



Why does everything slow down at once?

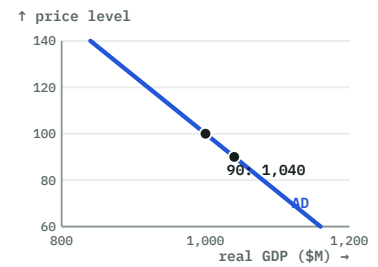
Coralia's whole economy on one chart: aggregate demand, aggregate supply, and what shocks do to prices and output.

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AD

aggregate demand

- AD = all spending on the island's output at each price level → $C + I + G + NX$ (consumption, investment, government, net exports)
- Axes: **price level** (index, 100 today) ↑ · **real GDP** (\$ million) →
- Slopes **down**: price level ↓ ⇒ real GDP demanded ↑ (100 → 90: 1,000 → 1,040M)
- Why: **wealth** effect (savings buy more) · **interest-rate** effect (less cash needed ⇒ cheaper loans) · **exchange-rate** effect (exports ↑, imports ↓)

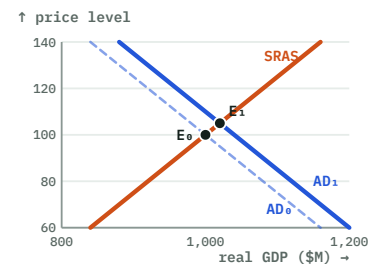


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Shifts of AD

move along ≠ shift

- Price level changes ⇒ move along AD · **C, I, G or NX** change at every price level ⇒ AD shifts
- right: tax cut, new machines, new harbor, boom abroad · ← left: the opposite, fewer tourists
- Tax cut: $C + 40 \Rightarrow AD \rightarrow 40$ · price level 100 → **105** · real GDP 1,000 → **1,020M** (+20 only: higher prices take back demand)

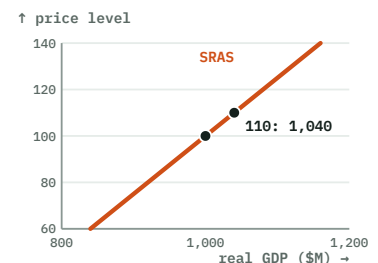


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SRAS

short-run supply

- Wages **sticky** (contracts) ⇒ prices ↑, costs fixed ⇒ profit per sale ↑ ⇒ output ↑
- Slopes **up**: 100 → 110: 1,000 → 1,040M
- Shifts with **firms' costs** at every price level: fuel, wages, imported inputs
- costs ↑ ⇒ SRAS ← · costs ↓ ⇒ SRAS → · price level alone ⇒ move along



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LRAS

long-run supply

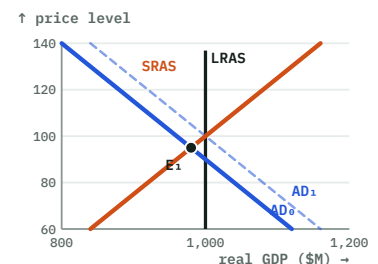
- Wages catch up with prices ⇒ price level no longer moves output ⇒ **vertical** line
- At **potential output** = full employment (\$1,000M) · set by workers, capital, technology

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Equilibrium, gaps

where AD meets SRAS

- Short-run equilibrium** = AD ∩ SRAS · price level and real GDP now · Coralia: 100 and 1,000M
- gap** = real GDP - potential · **RECESSIONARY** below potential ⇒ unemployment above natural rate (cyclical) · **INFLATIONARY** above potential ⇒ unemployment below natural, wages ↑
- Find it in a table: gap = want - make · > 0 ⇒ price level ↑ · < 0 ⇒ ↓ · 90: 1,000 - 960 = +40 · 95: 980 - 980 = 0 ✓ · 100: 960 - 1,000 = -40 ⇒ 95, \$980M, **20 below** potential



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Shocks

which curve, what result

SHOCK	CURVE	PRICE LEVEL	REAL GDP	RESULT
Tourists -80	AD ←	100 → 90	960M	recessionary gap 40
Boom +80	AD →	110	1,040M	inflationary gap 40
Fuel costs ↑ (-80)	SRAS ←	110	960M	stagflation
Tax cut +40 · tourists -40	AD → · AD ←	105 · 95	1,020 · 980M	gap 20 above · 20 below

- Stagflation** = output ↓ + prices ↑ together · hard to cure: more spending ⇒ prices ↑ still, less spending ⇒ output ↓ still · real case: oil ×4 in 1973-74, US prices +11%, unemployment 9%

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Self-correction

the long run

- Recession** ⇒ jobs lost ⇒ wages ↓ ⇒ costs ↓ ⇒ SRAS → (+80) ⇒ price level **80**, real GDP 1,000M
- Boom** ⇒ wages ↑ ⇒ costs ↑ ⇒ SRAS ← (-80) ⇒ price level **120**, real GDP 1,000M · no policy needed, but slow (months or years) ⇒ Lesson 5
- Watch out: a fall in the price level is a move **along** AD, never a shift · AD ← lowers prices but SRAS ← raises them

