

E01102 B, FINAL, ANSWER KEY, W08

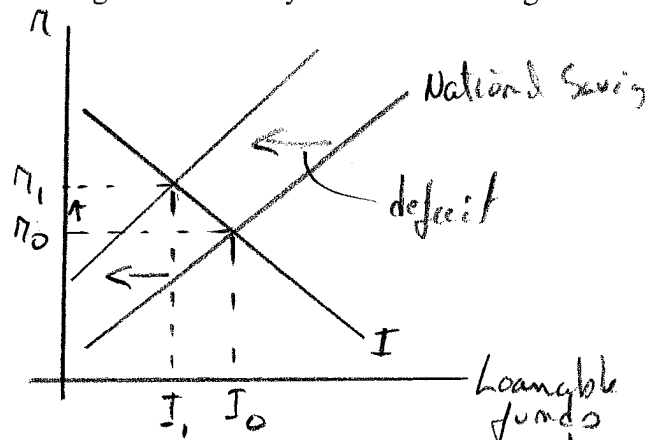
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72. The explanations for the slopes of the aggregate demand and aggregate supply curves are the same as the explanations for the slope of demand and supply curves for specific goods and services.
73. Technological progress shifts the long-run aggregate supply curve to the right.
74. Increased uncertainty and pessimism about the future of the economy decreases investment spending shifting aggregate demand to the left.
75. In response to a decrease in output the economy would revert to its original level of prices and output whether the decrease in output was caused by a decrease in aggregate demand or a decrease in aggregate supply.
76. Economists mostly agree that the Great Depression was the result of a very large adverse supply shock.
77. If the government increased the money supply in response to a decrease in aggregate supply, unemployment would return towards its natural rate, but prices would rise even more.
78. A recession has no benefit to society--it represents a sheer waste of resources.
79. Most economists agree that stabilization policy is likely to work despite lags in the effects of policy.
80. The cost of inflation reduction is a small but permanent increase in unemployment
81. The federal government has committed to eliminate federal public debt by 2021.

Short-Answer Questions (24 points)

Answer in the space provided.

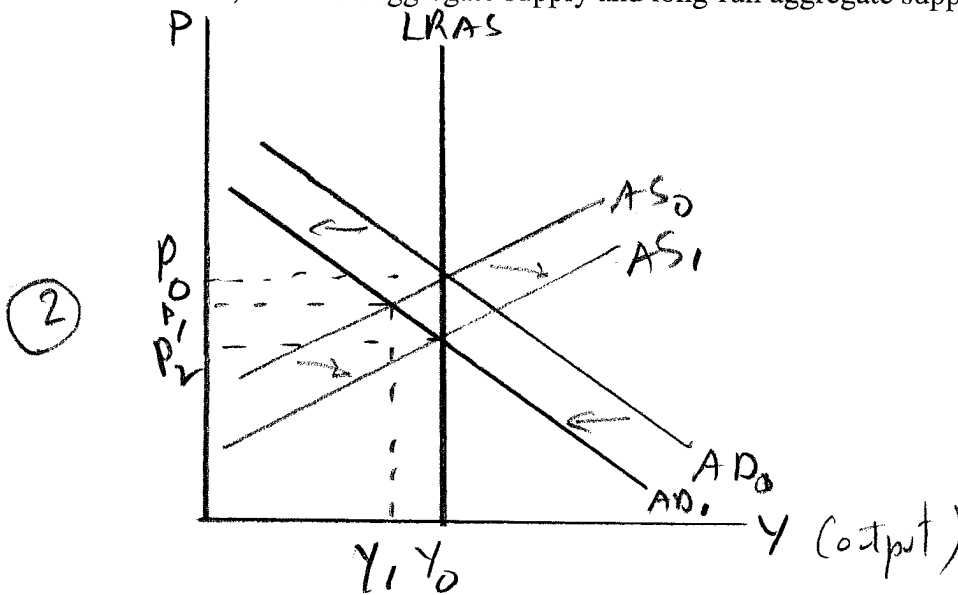
82. (4 points) Explain why sustained government deficits are likely to lead to lower living standards in the long run. You may want to use a diagram.



Sustained govt deficits reduce National saving \Rightarrow \uparrow in interest rate and \downarrow in capital investment \Rightarrow lower productivity and lower income.

X 83. (15 points) Suppose that the economy is in a long-run equilibrium.

a. Use a diagram to illustrate the state of the economy. Be sure to show aggregate demand, short-run aggregate supply and long-run aggregate supply.



b. Now, suppose that firms become pessimistic about future business conditions and significantly cut their capital investments. Use your diagram to show what happens to output and the price level in the short run. What happens to the unemployment rate?

② - AD curve shifts left $\Rightarrow \downarrow Y$ and $\downarrow P$

- Unemployment \uparrow since $Y \downarrow$

c. Assuming no change in policy, what would happen to output, employment and the price level in the long-run? Explain. (For now, assume that there is no change in the long-run aggregate supply curve).

② Because of higher unemployment, nominal wages \downarrow in long-run, which means that real wages \downarrow for every $P \Rightarrow$ real wages $\downarrow \Rightarrow$ Short-run AS curve will shift right in long-run.

In long run equilibrium, output and employment will be at their natural rate and

$P \downarrow$

↳ The Bank of Canada

d. Is there anything the government could do in the short-run to soften the impact on the economy? Explain.

②

- The govt could increase expenditures and/or the Bank of Canada could increase money supply
- Either would increase AD and pull back output and employment towards their natural rates
- Would increase the price level though

e. How might the drop in capital investment affect the long-run aggregate supply curve?

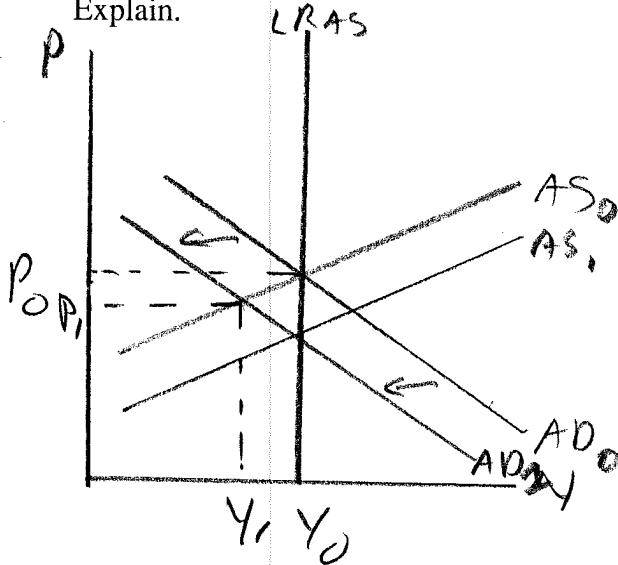
②

Drop in capital investment \Rightarrow \downarrow productivity
 \Rightarrow LRAS curve shifts left.

84. (5 points) In the 1970s people had become accustomed to high inflation. In 1979, the Bank of Canada decided to fight inflation and decreased the money supply growth rates. Many people thought that the Bank of Canada's action would cause a recession.

a. Is this thinking consistent with the aggregate demand and aggregate supply model?

Explain.



Yes. The AD-AS model predicts that a drop in MS \Rightarrow a drop in AD (i.e., AD curve shifts left) \Rightarrow \downarrow P but also \downarrow in Y

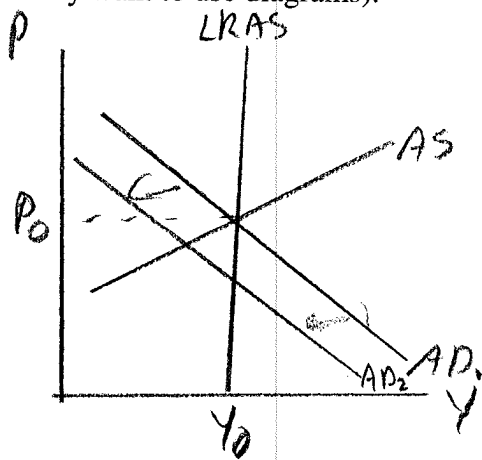
b. According to the sticky wage theory what should have happened to output if people had believed the Bank of Canada's commitment to reduce the inflation rate and had perfectly anticipated the drop in prices. Explain.

②

If people had perfectly anticipated the drop in prices, then nominal wages would have

dropped, that is short-run AS curve would have shifted right which means that the recession could have been averted.

85. (5 points) On April 22, the Bank of Canada will announce whether it increases, decreases or does not change the bank rate. What do you expect the announcement to be? Explain (you may want to use diagrams).



(I am not looking for an exact answer, just the direction of the change)

Some facts:

- US economy is slowing down $\Rightarrow \downarrow NX$
- Canadian stock markets are down $\Rightarrow \downarrow C, \downarrow I$

This strongly suggest that AD is shifting left. To counteract this the Bank of Canada will probably want to increase money supply by reducing the bank rate. In addition, at this juncture inflation seem to have subdued.

So everything seems to be pointing out to a decrease in the bank rate.