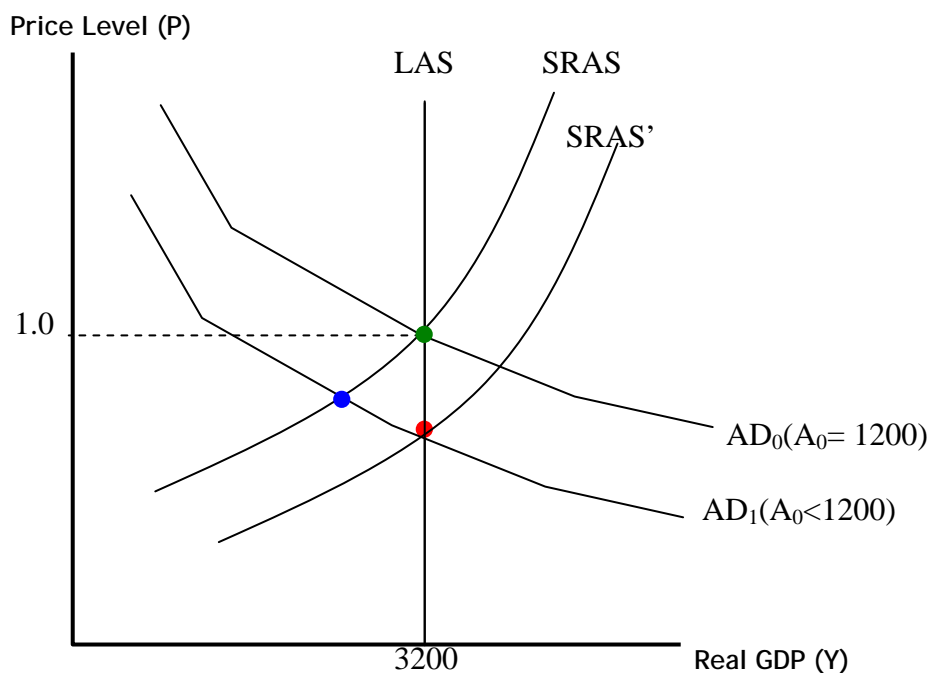


Assignment 7: Answers



	Short Run	Long Run
Interest Rate (r)	decreases	decreases
Price Level (P)	decreases	decreases
Real GDP (Y)	decreases	no change
Nominal Wage	no change	decreases
Real Wage (W/P)	increases	no change
Unemployment	increases	no change

In the short-run, the IS curve shifts left. As the AD declines, the Price declines (see blue dot), the real Money supply (M/P) increases, so the LM curve shifts to the right a bit, but the overall effect is one where AD decreases. Y declines as shown, and the real wage increases, given that the nominal Wage is constant and the Price level declines. This is consistent with the presence of unemployment.

In the long-run, nominal Wage reductions will occur. If workers receive catch-up wage changes, it will take several periods for full-employment to be achieved. In each period, though, with lower nominal wages, aggregate supply will increase (SAS will shift to the right). There will be an iterative adjustment to long-run equilibrium, where the labor market is in equilibrium, the real Wage is restored to the original level, employment and output remains unchanged at the original level, the Price level and nominal Wage decline.

Since the price level has declines further in the long-run, the real money supply increases yet

more in the long-run, lowering the interest rate further. It is instructive to note that in the long run, real GDP ($Y=Y_n$) does not change; so the total demand does not change either: $Y_n = C+I_p+G+NX$. This means that if G has declined, in the long run, the reduction in G will be fully offset by an increase in I_p . This is accomplished by a lower interest rate in the long run. Think of it as "crowding in".

In the short run, unemployment exists since the Price level has declined but the nominal Wage is constant. Consequently, the Real Wage increases, causing an excess supply of labor, or unemployment. The pool of unemployed workers, over time, will exert downward pressure on the nominal Wage. This will shift the SRAS curve to the right, the falling Real Wage will reduce the unemployment, and the process will continue until the nominal Wage has adjusted such that the original Real Wage is restored. At this point, the economy is at its long run equilibrium, albeit at a lower nominal Wage and a lower Price, both of which have declined equi-proportionately from their original levels.