Eco 201: Group Activity 6  
Covers Chap 20 & 21

Chapter 20:
1. 3rd Edition: p. 455, Quick Quiz Problem  
4th Edition: p. 467, Quick Quiz Problem

![Diagram of aggregate demand and supply curves]

When a popular presidential candidate is elected, causing people to be more confident about the future, they will spend more, causing the aggregate-demand curve to shift to the right, as shown in Figure 2. The economy begins at point A with aggregate-demand curve $AD_1$ and short-run aggregate-supply curve $AS_1$. The equilibrium has price level $P_1$ and output level $Y_1$. Increased confidence about the future causes the aggregate-demand curve to shift to $AD_2$. Now the economy is at point B, with price level $P_2$ and output level $Y_2$. Over time, the short-run aggregate-supply curve shifts up to $AS_2$ and the economy gets to equilibrium at point C, with price level $P_3$ and output level $Y_3$.

2. 3rd Edition: p. 457, Problems and Applications, Q3  
4th Edition: p. 469, Problems and Applications, Q2

a. When the United States experiences a wave of immigration, the labor force increases, so long-run aggregate supply increases as there are more people who can produce output.

b. When Congress raises the minimum wage to $10 per hour, the natural rate of unemployment rises, so the long-run aggregate-supply curve shifts to the left.

c. When Intel invents a new and more powerful computer chip, productivity increases, so long-run aggregate supply increases as more output can be produced with the same inputs.

d. When a severe hurricane damages factories along the East Coast, the capital stock is smaller, so long-run aggregate supply declines.
a. If households decide to save a larger share of their income, they must spend less on consumer goods, so the aggregate-demand curve shifts to the left, as shown in Figure 10. The equilibrium changes from point A to point B, so the price level declines and output declines.

![Figure 10](image)

b. If Florida orange groves suffer a prolonged period of below-freezing temperatures, the orange harvest will be reduced. This is represented in Figure 11 by a shift to the left in the short-run aggregate-supply curve. The equilibrium changes from point A to point B, so the price level rises and output declines.

![Figure 11](image)
c. If increased job opportunities cause people to leave the country, the short-run aggregate-supply curve will shift to the left because there are fewer people producing output. The aggregate-demand curve will shift to the left because there are fewer people consuming goods and services. The result is a decline in the quantity of output, as Figure 12 shows. Whether the price level rises or declines depends on the size of the shifts in the aggregate-demand curve and the short-run aggregate-supply curve.

4. 3rd Edition: p. 482, Questions for Review, Q3  

If the government spends $3 billion to buy police cars, aggregate demand might increase by more than $3 billion because of the multiplier effect on aggregate demand. Aggregate demand might increase by less than $3 billion because of the crowding-out effect on aggregate demand.

5. 3rd Edition: p. 482, Problems and Applications, Q1  
4th Edition: p. 494, Problems and Applications, Q1

a. When the Fed’s bond traders buy bonds in open-market operations, the money-supply curve shifts to the right from $MS_1$ to $MS_2$, as shown in Figure 1. The result is a decline in the interest rate.
b. When an increase in credit card availability reduces the cash people hold, the money-demand curve shifts to the left from $MD_1$ to $MD_2$, as shown in Figure 2. The result is a decline in the interest rate.

c. When the Federal Reserve reduces reserve requirements, the money supply increases, so the money-supply curve shifts to the right from $MS_1$ to $MS_2$, as shown in Figure 1. The result is a decline in the interest rate.

d. When households decide to hold more money to use for holiday shopping, the money-demand curve shifts to the right from $MD_1$ to $MD_2$, as shown in Figure 3. The result is a rise in the interest rate.
e. When a wave of optimism boosts business investment and expands aggregate demand, money demand increases from $MD_1$ to $MD_2$ in Figure 3. The increase in money demand increases the interest rate.

f. When an increase in oil prices shifts the short-run aggregate-supply curve upward, the increased price level increases money demand. The money-demand curve shifts to the right from $MD_1$ to $MD_2$, as shown in Figure 3. The result is a rise in the interest rate.

Assume the economy is in a recession. Explain how each of the following policies would affect consumption and investment. In each case, indicate any direct effects, any effects resulting from changes in total output, any effect resulting from changes in the interest rate, and the overall effect. If there are
conflicting effects making the answer ambiguous, say so.

a. an increase in government spending

b. a reduction in taxes

c. an expansion of the money supply

a. An increase in government spending would shift the aggregate demand curve to the right, increasing output. The rise in output would raise consumption spending, since people would have higher incomes, and raise investment spending through the accelerator. But money demand would also increase, raising the interest rate. This would tend to reduce consumption, as people would save more, and reduce investment, since the cost of investing would be higher. Overall, the changes in both consumption and investment are ambiguous.

b. A reduction in taxes would directly increase consumption spending, since people would have higher after-tax incomes. Also, since the reduction in taxes increases consumption spending, aggregate demand increases, so total output increases. The rise in output would raise consumption spending further, since people would have higher incomes, and raise investment spending through the accelerator. But money demand would also increase, raising the interest rate. This would tend to reduce consumption, as people would save more, and reduce investment, since the cost of investing would be higher. Overall, consumption must increase (otherwise aggregate demand would not have increased at all) while the change in investment is ambiguous.

c. An expansion in the money supply reduces the interest rate, thus increasing aggregate demand and output. The rise in output would raise consumption spending, since people would have higher incomes, and raise investment spending through the accelerator. The lower interest rate would increase consumption, as people would save less, and increase investment, since the cost of investing would be lower. Overall, both consumption and investment would increase.