1. (a). (i). An anticipated increase in the quantity of money, or an increase in government expenditures, or a tax cut, or an increase in exports. Anything that increase aggregate demand can set off an anticipated inflation process, so long as the event is anticipated. But to sustain such an anticipated inflation process, the quantity of money must keep rising along its anticipated path.

(ii). Starting out on AD0 & SAS0, the initial equilibrium is at A (where the economy is at its potential output level). Aggregate demand increases and the AD curve shifts rightward to AD1. The increase in aggregate demand is anticipated so the money wage rate rises and the SAS curve shifts to SAS1. The price level rises, and the RGDP remains at potential GDP.

(iii). Starting out on AD1 & SAS1, a further anticipated increase in aggregate demand occurs. The AD curve shifts to AD2, and because the increase in aggregate demand is anticipated, the money wage rate rises again and the SAS curve shifts to SAS2. Again the price level rises and the RGDP remains at potential GDP.

(b). The growth of an economy is the increase in the amount of goods & services available in the economy, over time.

We measure the growth of an economy between time period t and t+1 as the percentage change in RGDP of the economy between those periods: \( G_t = \frac{(Y_{t+1} - Y_t)}{Y_t} \times 100 \)

(c). Inflation is the rise in price level over time, leading to the loss of value of money. A one-time change in the price level is not inflation – it has to be an ongoing process.

We measure inflation by calculating the inflation rate, which is the annual percentage change in price level between year t and t+1: \( I_t = \frac{(P_{t+1} - P_t)}{P_t} \times 100 \)

2. (i). The initial equilibrium is (Y*, P*)

(ii). RGDP & price level fall to (Y1, P1). Then as aggregate demand returns to its original level, the economy returns to its original equilibrium.

(iii). RGDP & price level fall to (Y1, P1). The government increases aggregate demand to compensate and the economy moves back to its original level. However, since the fall in demand was temporary, private demand returns to its original level, increasing aggregate demand even further. An inflationary
gap arises. Money wages rise, the supply curve shifts backwards & in the long run the economy settles back to $Y^*$ at a higher price level.

(iv). RGDP & price level fall to ($Y_1$, $P_1$). The economy is stuck at this point until the money wage rate falls, the aggregate supply curve shifts outwards and the economy settles into a long run equilibrium with lower prices, at the potential level of RGDP.

(v). RGDP & price level fall to ($Y_1$, $P_1$). The government increases aggregate demand to compensate and the economy moves back to its original level. Because the decrease in aggregate demand is permanent, this is the end of the sequence of events.

(vi). The Keynesian will advise a more activist role for the government compared to the Monetarist.

3. (a). (i). The economy might have gotten into the described state because of a combination of rapid money supply growth (bringing inflation) and large structural changes (bringing high unemployment & a slowdown in productivity growth).

(ii). A slowdown in money growth will lower the inflation rate. Improvements in incentives to invest in physical or human capital or to innovate and speed up the pace of technological progress will quicken productivity growth.

(b). We say that economic agents have rational expectations when they forecast future inflation by making the best possible use of all relevant information about the past current and future states of the world that they currently possess, or can optimally gather.

(c). The four main domestic policy goals of the government are:

1. Achieve the highest sustainable rate of potential GDP growth
2. Smooth out avoidable business cycle fluctuations.
3. Maintain low unemployment
4. Maintain low inflation

(d). It is the unemployment rate present in the economy even when it is at the full employment potential output level.

The natural rate of unemployment is affected by factors like: Demographic change, the rate of unemployment compensation, and structural changes in the economy.

4. (a). (i). Both the inflation rate & unemployment rate have increased. So the expected inflation rate has increased and the natural rate of inflation might have increased (but not definitely). Any event that changes expected inflation rate might have occurred, like the expected growth of money supply.

(ii). The SRPC will pass through A, and the LRPC will be vertical through A.

(iii). The SRPC will pass through D, and the LRPC will be vertical through D.
(b). Effects in the labor market: Redistribution of income (between capitalists & laborers) & Departure from full employment.

Effects in the capital market: Redistribution of income (between borrowers & lenders) & Too much borrowing or lending.

(c). Demand-pull inflation can arise from any factor that increases aggregate demand, like: Increase in the quantity of money, increase in government purchases, and increase in exports.