Aggregate Demand & Aggregate Supply

Equilibrium and Policy Analysis

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Overview

Equilibriums in this simple AD-AS model

"Inflation, and now this"

Equilibriums in this simple AD-AS model

At last... from interest rates to inflation

We have successfully endogenised price changes – and hence, inflation!

- We can see that there are two main equilibriums to be discussed
  1. Short-run equilibrium
  2. Long-run equilibrium
- Different factors affect different parts of the model.
- This is the main tool to analyse business cycles or economic fluctuations!

Recessionary gap: a visual example

Inflationary gap: a visual example

Slowly adjusting to the long-run equilibrium after AD shocks

Permanent vs. temporary AS shocks

On the production side, the effects depend on what type of shocks do we have at hand.

1. Temporary supply shocks
    - Epidemic
    - A drought, or any other type of weather shocks
2. Permanent supply shocks
    - Technological revolutions
    - Permanent changes in birth rates or mortality rates

Permanent vs. temporary AS shocks: visual examples

What we have learned about causes of inflation?

The AD-AS is very useful at visualising (and also analysing) the factors that influence inflation. Remember, we have at our hands:

1. Demand-pulled inflation
2. Cost-pushed inflation

Comparing the two visually

Inflation, Business Cycles, and the Phillips Curve

An example of a business cycle upswing

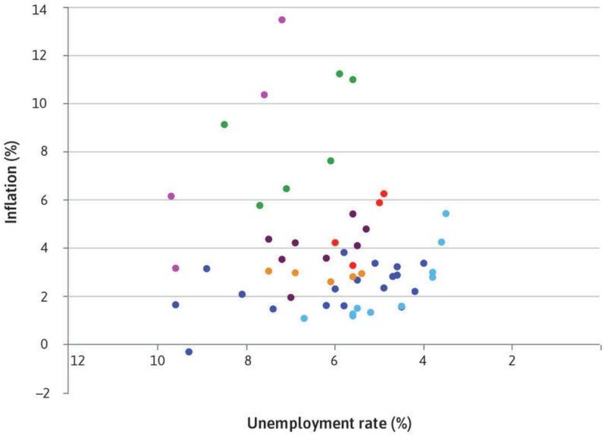
An easy way to visualise how inflation affects the economy is this. Let's imagine an economy at a labour market equilibrium and with constant prices. Now, consider a rise in AD – which reduces unemployment below the equilibrium.

1. When unemployment is low, the HR needs to set higher wage. Why?
2. Higher wages mean higher costs for firm. What shifts?
3. Price levels will have gone up! This is what we call "wage-price spiral"

Remember the trade-off between unemployment and inflation?

This is it. On top of economic growth, they are the two “most important things” to macroeconomists (not true). Jokes aside, these things affect the lives of everyone – and most likely unequally.

Phillips curves in the US (1960–2014)



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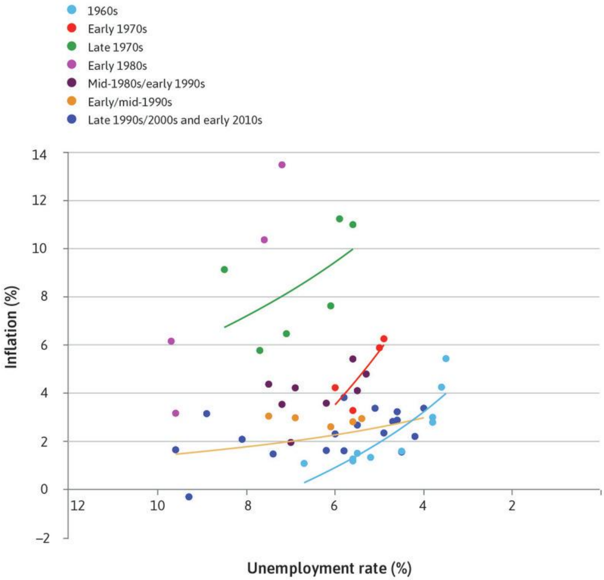
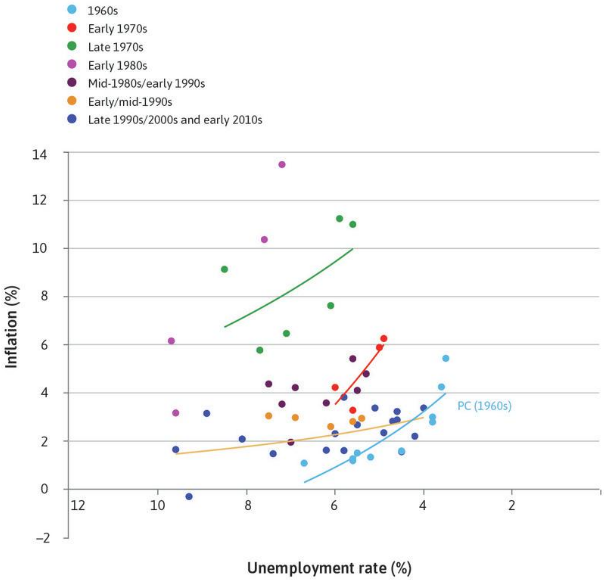
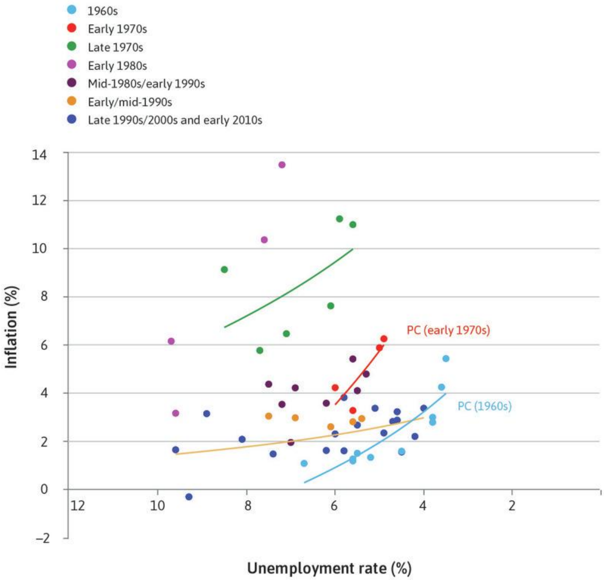


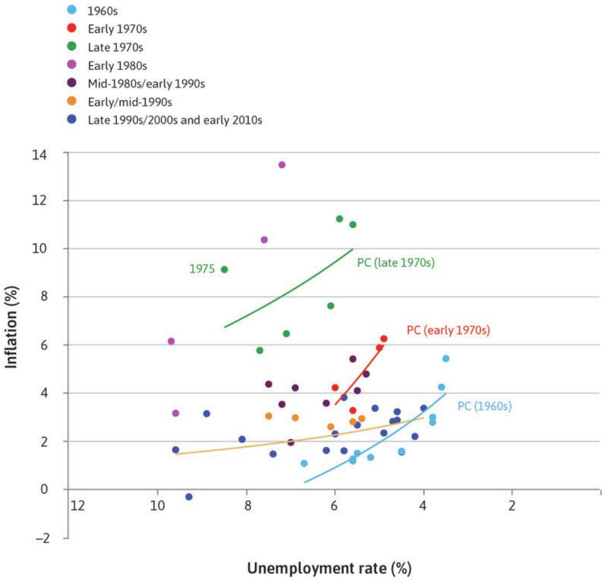
1960s: a good looking Phillips curve



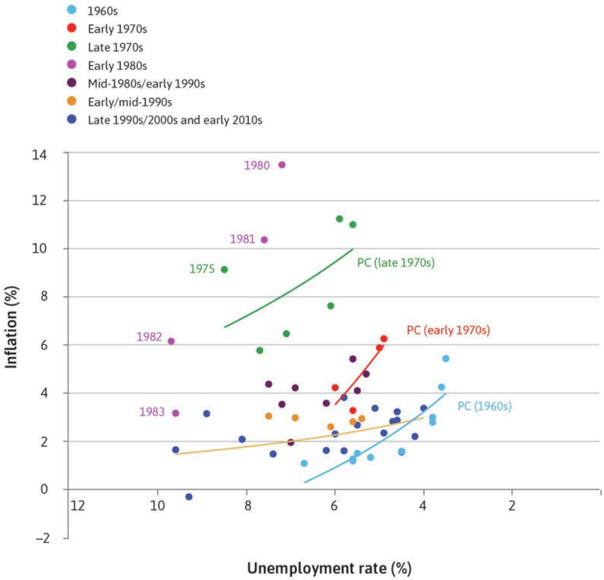
An upward shift in the early 1970s



Another upward shift in the late 1970s



Up up and away in the early 1980s



In the late 1990s to the present, the Phillips curve is low and flat.