Lesson 6: Aggregate Supply & Demand
Reading: Chapters 9 & 10

In this lesson we will:
- Study how the different sectors of the economy interact
- Use aggregate supply and demand to represent the economy

- The economy is made up of four sectors that interact in 4 markets. What do the arrows indicate?

![Diagram of the economy's sectors and markets](Figure 6-1: The Sectors of the Economy)

The price level and aggregate quantity demanded are inversely related:
- **Wealth Effect:** As the overall price level rises consumers will be able to purchase less with the total amount of fixed wealth that they possess. What wealth is fixed?
- **Substitution Effect:** As prices of domestic products increases, consumers will substitute domestic goods for ... What will happen to GDP and why?
- **Interest-rate Effect:** An increase in the price level will increase the demand for money and drive up interest rates, thus reducing investment and consumption of durables.

**Short-run Aggregate Supply (SAS):** the relationship between production price level in the short macroeconomic short run. Why don’t wages adjust in the short-run?

**Long Run Aggregate Supply (LAS):** equals potential GDP and is not affected by the price level. The LAC represents potential GDP. Why is it a vertical line?
- In the long run the economy will gravitate towards the Long-run Aggregate Supply curve at which point the economy would be operating under full employment.
In the short-run, the economy will settle where the AD and the SAS curves intersect.
- If the price level is above $P^*$ then there will be a surplus or *excess inventories*. *What will firms do?*
- *What will happen if the price level is below $P^*$?*

**Long run Adjustments:**
- If real GDP is above potential GDP, the difference between the two is called an *inflationary gap*. If real GDP is below potential GDP, the difference between the two is called a *recessionary gap*. *What are automatic stabilizers? What will happen to wages, the i-rate and stabilizers in the long run?*
  - Interest rate, wages and automatic stabilizers are *counter-cyclical*

**Shifts in the Curves**
- AD = C + I + G + (X − M). Anything that changes the 4 components will change AD. *What will change each one of these variables? What will cause consumers to buy more?*
  - The SAS will shift if there is an overall increase to the costs of inputs (*like what?*) or a supply shock (like a natural disaster).
  - The LAS and SAS will both shift if the economy’s potential to produce increases. *What would increase this potential (think about the PPF)?*

**How do business cycles occur?**
- Recessions occur because prices in the goods market are relatively low to resource costs due to an unexpected decrease in the AD or an unfavorable *supply shock*. The recession of 1974-5 occurred because of a rise in oil prices.
- Expansions occur when prices in the goods market are relative high to resource costs because of an unexpected increase in the AD or a favorable supply shock.
  - *How does the economy recover from recessions and expansion?*
An increase in the LAS will increase GDP while driving prices down.
- Potential GDP increase by 3% per year on average
- When the LAS shifts the SAS shift with it. Like two sticks glued together
- As our economy grows we can produce more goods and at a lower cost.

Types of Inflation:
- **Demand-pulled Inflation**: occurs when an increase in AD causes a continuous rise in prices. *List 3 things that can cause a demand-pulled inflation.* A mild or moderate demand-pulled-inflation can improve expectations and wealth, thus … AD. *What is true about unemployment during demand-pulled inflation?*
- **Cost-pushed Inflation**: occurs when the SAS decrease due to a rise in the prices of inputs (especially petroleum). *What is true about unemployment in this case?*
- **How can the government slow down inflation?** [Hint: by reducing AD]

**Figure 7-2:** Demand-pulled inflation.

A demand pulled inflation can be caused by any event that increases AD, thus moving the economy from A to B.
- At point B *various adjustment mechanisms* will move the economy back to potential GDP (point C)
- If AD keeps increasing, prices will continue to rise.

*Use aggregate supply and demand to illustrate a cost-pushed inflation.*

How will each of the following events affect GDP and the price level?
- A rise in income tax?
- A series of hurricanes?
- An increase in the interest rate?
- An increase in the stock of physical capital?
- A depreciation in the currency?
- A fall in the price of fuel coupled with a rise in consumer confidence?

**Review:** pp. 234-35, problems 1, 2, 4, 9, 12, 15 & 18.