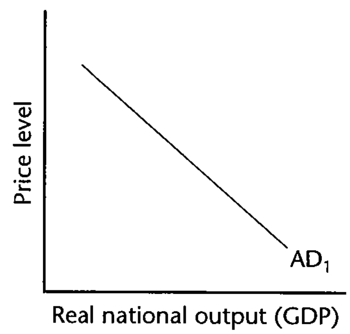
ACTIVITY 20
Manipulating the AD/AS Model: Exogenous Demand and Supply Shocks

Part A. Exogenous Demand Shocks

Read the description of each exogenous shock to aggregate demand and then draw a new AD curve that will represent the change caused by the demand shock. Label the new curve AD_2. Then briefly explain the reason for the change in the graph.

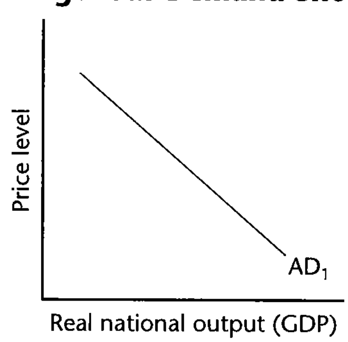
1. **Exogenous Demand Shock A**



EXOGENOUS SHOCK A:
General Motors lays off 30,000 workers.

EXPLANATION:

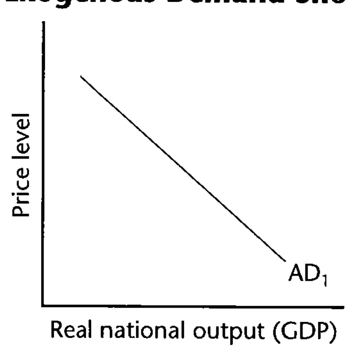
2. **Exogenous Demand Shock B**



EXOGENOUS SHOCK B:
Economic booms in both Japan and Europe result in massive increases in orders for exported goods from the United States.

EXPLANATION:

3. **Exogenous Demand Shock C**

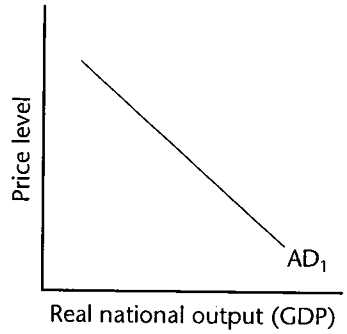


EXOGENOUS SHOCK C:
As part of its countercyclical policy, the government both reduces taxes and increases transfer payments.

EXPLANATION:

ACTIVITY 20 continued

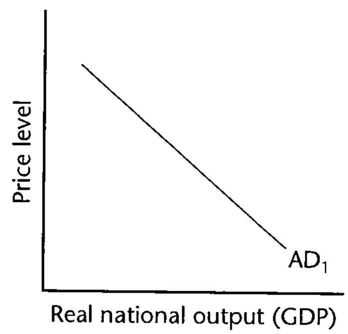
4. **Exogenous Demand Shock D**



EXOGENOUS SHOCK D:
While the United States was in the midst of the Great Depression, a foreign power attacked. Congress declared war and more than 1,000,000 soldiers were drafted in the first year while defense spending was increased several times over.

EXPLANATION:

5. **Exogenous Demand Shock E**



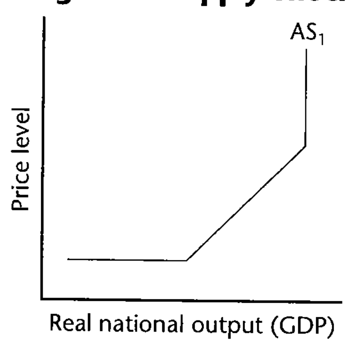
EXOGENOUS SHOCK E:
In order to balance the budget, the federal government cuts Social Security by 10 percent and federal aid to education by 20 percent.

EXPLANATION:

Part B. Exogenous Supply Shocks

Read the description of each exogenous shock to aggregate supply and then draw a new AS curve that will represent the change caused by the shock. Label the new curve AS_2. Then briefly explain the reason for the change in the graph.

1. **Exogenous Supply Shock F**

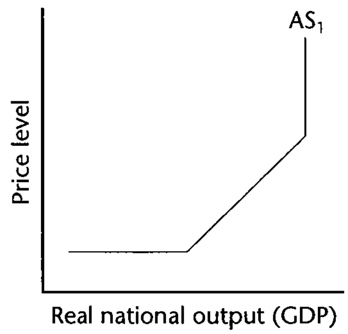


EXOGENOUS SHOCK F:
New environmental standards raise the average cost of autos and trucks five percent.

EXPLANATION:

ACTIVITY 20 continued

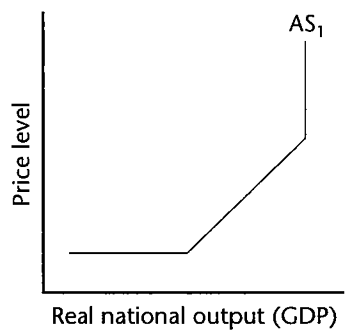
2. **Exogenous Supply Shock G**



EXOGENOUS SHOCK G:
Fine weather results in the highest corn and wheat yields in 40 years.

EXPLANATION:

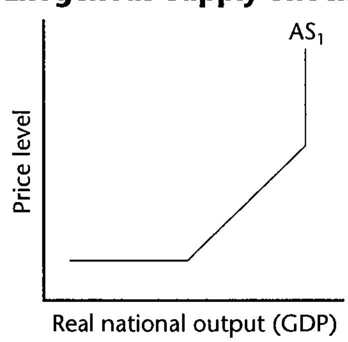
3. **Exogenous Supply Shock H**



EXOGENOUS SHOCK H:
Due to decreased international tensions, the government sells off thousands of Army surplus Jeeps and trucks at prices that are far less than the market price for their commercial counterparts.

EXPLANATION:

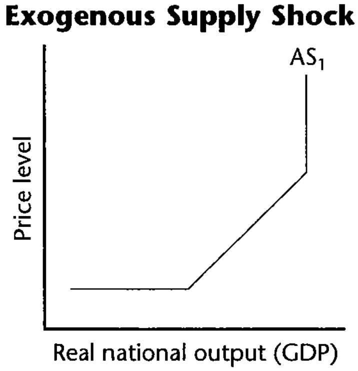
4. **Exogenous Supply Shock I**



EXOGENOUS SHOCK I:
An enemy power mines the sea lanes leading to the United States, and most ships refuse to deliver cargo through the mined areas.

EXPLANATION:

5. **Exogenous Supply Shock J**



EXOGENOUS SHOCK J:
After a long war, many ships, planes, trucks, and trains that had been commandeered for military use are returned to their civilian operators.

EXPLANATION:

ACTIVITY 20 continued

Part C. Manipulating the Aggregate Supply and Demand Model
Read each of the scenarios below and explain the impact the exogenous shocks will have on aggregate supply and demand. Then draw an aggregate demand and aggregate supply diagram to illustrate each impact.

1. During a long, slow recovery from a recession, consumers postponed major purchases. Suddenly they begin to buy cars, refrigerators, televisions, and heating units to replace their failing models.

2. With no other dramatic changes, the government raises taxes and reduces transfer payments in the hope of balancing the budget.

3. News of possible future layoffs frightens the public into reducing spending and saving for the feared "rainy day."

4. Due to rising tensions in many developing countries, firms begin to build new factories in the United States and to purchase sophisticated machinery that will enable them to produce here at prices that are competitive with those of low-salaried foreign countries.

5. Brazil solves its foreign debt and inflation problems. It then orders $10 billion worth of capital machinery from the United States.

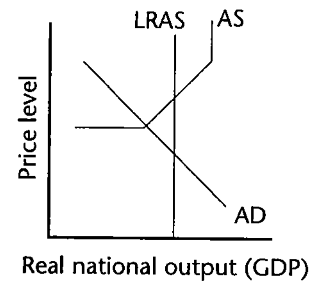
ACTIVITY 20 continued

Part D. Responses to All Shocks (Short-Run and Long-Run)
Read the description of each exogenous shock to aggregate supply and aggregate demand and draw a new AS or AD curve that represents the change caused by the shock. In some cases, several curves may be shifted. Then explain the reasons for the change in the graph and the effects of the change on the economy.

1. EXOGENOUS SHOCK K:
   Several Japanese firms open large plants in the United States.

   EXPLANATION:

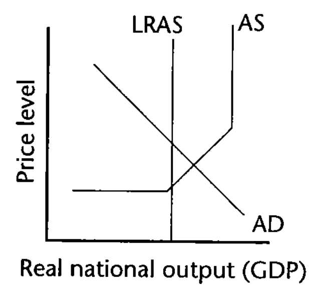
Response to Exogenous Shock K



2. EXOGENOUS SHOCK L:
   In order to lower inflation, the government raises personal income taxes by 20 percent.

   EXPLANATION:

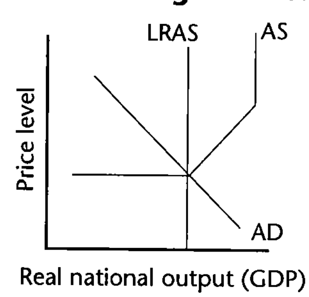
Response to Exogenous Shock L



3. EXOGENOUS SHOCK M:
   The government increases defense spending by 10 percent per year over a five-year period.

   EXPLANATION:

Response to Exogenous Shock M

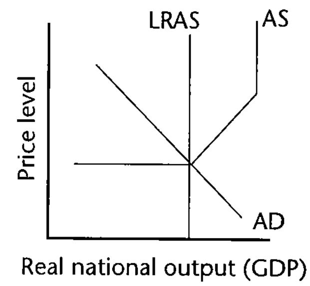


ACTIVITY 20 continued

4. EXOGENOUS SHOCK N:
   OPEC cuts production by 30 percent, and the world price of oil rises by 40 percent.

   EXPLANATION:

Response to Exogenous Shock N



5. EXOGENOUS SHOCK O:
   The government announces a "War on Poverty" and increases spending on education, health care, housing, and basic services for the poor. No increase in taxes accompanies the program.

   EXPLANATION:

Response to Exogenous Shock O