Section 8: The IS-LM/AS-AD Model...

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1 Short-run disequilibrium
Based on ABE Ch. 9 AP #3

Suppose that the price level is fixed in the short run to that the economy doesn’t reach general equilibrium immediately after a change in the economy. For each of the following changes, what are the short-run effects on the real interest rate and output? When the economy is in disequilibrium, assume that only the labor market is out of equilibrium and that firms are briefly willing to produce enough output to meet the aggregate demand for output.

a) A decrease in the expected rate of inflation.

b) An increase in consumer optimism that increases desired consumption for all income levels and real interest rates.

c) A temporary increase in government expenditures.

d) An increase in lump-sum taxes (consider both the case in which Ricardian equivalence holds and the case in which it doesn’t).

e) A scientific breakthrough that increases the expected future MPK.

2 Monetary Policy and the Misperceptions Theory
Based on ABE Ch. 10 AP #4

An economy has the following AD and AS curves:

\[
AD : \quad Y = 300 + 30(M/P) \\
AS : \quad Y = \bar{Y} + 10(P - P^e)
\]

Where \( \bar{Y} = 500 \) and \( M = 400 \).

a) Suppose that \( P^e = 60 \). What are the equilibrium values of the price level, \( P \), and output, \( Y \)?

b) An unanticipated increase raises the money supply to \( M = 700 \). Because the increase is unanticipated, \( P^e \) remains at 60. What are the equilibrium values of the price level, \( P \), and output, \( Y \)?
c) The Fed announces that the money supply will be increased to $M = 700$, which the public believes. Now what are the equilibrium values of the price level, $P$, the expected price level, $P^e$, and output, $Y$?

3 RBC Review
ABE Ch. 10 RQ #2, 4

What are the two main components of any theory of the business cycle? Describe these two components for the real business cycle (RBC) theory.

What major business cycle business cycle facts does the RBC theory explain successfully? Does it explain any facts less well?