

## FINAL EXAM ECON

### Factors that effect AD

- Income taxes/Business taxes
- Interest rates
- Government expenditures
- Household's expected future income
- Firms expectations of future profitability
- Strength of the dollar
- Relative growth of GDP

### Why does AD have a negative slope?

- Wealth effect
- Interest Rate effect
- NX effect

### Wealth is equal to Assets-Liabilites

- As PL rises, wealth falls, so consumption decreases and saving increases
- This would result in a shift along the AD curve because directly related to PL

### Interest Rate Effect

- As the PL rises, we need more money to buy goods and services
- Households hold more cash and borrow more
  - The increase in demand for loans increases the real interest rates on loans, so consumption and investment both decrease

### Net Export Effect

- As PL rises faster in the US compared to the ROW
  - Exports decrease
  - Imports increase
  - So net exports decrease

### LRAS

- Identifies output at full potential (full employment)
- Shifts
  - Change of resource base (input costs)
  - Change in number of workers
  - Change in the size of the capital stock
  - Technological advancement
- EXAMPLE: How the internet effected the LRAS
  - Output at potential shifts right because workers are more productive

### SRAS

- Is upward sloping
  - Input prices (wages are sticky)
  - As PL increases, the quantity of goods and services firms are willing to supply increases
  - Revenue-Cost=Profits
  - As demand increases, firms may not increase their prices due to menu costs
    - Menu costs are the costs for firms to change prices
  - A rising PL leads to a larger quantity of goods and services supplied

- Shifts in SRAS
  - An unexpected change in the input prices (oil)
  - Increase in the labor force and/or the capital stock
  - Technological change (Increases productivity)
  - An increase in the expected future PL
  - Workers and firms adjustment to errors in past expectations of PL
  - EXAMPLE: A supply shock causing an increase of the price of oil
    - Shifts SRAS to the left
    - If economy stayed at PL of 100, there's a shortage
    - PL must rise
    - However, since recession causes falling wages and lower PL, the economy corrects itself and shifts back to equilibrium
  - If PL in US falls, NX rise because products are cheaper to ROW\
  - The internet also effected SRAS, because PL decreased since productivity increase, so the cost for firms decreased which means firms can offer more goods/services at lower prices
  - If AD shifts right because of something like investment, SRAS will shift left because wages are flexible, causing same output at lower PL.
  - If SRAS shifts left due to increase in oil prices, a resulting decrease in C and I will cause a small increase of PL, but a huge decrease in output and employment

#### Monetary vs Fiscal Policy (BOTH CHANGE AD)

- Monetary changes interest rates and investment
- Fiscal policy changes taxes and government expenditures

#### Firms are responsible for supply curve

- Flexible wages and demand for their output

#### The FOMC

- Meeting December 17-18
- They will look at U,E,CC,RGDP, and Fiscal Policy
- Their decisions will be made with respect to interest rates
- Different Policies
  - Conventional-Lower short term interest rates (Accelerate)
  - Non-conventional- Lower long term interest rates (REALLY accelerate)
  - Tapering- Letting up on the gas as economy gains momentum
- PROBABLY A TEST QUESTION
  - In its two-day meeting in December, the FOMC will be discussing how to signal that tapering does not mean that short term and long term interest rates will....

#### The Federal Reserve

- Open Market Operations
  - Recession- Open Market Purchase of US Treasury bonds from public
    - Bond sellers receive a check from the Fed which they can deposit at a local bank (M1 supply increases)
  - Inflation- Open Market Sale

- Fed sells bonds to public, public writes a check (M1 supply decreases)
- DO NOT DIRECTLY CHANGE INTEREST RATES. ONLY BUY/SELL BONDS WHICH SHIFTS SUPPLY OF LOANABLE FUNDS LEFT/RIGHT WHICH IMPACTS  $i$

#### Inflationary Situation

- The Fed will sell bonds to decrease the amount of money in the economy
- This will shift supply of loanable funds to the left
  - This raises interest rates
- With higher interest rates, consumption and investment decrease
  - This is because people want to save more and spend less
- This will shift AD to the left