Liberty High School

AP Macroeconomics

Mr. Lopez

Chapter 33

Aggregate Demand and Aggregate Supply

Study Guide

Name:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ Period:\_\_\_\_\_

Part 1 –Key terms:

1. Recession:
2. Depression:
3. The Business Cycle:
4. Model of aggregate demand and aggregate supply:
5. Aggregate-demand curve.
6. Aggregate-supply curve:
7. Natural level of output:
8. Menu costs:
9. Stagflation:
10. Accommodative policy:

Part 2 Problems and short answers. You may need to draw a graph of the model of aggregate demand and aggregate supply on scratch paper.

1. For the following four cases, trace the impact of each shock in the aggregate-demand and aggregate supply model by answering the following three questions for each:. What happens to prices and output in the short run? What happens to prices and output in the long run if the economy is allowed to adjust to long run equilibrium on its own? If policymakers had intervened to move output back to the natural level instead of allowing the economy to self-correct, in which direction should they have moved aggregate demand?
   1. Aggregate demand shifts left?
   2. Aggregate demand shifts right?
   3. Short-run supply shifts left
   4. Short run aggregate supply shifts right
2. The following events have their initial impact on which of the following aggregate demand, short-run aggregate supply, long run aggregate supply, or both short-run and long run aggregate supply? Do the curves shift to the right or left?
   1. The government repairs aging roads and bridges.
   2. OPEC raises oil prices.
   3. The government raises unemployment benefits, which raises the natural rate of unemployment.
   4. Americans feel more secure in their jobs and become more optimistic.
   5. A technological advance takes place in the application of computers to manufacturing of steel.
   6. The government raises the minimum wage.
   7. Because price expectations are reduced, wage demands of new college graduates fall.
   8. The Federal Reserve decreases the money supply.
   9. A drought destroys much of the Midwest corn crop.
3. Suppose the economy is in long run equilibrium. Then suppose the Federal Reserve suddenly increases the money supply.
   1. Describe the initial impact of this event in the model of aggregate demand and aggregate supply by explaining which curve shifts which way.
   2. What happens to the price level and real output in the short run?
   3. If the economy is allowed to adjust to the increase in the money supply, what happens to the price level and real output in the long run when compared to their original levels. What name do economists attach to the long run impact of a change in the money supply on the economy?
   4. Does an increase in the money supply move output above the natural level indefinitely? Why or why not?
4. Suppose the economy is in long run equilibrium. Then, suppose workers and firms suddenly expect higher prices in the future and agree to an increase in wages.
   1. Describe the initial impact of this event in the model of aggregate demand and aggregate supply by explaining which curve shifts which way.
   2. What happens to the price level and real output in the short run?
   3. What name do we have for this combination of movements in output and prices?
   4. If policymakers wanted to move output back to its natural level of output, what should they do?
   5. If policymakers were able to move output back to the natural level of output, what would the policy do to prices?
   6. If policy makers had done nothing at all, what would have happened to the wage rate as the economy self-corrected or adjusted back to the natural level of output on its own?
   7. It is likely that an increase in price expectations and wages alone can cause a permanent increase in the price level? Why or why not?
5. Suppose the economy is at a point such as point B in exhibit 2. That is, aggregate demand has decreased, and the economy is in a recession. Describe the adjustment process necessary for the economy to adjust on its own to point C for each of the three theoretical short-run aggregate supply curves.
   1. The stick-wage theory
   2. The stick price theory
   3. The misperceptions theory
   4. Do you think the type of adjustments described above would take place more quickly from a recession or from a period when output was above the long-run natural level? Why or why not?
6. Name the three key facts about economic fluctuations.
7. What are the three reasons the aggregate demand curve slopes downward? Explain them.
8. Explain the slope of the short run aggregate supply curve using the stick wage theory.
9. Does a shift in aggregate demand alter output in the short run? Why or why not?
10. Does a shift in aggregate demand alter output in the long run? Why or why not?
11. If the economy is in a recession, why might policymakers choose to adjust aggregate demand to eliminate the recession rather than let the economy adjust, or self correct, on its own?
12. Which component of aggregate demand is most volatile over the business cycle?
13. Why is a decrease in the money supply unlikely to be neutral in the short run?
14. Suppose OPEC breaks apart and oil prices fall substantially. Initially, which curve shifts in the aggregate supply and aggregate demand model? In what direction does it shift? What happens to the price level and real output?
15. What causes both short run and long run aggregate supply to shift together? What causes only the short run aggregate supply to shift while the long run aggregate supply remains stationary?

Part 3 – True or False

1. \_\_\_\_\_over the last 50 years, US real GD{ has grown about 5% per year.
2. \_\_\_\_\_Investment is a particularly volatile component of spending across the business cycle.
3. \_\_\_\_\_An increase in price expectations shifts the long run aggregate supply curve to the left.
4. \_\_\_\_\_In the classical dichotomy and monetary neutrality hold in the long run then the long run aggregate supply curve should be vertical.
5. \_\_\_\_\_Economists refer to fluctuations in output as the “business cycle” because movements in output are regular and predictable.
6. \_\_\_\_\_One reason aggregate demand slopes downward is the wealth effect: A decrease in the price level increases the value of money holdings and consumer spending rises.
7. \_\_\_\_\_If the Federal Reserve increases the money supply, the aggregate demand curve shifts to the left.
8. \_\_\_\_\_The misperceptions theory explains why the long run aggregate supply curve is downward sloping.

Part 4 – Critical Thinking

1. You are watching the evening news on television. The news anchor reports the union wage demands are much higher this year because the workers anticipate an increase in the rate of inflation. Your roommate says “Inflation is a self-fulfilling prophecy. If workers think they are going to be higher prices, they demand higher wages. This increases the cost of production and firms raise their prices. Expecting higher prices simply causes higher prices.”
   1. Is this true in the short run? Explain.
   2. If policymakers do nothing and allow the economy to adjust to the natural level of output on its own, does expecting higher prices cause higher prices in the long run? Explain.
   3. If policymakers accommodate the adverse supply shock, does the expectation of higher prices cause higher prices in the long run? Explain.