Unit 03 Preview

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Aggregate Demand

The Wealth Effect

- Higher price levels reduce the purchasing power of money, which decreases the quantity of expenditures.
- Lower price levels increase purchasing power and increase expenditures

Interest Rate Effect

- When the price level increases, lenders charge higher interest to get a REAL return on their loans

Foreign Trade Effect

- When price levels rise, foreign buyers purchase fewer U.S. goods and Americans buy more foreign goods. X_n decreases.

Figure 1 An aggregate demand curve

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Multipliers

- Marginal Propensity to Save (MPS); How much people save instead of consume when there is a change in income. Expressed as

$$MPS = \frac{\Delta \text{savings}}{\Delta \text{Disposable Income}}$$

- Marginal Propensity to Consume (MPC); How much people consume rather than saving when disposable income changes. Expressesed as a fraction:

$$MPC = \frac{\Delta \text{consumption}}{\Delta \text{Disposable Income}}$$

- Spending Multiplier

$$\frac{1}{MPS} = \frac{1}{1 - MPS}$$

- Simple Tax Multiplier

$$\frac{MPS}{MPC}$$

Short-Run Aggregate Supply (SRAS)

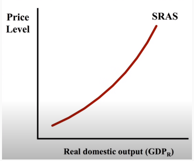
Things that can affect SRAS

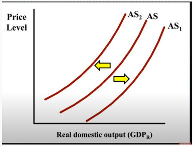
- Change in the prices of resources
- Changes in taxes, subsidies, or regulations
- Change in productivity
- Expectations

Definitions

- Short-run, a period in which the price cannot change for at least one factor of production.
- Expectations: what firms believe will happen to the prices.
- Menu costs: firms might not change prices because its too expensive.

$$Y = Y^* + \alpha(P - P_e)$$

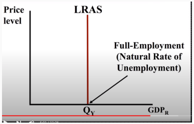


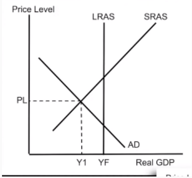


Long-Run Aggregate Supply (LRAS)

- The curve shows what we can produce at the natural rate of unemployment.
- A recessionary gap doesn't necessarily mean there's a recession.
- The curve shows relationship between price level and real GDP if everything was fully flexible. LRAS is vertical.

$$Y = Y^*$$





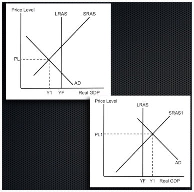
Equilibrium in the Aggregate Demand-Aggregate Supply (AD-DS) Model

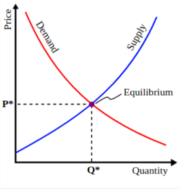
Overview

- Puts aggregate deamnd and aggregate-supply together.
- Recessionary gap doesn't necessarily mean there's a recession

Aggregate demand equation

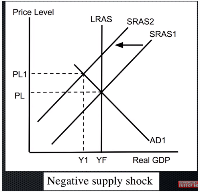
$$AD = C + I + G + (X - M)$$





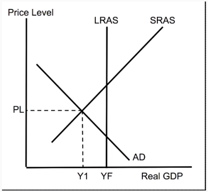
Change in the AD-AS Model in the Short Run

- This unit revolves around shifting curves, specifically SRAS, AD1
- Positive supply shock: the short supply increase.
- Cost push inflation, supply shifts left, and demand-pull shifts right.



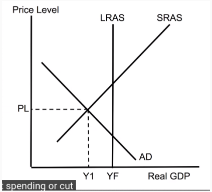
Long-Run Self Adjustment

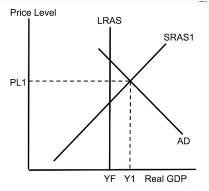
- Idea that the economy self-adjusts; it's not demand that changes, it's shortened supply.
- If flexible, short ag will shift to the right, putting back at full employment.



Fiscal Policy

- Government gets involved.
- Expansionary fiscal policy; laws that reduce unemployment and increase GDP; increaes spending, decrease taxes, combinations of the two.
- Contractionary fiscal policy; laws that reduce inflation, decrease GDP; decrease government spending, increase taxes, combinations.





Automatic Stabilizers

- Discretionary fiscal policy; congress creates new bills that changes AD through spending
- Non-Discretionary fiscal policy; aka. automatic stabilizers. Permanent spending or taxation laws to work counter cyclically to stabilize the economy.
- When GDP goes down, government spending automatically increase, and taxes fall