March 8, 2012

4.3 Equilibrium → Short-Run (SR)

→ Long-Run (LR)

→ Deflationary Gap
→ Inflationary Gap
} Adjustment of factors' price & Potential GDP

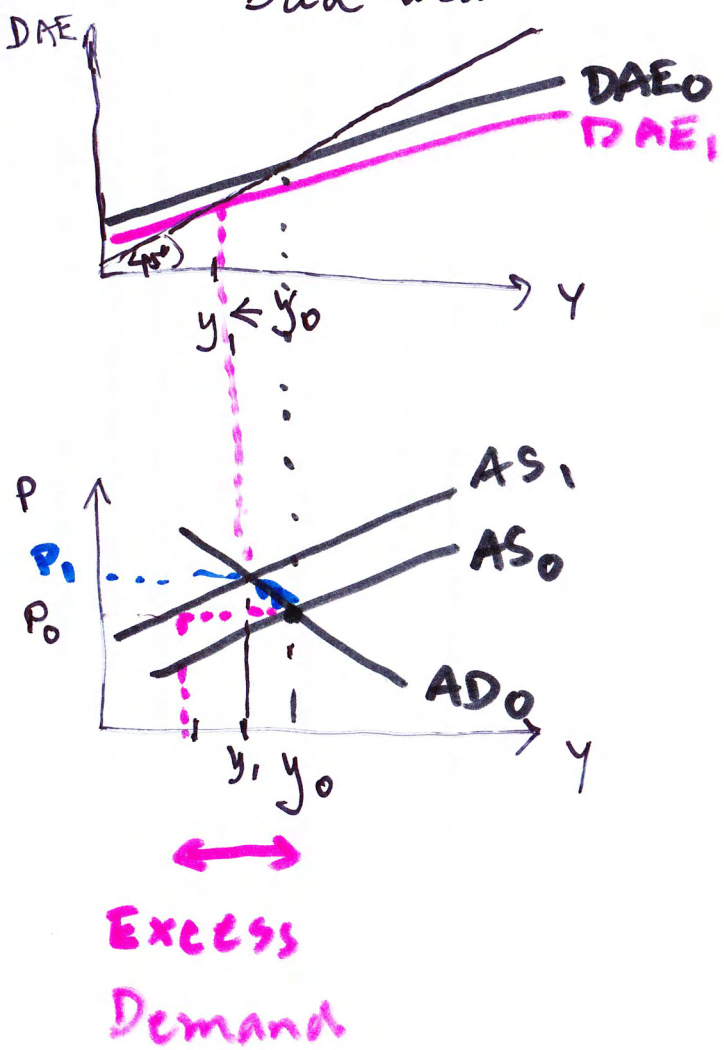
Price level & Inflation
→ Demand-Pull
→ Cost-Push

4.4 Phillips Curve

4.3 Equilibrium : Short-Run (SR)

Example 1: AS ↓

e.g. Bad weather



Step 1: AS shifts to the left

(Price does not change ; P_0)

($AS_0 \rightarrow AS_1$ due to bad weather)

At P_0 : there is the excess demand.

Step 2: Price ↑ (moving along AD)

$P_0 \rightarrow P_1$

Real Wealth ↓

X↓ M↑ C↓

DAE ↓

y ↓

Inflation (P↑) + Stagnation (Y↓)

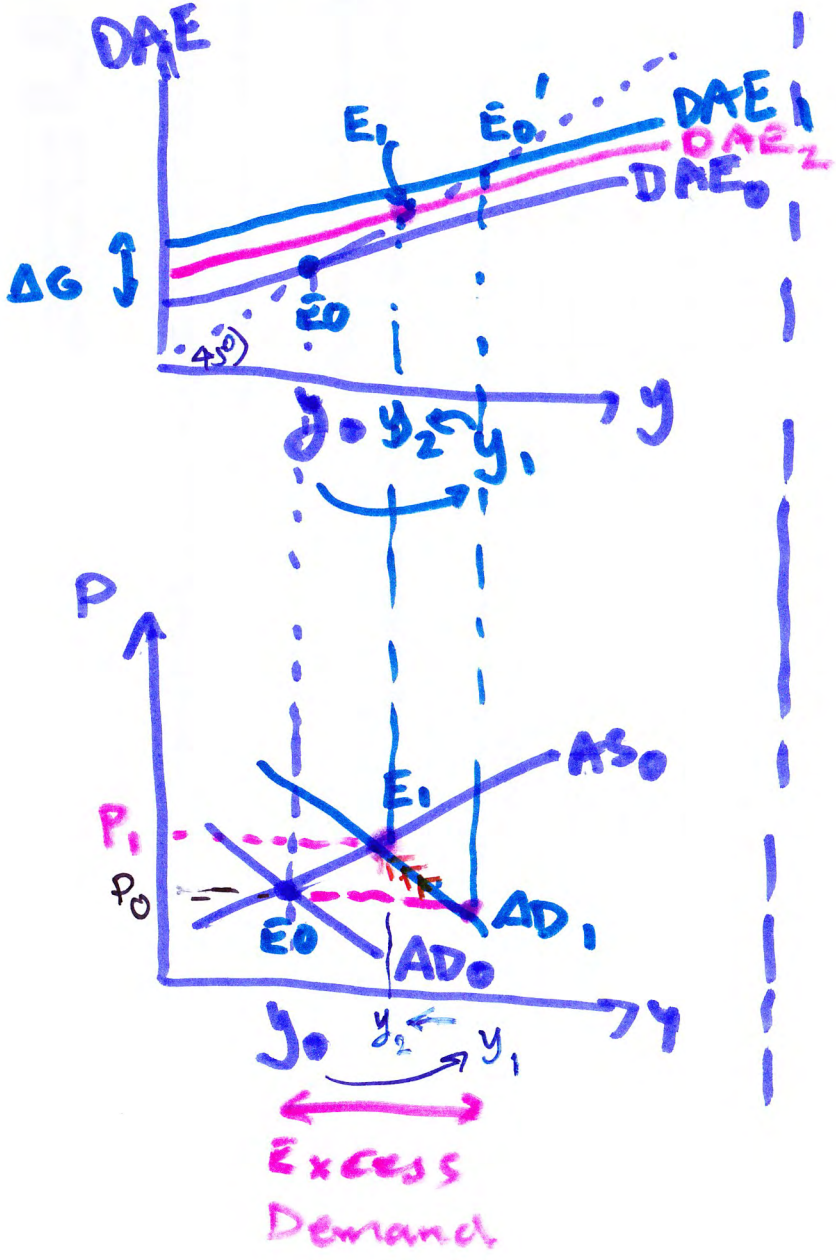
↘ ↙

Stagflation

(e.g. Oil Shock, Bad weather)

4.3 Short-Run Equilibrium (Crowding-out effect: Govt's Stimulus eventually leads to the negative effect on the economy)

Example 2: AD ↑



Step 1: $\Delta G \uparrow \Rightarrow DAE_0 \rightarrow DAE_1$

$\Rightarrow AD_0 \rightarrow AD_1$

(Price does not change: @ $P_0 \Rightarrow$ there is an excess demand)

Step 2: Price ↑ (moving along AD_1)

$P_0 \rightarrow P_1$

Real Wealth ↓

X ↓ M ↑

C ↓

DAE ↓ ($DAE_1 \rightarrow DAE_2$)

↓

y ↓ ($y_1 \rightarrow y_2$)

4.3 Long-Run Equilibrium

Short-Run (SR): Factors' prices (Wage, Rent, Raw Materials' price) are assumed to be exogeneous (given, Fixed)

⇓

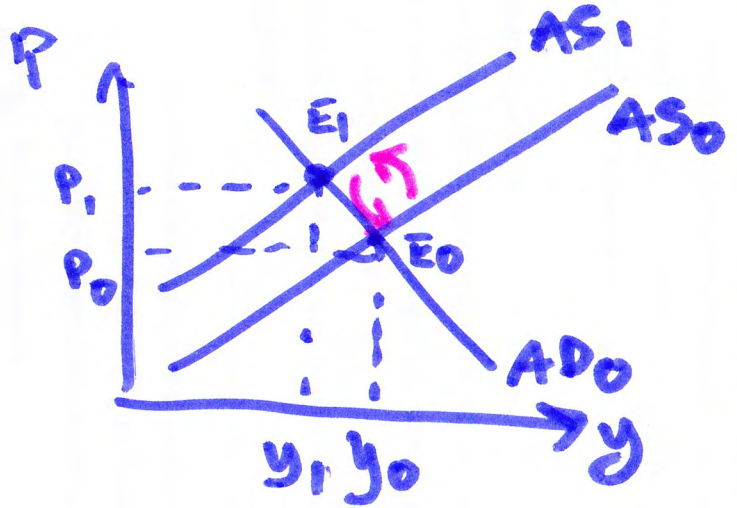
Transition Period: Factors' prices are assumed to be flexible and adjust to bridge the output gap → (Diff btw gdp_a and potential gdp)

⇓

Long-Run (LR): Factors' prices are fully adjusted (GDP returns to its potential level).

4.3 LR Equilibrium

Example # 1 : AS ↓



Short-Run : When AS ↓ ($AS_0 \rightarrow AS_1$)

SR-Equilibrium : E_1 → y↓ : $y_0 \rightarrow y_1$

→ P↑ : $P_0 \rightarrow P_1$

↓

Transition Period ($y_0 = y^* =$ Potential GDP)

$y_1 < y^*$ → Deflationary Gap → Pressure on Factors' prices ↓ → Unit Cost ↓ → AS shifts to AS_0

↓

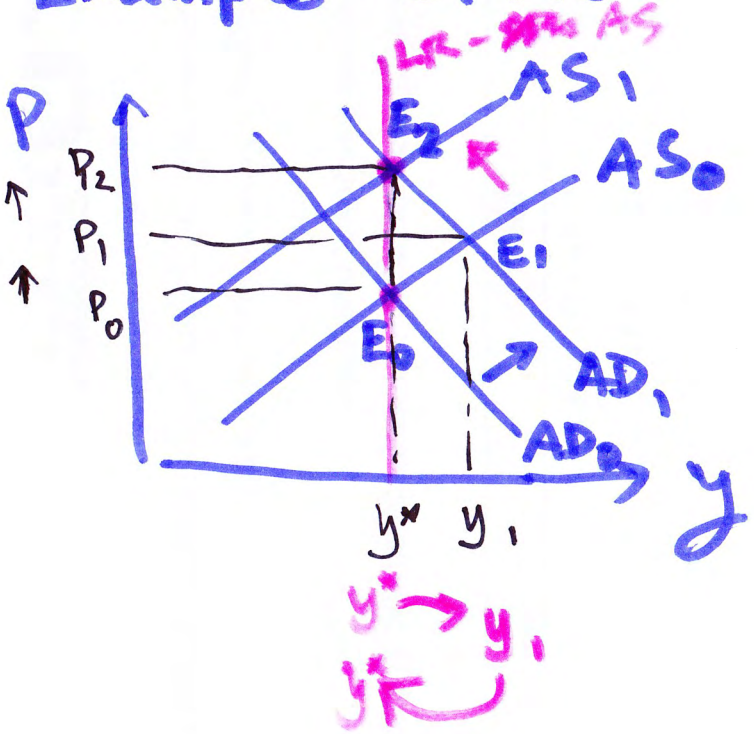
Long-Run

LR-Equilibrium = E_0 → y @ $y^* = y_0$

→ P @ P_0

4.3 LR Equilibrium

Example #2: AD↑



Short-Run Equilibrium

The economy is at E_1 → y↑ ($y^* \rightarrow y_1$)
↳ P↑ ($P_0 \rightarrow P_1$)

⇓

Transition Period

$y_1 > y^*$ ⇒ Inflationary gap ⇒ Pressure on factors' price ↑ ⇒ Unit cost↑ ⇒ AS shifts to AS1

↳ wage or price of input

⇓

Long-Run Equilibrium

Not the price of output

AS shifts ($AS_0 \rightarrow AS_1$)

↳ Equilibrium is now at E_2

↳ P↑ ($P_1 \rightarrow P_2$)

↳ Y↓ ($Y_1 \rightarrow y^*$)

4.4. Price Level & Inflation

- **Inflation** (Flow variable): An increase in price level (Stock variable) (CPI)

(Latin America in 1970s-80s)

- **Sustained Inflation**: The overall price level continues to rise over some fairly long period

- **Hyperinflation**: A period of very rapidly increases in price level. (100% - 1000%)