Answers to Questions for Review

24.1  (a) Monetarists would expect a fall in demand leading to a fall in output and a rise in unemployment; but they would also expect the labour market to return fairly quickly to equilibrium with a fall in nominal wages, and this would shift SAS to the right, and so return output to the potential level and employment to the natural rate.

(b) Keynesians would expect little effect on demand, and so little effect on output and unemployment.

(c) New Keynesians would expect some effect on demand, and so on output and unemployment; and they would expect the labour market to return slowly to equilibrium, leaving output below its potential level and unemployment above the natural rate for some time.

(d) New classical economists would take the monetarist view, but expect the labour market to react more quickly.

24.2  (a) Monetarists would no doubt expect an increase in investment in the new engine, and hence an initial increase in planned spending; but as output started to rise, the demand for money would rise and the interest rate would rise, and this would choke off some consumption and other investment to leave aggregate demand and output little changed.

(b) Keynesians would expect an increase in investment that was little offset by the effects of a rise in the demand for money, so they would expect a shift in aggregate demand and a rise in output.
(c) New Keynesians would agree with Keynesians, even allowing for rational expectations, because the engine development and subsequent investment were unexpected.

(d) The new engine would make production more profitable, so RBC theory would predict an increase in labour demand; this would raise the level of natural employment and so raise the level of potential output, shifting a vertical aggregate supply curve to the right and causing a permanent increase in output. RBC theory would also expect aggregate demand to increase, but this would not affect the level of output because this theory regards the aggregate supply curve as vertical.