Review Notes – Economic Fluctuations

- Economic fluctuations over time
  - Why is there so much change in the economy (e.g., real GDP growth) over time?
  - Build a model that explains the differences between short and long run in the macro economy.
    - Long run = flexible prices leading to full employment
    - Short run = sticky prices leading to unemployment or over-employment
  - What is Aggregate Demand?
    - Shows the relationship between the total demand for all goods/services produced in the economy (Y) and aggregate prices (P).
  - What is Aggregate Supply?
    - Shows the relationship between total supply of all goods/services produced in the economy (Y) and aggregate prices (P).

Aggregate Demand
- Quantity exchange equation determines AD
  - \( MV = PY \Rightarrow Y = (M/P)V \Rightarrow P \uparrow \Rightarrow Y \downarrow \) - why?
    - When \( P \downarrow \) then less $ needed for transactions and D for loanable funds \( \downarrow \Rightarrow r \downarrow \Rightarrow I \uparrow \) (and \( C \uparrow \)) \( \Rightarrow AD \uparrow \)
    - Also wealth effect and foreign sector substitution effect
  - What causes AD to shift? Changes in:
    - C
    - I
    - G
    - NX
    - Money
    - Know how each one works

Aggregate Supply
- What does AS look like?
  - In the long-run
    - \( Y = f(L, K) = \bar{Y} \) so LRAS is vertical at full employment output \( (\bar{Y}) \).
    - AS determines Y while AD determines P.
  - In the short-run
- Depends on whether prices are totally inflexible or just partially inflexible.
  - If totally inflexible then SRAS is perfectly elastic (why?).
  - If partially inflexible then SRAS is upward sloping (why?).

- What causes shifts in aggregate supply?
  - Resource costs
  - Technology
  - Labor/leisure choices
  - Etc.

- Shocks to the economy
  - Adverse demand shock
    - $AD \downarrow$ or $\uparrow$ => what happens in the short-run and in the long-run (i.e., inflation or unemployment or both)?
    - What is an appropriate fiscal policy?
    - What is an appropriate monetary policy?
  - Adverse supply shock
    - $SRAS \downarrow$ or $\uparrow$ => what happens in the short-run and in the long-run (i.e., inflation or unemployment or both)?
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