

AS-AD Model
Chapter 9 (cont)

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1 Potential Output and LRAS with price on vertical axis

- Labor market equilibrium implies \bar{N}
- Production function with a capital stock determined by last period's decisions implies \bar{Y}
- LRAS is vertical at \bar{Y}
- Same as FE in IS-LM graph and shifts are identical

2 Aggregate Demand Curve: Derivation

- Combinations of price and output which yield equilibrium in goods ($I = S$) and money markets ($\frac{M}{P} = L(Y, i)$) P, Y plane.
- In the IS-LM diagram, choose a value for initial price, P_0 implying a position for the LM curve, and locate equilibrium Y_0 . Plot this combination of P_0 and Y_0 in the P, Y plane.
- Let P increase to P_1 , shifting the LM curve left. Locate the corresponding equilibrium Y_1 . Plot this in the P, Y plane.
- Connect the points to obtain the AD curve.

- Why does an increase in price reduce output demanded?
 - not the same reason as in micro when the price of a good increases all other prices held constant
 - when P increases, real money falls, raising the real interest rate decreasing aggregate demand

3 Shifts in Aggregate Demand

- Anything which changes equilibrium output for a given price level.
- Since $IS=LM$ determines equilibrium output, this is equivalent to anything which shifts IS or LM other than the price level.
- Examples

4 Classical Model

- AD curve and the LRAS curve
- Price always adjust to keep output at full employment

5 Keynesian model and SRAS

- Assume that price does not adjust quickly enough to maintain full employment.
- Assume more specifically that price is fixed for the current period.
- Price rises if output exceeds potential and falls if output is less than potential.
- Example

6 IS-LM AS-AD analysis of shocks - Keynesian model in SR and LR

- Note in LR, Keynesian model is the Classical model
- Increase in the money supply (monetary neutrality?)
- Transitory increase in government spending
- Transitory increase in lump-sum taxes
- Increase in the price of imported oil