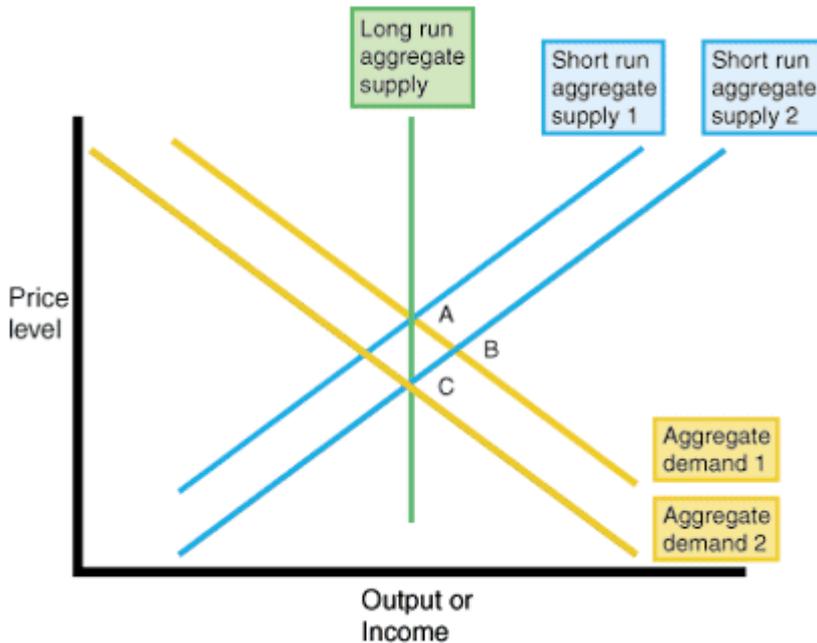


Answer on Question #43527, Economics, Macroeconomics

There are two types of supply shocks. Adverse supply shocks include things like increases in oil prices, a drought that destroys crops, and aggressive union actions. In general, adverse supply shocks cause the price level for a given amount of output to increase. This is represented by a shift of the short-run aggregate supply curve to the left. Positive supply shocks include things like decreases in oil prices or an unexpected great crop season. In general, positive supply shocks cause the price level for a given amount of output to decrease. This is represented by a shift of the short-run aggregate supply curve to the right.



Now say that a positive supply shock occurs: a reduction in the price of oil. In this case, the short-run aggregate supply curve shifts to the right from short-run aggregate supply curve 1 to short-run aggregate supply curve 2. The intersection of short-run aggregate supply curve 2 and aggregate demand curve 1 has now shifted to the lower right from point A to point B. At point B, output has increased and the price level has decreased. This is the new short-run equilibrium.

However, as we move to the long run, aggregate demand adjusts to the new price level and output level. When this occurs, the aggregate demand curve shifts along the short-run aggregate supply curve until the long-run aggregate supply curve, the short-run aggregate supply curve, and the aggregate demand curve all intersect. This is represented by point C and is the new equilibrium where short-run aggregate supply curve 2 equals the long-run aggregate supply curve and aggregate demand curve 2. Thus, a positive supply shock causes output to increase and the price level to decrease in the short run, but only the price level to decrease in the long run.