AP Macro Unit 3 Cheat Sheet

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Why is AD downward sloping?

Wealth (Real Balance) Effect	As price levels increase, purchasing power and value of assets decreases → quantity of expenditures decreases. OR, as prices levels decrease, purchasing power and expenditures increase because money "goes further."
Interest Rate Effect	When price level is higher lenders charge higher nominal interest rates in order to obtain a real return on their loans.
Foreign Trade Effect	When price levels in the U.S. increase, foreign buyers purchase fewer American goods and Americans buy more foreign goods → exports fall and imports rise, causing real GDP demanded to fall (Xn decreases).

Models

AD/AS Model		
PPC		
LRAS	Economy is producing at full employment. Wages, resource prices DO ↑ as PL ↑. If real profit doesn't change, firms don't have incentive to increase output.	↑ PL, X RGDP

Models (cont)

SRAS	Wages, resources prices DON'T ↑ as PL ↑. With higher profits, firms have incentive to increase production.	Revenue - cost = profit
Three Ranges Model	1) Keynesian Range - Horizontal at low output 2) Intermediate Range - upward sloping 3) Classical Range - Vertical at physical capacity	

Basic Concepts

AD	Demand for everything by everyone	
AS	Production of all the firms in the economy	
Sticky Wages/Prices are subject to some impediment or cost that causes them to change prices infrequently	it is difficult, $$$ to adjust prices of entire inventories only to collect less money 2) employee morale must be kept above a certain level 3) wage contracts have been signed	Ex: Minimum wage
Flexible Wages/Prices are free to adjust quickly to changing market conditions		Ex: Gasoline

Basic Concepts (cont)

LRAS	a curve that shows the relationship between price level and real GDP that would be supplied if all prices, including nominal wages, were fully flexible; price can change along the LRAS, but output cannot because that output reflects the full employment output.
SRAS	a graphical model that shows the positive relationship between the aggregate price level and amount of aggregate output supplied in an economy. It lets us capture how all of the firms in an economy respond to price stickiness. When prices are sticky, the SRAS curve will slope upward. The SRAS curve shows that a higher price level leads to more output.

Problem with Fiscal Policy

Deficit Spending	If the govt increases spending w/o increasing taxes, they will increase national debt and thus annual deficit. Budget deficits are a necessary evil bc forcing a balanaced budget would not allow COngress to stimulate the economy.
Problems of Timing	Recognition lag (congress must react to eocnomic indicators before it's too late), administrative lag (congress takes time to pass legislation), operational lag (sepdning/planning takes time to organize/execute --> changing taxation is quicker)
Politically Motivated Policies	Politicians may use economically inappropriate policies to get reelected
Unintended Effects that Weaken the Impact of the Policy	Crowding out effect: gov "-Crowds out" consumers/investors
Net Export EFfect	Int trade reduces effectiveness of fiscal policies

The Good, Bad, and Ugly

Good	4-6% UE	1-3% Inflation	2.5-5% GDP growth
Bad	7-8% UE	4-8% Inflation	1-2% GDP growth
Ugly	9+% UE	9+% UE Inflation	> 1% GDP growth

AD Shifters (AD = CIGX)

Change in Consumer Spending can be caused by changes in consumer wealth, consumer expectations, household indebtedness, and taxes.	Ex: A stock market boom would increase consumer wealth.
Change in Investment Spending can be caused by changes in real interest rates, future business expectations, productivity and technology, and business taxes.	Ex: Samsung decides to invest in productivity and technology by purchasing new chip-making robots.
Change in Govt Spending can be caused by changes in war, national health care, and defense spending.	Ex: During World War II, government spending increased due to the cost of military supplies, training, weapons, etc.
Change in Net Exports (x - m) can be caused by changes in exchange rates and national income compared to abroad	Ex: If PL rises in the US, Japan will buy fewer of our goods and 1) Americans will buy more of their goods + exports will decrease → imports will increase + net exports will move towards negatives.

AS Shifters (AS = IRAP)

Change in inflationary expectations If suppliers think goods will sell at a higher PL in the future, they will supply less in the current time period	Ex: A stock market boom would increase consumer wealth.
Change in Resource/Input Prices	Ex: Cost of chocolate chips ↑, so the Girls scouts ↑ PL of Samoas.
Change in govt actions Changes in minimum wage, subsidies/grants for domestic producers, or government regulations can increase or decrease cost of production and thus supply.	Ex: Lower subsidies for domestic farmers will reduce production because domestic farmers now have to pay more for production out-of-pocket.
Change in Productivity Producing more/less of an output using the same amount of inputs can cause supply to increase or decrease	(Technology) A computer virus destroys half of the computers at Microsoft headquarters → productivity decreases as a result.

Review Questions

Assume consumers ↑ spending. Effect on PL, output?	Workers have leverage to ask for wage increases due to low unemployment rate → production costs increase → back to full employment w higher PL

Review Questions (cont)

Assume consumers ↓ spending. Effect on PL, output in short run AND long run?	In short run, AD ↓, PL and Q ↓. In long run, AS ↑ as workers accept lower wages and production costs fall → PL goes down, Q goes back to Full Employment
Does deflation (falling prices) often occur?	Not as often as inflation bc 1) if prices ↓, cost of resources MUST ↓ or firms would go out of biz 2) cost of resources (especially labor) rarely fall bc labor contracts (unions), wage decrease → low employee morale, $$$ to change inventory and advertise new prices

Review Questions (cont)

Why is the AS curve parallel to the x-axis on the Keynesian model?	the firm will supply whatever amount of goods is demanded at a **particular price level** during an economic depression. producers will not supply goods at a lower price anymore. Any government stimulus or growth in the economy will just increase output. This means the economy has a lot of productive capacity left un-utilized.

Review Questions (cont)

Why is the AS curve perpendicular to the x-axis on the Classical model?	Because, in the long-run, the potential output an economy can produce isn't related to the price level. There are only two things that matter for potential output: 1) the quantity and the quality of a country's resources, and 2) how it can combine those resources to produce aggregate output. When you reach the limits of the capital in place, you can't produce more, at any price. So, price ceases to matter, it can't increase GDP. Thus, the vertical line. The line means the output will be the same no matter how high the price.

Review Questions (cont)

SRAS vs LRAS?	1) no tradeoff between unemployment, inflation. Output is tied to employment on the LRAS, so if output doesn’t change in response to the price level, neither will employment. The SRAS curve tells us that firms will respond to inflation by producing more. If you want to produce more, you will need to hire more workers, so the unemployment rate decreases. In this way, the SRAS captures the tradeoff between inflation and unemployment. 2) prices/wages are fully flexible in LRAS → no long-run trade-off between inflation and output.	suppose the price of gas goes up so much it takes a really big chunk of money out of your budget. The short run is how you react when you see the higher price on Monday morning. The long run is however long it takes for you to adapt to that price shock (carpool, take bus).

Review Questions (cont)

What shifts SRAS?	When the price level changes and firms produce more in response to that, we move along the SRAS curve. But, any change that makes production different at every possible price level will shift the SRAS curve. Events like these are called “shocks” bc they aren’t anticipated. USE SPITE (subsidies for businesses, productivity, input prices, taxes on biz, expectations about inflation)	If showing a change in wage costs or oil prices, I would use a SRAS. For showing long run economic growth, and an increase in capital stock and investment I would show a shift in LRAS.

Review Questions (cont)

What shifts LRAS?	productivity growth shifts LRAS. The primary production factors that cause the changes in the LRAS curve include labor productivity levels, workforce size, capital size, and education levels. When the economy experiences an increase in growth and investments, the long-run aggregate supply curve also shifts to the right, and vice versa.

Theories

Classical Theory
Keynesian Theory

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Classical Theory	1) A change in AD WONT change output even in the short run bc prices of resources (wages) are very flexible 2) AS is vertical so AD CANT increase w/o causing inflation	Recessions caused by a fall in AD are temporary...price level will fall and economy will fix itself → no govt intervention required

Theories (cont)

Keynesian Theory	1) A decrease in AD WILL lead to a persistent recession bc prices of resources (wages) are NOT flexible 2) Increase in AD during a recession doesn't cause inflation	"Sticky Wages" prevent wages from falling → govt should ↑ spending to close the gap
Ratchet Effect	A ratchet (socket wrench) permits one to crank a tool forward but not backward. Like a ratchet, prices can easily move ↑ but not ↓	

Economic Stabilizers/Policies

Fiscal Policy	Actions by President, Congress to increase/decrease and thus stabilize the economy. Tools are taxation and gov spending.
Contractionary fiscal policy (BRAKE)	Laws that reduce inflation, decrease AD (Close an inflationary gap)

Economic Stabilizers/Policies (cont)

Expansionary Fiscal Policy (GAS)	Laws that reduce unemployment and increase AD (Close a recessionary gap)
Monetary Policy	Actions by the Central Bank (Fed Reserve) to stabilize the economy
Discretionary Fiscal Policy	Congress creates a new bill designed to change AD thru govt spending or taxation. Issue is that time lags due to bureaucracy --> takes time for Congress to act

Economic Stabilizers/Policies (cont)

Non-Discretionary Fiscal Policy (Automatic stabilizer)	legislation that acts counter cyclically without explicit action by policymakers. The stabilizer is permanent spending or taxation laws enacted to work counter cyclically (quantities increase when the economy slows down) to stabilize the economy. The more preogressive the tax system, the greater the economy’s built-in stability.	When unemployment is high, unemployment benefits and food stamps are given to citizens to increase their consumer spending.