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 Say’s 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.
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

Classical View
- Assumes flexible price
- Savings depends on interest rates
- Investment depends on interest rates
- Wages flexible
- Wait for Long Run

Keynesian View
- Assumes flexible demand for output
- Savings depends on income
- Investment depends on profit expectations
- Wages sticky
- 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.

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.

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

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.