Answers to Questions for Review

21.1.  (a) This will reduce frictional unemployment, and so increase the number of people with jobs at any real wage. So the aggregate supply of labour curve, $ASL$, will shift to the right, raising the equilibrium level of employment and shifting $LAS$ to the right. Then real output will rise and the GDP deflator will fall; and $SAS$ will shift to the right to intersect aggregate demand at the same place as $LAS$.

(b) This will increase the demand for labour. The effects are shown in Figure 21.13, with real GDP increasing and the GDP deflator falling.

(c) This will shift the labour force curve to the right, and in turn shift $ASL$ to the right. The effects will then be as in (a).

21.2.  (a) This will increase planned spending and so shift $AD$ to the right. In the short-run, the price level will rise, the real wage will fall, unemployment will fall below the natural level, and output will rise above the potential level. In the long-run, the labour market will return to equilibrium with the same real wage as before, with unemployment back at the natural level, and with output back at the potential level; but $SAS$ will shift to the left to intersect the new $AD$ at the same point as $LAS$ intersects it, and this will be at an even higher price level.

(b) This will reduce planned spending and so shift $AD$ to the left. In the short-run the price level will fall, the real wage will rise, unemployment will rise above the natural level, and output will fall below the potential level. In the long-run, the labour market will return to equilibrium with the same real wage as before, with unemployment at the natural level, and with output back at the potential level; but
SAS will shift to the right to intersect the new $AD$ at the same point as $LAS$ intersects it, and this will be at an even lower price level.

(c) This will increase planned spending and so have the same effects as (a).

(d) This will reduce investment and so reduce planned spending and have the same effects as (b). You may have noted that if the pessimism felt by firms extends also to people who own shares, then some of those people may sell shares in the expectation that their prices will fall, and prefer to hold money. So the demand for money will increase, pushing interest rates up and so adding further downward pressure on investment as well as creating downward pressure on consumer spending, thereby increasing the leftward shift in $AD$. 