Chinese Output Growth and Inflation, 2006-2009

Year	Output Growth(%)	Inflation Rate (Year to Year)(%)
2006	11.8	1.5
2007	12.4	4.8
2008, June	11.2	7.9
2008, Dec.	4.4	3.9
2009, June	11.1	-1.1
2009, Dec.	10.4	-0.3

Source: International Monetary Fund (IMF).2010.

RECAP:

- **Demand shocks:** Shocks that cause the aggregate demand curve to shift.
- **Demand shock:** A shock that leads to a decline in the quantity of output produced from given quantities of capital and labor.
- **Underground economy:** Goods and services produced that are hidden from the government, either because they are illegal or because the person producing the goods and services is avoiding paying taxes on the income he or she receives.
- **Unemployment gap:** The difference between the unemployment rate and the natural rate of unemployment.
- **Unemployment spells:** The length of time a worker remains unemployed.
- **Monetary transmission mechanisms:** Alternatives that stimulate aggregate demand through noninterest rate channels of transmission.
- **Moral hazard:** The risk (hazard) that the one party will engage in activities that are undesirable(immoral) from the point of view of the other party.

REVIEW QUESTIONS

1. Explain why the aggregate demand curve slopes downward and the short-run aggregate demand curve slopes upward.

2. Identify changes in three factors that will shift the aggregate demand curve to the right and changes in three different factors that will shift the aggregate demand curve to the left.

3. What factors shift the short-run aggregate supply curve? Do any of these factors shift the long-run aggregate supply curve? Why?

4. How does the condition for short-run equilibrium differ from that for long-run equilibrium?

5. What are demand shocks? Distinguish between positive and negative demand shocks.

6. Starting from a situation of long-run equilibrium, what are the short-and long-run effects of a positive demand shock?

7. What are supply shocks? Distinguish between positive and negative supply shocks and between temporary and permanent ones.

8. Starting from a situation of long - run equilibrium, what are the short-and long-run effects of a permanent negative supply shock?

9. Explain how the economy would respond to a negative price shock if there were no policy response.

SUPPLEMEMTAL EXERCISES

Exercise #1

Suppose the economy has the aggregate demand curve

$$Y = 3,401 + 2.888\frac{M}{P}$$

and the price adjustment schedule

$$\pi = 1.2\left(\frac{Y_{-1} - 6,000}{6,000}\right)$$

The money supply is $900 billion.

a. Plot the AD curve and the potential GDP line. Explain why the aggregate demand curve is not a straight line.

b. If $P_0 = 0.5$, what is Y_0? Does this place upward or downward pressure on prices?

c. Compute the path of the economy–that is, calculate GDP, the price level, and inflation–for each year until GDP is within 1 percent of potential.

d. Assume now that inflation is given by

$$\pi = \pi_1 + 1.2\left(\frac{Y_{-1} - 6,000}{6,000}\right)$$

Compute the path of the economy for the first five years, and diagram the economy's path

. Is there overshooting?

Exercise #2

Suppose that output is equal to potential at 4,000 and the equilibrium interest rate is 0.05. Money demand is given by

$$M = (0.3Y - 4,000)P$$

Money supply is set at 1,000 by the Fed.

a. What price level is required for equilibrium in the money market?

b. Suppose the Fed increases the money supply by 100. What is the new price level? What is the percentage change in the money supply? In the price level?

c. Starting with a money supply of 1,000 and price level of 1.0, how does an increase in the interest rate from 0.05 to 0.10 affect the equilibrium price level? What could cause such an increase in the real interest rate?