ECON 1010C
Principles of Macroeconomics
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Suggested Solutions to Assignment 2

Part A Multiple-Choice Questions

1. D
2. B
3. B
4. C
5. A
6. D
7. B
8. A
9. C
10. D
11. A
12. C
13. D
14. A
15. B

PART B

B-1.

False.

Consider the AS/AD model which determines the price level and real GDP. Assume that the economy is initially at the long-run equilibrium **A** in Figure-1 and there is no government intervention. A decrease in the value of Canadian dollar makes the Canadian goods and services relatively cheaper. As a result, the demand of Canadian goods and services increases in the world market. That means, the Canadian exports will increase which will, in turn, increase the net exports. Consequently, the aggregate demand will increase and AD curve will shift right to AD_2. Thus, economy will move to a new short-run equilibrium **B** with a higher price and real output level.

B-2.

False.

Consider the AS/AD model which determines the price level and real GDP. Assume that the economy is initially at the long-run equilibrium **A** in Figure-2 and there is no government intervention. An oil-price shock increases the costs of production and lowers the profits of firms. Firms respond by decreasing their production levels. Consequently, the short-run aggregate supply curve shifts left to SAS_2. Thus, economy will move to a new short-run equilibrium **B** with a higher price and lower real output level. At B, some factors of production, including labor, are unemployed. In the long-run, these unemployed factors of production will be willing to accept lower factor prices. Thus, in the long-run, costs of production will decrease and the short-run aggregate supply curve will shift back to SAS_1. The economy will move back to its initial long-run equilibrium **A**. So, in the long-run, there will be no change in price and output level.

PART C

C-1.

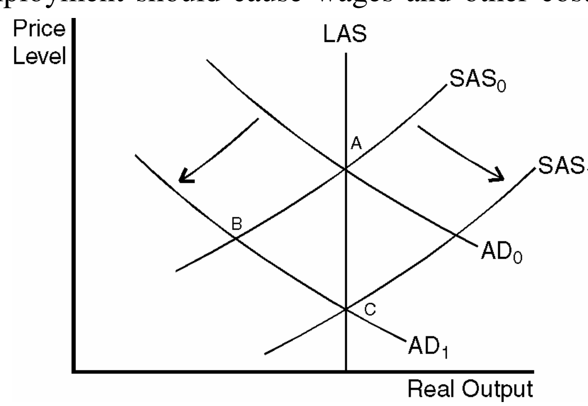
a. The AD curve will be steeper because a change in the price level will be offset by a change in the exchange rate eliminating the international effect on the AD curve.
b. The AD curve will become steeper if a fall in the price level doesn't make people feel richer since the fall in the price will not cause them to increase their expenditures. This is an example of the wealth effect not working.
c. The AD curve will be steeper if a fall in the price level creates expectations of a further fall in the price level (it may even be backward bending) since the fall in the price level will cause people to shift expenditures further out into the future.
d. Assuming poor people consume more than rich people, the AD curve will shift to the right.
e. The AD curve will shift to the right by a multiple of 20.
f. The AD curve will shift to the left by a multiple of 10.

C-2.

a. An increase in the availability of inputs will shift the LAS curve to the right.
b. A civil war will presumably destroy productive capacity or otherwise halt production and cause a shift in the LAS curve to the left.
c. To the degree that the rise in oil prices results in an overall rise in the price level, this will shift the SAS curve up. Otherwise, other relative prices will decline to offset the rise in oil prices and the SAS curve will not shift at all.
d. If wages become flexible and were previously fixed and aggregate demand increases, the SAS curve will shift up as wages rise.

C-3.

Assume that the Canadian economy is initially at a long-run equilibrium **A**. A decline in AD will shift the AD curve to AD_1 in the following figure and the economy will move to a short-run equilibrium **B**. At this short-run equilibrium, the price level is lower than the initial level and the output is below the potential level. In the long run, lower prices and higher unemployment should cause wages and other costs of production to fall and the



SAS curve will shift right to SAS_1, returning the economy to its new long-run equilibrium **C**.

C-4.

Assume that the Canadian economy is initially at a long-run equilibrium **A** in Figure-3.

a. Tax cuts at home would stimulate AD and shift the curve right from AD_1 to AD_2. The economy moves to a short-run equilibrium **B** with a higher price and real output level. On the other hand, softwood lumber duties would reduce Canadian exports and shift AD left from AD_1 to AD_3. The economy moves to a short-run equilibrium **C** with a lower price and real output level.

b. In the long-run AD would be permanently lower: this would put pressure on wages and other factor prices to fall and the SAS curve would shift right from SAS_1 to SAS_2. Thus, the economy will move from the short-run equilibrium **C** to a new long-run equilibrium **D**. So, in the long run the price level would fall, but there would be no change in the real output level.

   We assumed that there is no government intervention and no downward rigidity in factor prices.

c. We do not know the relative sizes of the tax cut and lumber-duty effects on AD. If they offset one another, AD would remain unchanged at AD_1.