Study Guide
Chapter 8: Aggregate Demand and Aggregate Supply

1. Aggregate Demand
Aggregate demand curve slope downward because
(1) interest rate effect
(2) wealth effect
(3) international trade effect

2. Aggregate Supply (AS)
   - Classical theory: in the long run, AS is vertical because _______________
     - potential output
     - full employment output
     - Classical economists believe that an economy would tend to produce at its potential output level. Thus if the unemployment rate is higher than 5%, it would only be temporary.
     - Keynesian theory: AS curve is flat (slightly upward) because _______________

   - Mainstream economists believe there are two AS curves:
     (1) long run AS curve (LRAS) is vertical as what classical economists describe;
     (2) short run AS curve (AS) consists of three sections:

3. Changes in aggregate demand and aggregate supply
   - Since AD consists of consumption, investment, government spending and net export, increase in any one of these components would lead to a increase in AD, and the AD curve would shift to the right;
     Any decrease in those components would cause AD to decline, and the AD curve would shift to the left.

   - Since the availability of resources determines AS, any increase in land, labor, capital, or improvement in technology would lead to an increase in AS. And the AS curve would shift to the right. Vice versa. In addition, if workers expect price level will go up, they would negotiate for higher wages. Since this will add to the production cost, firms will produce less. Thus real GDP drops.
4. Macroeconomic Equilibrium
Draw AS-AD diagrams to illustrate each of the following.
In each case, identify
Actual GDP
Potential GDP
GDP gap
Unemployment rate
Inflation rate

Case 1. Full Employment

Case 2. Recession

Case 3. Overheat

Case 4. Stagflation

Case 5. Steady Growth

5. Okun’s Law
Every 2% of a GDP gap will add 1% unemployment rate on top of the natural rate of unemployment.
Unemployment rate% = Natural rate of unemployment – (0.5)(GDP gap%)