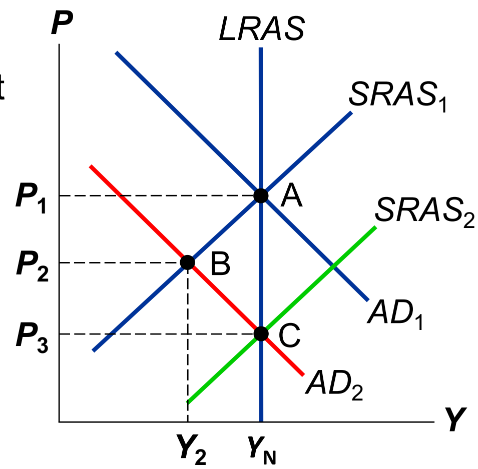
ECO 300 Macroeconomic Theory

Final exam Review for graphical analysis part

The Effects of a Shift in *AD*

Event: Stock market crash

1. Affects ***C***, *AD* curve
2. ***C*** falls, so *AD* shifts left
3. SR eq'm at B.
   P and ***Y*** lower,
   unemp higher
4. Over time, P_E falls,
   SRAS shifts right,
   until LR eq'm at C.
   Y and unemp back
   at initial levels.

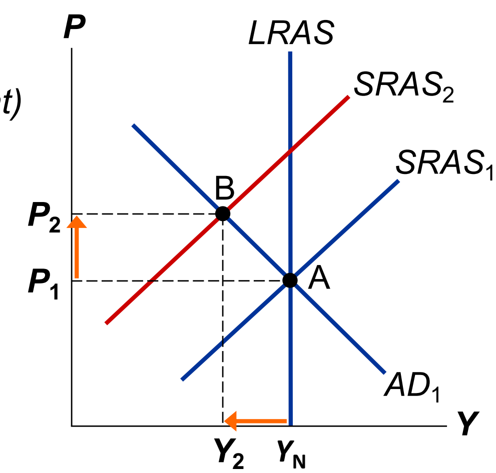


The Effects of a Shift in *SRAS*

Event: Oil prices rise

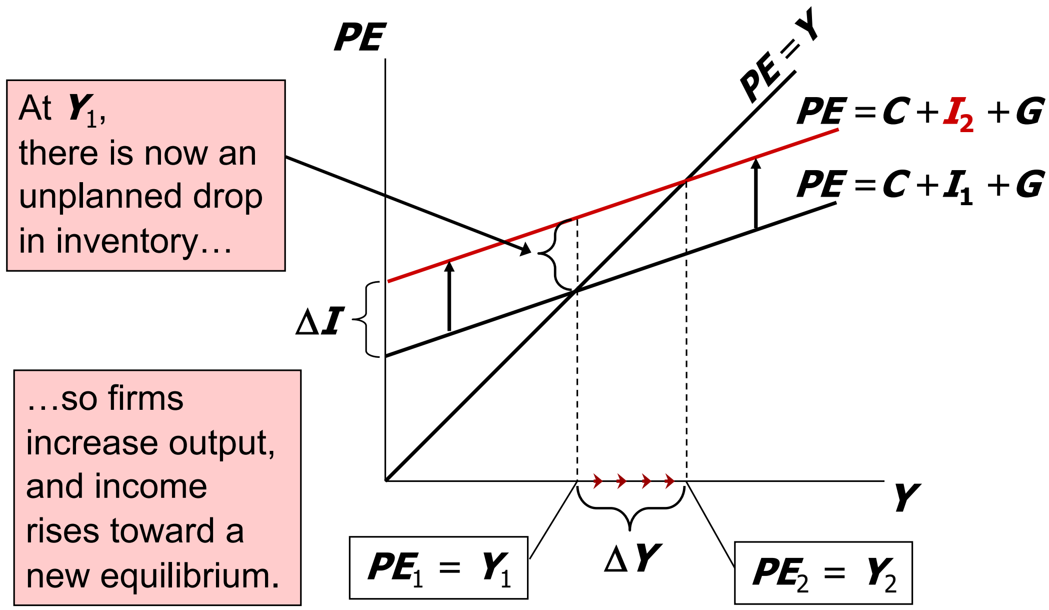
1. Increases costs,
   shifts *SRAS*
   (assume LRAS constant)
2. *SRAS* shifts left
3. SR eq'm at point B.
   P higher, ***Y*** lower,
   unemp higher

   From A to B,
   stagflation,
   a period of
   falling output
   and rising prices.



ANSWERS

Practice with the Keynesian cross



NOW YOU TRY

Shifting the IS curve: ΔT

- Use the diagram of the Keynesian cross or loanable funds model to show how an increase in taxes shifts the IS curve.
- If you can, determine the size of the shift.

ANSWERS

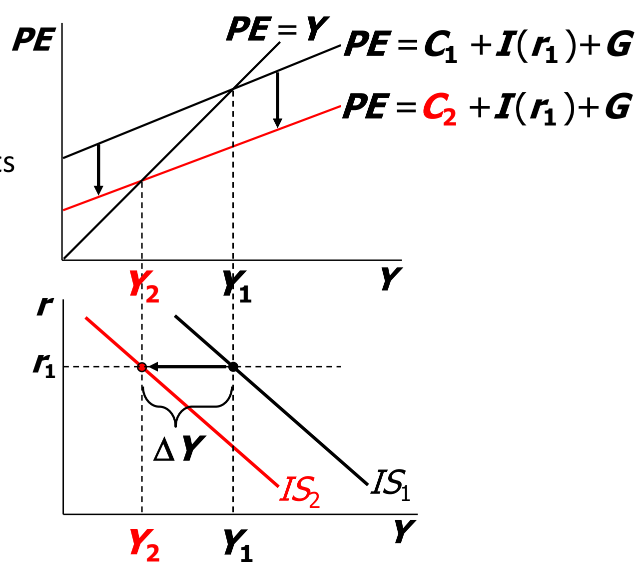
Shifting the IS curve: ΔT

At any value of r,
$\uparrow T \Rightarrow \downarrow C \Rightarrow \downarrow PE$

…so the *IS* curve shifts to the left.

The horizontal distance of the *IS* shift equals

$$\Delta Y = \frac{-\text{MPC}}{1-\text{MPC}} \Delta T$$



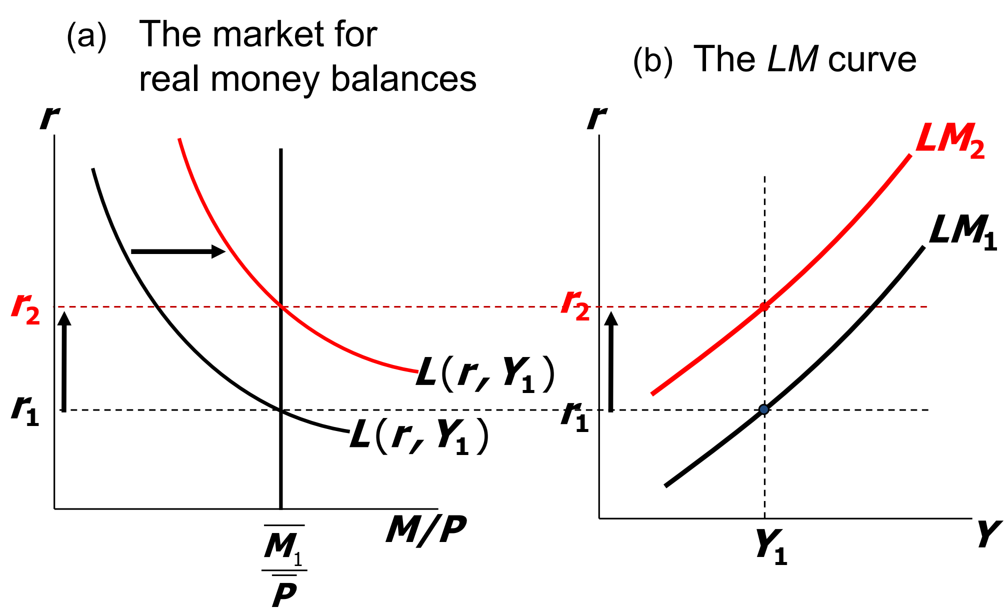
NOW YOU TRY

Shifting the *LM* curve

- Suppose a wave of credit card fraud causes consumers to use cash more frequently in transactions.
- Use the liquidity preference model to show how these events shift the *LM* curve.

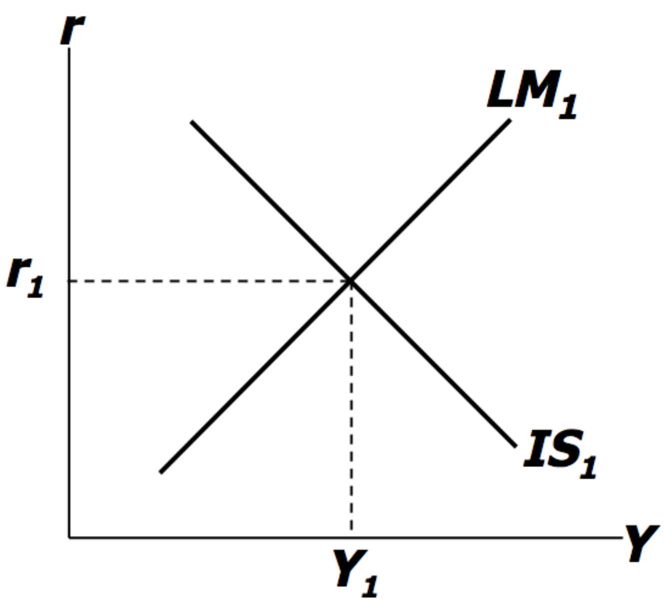
ANSWERS

Shifting the *LM* curve

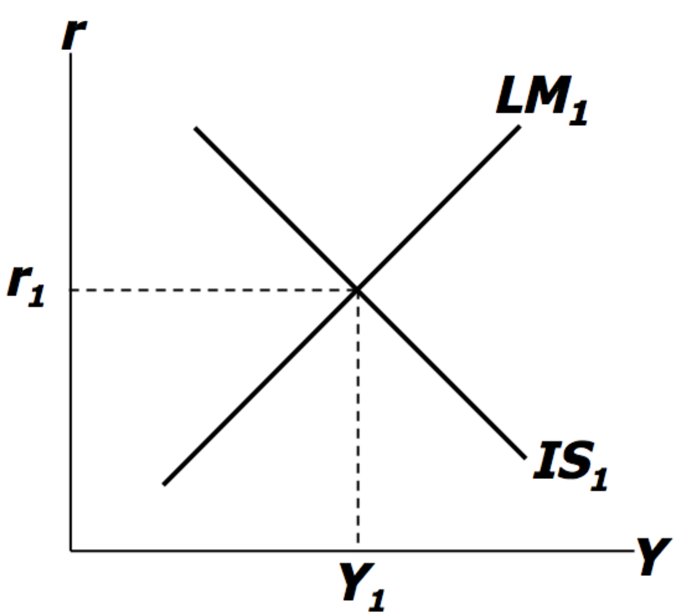


Use the *IS-LM* model to analyze the effects of
1. A housing market crash that reduces consumers' wealth
2. Consumers using cash in transactions more frequently in response to an increase in identity theft
For each shock, use the *IS-LM* diagram to determine the effects on ***Y*** and ***r*.** Figure out what happens to ***C***, ***I***, and the unemployment rate.

1. Housing market crash



2. Increase in money demand



NOW YOU TRY

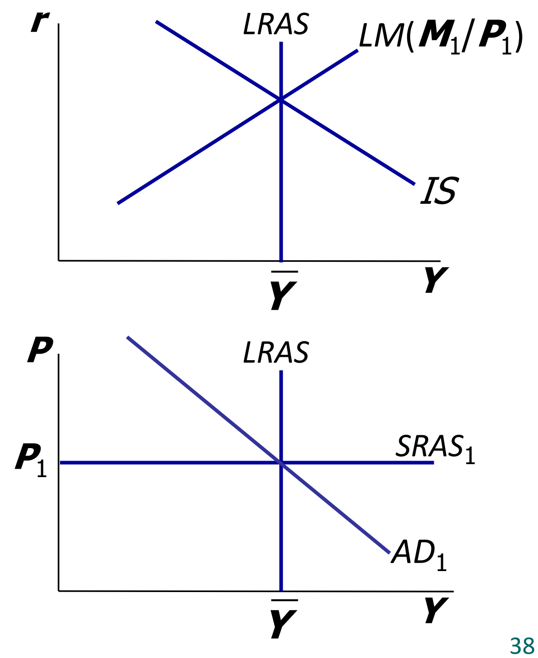
Analyze SR & LR effects of ΔM

a. Draw the *IS-LM* and *AD-AS* diagrams as shown here.

b. Suppose Fed increases ***M.*** Show the short-run effects on your graphs.

c. Show what happens in the transition from the short run to the long run.

d. How do the new long-run equilibrium values of the endogenous variables compare to their initial values?

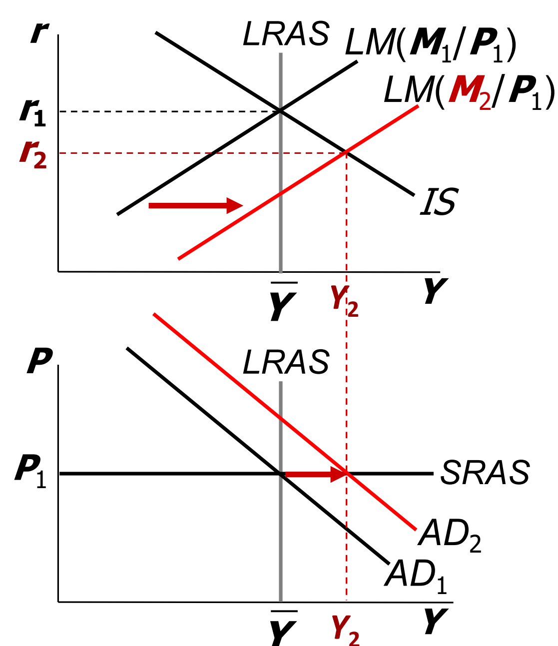


ANSWERS, PART 1

Short-run effects of ΔM

LM and *AD* shift right.

$\boldsymbol{r}$ falls, $\boldsymbol{Y}$ rises above $\boldsymbol{\bar{Y}}$



Transition from short run to long run

Over time,

- ***P*** rises
- *SRAS* moves upward
- ***M***/***P*** falls
- *LM* moves leftward

New long-run eq'm

- ***P*** higher
- all *real* variables back at their initial values

Money is neutral in the long run.