

# Writing Assignment 1

## AS/AD Model

Econ520. Fall 2024

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UNC

See course website for due date

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The Fed has invested a great deal of effort in order to "anchor" inflation expectations at its target of two percent per year.

Here, we try to get a sense of why this makes sense through the lens of the AS/AD model. Since that model does not have inflation yet, we assume instead that the Fed can anchor expectations about price levels  $P^e$ .

Suppose the economy is hit by a temporary negative supply shock. The shock shifts  $m$  up, thereby reducing SR-AS and MR-AS. However, after some time  $m$  returns to its original value (and SR-AS and MR-AS shift back to their original positions).

Consider the implications for output and prices over time for the following scenarios:

1. The Fed does nothing. Price expectations adjust as usual. How would output and prices evolve over time? Explain the intuition.
2. Now consider the case where price expectations are well anchored (treat them as fixed). How does this change the outcome? What does the Fed gain from anchoring expectations. Hint: What happens to SR-AS while  $m$  is high?
3. Next consider the case where the Fed stabilizes output at the original (pre shock)  $Y_n$  through the entire episode. Price expectations move around as usual. Is there a risk that inflation expectations might get entrenched (although that is not in our model)?
4. Finally, consider the case where the Fed stabilizes output but price expectations are well anchored. Are the outcomes better than with price expectations that move around?

Be sure to explain the economic intuition for everything that happens.

It is likely easiest to do case 2 before case 1 and to do case 4 before case 3.