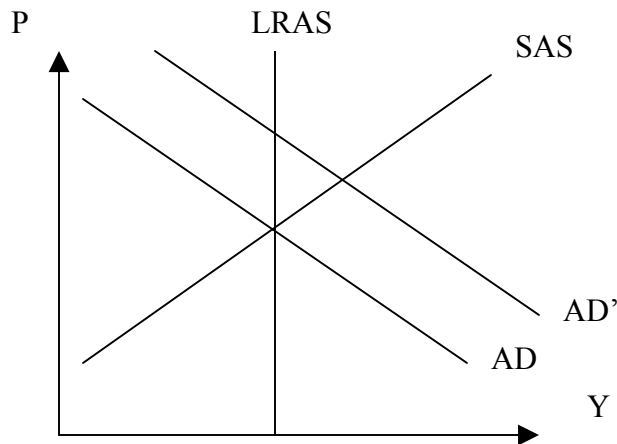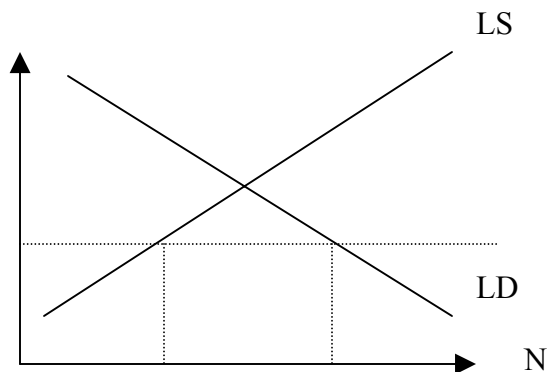Dear all,

The example I gave during tutorial was not really good. Here are some clarifications:

(a) Suppose there is a positive shock to AD (i.e. any one of C, I, G or NX increases)


And in this case there is an increase in the price level. And if you are asked what will happen in the labour market in this case:


Hence LD>LS => Nominal wage W will go up and Cost of production will go up. SRAS will shift to the left to clear the inflationary gap.

(b)But if there is an oil price shock => negative supply shock : costs of production has gone up and so labour demand has gone down.

So what happens in the labour market is like this:
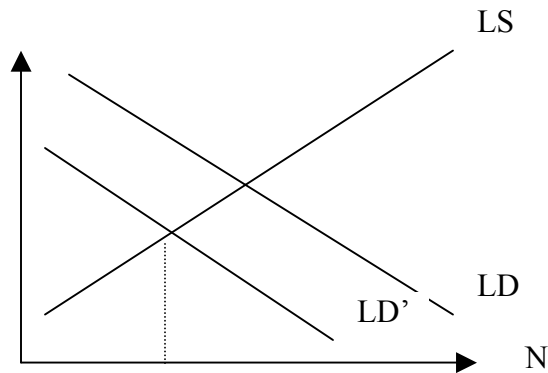
So full employment level N* has gone down as well. This means that Potential ouput Y* will go down and LRAS will move to the left. Besides, the increase in oil price will shift SRAS to the left because of higher cost of production. So it becomes something like this:
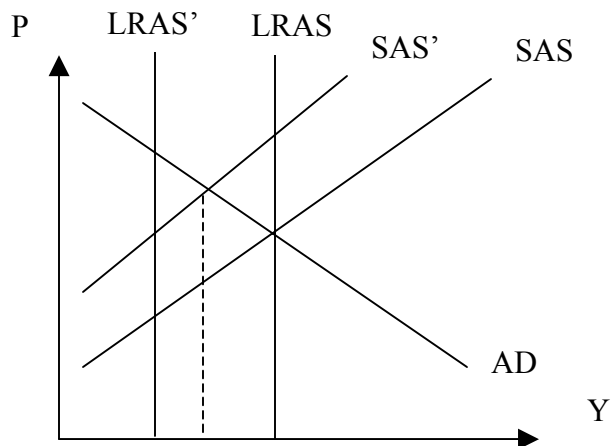
This is only one of the cases where the corresponding diagramme for labour market is:
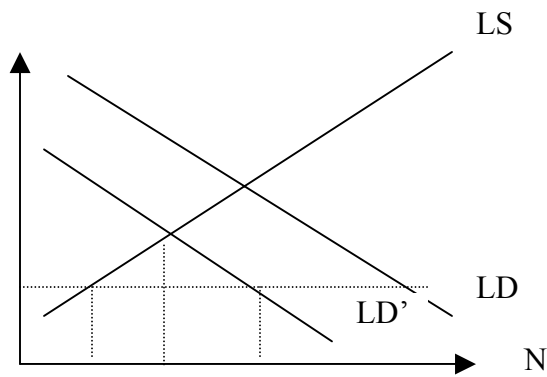
So in this case, the LD> LS and W will go up => SRAS will shift to the left again to restore long run equilibrium.

There are two more cases and you'll draw them yourself.