	no effect	no effect
Autonomous C↑	up	no effect	no effect
Autonomous I↓	down	no effect	no effect
M↓	down	no effect	no effect
i↑	down	no effect	no effect
Temporary epidemic (assuming AD unchanged)	No effect	left	no effect
Permanent increase in population growth rate (assuming AD unchanged)	No effect	right	right
W↑	no effect	left	no effect
Bad seasonal weather	no effect	left	no effect
Permanent loss in agricultural land due to climate change	no effect	left	left
Discovery of new technology	no effect	right	right
Short-term worker training	no effect	left	no effect
Permanent education reform	no effect	right	right

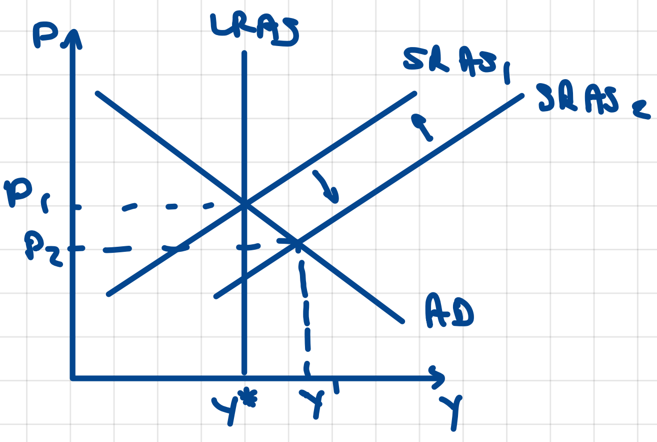
⑤. -The economy faces negative AD shock → AD shifts downwards. At B, there is a deflatory gap which output would be produced under full employment.



. If government wants to intervene, it can employ expansionary fiscal policies by increasing G or decreasing T to encourage consumption. G↑ → Y↑ → AD shifts up to equilibrium at point A.

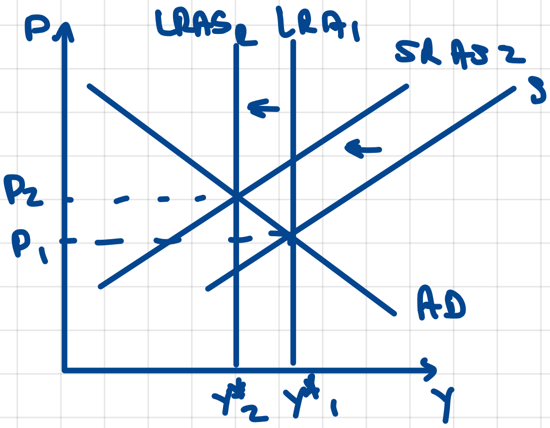
. If the government doesn't intervene, AD shifts downward and SRAS will shift downward too since there is no demand for the output. Since wage is sticky in SR, a portion of labor force will be laid off due to increased real wage. In LR however, wage will adjust to price and real wage becomes reasonable again leading to firms hiring back labor force.

⑥ .- When the economy faces temporary positive AS shock, SRAS will shift to the right. For example can be clearer traffic that lead to better supply.



- If there is no government intervention, as SRAS shifts to the right, output increases as price decreases. However, wage is sticky and as price decreases real wage goes up → higher production cost → firms produce less shifting SRAS back left.

⑦ The economy faces permanent negative AS shock, SRAS and LRAS will both shift to the left. An example would be running out of coal.

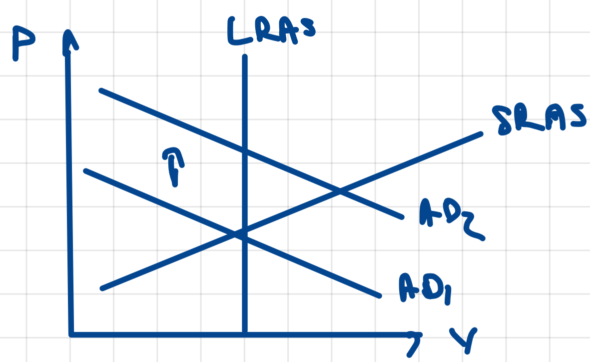


- If the government doesn't intervene, SRAS will shift to the left → higher price and lower output. LRAS also shifts which also leads to relatively lower output with higher price.

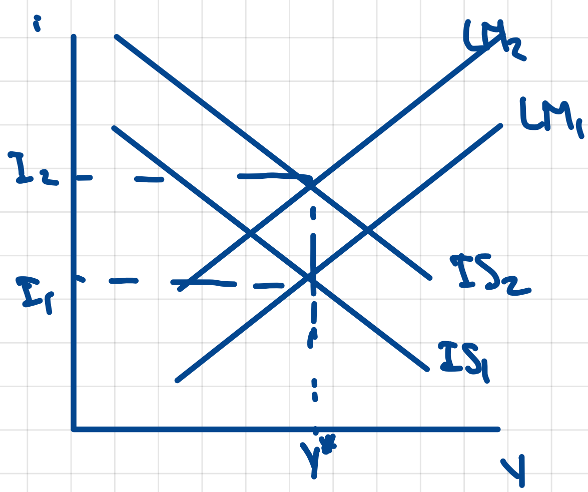
⑧ Money neutrality holds true for AD-AS model. AD-AS analyzes economy both in SR and LR. Money supply doesn't affect aspects like employment as the economy adjusts itself back to equilibrium at full employment output.

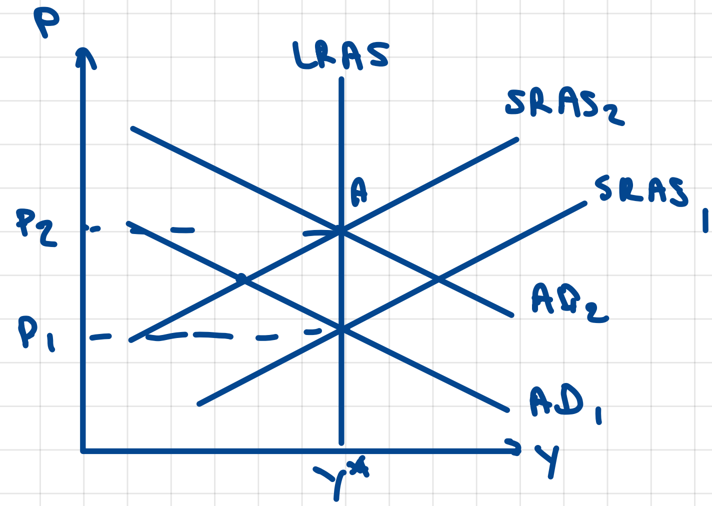
⑨. To change output LR, government can look at alternatives like investing in education to create permanent benefit in the long run (LRAS shifts right).

⑩. The trade-off in SR means that if AD shifts up there will be unemployment, but at a high inflation. In LR however, wage can adjust to price and thus output will at full employment despite inflation.



11 IS-LM: AD-AS





When G↑:

- IS shifts up because AE↑
- AD shifts right → P↑
- LM shifts left due to decreas in Ms
  - → new equilibrium IS-LM occurs at higher i but same Y*

- AD shifts right indicating deflationary gap, but when in LR there will change in wage due to flexibility indicating a new SRAS → new equilibrium.