The AS–AD Model

- The AS-AD model uses the AS curve and the AD curve together to analyze economic fluctuations.
Short-Run Macroeconomic Equilibrium

• The economy is in **short-run macroeconomic equilibrium** when the quantity of aggregate output supplied is equal to the quantity demanded.

• The **short-run equilibrium aggregate price level** is the aggregate price level in the short-run macroeconomic equilibrium.

• **Short-run equilibrium aggregate output** is the quantity of aggregate output produced in the short-run macroeconomic equilibrium.
The AS–AD Model

Aggregate price level

Real GDP

Short-run macroeconomic equilibrium

AD

SRAS

$P_E$

$Y_E$

$E_{SR}$
Macroeconomic Shocks

- If a demand or supply shock hits the economy, **AD** or **AS** shifts and moves the economy to a new equilibrium.
Demand Shocks

(a) A Negative Demand Shock

A negative demand shock...

...leads to a lower aggregate price level and lower aggregate output.

(b) A Positive Demand Shock

A positive demand shock... 

...leads to a higher aggregate price level and higher aggregate output.
Supply Shocks

(a) A Negative Supply Shock

A negative supply shock...

...leads to a lower aggregate output and a higher aggregate price level.

(b) A Positive Supply Shock

A positive supply shock...

...leads to a higher aggregate output and lower aggregate price level.
The economy is in long-run macroeconomic equilibrium when the point of short-run macroeconomic equilibrium is on the long-run aggregate supply curve.
Long-Run Macroeconomic Equilibrium

- Long-run macroeconomic equilibrium
- Potential output

Aggregate price level

Real GDP

LR AS

SR AS

AD

PE

YP

ELR

Long-run macroeconomic equilibrium

Potential output
SR vs LR Effects of a Negative Demand Shock

1. An initial negative demand shock...

2. ...reduces the aggregate price level and aggregate output and leads to higher unemployment in the short run...

3. ...until an eventual fall in nominal wages in the long run increases short-run aggregate supply and moves the economy back to potential output.
SR vs LR Effects of a Positive Demand Shock

1. An initial positive demand shock...

2. ...increases the aggregate price level and aggregate output and reduces unemployment in the short run...
Long-Run Macroeconomic Equilibrium

- The economy is **self-correcting** when shocks to AD affect aggregate output in the short run, but not the long run.
- **Stabilization policy** is the use of government policy to reduce the severity of recessions and rein in excessively strong expansions.
- If policy makers react quickly to a fall in aggregate demand, they can use monetary or fiscal policy to shift the AD curve back to the right.
- Unlike demand shocks, there are no government policies that can easily react to shocks an AS shock.