Review questions for chapters 11 and 12.

1. The long run aggregate supply (LRAS) curve is vertical at the full employment level of output ($y_f$).
   a. Use the labor market and production function to illustrate how $y_f$ is determined.
   b. Use the labor market and production function to illustrate how each of the following would affect $y_f$.
      • an increase in labor supply
      • an increase in labor demand
      • an upward shift in the production function.
   c. Explain how each of the following would affect $y_f$.
      • a tax cut that encourages more people to work.
      • good weather that improves agricultural production
      • an increase in imported oil prices
      • a technological innovation that improves productivity
      • deterioration of capital in the economy
   d. If the economy is currently producing more than $y_f$,
      • is the unemployment rate above or below the natural rate of unemployment?
      • is there upward or downward pressure on real wages?
      • how will the economy return to full employment?
   e. If the economy is currently producing less than $y_f$,
      • is the unemployment rate above or below the natural rate of unemployment?
      • is there upward or downward pressure on real wages?
      • how will the economy return to full employment?

2. What is the real balance effect? What does it have to do with aggregate demand?

3. What are the four components of aggregate demand?

4. Which component of aggregate demand is the most volatile over the business cycle?

5. Explain why each of the following will affect aggregate demand and the direction of the effect.
   a. an increase in the money supply.
   b. an increase in consumer confidence regarding future job security and/or income growth.
   c. an increase in government purchases of goods and services.
   d. an increase in taxes on income.
   e. an increase in income in foreign countries that we trade with.
   f. a technological innovation that creates many new profitable investment opportunities.
   g. an increase in the value of the dollar in foreign exchange markets.

6. What is the major source of "sticky prices" in an economy?

7. What can make nominal wages "sticky" in an economy?
8. In the sticky wage model, if AD increases and the economy is pushed beyond the full employment level in the short run:
   a. is the unemployment rate above or below the natural rate of unemployment?
   b. is there upward or downward pressure on real wages?

9. If there are signs that the economy is moving beyond full employment, what response would the Federal Reserve make and why?

10. Suppose the economy is initially at a long run equilibrium -- as depicted in the diagram below. Suppose there is an increase in aggregate demand.

   ![Diagram](image.png)

   a. Explain the short run effect on prices, real wages, output, and unemployment.
   b. At the new short run equilibrium, is there upward or downward pressure on wages? Why?
   c. How does the wage pressure mentioned in b affect the SRAS over time and move the economy to its new long run equilibrium? Demonstrate this in a graph like that drawn above.

11a. Explain why the Phillips curve generally is downward sloping. What opportunity does this present for policy-makers?
   b. Explain why an increase in inflation expectations will cause the Phillips curve to shift right.
   c. If inflation exceeds the expected level of inflation, why will unemployment fall below the natural rate?

8a. What is “supply side” economics?
   b. What kinds of policies could positively influence the supply side of the economy?
   c. What kinds of “shocks” that are not controlled by policy makers could positively influence the supply side of the economy? negatively influence it?

12a. Explain how the 1982 recession may have been caused by Fed policies.
   b. Some argue that the 1982 recession would not have been as severe if the Fed had been “credible” in terms of its announcement that it would reduce money growth in inflation. Why would this be the case?

13a. In 1973 and 1979, imported oil prices increased substantially for the U.S. Given the likely effect on LRAS, what would you expect would happen to output and prices?
   b. Given your answer in (a), what could the Fed do to offset the effect on output? What would be the “down-side” of this Fed action?