UNIT 3 AP MACROECONOMICS

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Unit 3 - National Income and Price Determination

AGGREGATE DEMAND CURVE

Shows relationship between aggregate price level & quantity of aggregate demand by households, firms, government, and the rest of the world.

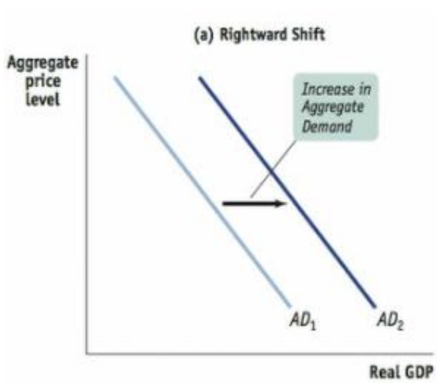
DOWARDING SLOPE BECAUSE OF...

- Real-balance effect (increase in price level decreases the purchasing power of money)
- Interest rate effect (increase in interest rate decreases borrowing and spending)
- Open **economy effect** (higher price levels decreases net exports)
    - Made up of consumption, investment, government spending, and net exports
- **Shifters**
- Changes in expectations (optimistic beliefs increase demand)
- Changes in **wealth** (rise in asset value increase demand)
- Size of existing physical capital (small existing stock of physical capital increases demand)

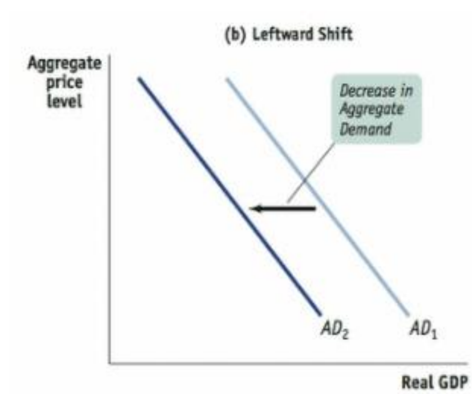
Fiscal Policy: Government spending **increase or tax cuts increase demand.**

Monetary Policy: Quantity of money **increases demand.**

Increase:



Decrease:



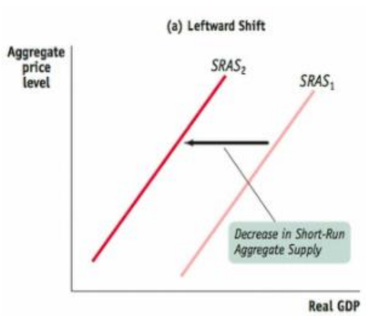
Short-run Aggregate Supply (SRAS)

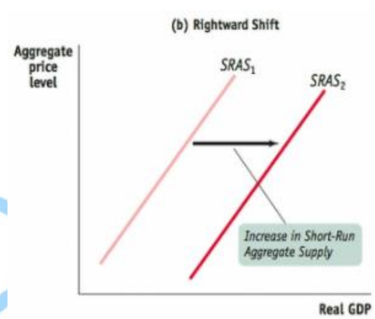
When firms haven't made price changes in response to an economic shock (sticky prices).

Is upward sloping because of

UPWARD SLOPE BECAUSE OF...

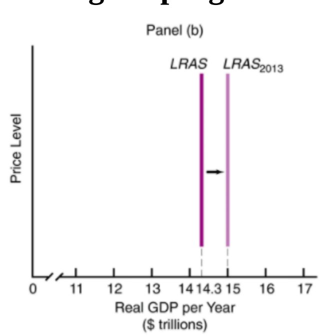
- The **misperception theory** (producers mistaken price increase as greater profit)
- Sticky Price Theory (producers temporarily reduce quantity b/c of menu costs)
- Sticky Wage Theory (production costs can be higher from union contracts)
- Shifters
- Changes in **commodity prices** (lower commodity price increases SRAS)
- Changes in **nominal wages** (lower nominal wages increases SRAS)
- Changes in productivity (more productive workers increases SRAS)

Increase - 

Decrease - 

Long-run aggregate supply (LRAS)

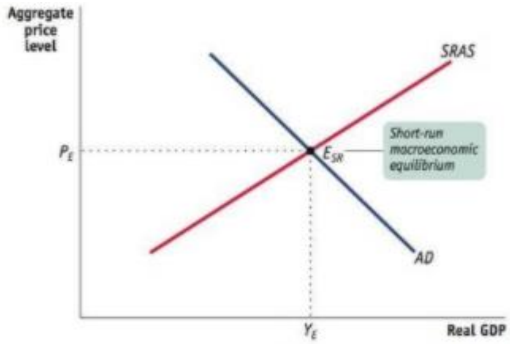
- After producers have adjusted their prices according to economic shocks
- All production costs are **fully flexible**
- It is an economy's potential output (represent the full-employment output)
- Shifters that cause and increase
- Increases in the quantity of resources (e.g., land, labor)
- Increases in the quality of resources (e.g., education)
- **Technological progress** can increase LRAS

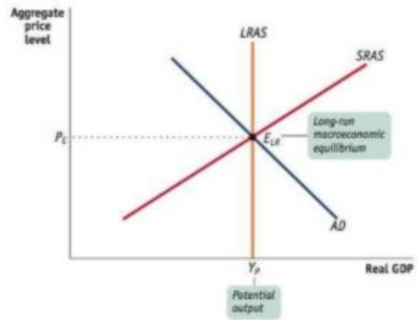
Increase - 

Decrease is **opposite**

LRAS shifts indicate changes in full-employment level of **output & economic growth.**

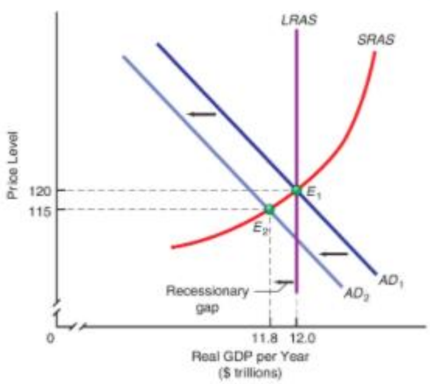
AD-AS MODEL





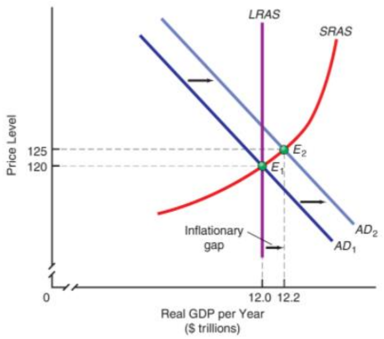
- If aggregate price level is above equilibrium, AS will exceed AD and cause the aggregate PL to **fall**, pushing it back to the equilibrium. If aggregate price level is below equilibrium, AD will exceed AS and cause the aggregate price level to **rise**, pushing it back to the equilibrium.
- Positive demand shock increases aggregate price and aggregate output **(demand-pull).** Negative demand shock decreases aggregate price and aggregate output.
- Positive supply shock decreases aggregate price and increases aggregate output. Negative supply shock increases aggregate price and decreases aggregate output **(supply-push).**

Recessionary gap: Exists when SRAS equilibrium is **less than LRAS equilibrium.**



If so, wages would fall and SRAS would shift to the right, bringing the economy back to LRAS equilibrium.

Inflationary gap: Exists when SRAS equilibrium is **greater than LRAS equilibrium.**



If so, wages would rise and **SRAS would shift to the right,** bringing the economy back to LRAS equilibrium.

- Economy self-corrects in the long-run

EQUILIBRIUM

- Short-run equilibrium is when AD & SRAS are equal
- Long-run equilibrium is when AD & SRAS are equal and interest on LRAS

FISCAL POLICIES (affect AD)

Expansionary Fiscal policies that **increase aggregate demand:**

- Increase in **government purchases** (has greatest effect)

Multiplier =

$$\frac{1}{(1-MPC)} \times \Delta AAS$$

MPC = (Change in consumer spending) / change in disposable income

MPC+MPS = 1

- Cut in taxes

Multiplier = (MPC) / MPS

MPS = 1 - MPC

- Increase in **government transfers**

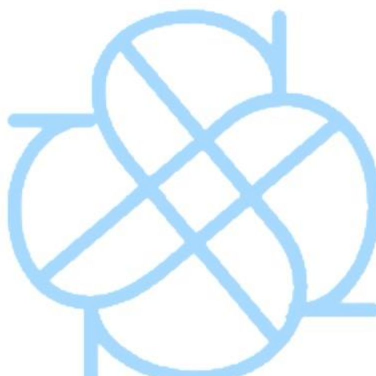
Contractionary Fiscal Policies that **decrease aggregate demand:**

- Decrease in government purchases
- Increase in **taxes**
- Decrease in government transfers

Expansionary policies are used in recessions and contractionary fiscal policies are used in expansions.

<u>Government spending and taxation rules</u> that cause fiscal policy to be automatically expansionary during recessions and contractionary during expansions are **automatic stabilizers:**

- Ex. Tax revenues automatically **decrease as GDP falls**, increasing consumption and preventing the economy falling into a greater recession.
- Ex. Tax revenues automatically **increase as GDP rises**, decreasing consumption and the economy from overheating.



KEY:

UMP - Unemployment

PL - Price level

MB - Market basket

G&S - Goods and services

PV - Present value

FV - Future value

RGP - Real gross domestic product

AD - Aggregate demand

SRAS - Short-run aggregate supply

LRAS - Long-run aggregate supply

SRPC - Short-run phillip's curve

LRPC - Long-run phillip's curve

PPC - Production possibilities curve

SOURCES:

- https://apcentral-stg.collegeboard.org/pdf/ap-macroeconomics-course-and-exam-description.pdf
- https://matermiddlehigh.enschool.org/ourpages/auto/2015/8/25/54609372/Krugman_s%20Economics%20for%20AP.pdf
- https://prezi.com/view/1VuIm7ij82RHI6nXtCmV/
- https://www.google.com/imghp?hl=EN