

**Homework II  
Solutions**

1. Textbook (Colander 11th edition) Chapter 26 Questions and Exercises page 606 question 8

- a. The *AD* curve will be steeper because a change in the price level will be offset by a change in the exchange rate eliminating the international effect on the *AD* curve. Note that the exchange rate, the money wealth effect, and international effect all help explain why the aggregate demand curve is not vertical, so any reduction in these three effects would make the aggregate demand curve steeper or closer to a vertical line.
- b. The *AD* curve will become steeper if a fall in the price level doesn't make people feel richer since the fall in the price will not cause them to increase their expenditures. This is an example of the money wealth effect not holding true.
- c. The *AD* curve will be steeper if a fall in the price level creates expectations of a further fall in the price level (it may even be backward bending) since the fall in the price level will cause people to reduce their present expenditures in the hope of getting more for their money in the future.
- d. Assuming that poor people spend a higher percentage of their income than rich people (as suggested by the data), the *AD* curve will shift to the right.
- e. The *AD* curve will shift to the right by a multiple of 20 (the multiplier effect).
- f. The *AD* curve will shift to the left by a multiple of 10 (the multiplier effect).

2. Textbook (Colander 11th edition) Chapter 26 Questions and Exercises page 606 question 12

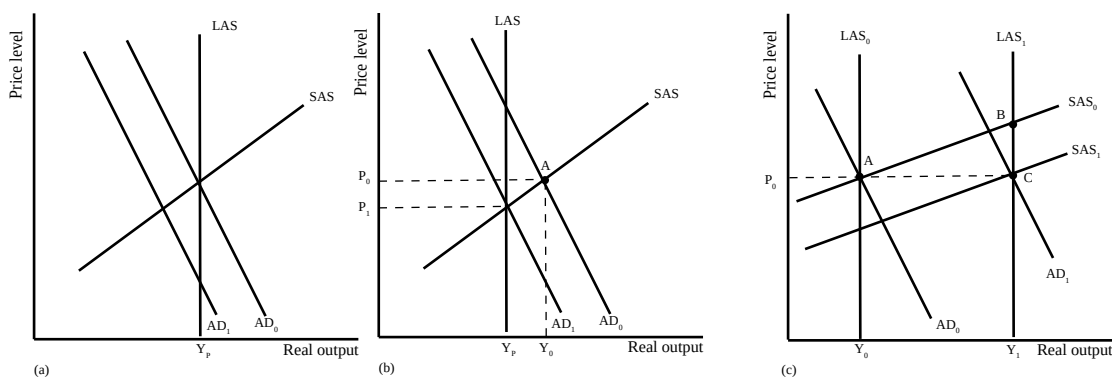
- a. An increase in the availability of inputs will shift the *LAS* curve to the right. The *SAS* curve will not shift initially.
- b. A civil war will presumably destroy productive capacity or otherwise halt production and cause a shift in the *LAS* curve to the left. In the short run, it will also increase the prices of inputs and increase inflationary expectations, shifting the *SAS* curve up.
- c. If wages that were fixed become flexible and aggregate demand increases, the *SAS* curve will shift up as wages rise. The *LAS* curve does not shift.

3. Textbook (Colander 11th edition) Chapter 26 Questions and Exercises page 606 question 16

- a. The slowing of foreign economies will reduce exports, shifting the *AD* curve to the left by a multiple of the initial decline in exports (from  $AD_0$  to  $AD_1$  in the accompanying graph). You should recommend that the government increase expenditures by an

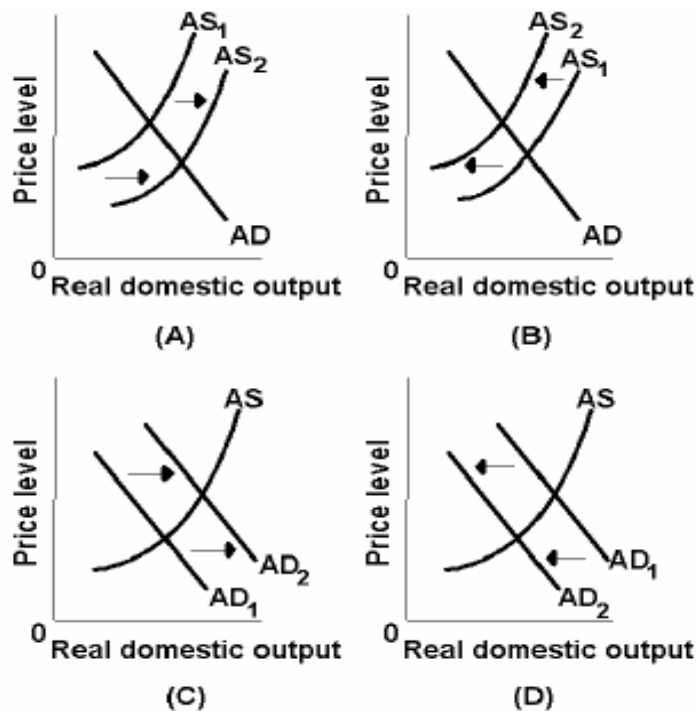
amount equal to the initial decline in exports. This will shift the  $AD$  curve back to its initial position, as shown in graph (a).

- b. An economy operating above potential output is shown by point A in graph (b). To keep the inflation from rising (the  $SAS$  curve from shifting up), the government should reduce expenditures enough (shifting the  $AD$  curve from  $AD_0$  to  $AD_1$ ) to bring the economy back to long-run equilibrium at potential output,  $Y_P$ , and the price level,  $P_1$ , as shown.
- c. A new technology that increases potential output will shift the  $LAS$  curve to the right (from  $LAS_0$  to  $LAS_1$ ), as shown in graph (c), creating excess capacity and downward pressure on factor prices. If left alone, the price level will fall and real output will rise. If the government wants to keep the price level constant, or if it wants to take advantage of a faster increase in aggregate demand, it can increase expenditures enough to increase output to the new potential (shifting the  $AD$  curve from  $AD_0$  to  $AD_1$ ).



4. What effect would each of the following have on aggregate demand or aggregate supply, other things equal? In each case, use a diagram to show the expected effects on equilibrium price level and the level of real output, assuming that the price level is flexible both upward and downward.

- a. A widespread fear of consumers of an impending economic depression.
- b. A new national tax on producer based on value added between the cost of inputs and the revenue received from their output.
- c. A reduction in interest rates at each price level.
- d. A major increase in spending for health care by the government.
- e. The general expectation of coming rapid inflation.
- f. The complete disintegration of OPEC, causing oil prices to fall by one-half.
- g. A 10 percent across the board reduction in personal income taxes.
- h. A sizeable increase in labor productivity (with no change in nominal wages).
- i. A 12 percent increase in nominal wages (with no changes in labor productivity).
- j. An increase in exports that exceeds an increase in imports.



- a. Due to expected depression consumers may think that their income will fall in the future. Therefore, current consumption may be reduced and Aggregate Demand (AD) shifts to the left (Panel D).
- b. The new tax imposed will increase cost of production and will cause aggregate supply (AS) to decrease (Panel B).
- c. A decrease interest rate will increase investment and AD (Panel C).
- d. An increase in government spending for health expenses will increase AD (Panel C).
- e. An expected inflation will increase current consumption and therefore AD since people would like to buy good before rising prices (Panel C).
- f. Fall in oil prices will decrease cost of production therefore increase AS (Panel A).
- g. A decline in income taxes will increase disposable income consumption therefore AD (Panel C).
- h. AS will increase (Panel A).
- i. An increase in cost of production will decrease AS (Panel B).
- j. An increase in AD (Panel C).