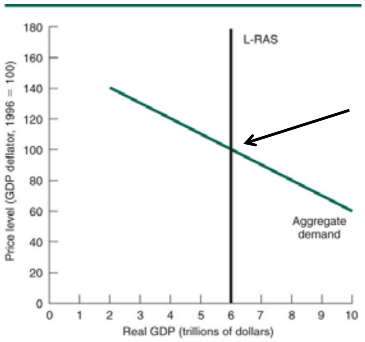
Aggregate Supply & Aggregate Demand

Chapter 11

The *AS–AD* Model

The **AS-AD model** uses the aggregate supply curve and the aggregate demand curve together to analyze economic fluctuations.

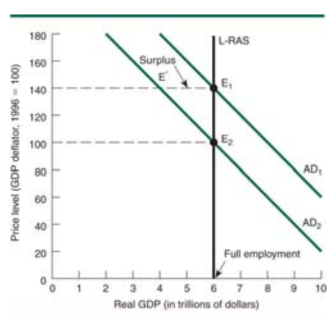
Long-Run Macroeconomic equilibrium



LR equilibrium of $6 trillion in real GDP and price level of 100.

Supply Creates Its Own Demand!

Classical View of Recessions



1. Economy starts at AD_1: E_1 at Full employment GDP and Price level = 140.
2. During recession, AD decreases to AD_2: E' at lower output ($4 trillion).
3. Surplus inventory of $2 trillion so firms decrease prices until sell off surplus at E_2.

Conclusion: No government intervention necessary. Flexible prices will pull economy out of recession. Economy is self-adjusting!

Part II: The Keynesian Critique of the Classical System

- Until the Great Depression, classical economics was the dominant school of economic thought.
  - "Laissez-Faire": government should intervene in economic affairs as little as possible.
- The Great Depression undermined faith in Say's Law.
- John Maynard Keynes developed alternative theory of macroeconomics:
  - Advocated government intervention to bring an end to the Great Depression.
  - Focused on boosting demand for output, not flexible prices.
- These two views continue to shape policy debates.

Keynes' Critique of Say's Law: $S \neq I$

- Savings and investment are not equalized by interest rates:
  - Saving is not affected by interest rates. People save for future purchases and based on income.
  - Businesses invest when expect demand for product. In recession, why expand even if interest rates are low?
- If $S > I$, not everything being produced would be purchased.

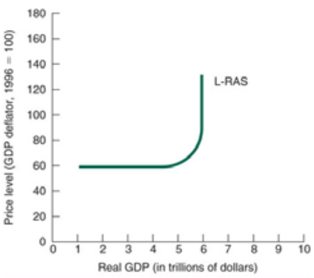
Keynes' Critique of Says Law: Prices and Wages are not Flexible

- Prices are not downwardly flexible, even in a recession.
  - Big firms in concentrated industries (oligopolies) can wait out recession without lowering prices.
  - They would rather temporarily reduce output.
- Wages are not downwardly flexible, even in a recession.
  - Labor unions with long-term contracts resist wage cuts.
  - Lowering wages not ideal way to increase inflation because it reduces income.
- If prices and wages are not flexible, Supply does not create its own Demand.

Keynesian View of Macroeconomic Equilibrium

- Economy was not always at, or tending toward, a full employment equilibrium.
- Three equilibriums are possible:
  - *Below* full employment
  - *At* full employment
  - *Above* full employment
- Famous quote: "In the Long Run, we are all dead."
  - Don't wait for the economy to fix itself, even if it could.

Modified Keynesian Aggregate Supply Curve



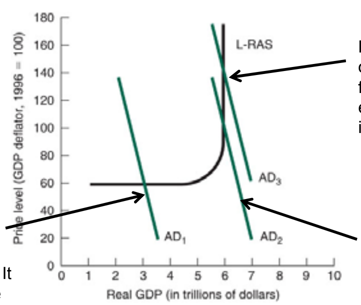
1. During recession, output can be increased without raising prices (flat part of curve).
2. As approach full employment ($6 trillion), prices begin to increase (upward sloping part of curve).
3. At full employment level of GDP, L-RAS is vertical. Output cannot be expanded, but price level can increase.

Keynesianism is Demand-Side Economics

- Keynes stood Say's Law on its head:
  - Can be summarized as, **"Demand creates its own Supply."**
  - Business firms produce only the quantity of goods and services they believe consumers (C), investors (I), governments (G), and foreigners (X) will plan to buy.
- Aggregate Demand is the prime mover of the economy.
  - If you can expand C, I, G, and/or X (demand for goods and services), businesses will sell surplus and continue to expand.
  - Level of GDP depends upon **planned expenditures**.

Three Possible Equilibriums

AD_1 represents aggregate demand during a recession or depression. It can increase without inflation.



Expanding output beyond full employment is inflationary.

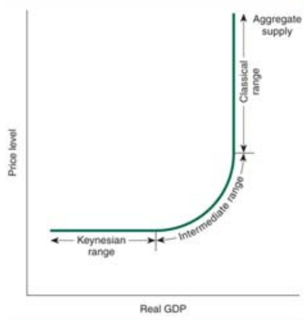
AD_2 crosses the long-run aggregate supply curve at full employment

Summary of Two Theories

Classical View	**Keynesian View**
• Assumes flexible price	• Assumes flexible demand for output
• Savings depends on interest rates	• Savings depends on income
• Investment depends on interest rates	• Investment depends on profit expectations
• Wages flexible	• Wages sticky
• Wait for Long Run	• Fix in Short Run

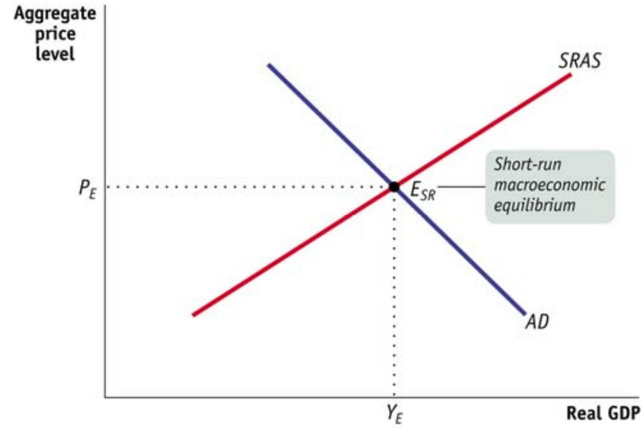
Which assumptions seems more realistic to you?

Three Ranges of the Aggregate Supply Curve



- Contemporary macroeconomists often synthesize the two theories, suggesting that each theory could hold true under different economic conditions.

The *AS–AD* Model



Short-Run Macroeconomic Equilibrium

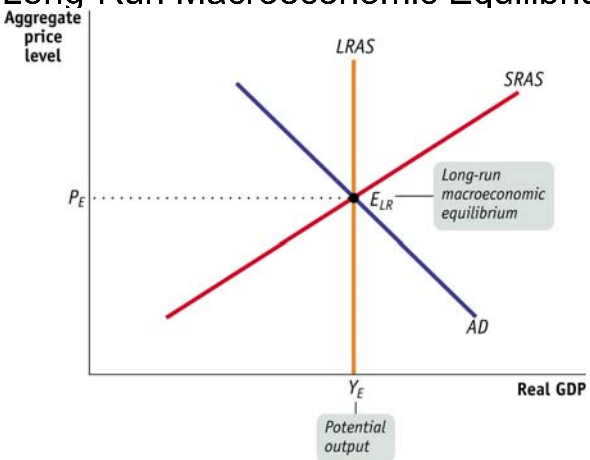
- The economy is in **short-run macroeconomic equilibrium** when the quantity of aggregate output supplied is equal to the quantity demanded.
- The **short-run equilibrium aggregate price level** is the aggregate price level in the short-run macroeconomic equilibrium.
- **Short-run equilibrium aggregate output** is the quantity of aggregate output produced in the short-run macroeconomic equilibrium.

An important point that is not in clearly defined in your textbook

Long-Run Macroeconomic Equilibrium

The economy is in **long-run macroeconomic equilibrium** when the point of short-run macroeconomic equilibrium is on the long-run aggregate supply curve.

Long-Run Macroeconomic Equilibrium



Self-correcting Mechanism

In the long run the economy is **self correcting:** shocks to aggregate demand do not affect aggregate output in the long run.

From your textbook

The Debate As Framed By Your Textbook

- Your textbook frames the debate between the classical economist and Keynesian as a debate about the shape of the Aggregate Supply curve.