Explanations of difficult problems on quiz 2(Chapter 6)

3) Which of the following is true about the long-run aggregate supply curve?
A) It shows the relationship between the price level and real GDP when wages and other costs are at an equilibrium level.
B) It does not shift in response to temporary changes in aggregate demand.
C) It is vertical at the level of potential GDP.
D) All of the above are true.

Answer: D

We know the long run aggregate supply curve is the relationship b/w the quantity of real GDP supplied and the price level in the long run when real GDP equals potential GDP. And the potential GDP is the quantity of real GDP at full employment Here the wages and other costs are at the equilibrium level, so it is at the level of potential GDP. So (A) is correct; Because potential GDP is independent of the price, the long-run aggregate supply curve is vertical, (C) is correct; It is at the long run equilibrium level, It does not shift in response to temporary changes in aggregate demand, so (B) is correct. Hence all of the above are true.

7) In the figure above, the economy is at point A when the price level falls to 100. Money wages and all other resource prices remain constant. Firms are willing to supply output equal to
A) $10.5 trillion. B) $10.0 trillion.
C) $9.5 trillion.  D) None of the above answers is correct.

Answer: C
The long run aggregate supply is independent of price level. So the temporary price shock won't have any impact on LAS, but it does effect on the short run aggregate supply, if the price falls to 100, from the SAS, we can get the firms are willing to supply output equal to $9.5 trillion.

13) In the above figure, the economy is at point A when the money wage rate and the price level both fall by 10 percent. Firms will be willing to supply output equal to A) less than $10.0 trillion. B) more than $10.0 trillion. C) $10.0 trillion. D) Without more information, it is impossible to determine which of the above answers is correct.

Answer: C
Although all money wage rate and the price level both fall by 10 percent, the relative prices and the real wage remain constant. When the prices level changes but relative prices and the real wage rate remain constant, real GDP remains constant. So, from the graph, we know that the real GAP is still $10.0 trillion just as the level before the prices changing.

19) The intertemporal substitution effect of prices on aggregate demand
A) is one reason that the aggregate demand curve has a positive slope.
B) explains why aggregate demand increases when the amount of money increases.
C) is one reason that the aggregate demand curve has a negative slope.
D) is the same as the real wealth effect.

**Answer: C**

A rise in the price level decreases the real value of the money in people's pockets and bank accounts, and other lenders can get a higher interest rate, people and businesses delay plans to buy new capital and consumer durable goods and cut back on spending. So this is the intertemporal substitution effect, i.e. substitution across time.

22) Which of the following does NOT shift the aggregate demand curve?
A) an increase in the price level
B) a decrease in the money supply
C) a decrease in taxes
D) an increase in investment

**Answer: A**

We know when the aggregate demand changes, the aggregate demand curve shifts. But here we must make it clear that moving on the aggregate demand curve, the whole aggregate demand curve's moving. The aggregate demand curve describes the relationship between the price level and the real GDP, so when there is an increase in the price level, there is a decrease in the level of real GDP correspondingly, and it won't cause the shift of the aggregate demand curve. (B), (C), (D) are the exogenous influencing factors except the price, as mentioned in class, it will shift the aggregate demand curve.

23) An increase in expected future incomes
A) increases aggregate demand.
B) decreases aggregate demand.
C) decreases the aggregate quantity demanded.
D) increases the aggregate quantity demanded.

**Answer: A**

A change in any factor that influences buying plans other than the price level brings a change in aggregate demand. The main factors are: expectations, fiscal policy and monetary policy; the world economy. This problem is about expectation. An increase in expected future income increases the amount of consumption goods that people plan to buy today and increases aggregate demand.
<table>
<thead>
<tr>
<th>Price Level</th>
<th>Aggregate demand (trillions of 1996 dollars)</th>
<th>Short-run aggregate supply (trillions of 1996 dollars)</th>
<th>Long-run aggregate supply (trillions of 1996 dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>120</td>
<td>$</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>110</td>
<td>$</td>
<td>11</td>
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<td>100</td>
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<tr>
<td>90</td>
<td>$</td>
<td>$</td>
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</tbody>
</table>

30) The data in the above table indicate that when the price level is 100,
A) inventories rise and the price level falls.
B) the unemployment rate is at its equilibrium level.
C) the economy is in a long-run macroeconomic equilibrium.
D) inventories fall and the price level rises.

*Answer: D*

when the price level is 100, aggregate demand greater than short-run and long run aggregate supply, so firms are unable to meet the demand for their output. Inventories decrease, and customers clamor for goods and services. So firms increase production and raise prices.

31) The data in the above table indicate that when the price level is 120,
A) firms have unexpectedly low inventories, so prices will rise.
B) firms have unexpectedly high inventories, so prices fall.
C) firms will plan to increase the level of output.
D) inventories are at levels planned by firms.

*Answer: B*

when price level is 120, short-run and long run aggregate supply greater than aggregate demand, so firms are unable to sell all their output, unwanted inventories pile up, and firms cut both production and price.
32): In the above figure, at the point where $AD$ equals $SAS$,
A) potential GDP exceeds real GDP.
B) real GDP exceeds potential GDP
C) the economy is in a recession.
D) the unemployment rate is zero.

Answer: B

This figure shows an above full-employment equilibrium, in which real GDP exceeds potential GDP. The amounts by which real GDP exceeds potential GDP is called an inflationary gap.

33) In the above figure, as the economy adjusts toward equilibrium, the
A) $AD$ curve will shift leftward  
B) $SAS$ curve will shift leftward
C) $SAS$ curve will shift rightward.  
D) $AD$ curve will shift rightward

Answer: B

Suppose that the world economy expands and that the demand for U.S made goods increases in Japan and Europe. The increase in U.S exports increase aggregate demand in the United States, so AD curve shifts rightward. So firms increase production and raise prices. The economy is now in an above full-employment equilibrium. At this stage, prices of goods and services have increased but wage rates have not changed, so workers have experienced a fall in the buying power of their wages and firms' profits have increased, so if firms do not raise the money wage rate, they will either lose workers or have to hire less productive ones. As the money wage rate raises, the SAS curve begins to shift leftward. So the raise in the wage rate and the shift in the SAS curve produce a sequence of new equilibrium positions.
Attachment:

15 answer keys: