# Lab 12 – General Equilibrium and Money

## A Quick Review

1. The Fed has hired you to calculate inflation for 2000 to 2001, 2000 to 2003, and 2004 to 2005. You are given the following list of CPI values (base year 2000):
    i. CPI 2000 – 100
    ii. CPI 2001 – 107
    iii. CPI 2002 – 110
    iv. CPI 2003 – 115
    v. CPI 2004 – 127
    vi. CPI 2005 – 120
2. List the reasons for why the Potential Real GDP (PRGDP) line would shift
    a.
    b.
    c.
3. What will shift the Aggregate Supply (AS) curve but leave PRGDP unaffected?

## Classical Model of Equilibrium

1. Implies that excessive unemployment and unused productive capacity would set up forces that would eventually increase real GDP and eliminate the cyclical unemployment of workers
2. The economy has a self correcting mechanism that keeps it at full employment most of the time
3. Concludes that equilibrium Real GDP can never deviate for long below the level of full employment
4. Assumes prices and quantities in all markets are flexible
5. Question, how should we classify wages? Is this a part of AD or AS?
6. Shocks from AD will be corrected through AS quickly to keep equilibrium Real GDP at PRGDP

## Keynesian Model of Equilibrium

1. Rigid nominal wages lead to slow changes in AS
2. Slow changes in AS implies government needs to interact and attempt to restore AD to a level that ensures full employment and avoid declines in aggregate real income and employment
3. The key to this model is the idea of <u>downward nominal wage rigidity</u>—the classical model seemed logically correct but evidence suggested that nominal wage levels are semi-inflexible in the period of one year. This doesn't mean input prices don't fall—just that they do not fall enough to increase the profitability of production (and the AS curve) to restore full employment when economy is operating below PRGDP

## Money

1. Money serves four basic functions: 1) Medium of Exchange 2) Standard of Value 3) Standard of Deferred Payment 4) Store of Value
2. Measuring the money stock
   a. M1 =
   b. M2 = M1 +
   c. M3 = M2 +
3. Demand for Money –

4. Changes in Demand for Money
   a. Changes in Real GDP
      i.
   b. Changes in Price Level
      i.
   c. Changes in transaction costs
      i.
5. Supply of Money –

6. Determined by the government, this implies an inelastic supply in the short run and an upward sloping curve in the long run

## Problems

1. The classicists argued that an increase in aggregate demand would ____________ in the short run, but in the long run real GDP would ____________.
    a. decrease aggregate supply, rise
    b. increase real GDP, return to its potential level
    c. increase real GDP, rise further causing inflation
    d. decrease real GDP, increase
2. John Maynard Keynes argued that
    a. downward nominal-wage rigidity prevented the classical self-correction mechanism from working to eliminate recessionary GDP gaps.
    b. the automatic forces of the market would restore the economy to full employment very quickly.
    c. the classical macroeconomic argument that government spending should be used in recessions wouldn't eliminate a recessionary GDP gap.
    d. fluctuations in aggregate demand were the primary cause of recessions.
    e. Both (a) and (d).
3. If an economy is currently operating at its potential level of real GDP, an increase in aggregate demand will
    a. increase the price level and produce an inflationary gap.
    b. cause stagflation.
    c. produce long-run economic growth.
    d. decrease the price level and produce a recessionary gap.
4. Which of the following shift the long-run aggregate supply curve rightward?
    a. Improvements in technology
    b. Improvements in the efficiency with which resources are used
    c. Increases in the quantity of resources available to a nation
    d. Increases in the productivity of productive resources
    e. All of the above.
5. Which of the following is perfectly inelastic?
    a. Money demanded in the short run
    b. Money supplied in the short run
    c. Money demanded in the long run
    d. Money supplied in the long run