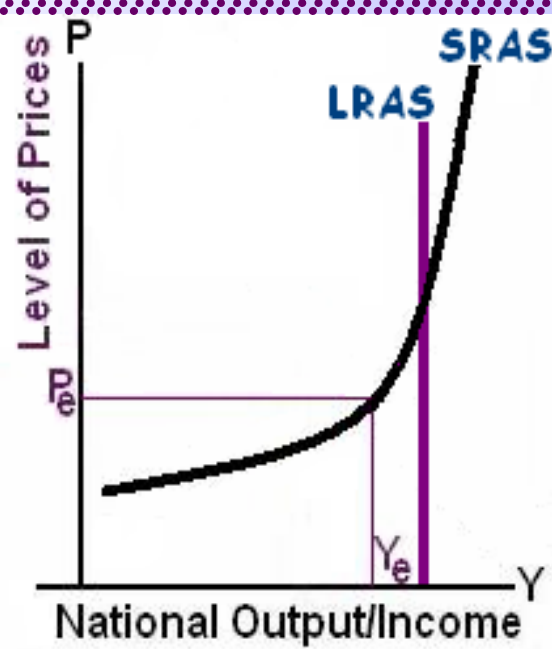
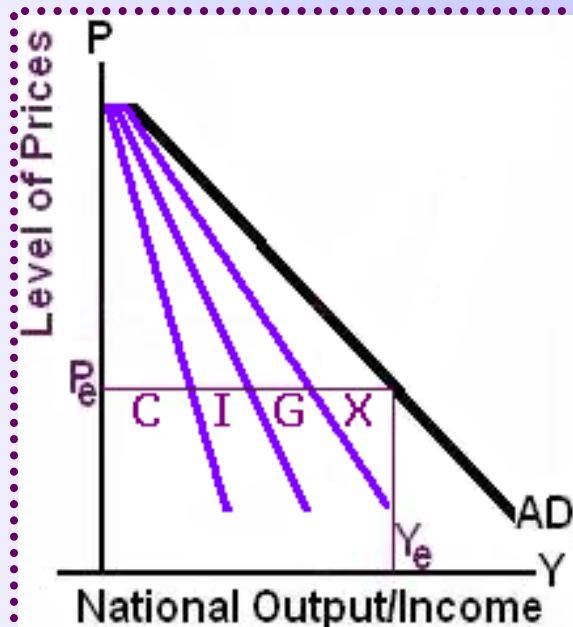


Aggregate Supply, Aggregate Demand

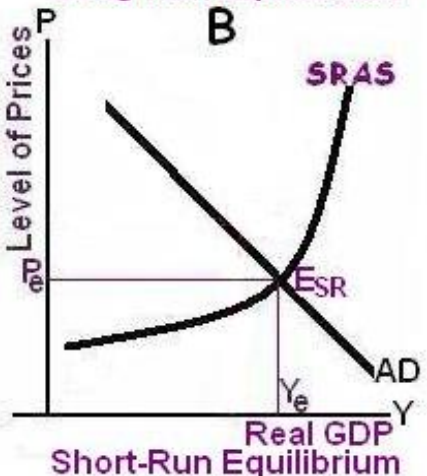
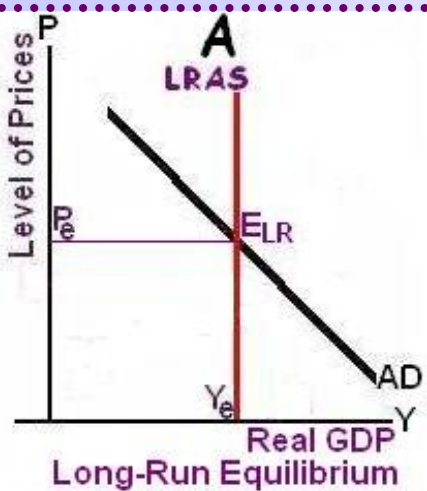
1

- **Aggregate Demand:** total quantity of final goods and services that all sectors in the economy (households, businesses, government & foreigners) are willing to purchase at a given level of prices in a given time period .
- **AD Curve (Schedule) is downward-sloping – spending & P are inversely related. Why?**
- ✓ **Welfare or real-balance effect:** lower prices allows buy more goods per unit of money;
- ✓ **Interest-rate effect:** lower prices usually come with lower interest rates, encourage investment
- ✓ **Foreign-trade (exchange-rate effect):** As domestic prices rise, imports becomes relatively cheaper, local consumers to foreign goods
- **Aggregate Supply:** total quantity of final goods and services that domestic businesses are willing to produce and sell at a given level of prices in a given time period .
- **Aggregate Supply Curve (Schedule) is upward-sloping – sales & P are directly related in the Short-Run, but it is vertical in the Long-Run. Why?**
- ✓ In the *Short-Run* (SRAS), producers respond to higher demand & prices by bringing more inputs into the production process
- ✓ *Long-Run* aggregate supply (LRAS=Potential GDP) is independent of the price, it depends only on available resources and their productivity

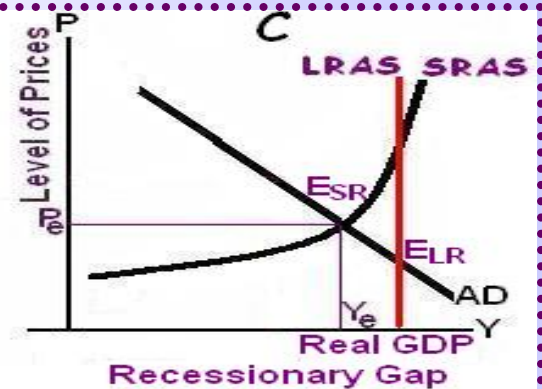
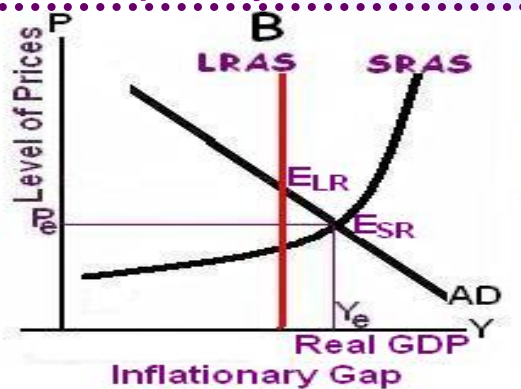
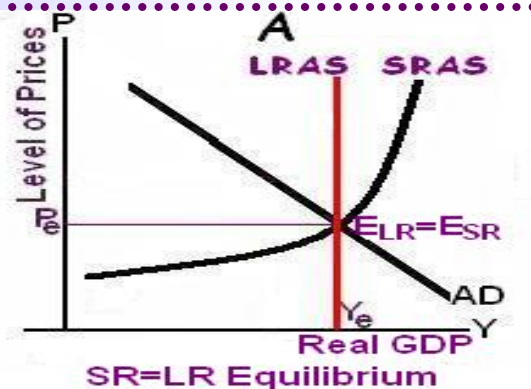


Equilibrium: Long-Run vs. Short-Run

- In macroeconomics we have *SRAS* & *LRAS*, so - there are two aggregate equilibriums with different set of equilibrium price level and output:
 - ✓ A. long-run equilibrium - E_{LR} @ $AD=LRAS$;
 - ✓ B. short-run equilibrium - E_{SR} @ $AD=SRAS$.
- The **GDP (output) gap**: difference between actual GDP and potential GDP equilibrium outputs.



- Three possible cases of the GDP gap:
 - ✓ **No gap (A)**: SR & LR equilibriums coincide - actual real GDP equals potential GDP, all resources are fully employed, economy is efficient along its PPF;
 - ✓ **Inflationary gap (B)**: SR equilibrium higher than LRAS - actual real GDP is above potential GDP, prices are below ELR level of prices. Resources are overstretched, their prices start going up, putting inflationary pressure on the economy;
 - ✓ **Recessionary gap (C)**: SR equilibrium lower than LRAS - GDP is below potential GDP, prices are above ELR level of prices. Resources are underutilized, their prices start going down, businesses work under capacity.

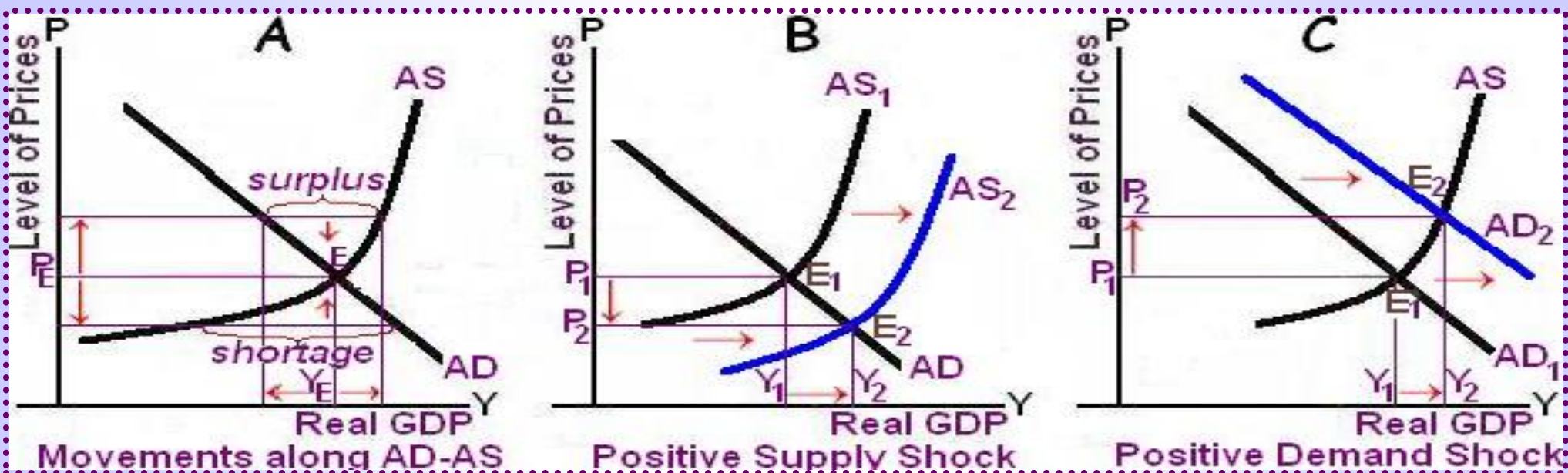


SR Equilibrium: Disequilibrium & Shocks

3

➤ **Macroeconomic Equilibrium:** the state of national economy when all currently produced output is sold to consumers and neither buyers, nor sellers wish to change their purchases, sales, or prices.

- ✓ **Movement along** the AD/AS curves is caused by change in the level of prices: they can bring brief periods of disequilibrium, but resulting surpluses or shortages will drive aggregate market back to SR equilibrium level of price (P_E) and output (Y_E)
- ✓ **Change (shift)** in AD/AS is caused by a change in the determinants of AD/AS and lead to *macroeconomic shocks*.



Results of AS/AD Shocks

➤ Table illustrates how AD and AS shocks change the equilibrium price level P_E and output Y_E

✓ For example: an increase in AS (positive supply shock), shifts the AS curve to the right (down, out) and decreases P_E , but increases Y_E (deflationary expansion).

➤ Table illustrates results of AD/AS shocks. Four possible cases (cases 1-4):

- ✓ 1. deflationary expansion;
- ✓ 2. inflationary recession;
- ✓ 3. inflationary expansion;
- ✓ 4. deflationary recession.

Cases	AD	AS	P_E	Y_E
Single Shock				
1		(+)	(-)	(+)
2		(-)	(+)	(-)
3	(+)		(+)	(+)
4	(-)		(-)	(-)
Double Shock				
5	(+)	(+)	(?)	(+)
6	(-)	(-)	(?)	(-)
7	(+)	(-)	(+)	(?)
8	(-)	(+)	(-)	(?)
(+) (?) (-) increase; (-) decrease; ambiguous				

Factors that affect (determinants of) AD & AS

Aggregate Demand

Aggregate Supply

1. Income	(+)	1. Costs	(-)
2. Wealth	(+)	(a) Labor (wages)	
3. Population	(+)	(b) Resource	
4. Interest rates	(-)	2. Investment (prior)	(+)
5. Credit availability	(+)	3. Productivity	(+)
6. Government demand	(+)	4. Interest rates	(-)
7. Taxation	(-)	5. Credit availability	(+)
8. Foreign demand	(+)	6. Foreign supply	(-)
9. Investment	(+)	7. Expectations	
10. Expectations		(a) Profits	(+)
(a) Inflationary	(+)	(b) Inflationary	(±)
(b) Income	(+)	(c) Interest rate	(±)
(c) Wealth	(+)	8. Taxation	(-)
(d) Interest rate	(+)		

(+): An increase in this factor causes the curve to shift right

(-): An increase in this factor causes the curve to shift left

- ✓ *macroeconomic AD/AS Model;*
- ✓ *AD curve (schedule);*
- ✓ *welfare, interest rate, foreign trade effects;*
- ✓ *AS curve (schedule);*
- ✓ *LRAS vs. SRAS;*
- ✓ *long-run vs. short-run equilibrium;*
- ✓ *GDP gap;*
- ✓ *short-run equilibrium: movements along vs. shifts;*
- ✓ *macroeconomic (AD, AS) shocks;*
- ✓ *determinants of AS and AD.*

Course Web Support:

<http://www.skylinecollege.info/mosesov/macro/>

<http://www.mhhe.com/economics/samuelson17/students/Ch21.mhtml>