Short-Run Economic Fluctuations

- Economic activity fluctuates from year to year.
  - In most years production of goods and services rises.
  - On average over the past 50 years, production in the U.S. economy has grown by about 3 percent per year.
  - In some years normal growth does not occur, causing a recession.

Three Key Facts About Economic Fluctuations

- Economic fluctuations are irregular and unpredictable.
  - Fluctuations in the economy are often called the business cycle.
  - Recessions and Depressions
  - Most macroeconomic variables fluctuate together.
  - As output falls, unemployment rises.
A Look At Short-Run Economic Fluctuations

(a) Real GDP

Recessions

Real GDP

A Look At Short-Run Economic Fluctuations

(b) Investment Spending

Recessions

Investment spending

A Look At Short-Run Economic Fluctuations

(c) Unemployment Rate

Recessions

Unemployment rate
The Basic Model of Economic Fluctuations

Economists use the model of **aggregate demand** and **aggregate supply** to explain short-run fluctuations in economic activity around its long-run trend.

- **Price level** as measured by the CPI
- **Aggregate Output** as measured by real GDP.

The aggregate demand curve shows the quantity of goods and services that households, firms, and the government want to buy at each price level.

The aggregate supply curve shows the quantity of goods and services that firms produce and sell at each price level.

Aggregate Demand and Aggregate Supply...
Why the Aggregate Demand Curve Is Downward Sloping

- The Price Level and Consumption: The Wealth Effect
- The Price Level and Investment: The Interest Rate Effect
- The Price Level and Net Exports: The Exchange-Rate Effect

Why the Aggregate Demand Curve Might Shift

- Y = C + I + G + NET EXPORTS
- Shifts arising from Consumption
- Shifts arising from Investment
- Shifts arising from Government Purchases
- Shifts arising from Net Exports
- Changes in the price level cause a movement along the Aggregate Demand Curve.
Shifts in the Aggregate Demand Curve...

The Aggregate Supply Curve

- The aggregate supply curve shows the level of production at each price level.
- In the long run, the aggregate-supply curve is vertical.
- In the short run, the aggregate-supply curve is upward sloping.

How the Short Run Differs From the Long Run

- Most economists believe that classical theory describes the world in the long run but not in the short run.
- Changes in the money supply affect nominal variables but not real variables in the long run.
- The assumption of monetary neutrality is not appropriate when studying year-to-year changes in the economy.
The Long-Run Aggregate-Supply Curve...

1. A change in the price level...

2. ...does not affect the quantity of goods and services supplied in the long run.

Why the Long-Run Aggregate Supply Curve Might Shift

- Shifts arising from Labor
- Shifts arising from Capital
- Shifts arising from Natural Resources
- Shifts arising from Technological Knowledge
- Any change in the economy that alters the natural rate of output shifts the long-run aggregate-supply curve.

The Short-Run Aggregate Supply Curve...

1. A decrease in the price level

2. reduces the quantity of goods and services supplied in the short run.
**Why the Short-Run Aggregate Supply Curve Slopes Upward in the Short Run**

- In the short run, an increase in the overall level of prices in the economy tends to raise the quantity of goods and services supplied.
- A decrease in the level of prices tends to reduce the quantity of goods and services supplied.
- Workers may be fooled as well—Sticky Wage Theory.
- But supply always snaps back to the Long run.

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**The Long-Run Equilibrium**

![Graph showing the long-run equilibrium]

- The market reaches equilibrium at point A, where aggregate demand equals aggregate supply.
- The equilibrium price and output levels are determined at this point.
- The natural rate of output is the level of output that exists when the economy is in a state of full employment.

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**A Contraction in Aggregate Demand...**

![Graph showing a decrease in aggregate demand]

1. A decrease in aggregate demand...
2. Causes output to fall in the short run...
3. But over time, the short-run aggregate-supply curve shifts...
4. And output returns to its natural rate.
An Adverse Shift in Short Run Aggregate Supply

- A decrease in one of the determinants of aggregate supply shifts the curve to the left:
  - Output falls below the natural rate of employment.
  - Unemployment rises.
  - The price level rises.
  - Stagflation results!

An Adverse Shift in Aggregate Supply...

- 1. An adverse shift in the short-run aggregate-supply curve...
- 2. ...causes output to fall...
- 3. ...and the price level to rise.

Policy Responses to Recession

- Policymakers may respond to a recession in one of the following ways:
  - Do nothing and wait for prices and wages to adjust.
  - Take action to increase aggregate demand by using monetary and fiscal policy.
1. When short-run aggregate supply falls...

2. ...policymakers can accommodate the shift by expanding aggregate demand...

3. ...which causes the price level to rise

4. ...but keeps output at its natural rate.

Accommodating an Adverse Shift in Aggregate Supply...