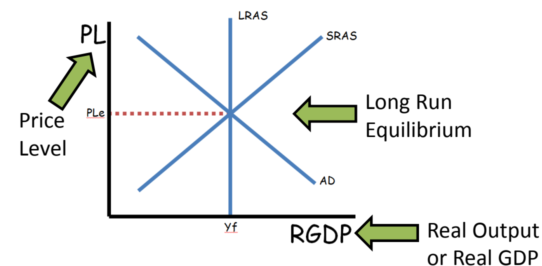
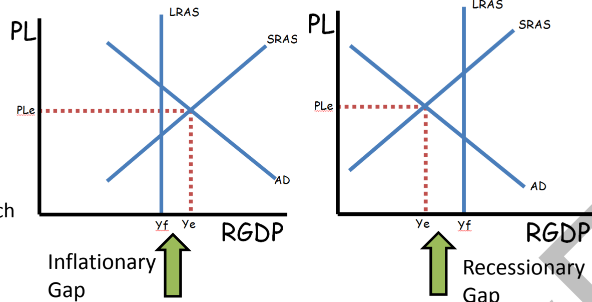
AS/AD Graph

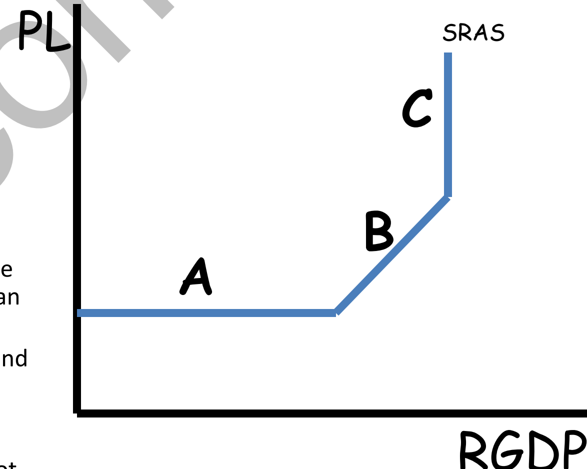
- LRAS is equal to the full employment level of output.
- In the long run the economy will always return to LRAS.
- In the short run the economy can have an inflationary gap (output above LRAS) or a recessionary gap (output below LRAS)
- AD is equal to GDP and $C+I_g+G+X_n$
- The government can use fiscal policy to shift AD right or left.
- The Fed can use Monetary Policy to shift AD right or left.
- AS can shift because of changes in productivity, costs of inputs, or supply shocks.
- The LRAS can shift based on anything that would move the production possibilities curve (see micro)
- If the economy is not at long run equilibrium, workers will eventually get lower (Recessionary gap) or higher (Inflationary gap) wages which means a change in input costs causing a shift of the AS towards long-run equilibrium





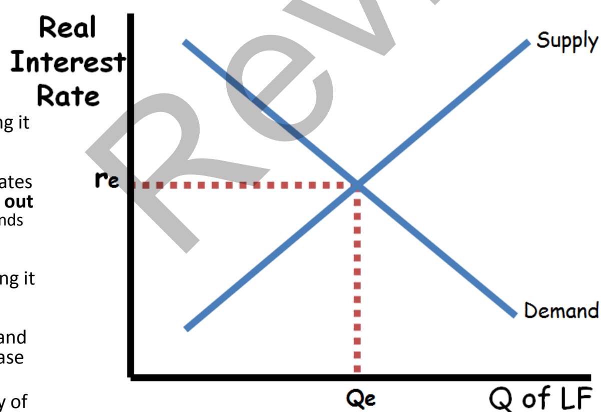
Parts of the SRAS Curve

- The SRAS is the same thing as the AS curve
- An economy with an AS curve like A will be able to increase output without increasing the price level.
- An economy with an AS curve like B will be able to increase output while increasing the price level.
- An economy with an AS curve like C cannot increase output. Only price levels can increase.
- **Remember the output and price level will be determined by the intersection between this curve and the AD curve (not shown)



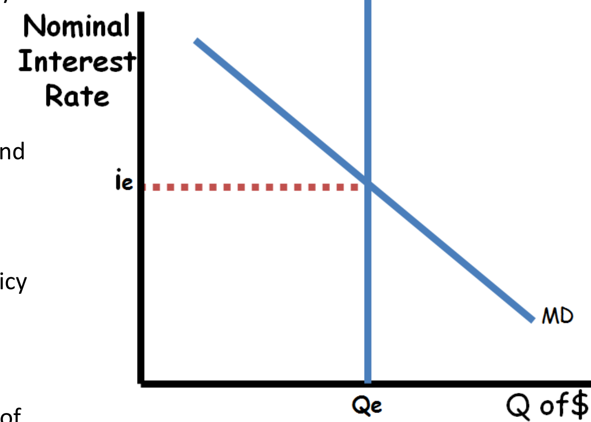
Loanable Funds

- The supply for loanable funds is determined by how much money is being saved in the economy.
- The demand for loandable funds is determined by the amount of investment businesses would like to make.
- If the government increases spending it causes a decrease in the supply of loanable funds (the government has taken them to deficit spend) that creates a higher interest rate. **AKA Crowding out** (an increase in the demand of loanable funds instead of a decrease in supply is also acceptable)
- If the government decreases spending it causes an increase in the supply of loanable funds that creates a lower interest rate. (a decrease in the demand of loanable funds instead of an increase in supply is also acceptable)
- The interest rate effects the quantity of investment in an economy (part of GDP) so a change in the interest rate will cause a shift in the AD curve
- The foreign exchange markets can also affect loanable funds. i.e. If financial capital is flowing into a country (capital account) there will be an increase in the supply of loanable funds.



Money Market

- MS is the amount of money in the economy as calculated by M1 or M2.
- The Federal Reserve (AKA Central Bank) regulates the money supply through open market operations (buying and selling bonds or securities), discount rate, reserve requirement.
- Expansionary monetary policy shifts the MS right.
- Contractionary monetary policy shifts the MS left.
- The MD can move because of a change in the number of transactions in an economy ($C+I_g+G+X_n$) or a change in the desire to hold cash as an asset



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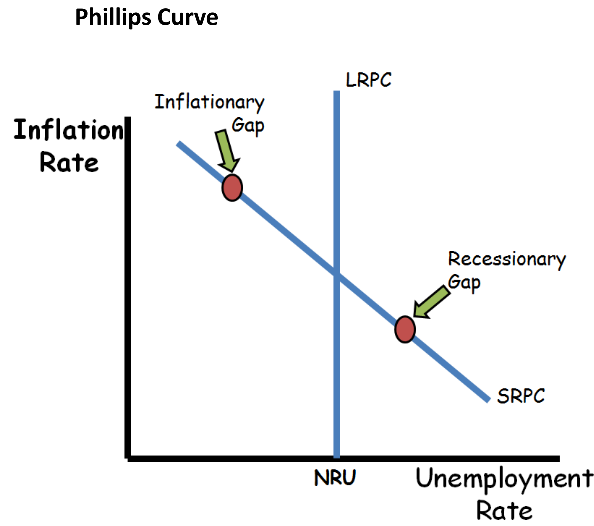
Phillips Curve

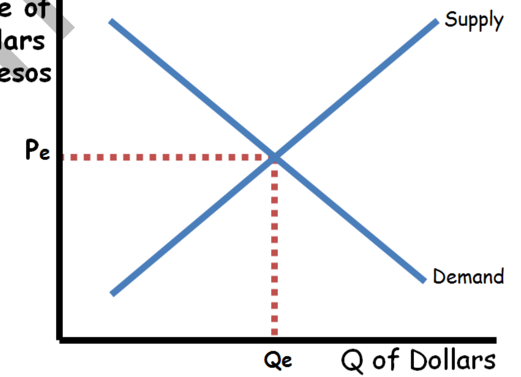
- The SRPC shows the inverse relationship between the inflation rate and the unemployment rate.
- The LRPC lies at the Natural Rate of Unemployment (full employment).
- The intersection between the SRPC and the LRPC is the expected rate of inflation.
- When an economy is in long-run equilibrium the inflation rate will be at the intersection between the LRPC and the SRPC.
- Changes in AD will cause movement along the SRPC.
- Changes in AS will shift the SRPC left or right.
- Changes in inflation expectations will cause SRPC to shift left or right.



Foreign Exchange Market

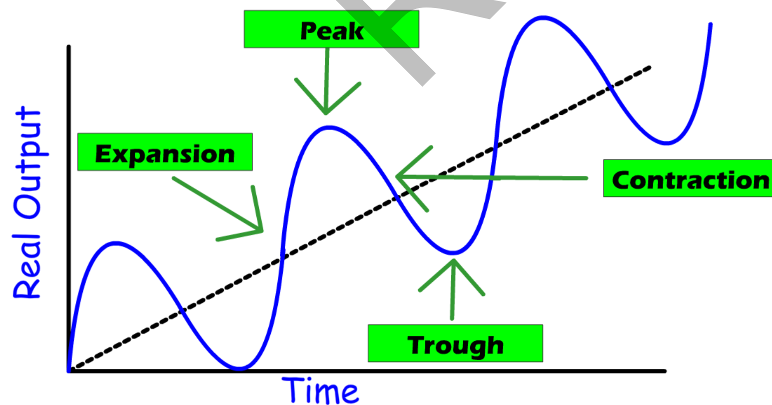
- Supply and demand determine the exchange rates for world currencies.
- The demand for a currency will shift because of a:
  - Change in the interest rate for this country or other countries
  - Change in the expected future exchange rate
  - Change in anything that would make foreigners want to have more of this countries currency
- The supply for a currency will shift because of a:
  - Changes in the interest rate for this country or other countries
  - Change in the expected future exchange rate
  - Change in anything that would make foreigners want to have more of this countries currency
- Anytime there is an increase in the demand for a currency, there is simultaneously a decrease in the supply of the same currency. And there will be a decrease in the demand for the other currency and a increase in supply of the other currency.

***Remember this is all **foreign** supply and demand for these currencies



Business Cycle

- Natural fluctuations in economic activity over time
- Expansion is also called recovery
- Peaks coincide with an inflationary gap and may bring high inflation.
- Contraction that last more than 6 months are generally referred to as recessions.
- Troughs coincide with a recessionary gap and bring high unemployment and possibly deflation.



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