Discussion Handout 8: Chapter 20 - Aggregate Supply & Aggregate Demand

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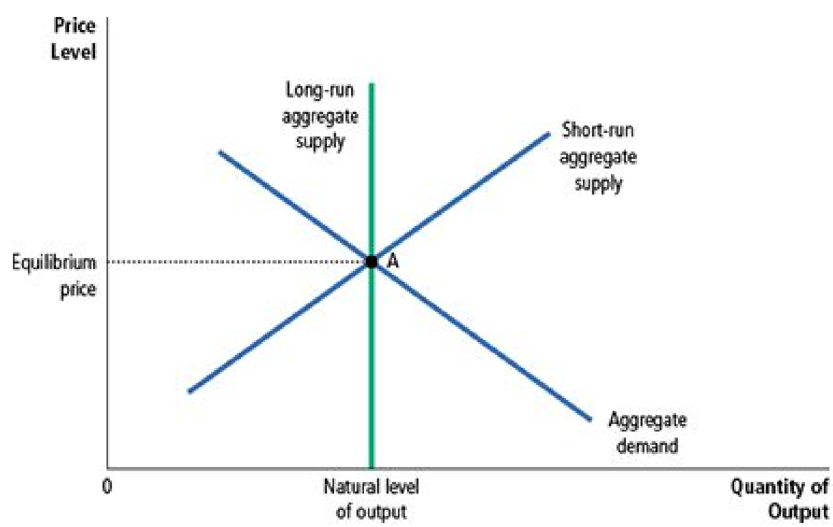
The Model of Aggregate-Demand and Aggregate-Supply

Overview: Want to be able to explain short-run changes. Previously examined what determines long-run trends (classical theory & money neutrality).

Concepts:

- Aggregate-Demand Curve - Quantity of goods and services that households, firms, the government, and customers abroad want to buy at each price level.
- Aggregate-Supply Curve - Quantities of goods and services that all firms produce and sell at each price level.



Aggregate-demand curve slopes down for three reasons:

1. Wealth Effect - when consumers feel wealthier they buy more

2. Interest-Rate Effect - lower interest rates encourages investment, so increases demand for goods and services by firms

3. Exchange-Rate Effect - Lower value of the dollar increases foreign demand for goods and services

Aggregate-demand curve slopes shifts for four reasons:

1. Consumption (C) - Consumers decide to consume less/more at every price level, which shifts curve left/right. For instance, because they receive a tax cut/decide to save more.

2. Investment (I) - Firms decided to invest less/more, which shifts curve left/right. For instance, because they receive a tax cut, interest rates change, worries about future business conditions.

3. Government - The government decides to spend less/more, which shifts curve left/right. For instance, to cut/increase military or infrastructure spending.

4. Net Exports (NX) - Foreigners decide to buy less/more goods from the US, which shifts curve left/right. For instance, if there is a recession/boom overseas or a change in the exchange rate.

Long-run aggregate-supply curve is vertical: From earlier in the book, we know that the production (supply) of goods & services (real GDP) depends on the supply of labor, capital, natural resources, and available technology. Price level does not change this (money neutrality).

Long-run aggregate-supply shifts for four reasons:

1. Labor - Less/more workers shifts curve left/right. Policy such as minimum wage, unemployment insurance, universal childcare.

2. Capital - Less/more capital shifts curve left/right. Also includes increases in human capital.

3. Natural Resources - Less/more access to resources shifts curve left/right. Might be restricted by access to oil.

4. Technological Knowledge - Less/more technology shifts curve left/right. Examples: new patents, regulation that prevents certain technologies from being used.

Short-run aggregate-supply curve slopes up, because of response to prices. Three theories why, all suggest that output deviates in the short run from natural level when the actual price level deviates from the price people expect:

1. Sticky wage theory - Slopes-up because nominal wages take a while increase/decrease to price changes. In the meantime, it might cause firms to produce more/less after a change in the price level.

2. Sticky price theory - Menu costs take awhile to adjust so lower/higher prices means firms have lower/higher supply than they would otherwise.

3. Misperceptions theory - Price level confuses people, don't realize it is relative, so they respond. Basically people don't realize there is money neutrality.

Aggregate-supply curve slopes shifts, in the short-run, for five reasons: :

1. Labor, Capital, Natural Resources, Technological Knowledge

2. Changes in the expected price level - A decrease/increase in the expected price shifts the curve to the right/left.

Four Steps for Analyzing Fluctuations:

1. Decide whether the event shifts the aggregate-demand or aggregate-supply curve, or both.

2. Decide which direction the curve shifts.

3. Use the diagram to determine short-run changes in price level

4. Use the diagram to analyze how the economy moves to new short-run or long-run equilibrium.