

What assumptions
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What assumptions cause the immediate-short-run aggregate supply curve horizontal? Why is the long run aggregate supply curve vertical? Explain the shape of the short-run aggregate supply curve. Why is short-run curve relatively flat to the left of the full-employment output and relatively steep to the right? The long-run aggregate supply curve is vertical because the economy's potential output is set by the availability and productivity of real resources instead of price.

The availability and productivity of real resources is reflected by price inputs and in long run price inputs which includes wages which adjust to match changes in the price level. Companies find there is no reason to increase production to take advantage of higher prices if they are facing equally higher resource prices. The shape of the short-run supply curve is up sloping because wages and other input prices adjust slower than the price level. This leaves room for companies to take advantage of the higher prices by increasing output. Companies face increasing per unit production costs as they increase output which makes higher prices necessary to induce them to produce more.

3. Other things equal, what effects would each of the following have on aggregate demand or aggregate supply? In each case use a diagram to show the expected effects on the equilibrium price level and the level of real output.

- a) A reduction in the economy's real estate. The aggregate demand will curve right with output and price being up.

- b) A major increase in federal spending for healthcare with no increase in taxes). Aggregate demand would curve right and output and price level would be up.
- c) The complete disintegration of OPEC, causing oil prices to fall by one half. Aggregate Supply would curve right and output would be up and the price level would be down.
- d) A 10 percent reduction in personal income tax rates (with no change in government spending). Aggregate supply would curve right as output would be up and the price level would also be up.
- e) A sizable increase in labor productivity (with no change in nominal wages). Aggregate Supply curve would curve right with output up and price level being down.
- f) A 12 percent increase in nominal wages (with no change in productivity). Aggregate supply will curve left with output being down and price level being up.
- g) A sizable depreciation in the international value of the dollar.

Aggregate Demand will curve right with the increased net exports and the Aggregate supply curve will curve left because of higher input prices.

4. Other things equal, what effect will each of the following have on the equilibrium price level and level of real output.

- a) An increase in aggregate demand in the steep portion of the aggregate supply curve. Price level increase a lot while output increases only nominally. When it's at the vertical only the price level will increase while the output will stay constant.

- b) An increase in aggregate supply, with no change in aggregate demand (assume that prices and wages are flexible upward and downward) The price level will decrease and output will increase.
- c) Equal increases in aggregate demand and aggregate supply. Price level will remain constant but output will increase
- d) A reduction in aggregate demand in the relatively flat portion of the aggregate supply curve. The Price level decrease by a little by output will decrease a lot. If horizontal only the output will decrease while the price level stays constant.
- e) An increase in aggregate demand and decrease in aggregate supply. If by the same proportion than output will remain constant while the price level will drop.

7. In early 2001 investment spending sharply declined in the United States. In the 2 months following September 11, 2001, attacks on the United States, consumption also declined. Use AS-AS analysis to show the two impacts on real GDP. Both events would be shown by a leftward shift in aggregate demand. Also the initial declines in spending would be multiplied. This would cause the real GDP to drop and with flexible prices there would be a drop in price level.