5EN 253
VSE, Spring 2010
Ex. session #11
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Exercise session #11 - Aggregate supply

Problem 1 - H 300/1

Assume closed economy with increasing SRAS curve.

- Using IS-LM and AS-AD models show the effect of increase in nominal money supply on real product and price level in the short and long run.
- Will there be a change in the supply of real money balances?

Problem 2 - H 272/2

Initial equilibrium in the economy is at the level of employment L_1^*, potential product Y_1^* and price level P_1^*. Then, because of technological progress there has been an increase in the labor force productivity. Use the short-term production function that describes the relationship between the product and amount of work, and show on the graph what will happen in the labor market, how will the domestic product change and how will the price level change (if we assume that central bank does not adjust nominal money supply).

Problem 3 - D-F 110/1

- If the government were to reduce income taxes, how would the reduction affect output and the price level in the short run? In the long run? Show how the aggregate supply and demand curves would be affected in both cases?
- What is supply-side economics? Is it likely to be effective, given your answer to the first part?

Problem 4 - D-F 110/2

Suppose that the government increases spending from G to G' while simultaneously raising taxes in such a way that, at the initial level of output, the budget remains balanced.

- Show the effect of this change on aggregate demand schedule.
- How does this affect output and the price level in the Keynesian case?
- How does this affect output and the price level in the classical case?

Questions for review:

Lecture 11: Aggregate supply

- Name three models of aggregate supply and what they try to explain.
- What is the main idea behind sticky-wage model? (How does this model explain positive relation of prices and output in the short run?)
- What implication of the sticky wage model is considered to be a major problem in comparison to real world data?
- What is the main idea behind imperfect-information model? (How does this model explain positive relation of prices and output in the short run?)
- What is the source of misperception in the imperfect-information model?
- State 3 reasons for prices to be sticky (why firms would not like to change prices)?
- What basic assumption of classical economy is sticky-price model departing from?
- What are the implications of sticky-price model for labor market and real wage?
- Explain effect of positive AD shock on the output and price level in the AD -AS framework, where SRAS curve is positively sloped .
- What are 3 determinants of inflation according to new Phillips Curve?
- Explain how you would derive Phillips curve from SRAS.
- What are adaptive expectations?
- When do we speak about inflation inertia?
- Explain two causes of rising / falling inflation.
- How do we measure sacrifice ratio?
- What is natural rate hypothesis?
- How does hysteresis theory challenge the natural rate hypothesis?