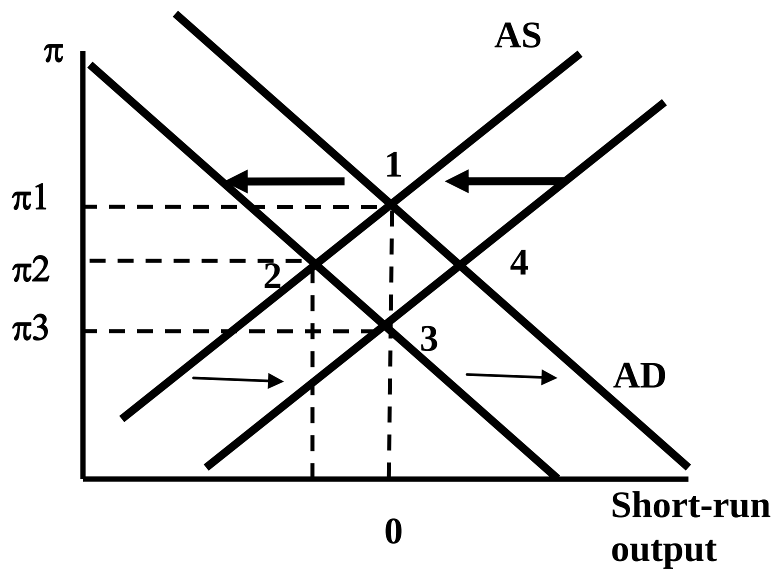
AD-AS Questions
Econ 311
Eschker

Graphically show using the AD-AS diagram what happens to the inflation rate and short run output when the following occur. Be sure to consider both the short run, the adjustment to the steady state long run, and the final values of π and $\tilde{Y}_t$. Assume that the economy starts at short run output equal to zero, inflation equal to the Fed's inflation target, and the real interest rate equal to the MPK.

1. The federal government is shut down due to political fighting and there is uncertainty about how long it will last. This makes firms less willing to invest and a_i falls temporarily which makes $\bar{a}$ negative. The uncertainty is resolved after a number of time periods and $\bar{a}$ returns to zero.

Start at point 1.
Investment falls so AD falls which lowers inflation rate and short run output (point 2).
The adjustment to the steady state begins, and AS falls as people start to expect lower inflation. Eventually short run output returns to zero (point 3).
Then AD rises as the temporary fall in investment is reversed which raises inflation rate (point 4).
The adjustment begins again, and AD rises as people start to expect higher inflation. Eventually short run output returns to zero (back to point 1).



2. A new administration signals that it will not vigorously enforce anti-trust laws. As a result, firms have increased market power which causes inflation to jump significantly in one period only.

Start at point 1.

This is a price shock and AS shifts up (point 2).
The price shock goes away the next period, but the AS does not fall back to original position since people now expect higher inflation.
The adjustment to the steady state begins, and AS shifts back down eventually reaching back to (point 1) where short run output is zero.