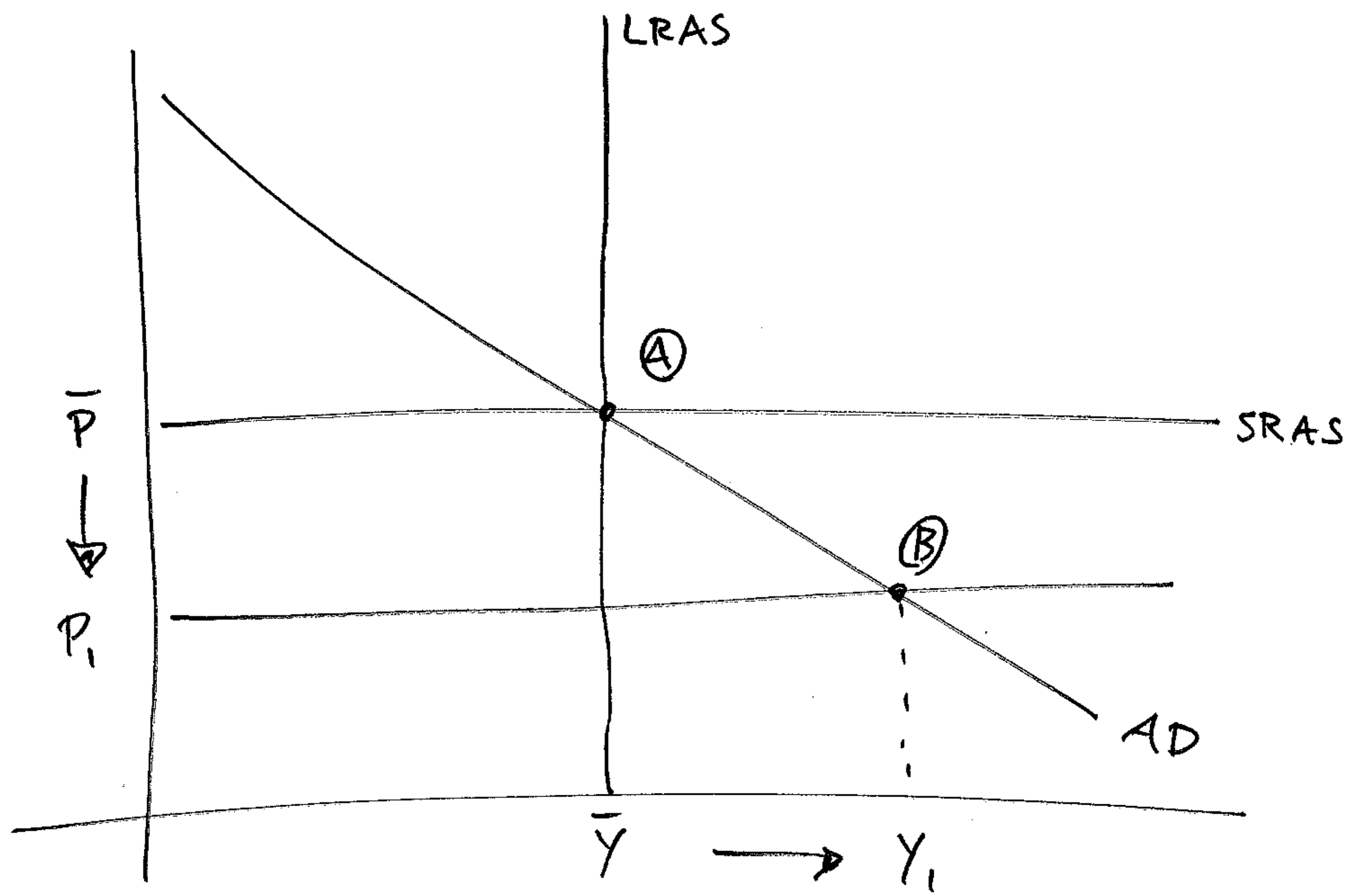
Rough answers to AS/AD practice

Positive Supply Shock



(A) initial LongRun EQ

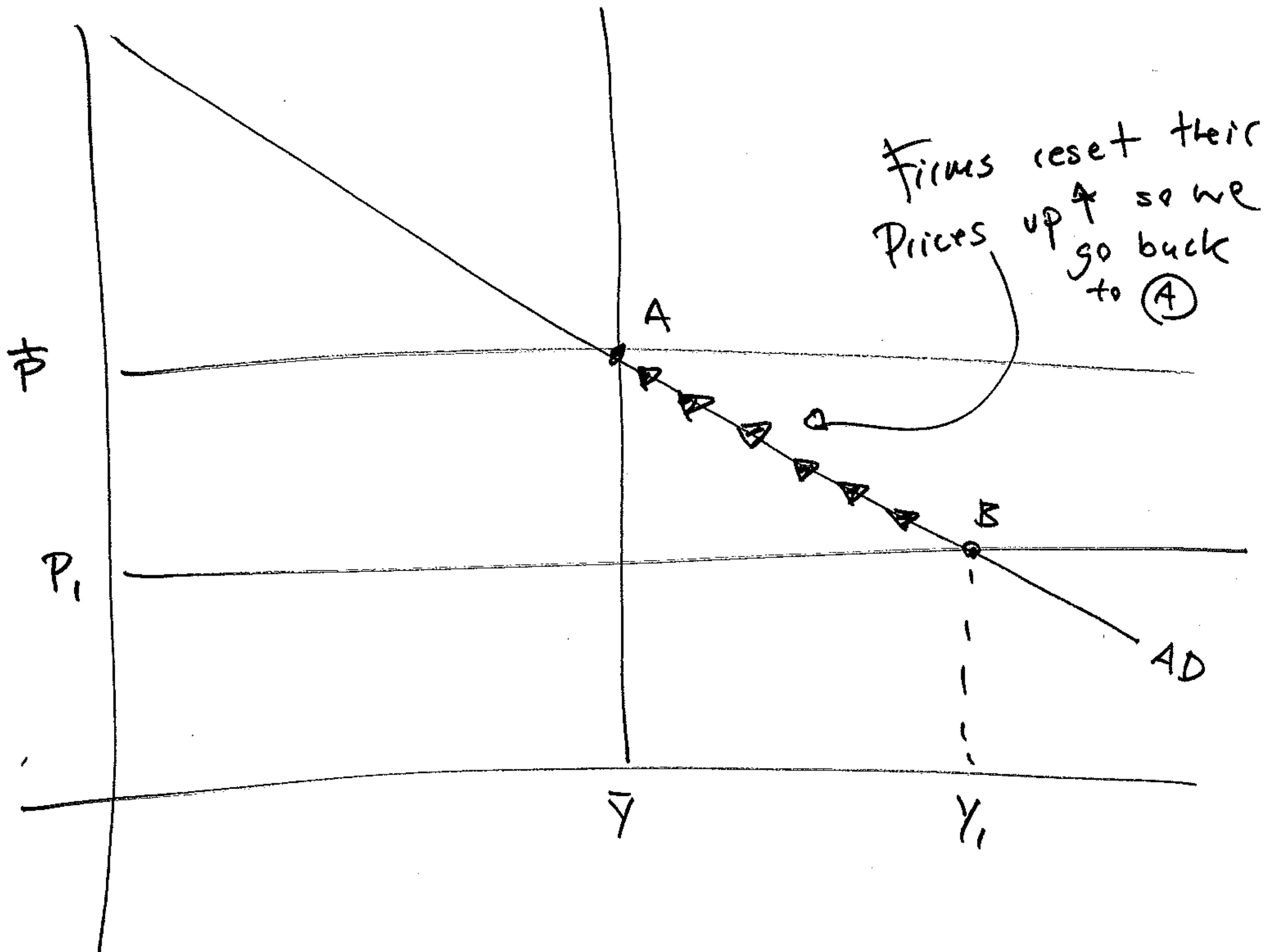
(B) Short-Run EQ .... Notice that

(1) output goes ↑, $\bar{Y} \to Y_1$ BOOM!

(2) Okun's Law ⟹ unemployment ↘ falling

(3) Prices initially fall.

If the FED did Nothing



Firms would realize they are producing too much Relative to Long-Run EQ, so they start to raise their prices... this mechanism pushes the SRAS curve back up untill the economy reaches its original LREQ @ A.

If the Fed were to do something....

First, Rember the FED has two goals....

1. Stable prices (Like keep economy $P = \bar{P}$)
2. Max Employment (Like keep $Y = \bar{Y}$)

The issue here is that (as with supply shocks in general) the goals are in conflict. If either

(A) does nothing and let the economy be "hot" for awhile

(B) Or "cool" of the economy by pulling the AD curve in but loose price stability.

If I were FED (A) is probably ok....

Lets just Look at (B).....

Fed wants to "cool" off economy.

How... perform O.M.O. (open market operations)...

(1) Sell T-Bills in exchange for Banking Reserves.

(2) Since Banking Reserves leaving the system $\Rightarrow$ B (monetary Base) $\downarrow$

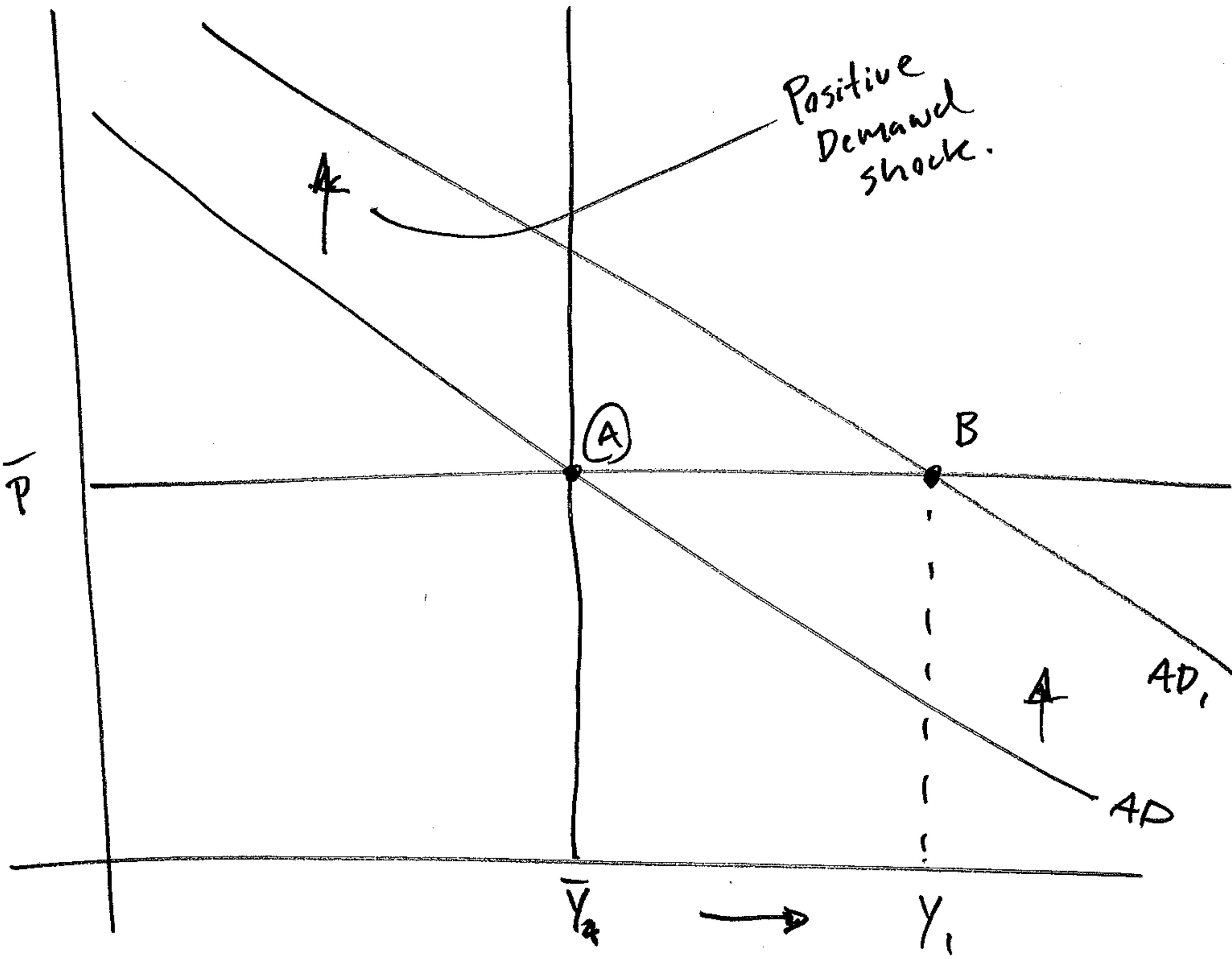
(3) $$AD = \frac{mB}{P} = \frac{1}{V} \cdot Y$$

$M = mB$

Since B is falling, <u>AD curve pulls in ward.</u>

(4) Note since FED is selling T-Bills ~~the~~ intrest rates are $\uparrow\uparrow$!

Rough Answers to Positive Demand Shock.

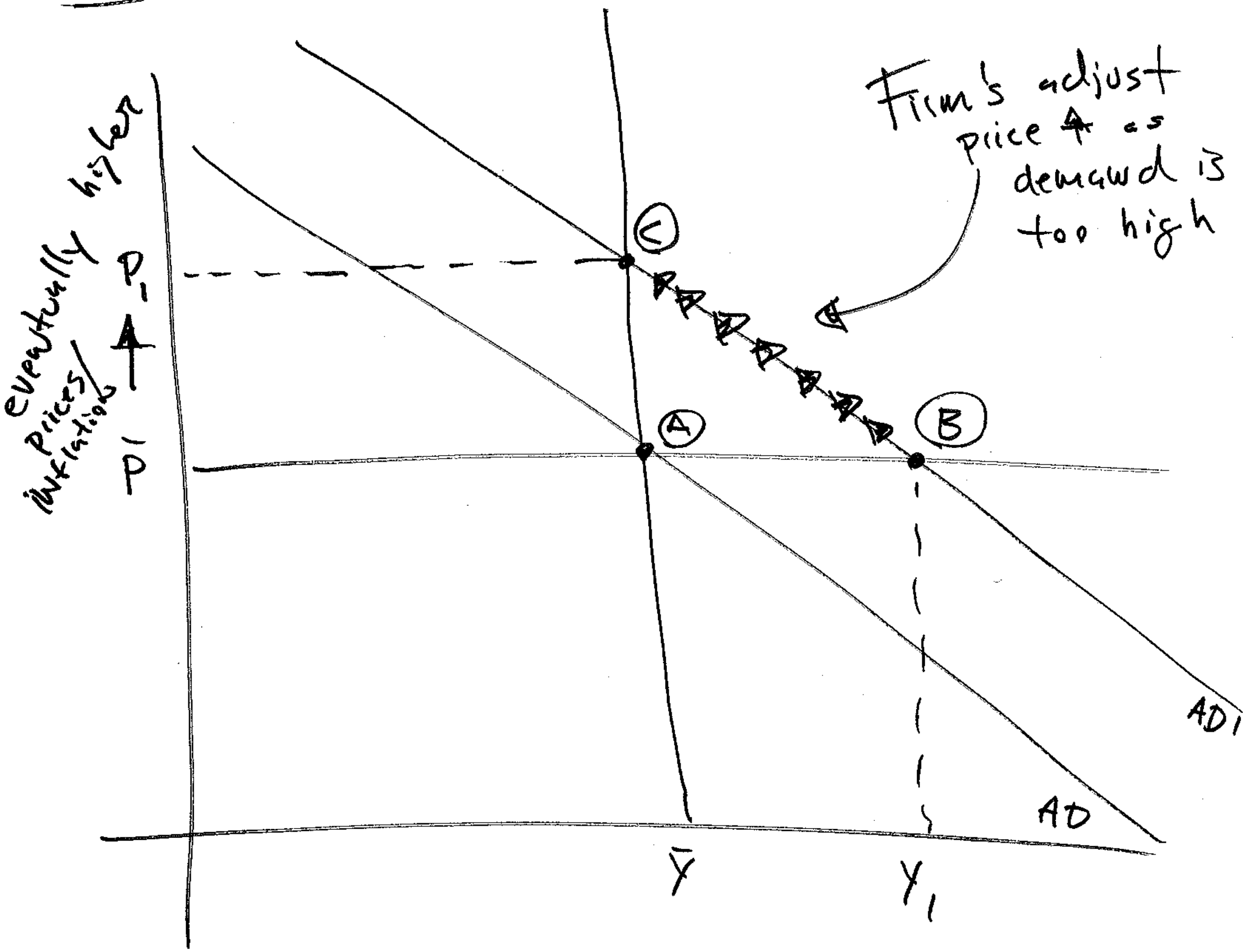


(A) initiall LR EQ

(B) New S.R. EQ with

1. output going ↑, $\bar{Y} \rightarrow Y_1$ Boom!
2. Okun's law ⇒ unemployment ↘
3. Prices stable (for now)

If the FED did nothing



At (B) Firm's realize they are producing "too much" relative to Long-Run, so they start to raise their price to reduce demand. This leads to higher inflation/prices at the <u>NEW</u> LREQ of (C).

IF the Fed did some thing...

→ Here the FED's goals are not in conflict. It can

(1) Achive Price Stability **AND**

(2) Stabalize output....

By reducing (AD) and pushing the economy back to (A) (rather than going to (C))

How....

(1) Sell T-Bills for Banking Reserves.

(2) This means Banking Reserves ↓

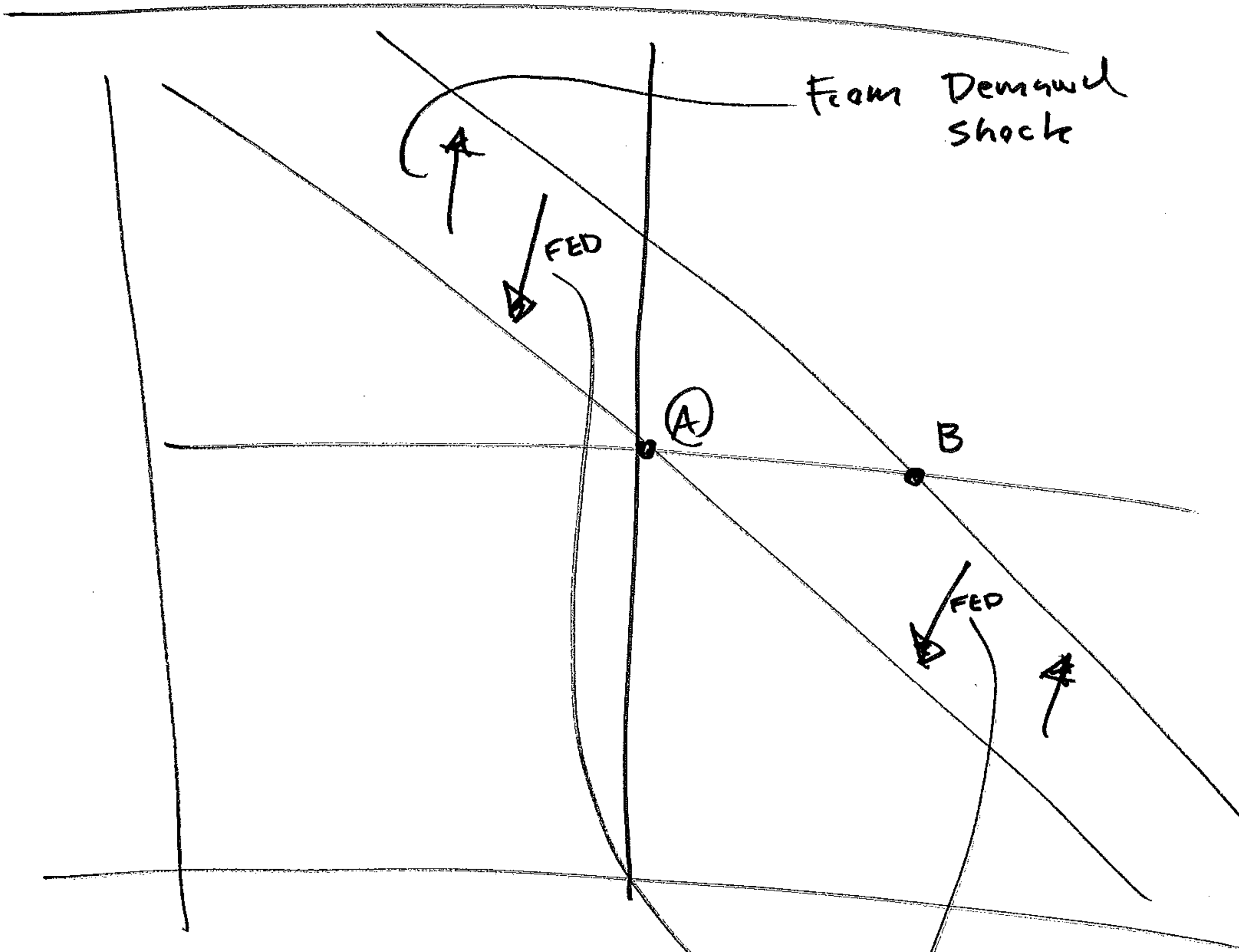
(3) B = Monetary Base (Amount of Banking Reserves) is falling

$$AD = \frac{mB}{P} = \frac{1}{V} \cdot Y$$

(4) Also ⇒ interest Rates ↑

if B ↓ then AD shifts in

What does this look like



Here FED pushes against demand shock to keep economy at A