

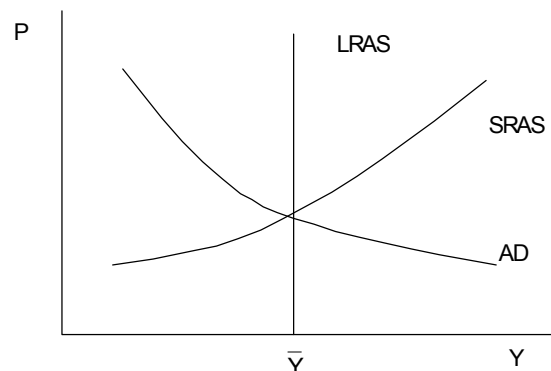
## Review Notes – Economic Fluctuations

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- 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
    - $MV = PY \Rightarrow Y = (M/P)V \Rightarrow$  when  $P \uparrow$  then  $Y \downarrow$  - 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
      - $Y = f(\bar{L}, \bar{K}) = \bar{Y}$  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.
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- Shocks to the economy
    - Adverse demand shock
      - $AD \downarrow$  or  $\uparrow \Rightarrow$  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  $\uparrow \Rightarrow$  what happens in the short-run and in the long-run (i.e., inflation or unemployment or both)?
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