Here are the FAQ’s from the Chapter 6 Quiz. I did not explicitly write the answers so you’ll still have to use that brain of yours to reason an answer, but the explanations should help clear any confusion. If not, send me an e-mail at emguflf@iastate.edu and I’ll give you further help. Good luck.

4) The short-run aggregate supply curve
A) shows a negative relationship between the price level and real national income holding constant potential GDP and all resource prices.
B) relates aggregate production and the price level holding constant potential GDP and all resource prices.
C) shows what each producer is willing and able to produce at each income level holding constant potential GDP and all resource prices.
D) becomes vertical if there is excess production capacity within the economy.

Question 4
The Short-run Aggregate Supply (SAS) curve maps the relationship between the quantity of real GDP supplied and the price level, holding constant the money wage rate, other resource prices, and potential GDP. Real national income or the income level are not a part of this relationship, so answers A and C are incorrect. Furthermore, the SAS curve has a positive slope, meaning that as prices rise, more product is supplied to the market (in the short-run at least). Therefore, answer D is also incorrect.

Important:
Make sure you can distinguish between the SAS curve and the variables (price level and quantity supplied) it is intended to explain. The SAS curve represents the entire relationship between price and quantity supplied, assuming that other factors do not change. The very purpose of this function (curve) is to explain the behavior or value of one of the variables when the other is known or changes. For example, if we know the price level, then, based on the SAS curve, we can determine the quantity of aggregate product supplied to the market, or vice versa. You must understand the difference between “supply” per se, and “quantity supplied.” This will help you to understand the events that cause a shift in “supply”, as opposed to the events that cause a change in “quantity supplied”. This may sound picky, but refusing to clarify this distinction can cause conceptual problems down the road (like on question 6).

6) A change in _______ causes a movement along the short-run aggregate supply curve but no shift in the short-run aggregate supply curve.
A) technology
B) wage rates (the cost of labor)
C) the quantity of capital
D) the price level

Question 6
In the explanation for Question 4, I wrote that the SAS curve maps a relationship between the price level and aggregate quantity supplied to the market. Implicit in this relationship is that “all other things are held equal” (ceteris paribus). When one of the variables in the relationship changes, such as the price level, we move along the curve to find how the other variable changes. We do not shift the entire curve. If we did shift the entire curve when the price level changed, what would be the point of drawing the curve!!! Quoting from above, “The very purpose of this function (curve) is to explain the behavior or value of one of the variables when the other is known or changes.” So, to summarize, only the variables related by the curve will cause a movement along the curve. Hence, technology, wage rates (cost of labor), and the quantity of capital are wrong. You should be able to figure the correct answer from here.
10) In the above figure, **B** is the current long-run aggregate supply curve and **E** is the current short-run aggregate supply curve. If there is an increase in the full-employment quantity of labor, then the long-run aggregate supply curve and the short-run aggregate supply curve

A) remain **B** and **E**.
B) shift to **A** and **F**, respectively.
C) shift to **A** and **D**, respectively.
D) shift to **C** and **F**, respectively.

**Question 10**

An increase in the full-employment quantity of labor essentially means more people in the economy. With more people with the potential for employment, potential production increases, shown by a rightward shift in the long-run aggregate supply curve (LAS) (B to C). The SAS curve also changes. With more potential workers “competing” for employment, the money-wage rate would fall, resulting in a rightward shift of the SAS curve (E to F).

Notice, here, that we are shifting the entire curve, rather than moving along it. Notice also that the question says nothing about a change in price level or quantity supplied. The shifting of the LAS or SAS curves occurs when something outside the relationship between price level and quantity supplied changes. Usually, these external or “exogenous” changes will be the things we made note of holding constant (see the explanation of question 4, first paragraph). Failing to hold these things constant is what causes the shift in the curve.

12) A change in which of the following **shifts the short-run aggregate supply curve**?

A) an advance in technology
B) a change in the money wage rate
C) a change in the quantity of capital
D) All of the above **shift the short-run aggregate supply curve**.
Question 12
The Short-run Aggregate Supply (SAS) curve maps the relationship between the quantity of real GDP supplied and the price level, holding constant the money wage rate, other resource prices, and potential GDP. Use the above explanation of 10 to reason the answer.

16) An increase in the price level causes
   A) consumption expenditures to decrease.     B) a movement along the aggregate demand curve.
   C) a wealth effect.                           D) All of the above answers are correct.

Question 16
If you read the explanations above, you should know that B is correct. An increase in the price level will cause a movement along the aggregate demand (AD) curve. The AD curve maps the relationship between said price level and the quantity of aggregate product demanded in the market. The curve has a negative slope. Therefore, when the price level rises, people demand less crap from the market. This should help you decide whether A is also a good answer. Finally, answer C mentions "a wealth effect." The book says that "real wealth is the amount of money in the bank, bonds, stocks, and other assets that people own, measured not in dollars but in terms of the goods and services that this money, stocks and bonds will buy." Thus, if prices rise, these assets can buy fewer goods and services and real wealth declines. There is indeed, a wealth effect.

18) A rise in the price level will have an effect on aggregate demand because
   A) the real value of people's wealth decreases and so they decrease their consumption.
   B) the more money people have, the more it is worth and hence the more goods and services they demand.
   C) people like to spend more when prices are higher.
   D) the real value of people's wealth varies directly with the price level and so does their spending.

Question 18
If all prices doubled tomorrow, with no corresponding rise in incomes, we would all be less wealthy, and we would all be able to buy much less (in fact, half as much). In other words, real wealth would decrease and so would our consumption.

19) Substitution effects help explain the slope of the aggregate demand curve. One substitution effect refers to the
   A) direct relationship between the interest rate and the real value of wealth.
   B) effect on investment expenditures that result from a change in interest rates produced by a change in the price level.
   C) inverse relationship between the interest rate and the price level.
   D) change in wealth that results from a change in the interest rate.
Question 19
Two types of substitution effects are discussed in the book. In this question, we are concerned with the intertemporal (time-related) substitution effect. The interest rate on investment is the cost or benefit of "intertemporal" trade (goods now vs. goods in the future). If interest rates go up, it becomes more attractive to save (trade goods now for goods in the future). It also becomes more costly to collect debt (trade goods in the future for goods now).

Now, when prices rise, interest rates go up. There are several ways to tell this story. One is to imagine yourself as an entrepreneur. You want to start a business; you need a loan. But prices have gone up, so you now need a larger loan to fund your business. So does every other entrepreneur. Hence, there's increased demand for money when prices rise, which puts upward pressure on interest rates charged by banks and other lending institutions. This higher interest rate in turn causes more agents (people, firms, etc.) in the economy to spend less today, save more for tomorrow. These agents offer more of their money to the investment pool rather than spending it today, and investment expenditure rises. All in all, higher prices lead to more saving/investment (i.e. trading of goods today for goods tomorrow) which should lead you to the correct answer.

28) The equilibrium level of GDP occurs at the level of GDP at which the
A) aggregate quantity demanded equals the aggregate quantity supplied.
B) aggregate demand curve becomes vertical.
C) unemployment rate is zero.
D) All of the above answers are correct.

Question 28
Sometimes, really obvious answers tend to fool otherwise intelligent students. Here's a hint: the unemployment rate does not have to be at zero for the level of GDP to be in equilibrium. You can take it from here.

33) In the above figure, the inflationary gap when AD₂ is the aggregate demand curve equals
A) the difference between 110 and 100.
B) AD₁.
C) LAS minus SAS at a price level of 100.
D) the difference between $10.5 trillion and $10.0 trillion.
Question 33
Inflationary gaps are measured in terms of real GDP (the horizontal axis). As the “gap” suggests, it is the difference between real GDP and potential GDP. Potential GDP, you should know, is measured by the LAS curve (the vertical one) at 10.0 trillion 1996 dollars. Where the SAS curve and AD2 curve meet represents the short-run inflated equilibrium, measured at 10.5 trillion 1996 dollars. You do the math.

For future reference and/or quiz questions, a recessionary gap occurs when the short-run equilibrium is off to the left of the LAS curve.

34) The reason that it is possible for the economy in the above figure to be at equilibrium $E_2$ rather than at $E_1$ is that
   A) in the long run there is always less than full employment.
   B) in the short run the economy can produce more than it can in a long-run situation.
   C) the economy must be in a recession.
   D) $AD$ always shifts rightward and never shifts leftward.

Question 34
The idea is that in the short-run, and especially when prices are rising (inflation), the economy can overheat, or expand too quickly. Under inflationary circumstances, the economy can produce more than it can maintain in the long run. To understand why this might occur, think about the causes of inflation, namely an increase in the quantity of money. Let’s just say we inject a huge increase of dollar bills into the economy. For a short while, this inflated amount of money will “chase” a constant amount of goods and services available. With more money in our pockets, we will surely spend more. Our aggregate demand will rise. Such a spike in demand will in turn pressure suppliers to produce more goods. But when they attempt to buy more inputs to produce these goods, they find that the price of inputs is increasing. With all the suppliers wanting more inputs, they’ve bid up the input prices. See, now we have more demand caused by more money, but the suppliers are facing higher input prices that they in turn pass on to consumers. To make a long story short, monetary inflation may produce temporary incentives to increase production, but in the long run, these increases are unsustainable.
35) In the above figure, suppose the economy had been at point A and now is at B. What could have lead to the movement to B?
   A) Money wages rose.
   B) Government purchases increased.
   C) Winter storms cause factories in the north to be shut down for several weeks.
   D) Unusually good weather causes the wheat crop to be larger than normal.

Question 35
Notice that the SAS curve fits both points A and B, meaning it did not change. So, if supply stayed constant, what must have changed? Demand, right? And which of the answers would reflect a change in demand?