STICKY PRICES

The following is from a discussion on the AP Teacher Macro Blog. I think the answer gets to the bottom of Sticky Prices and Wages pretty well and also tackles Classical v Keynesian.

Here's the part of the exam question being discussed in the QUESTION and ANSWER sections that follow:

1. Assume that the economy of Meekland is in a long-run equilibrium with a balanced government budget.

(a) Using a correctly labeled graph of aggregate supply and aggregate demand, show each of the following.

(i) Long-run aggregate supply

(ii) The output level, labeled Y_E, and the price level, labeled PL_E

(b) Assume consumer confidence falls. Show on your graph in part (a) the short-run impact of the change in consumer confidence and label the new equilibrium price level and output Y_1 and PL_1, respectively. What happens to price level? What happens to output?

QUESTION from teacher #1: Looking back at some of the free response questions the AD-AS analysis does not seem to take into account downward inflexible or sticky prices. There is a question that ask what happens when aggregate demand decreases, and a correctly drawn graph would show Real GDP (or output) decreases and Price Level decreases; however, I teach that prices are sticky in the short run and only Real GDP decreases. So my question is, if a student indicated that price level did not change because of sticky prices, would they get it correct? From 2011 Exam B, question 1 answer key states: AD shifts left because of a drop in consumer confidence (below long run equilibrium). Price level decreases. What if a student said PL remains unchanged because of sticky prices?

ANSWER from teacher #2: I don't know how to make a buzzing sound on something like this. But let's just pretend that this is it, "BRRRRRR". and then in a computer generated voice, " I m sorry, that answer is incorrect." Look at your graphing. A positively sloped SR-AS and negatively sloped AD that then shifts to the left. PL is down. **And this** Price level **change** might be thought of as out**put** prices **falling** which are less sticky than wages. (If the SR-AS were really, really sticky then it would be horizontal not upward sloped.)

The slow shifting of the SR-AS to the right to 'fill' the output gap (recessionary gap) would be input prices coming down, factor prices declining. And that is where the rubber hits the road. Classical economists would have wages fall, input prices be flexible. Keynesians would argue that wages are sticky and that this 'fall' might take quite a long time and be painful during this period. And that is where we have great discussions in economics. Do we need stimulus from government to get AD back up to its previous level, thereby eliminating the recessionary gap or do we wait?”