1. Clearly and accurately draw and label a diagram of the DAD-SAS Model.

2. Provide an economic explanation of the shape of the curve(s) in your diagram in #1.

The DAD curve shows the inverse relationship between inflation and economic output that maintains equilibrium in both the markets for goods and services and the market for money. This is an inverse relationship because as inflation rises, the real money supply declines, causing real interest rates to rise and reduce interest-sensitive spending and overall economic output.

The SRAS curve is horizontal at the current inflation rate. This indicates that current inflation is unrelated to current economic output because of wage and price stickiness. However, inflation is not exogenous but rather pre-determined by previous inflation (or inflationary expectations) and the previous output gap.

The LRAS curve is vertical at the full-employment level of output. This indicates that, in the long-run, the economy will always return to its full-employment output level.
3. List the variables (and the direction of their change) that would shift the DAD curve to the right.

   a. Increases in expected future income,
   b. Increases in wealth,
   c. Increases in the future expected marginal product of capital,
   d. Increases in government purchases,
   e. Decreases in taxes (assuming no Ricardian equivalence),
   f. Decreases in the effective corporate tax rate,
   g. Increases in the nominal money supply,
   h. Increases in the liquidity of non-money financial assets,
   i. Decreases in the riskiness of non-money financial assets, or
   j. Increases in payments technology.

4. List the variables (and the direction of their change) that would shift the SAS curve upward.

   a. A positive output gap in the previous time period,
   b. An exogenous increase in wages,
   c. An exogenous increase in commodity or raw material prices,
   d. An exogenous increase in imported goods prices (whether from higher foreign prices or a lower exchange rate),
   e. A decrease in productivity.
   f. A decrease in labor supply,
   g. A decrease in the capital stock.

5. List the variables (and the direction of their change) that would shift the LRAS curve to the right.

   a. An increase in productivity,
   b. An increase in labor supply, or
   c. An increase in the capital stock.

6. Assume that the economy starts in general equilibrium. Suppose now that there is an increase in government purchases. Describe the adjustment process that moves the economy from its initial general equilibrium to its final general equilibrium.

   The economy is initially in general equilibrium at the full-employment output level and a steady inflation rate.

   In Year 1, an increase in government purchases would shift the DAD curve to the right. Because wages and prices are sticky in the short-run, inflation would not change and the SRAS curve would not shift. Thus, economic output would increase while the inflation rate would stay the same.

   In Year 2, inflation would increase because of the positive output gap in Year 1. This shifts the SRAS curve up. Higher inflation reduces the real money supply and increases the real interest rate. This causes interest-sensitive spending and overall economic output to decline. Thus, in Year 2, economic output is lower and inflation is higher than in Year 1. However, because there is usually a multiyear adjustment process, output is still higher than its full-employment level of output.

   In Year 3, inflation would increase again because of the positive output gap in Year 2. However, this increase would be smaller than what occurred in Year 2 because the size of the output gap in Year 2 is smaller than it was in Year 1. This shifts the SRAS curve up again. Higher inflation reduces the real money supply and increases the real interest rate.
This causes interest-sensitive spending and overall economic output to decline. Thus, in Year 3, economic output is lower and inflation is higher than in Year 2.

In Year 4 and beyond, this adjustment process continues. As long as output is greater than the economy’s full-employment level of output, inflation will continue to rise, the SRAS curve will shift up, the real money supply will decline, the real interest rate will increase, and interest-sensitive spending and economic output will decline until general equilibrium is re-established.

General equilibrium will be re-established when output has returned to the economy’s full-employment output level. Once this has occurred inflation will be stable at a permanently higher rate.