Writing Assignment 1

AS/AD Model

Econ520. Fall 2024

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UNC

See course website for due date

Name:	PID:

The Fed has invested a great deal of effort in order to "anchor" inflation expectations at its target of two percent per year.

Here, we try to get a sense of why this makes sense through the lens of the AS/AD model. Since that model does not have inflation yet, we assume instead that the Fed can anchor expectations about price levels P^e.

Suppose the economy is hit by a temporary negative supply shock. The shock shifts m up, thereby reducing SR-AS and MR-AS. However, after some time m returns to its original value (and SR-AS and MR-AS shift back to their original positions).

Consider the implications for output and prices over time for the following scenarios:

1. The **Fed does nothing**. First, consider the case where price expectations are well **anchored** (treat them as fixed). How would output and prices evolve over time? Explain the intuition. Hint: What happens to SR-AS while m is high?
2. Now consider the case where price expectations adjust as usual. How does this change the outcome? What does the Fed gain from anchoring expectations.
3. Next consider the case where the **Fed stabilizes output** at the original (pre shock) Y_n through the entire episode. Price expectations are well anchored.
4. Finally, consider the case where the Fed stabilizes output but price expectations move around as usual. Is there a risk that inflation expectations might get entrenched (although that is not in our model)? Are the outcomes worse than with price expectations that are well anchored?

Be sure to explain the economic intuition for everything that happens. Also graph your answers.