

Recap AD-AS framework

Business cycle fluctuations: Short-run v.s. medium-run adjustment

Short-run

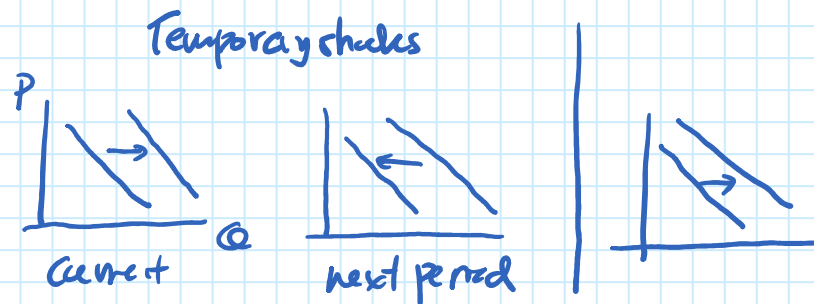
- > Immediate impact of shocks, causing a deviation from trend
- > Transmission mechanism of shocks

Medium-run

- > Self-adjusting process that puts the economy back to the long-run trend
- > Answer to question is related to the "nature of shocks": **Temporary v.s. permanent.**

Example:

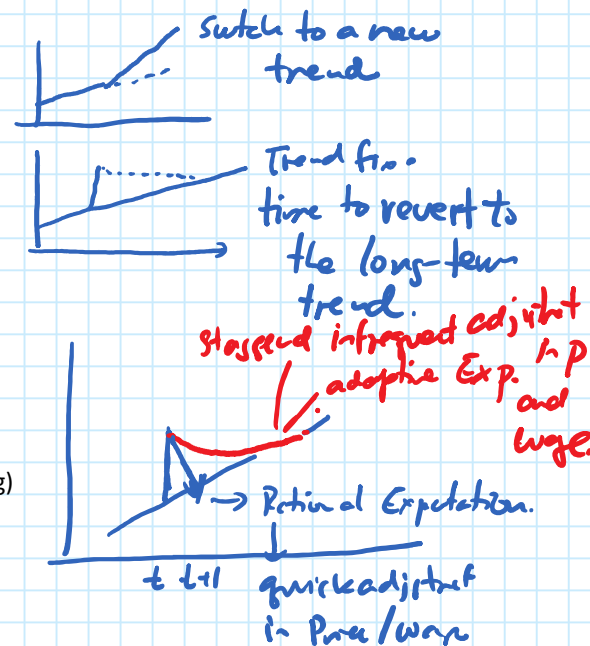
	temporary	permanent
AD	One time increase in demand	Permanent increase in demand
AS	Weather --> back to normal	Technology, climate (average rising temp)



In terms of dynamic, temporary shocks will be GONE on their own; rising and falling on their own. Permanent shocks might be more important.

Question: does the impact of permanent shocks last forever as the lasting periods of shocks?

- Yes for Permanent AS shocks --> lasting forever as it changes long-run trend.
- No for Permanent AD shocks --> Trend remains the same. Observed deviation is a temporary outcome.



Adjustment mechanism:

- Wage stickiness: people revise expectation, and bargain for new wage schemes.
- Price stickiness: firms adjust price
- > All these undo the initial impact of shocks (reverse the course of initial impact)

Speed of trend reversion:

- How people form their expectation...
 - "adaptive" (slowly learning) expectation v.s. rational expectation (highly-forward looking)
- How frequent can firms/workers adjust price?
 - Empirically, infrequent adjustment.
 - Moreover, speed varies across sectors.
 - Unsynchronized adjustment (aka staggered adjustment)
- Economy slowly reverts to the original trend on a persistent fashion.