

# Macroeconomics

## 8. The Aggregate Demand and Aggregate Supply Model

Bachelor's Degrees in Management and in Finance and Accounting

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# Equilibrium in the AD-AS model

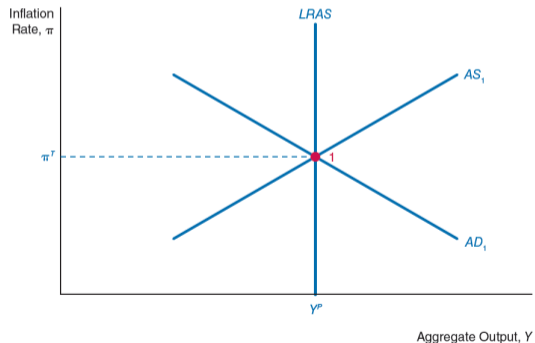
## Concept and short-run vs long-run definitions

- General equilibrium in the economy occurs when aggregate demand equals aggregate supply.
- **Long-run equilibrium:** aggregate demand equals short-run aggregate supply, which equals long-run aggregate supply, i.e.,  $AD = AS = LRAS$ .
- **Short-run equilibrium:** aggregate demand equals short-run aggregate supply, i.e.,  $AD = AS$ .

# Equilibrium in the AD-AS model

## Graphical representation

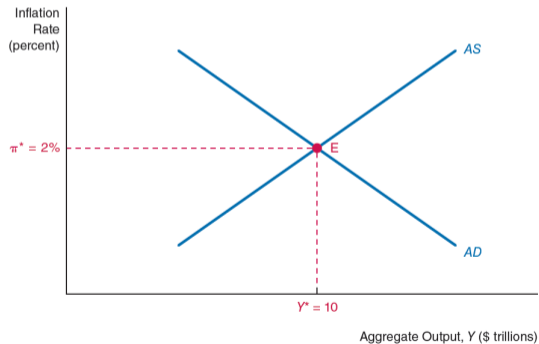
- Graphical representation of long-run equilibrium, where  $AD = AS = LRAS$ .



# Equilibrium in the AD-AS model

## Graphical representation

- Graphical representation of short-run equilibrium, where  $AD = AS$ .



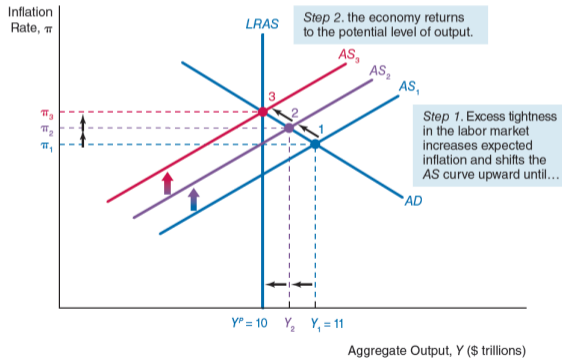
# Self-correction mechanism

- When short-run and long-run equilibria **coincide**, the short-run equilibrium occurs **at** the level of potential output ( $Y - Y^p = 0$ ).
- When short-run and long-run equilibria **do not coincide**, the short-run equilibrium occurs **above or below** potential output ( $Y - Y^p \neq 0$ ).
  - Causes we will analyze: demand shocks and supply shocks.
- **Self-correction mechanism:** whenever short-run equilibrium is above/below potential output, the short-run aggregate supply curve ( $AS$ ) shifts up/down in order to bring the economy back to full employment (potential output), eliminating the output gap:
  - This mechanism operates through the labour market.

# Self-correction mechanism

## Graphical representation

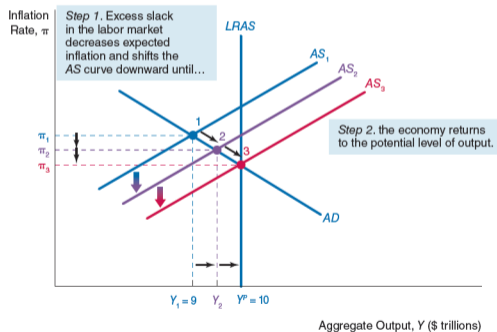
- Graphical representation of the self-correction mechanism when  $Y > Y^P$ .



# Self-correction mechanism

## Graphical representation

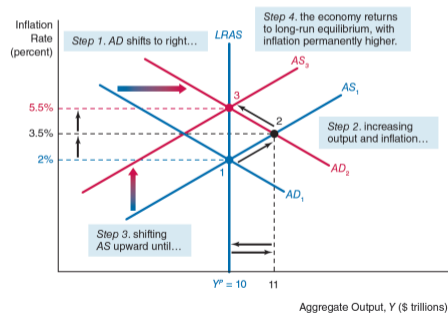
- Graphical representation of the self-correction mechanism when  $Y < Y^P$ .



# Aggregate demand shocks and the self-correction mechanism

## Graphical representation

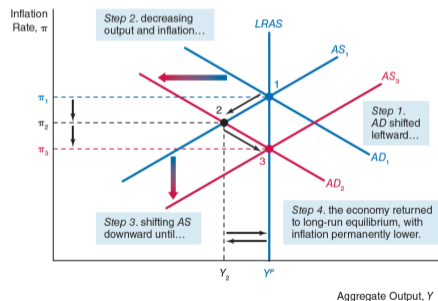
- Graphical representation of the self-correction mechanism after a **positive aggregate demand shock**. We have  $\uparrow \pi$  and  $Y = Y^P$ :



# Aggregate demand shocks and the self-correction mechanism

## Graphical representation

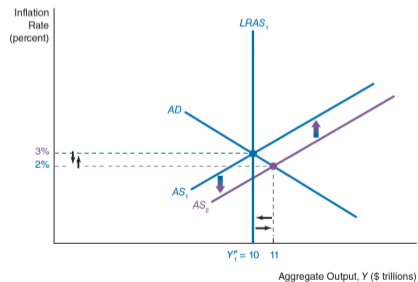
- Graphical representation of the self-correction mechanism after a **negative aggregate demand shock**. We have  $\downarrow \pi$  and  $Y = Y^P$ :



# Aggregate supply shocks and the self-correction mechanism

## Graphical representation

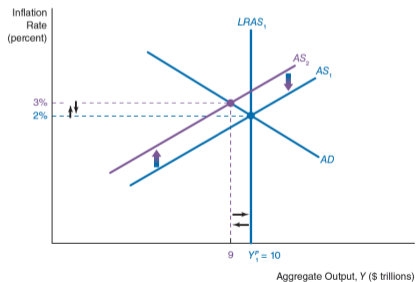
- Graphical representation of the self-correction mechanism after a **temporary negative price shock** ( $\rho < 0$ ) in short-run supply. The final equilibrium is the same as the initial one:



# Aggregate supply shocks and the self-correction mechanism

## Graphical representation

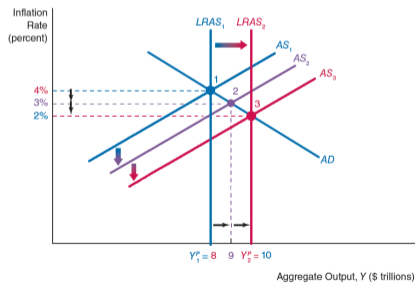
- Graphical representation of the self-correction mechanism after a **temporary positive price shock** ( $\rho > 0$ ) in short-run supply. The final equilibrium is the same as the initial one:



# Aggregate supply shocks and the self-correction mechanism

## Graphical representation

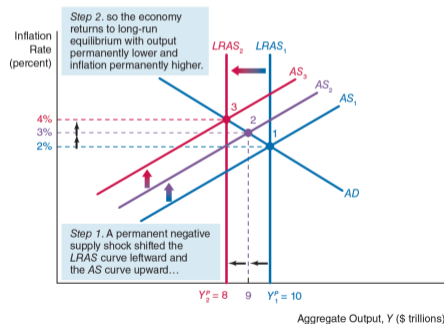
- Graphical representation of the self-correction mechanism after a **permanent positive supply shock**, i.e., a **positive shift in long-run aggregate supply**. We have  $\downarrow \pi$  and  $Y = Y^P$ :



# Aggregate supply shocks and the self-correction mechanism

## Graphical representation

- Graphical representation of the self-correction mechanism after a **permanent negative supply shock**, i.e., a **negative shift in long-run aggregate supply**. We have  $\uparrow \pi$  and  $Y = Y^P$ :



# References

- Mishkin, F. S. (2014), *Macroeconomics: Policy and Practice*, 2nd Edition, Pearson, Addison-Wesley, New York.