ECON 3560/5040
Quiz #6 (Answers)

Last Name:______________________, First Name:______________________

Part A (6 points) Fill-in Questions

(1) [2 points] When the Fed changes the money supply to offset an adverse supply or demand shock and to keep output and employment at their natural levels, this is an example of

Stabilization Policy

(2) [2 points] The *Aggregate Demand* curve depicts a relationship between the quantity of output demanded and the aggregate price level

(3) [2 points] The *IS curve* shows the relationship between the interest rate and the level of income at which planned expenditure is equal to actual expenditure

Part B (14 points)

(1) [9 points] **Short Run Economic Fluctuations**

Assume that the long-run aggregate supply curve is vertical at $Y = 3,000$ while the short-run aggregate supply curve is horizontal at $P = 1.0$. The aggregate demand curve is $Y = 3(M/P)$ and $M = 1,000$

(a) [3 points] If the economy is initially in long-run equilibrium, what are the values of P and Y?

$P = 1$, $Y = 3000$

(b) [3 points] Now suppose a supply shock moves the short-run aggregate supply curve to $P = 1.5$. What are the new short-run P and Y?

$P = 1.5$, $Y = 2000$

(c) [3 points] If the aggregate demand curve and long-run aggregate supply curve are unchanged, what are the long-run equilibrium P and Y after the supply shock?

$P = 1$, $Y = 3000$

(2) [5 points] **Aggregate Demand and Aggregate Supply Model**

Suppose that droughts in California substantially reduce food production in the U.S. Use the aggregate demand-aggregate supply model to illustrate graphically the ***short-run*** AND ***long-run*** impact of this adverse supply shock on output(Y) and prices(P)

In the short run, output decreases while the price level rises. In the long run, prices falls and output returns to the full-employed level