EC2010 Intermediate Economics
Macroeconomics Module
Michaelmas Term 2007

PROBLEM SET 4

A complete solution to problem 2 will be posted on the webpage for the course.
Problem 1 will be discussed in tutorials in week 6.

Problem 1 (Blanchard, chp. 7)

This exercise studies the short-run and medium-run effects of a negative shock on aggregate demand. We assume that the economy starts at the natural level of output. Suppose now that there is an exogenous decline in business confidence, so that investment demand falls for any interest rate.

(a) In the AS-AD diagram, show what happens to output and the price level in the short run and the medium run.

(b) What happens to the rate of unemployment in the short run and the medium run?

Suppose now that the central bank decides to respond in the short run to the decline in business confidence. In particular, suppose that the central bank wants to prevent the unemployment rate from changing in the short run after the decline in business confidence.

(c) What should the central bank do? Show how the central bank's action, combined with the decline in business confidence, affects the AS-AD diagram in the short run and the medium run.

(d) How do short-run output and the short-run price level compare to your answers from part (a)?

(e) How do the short-run and medium-run unemployment rates compare to your answers from part (b)?

Problem 2 (Blanchard, chp. 7)

Using the material covered in the lectures and chapter 7 of the textbook, label each of the following statements true, false, or uncertain. Explain briefly.

(a) The aggregate supply relation implies that an increase in output leads to an increase in the price level.

(b) The natural level of output can be determined by looking at the aggregate at the aggregate supply relation alone.

(c) The aggregate demand relation slopes down because at a higher price level, consumers wish to purchase fewer goods.

(d) In the absence of changes in fiscal or monetary policy, the economy will always remain at the natural level of output.

(e) Expansionary monetary policy has no effect on the level of output in the medium run.

(f) Fiscal policy cannot affect investment in the medium run because output always returns to its natural level

(g) In the medium run, prices and output always return to the same value.