The Business Cycle in the *AS-AD* Model

The business cycle occurs because aggregate demand and the short-run aggregate supply fluctuate, but the money wage does not change rapidly enough to keep real GDP at potential GDP.

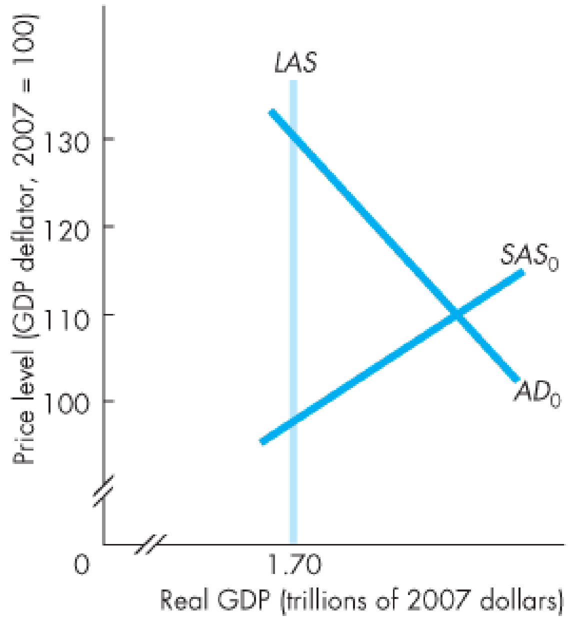
An **above full-employment equilibrium** is an equilibrium in which real GDP exceeds potential GDP.

A **full-employment equilibrium** is an equilibrium in which real GDP equals potential GDP.

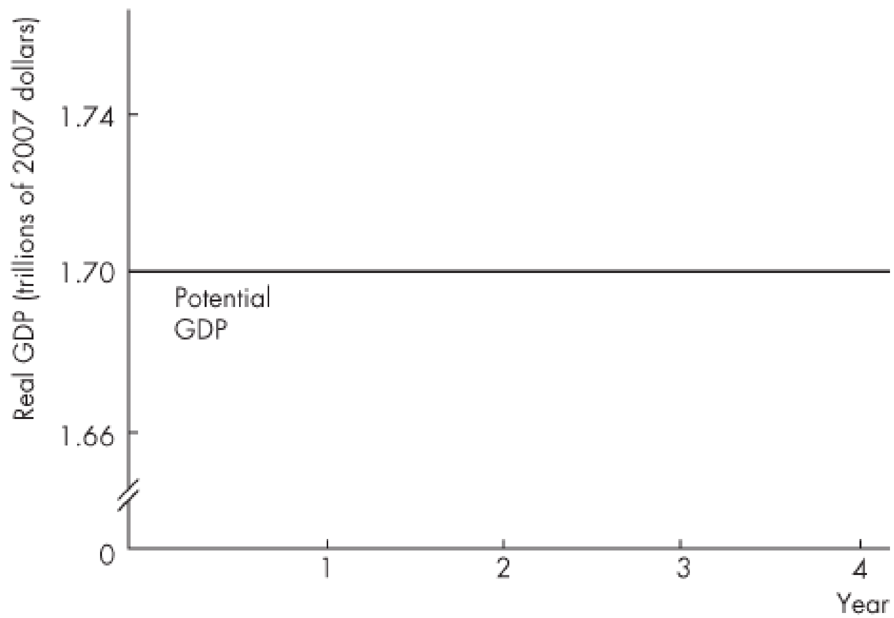
A **below full-employment equilibrium** is an equilibrium in which potential GDP exceeds real GDP.

Above full-employment equilibrium
The amount by which real GDP exceeds potential GDP is called an **inflationary gap**

(*output gap* which is the gap between real GDP and potential GDP, is positive).



(a) Above full-employment equilibrium



(d) Fluctuations in real GDP

Below full-employment equilibrium

The amount by which real GDP is less than potential GDP is called a **recessionary gap**.

The figure shows how, as the economy moves from one type of short-run equilibrium to another, real GDP fluctuates around potential GDP in a business cycle.

Fluctuations in Aggregate Demand

The effects of an increase in aggregate demand.

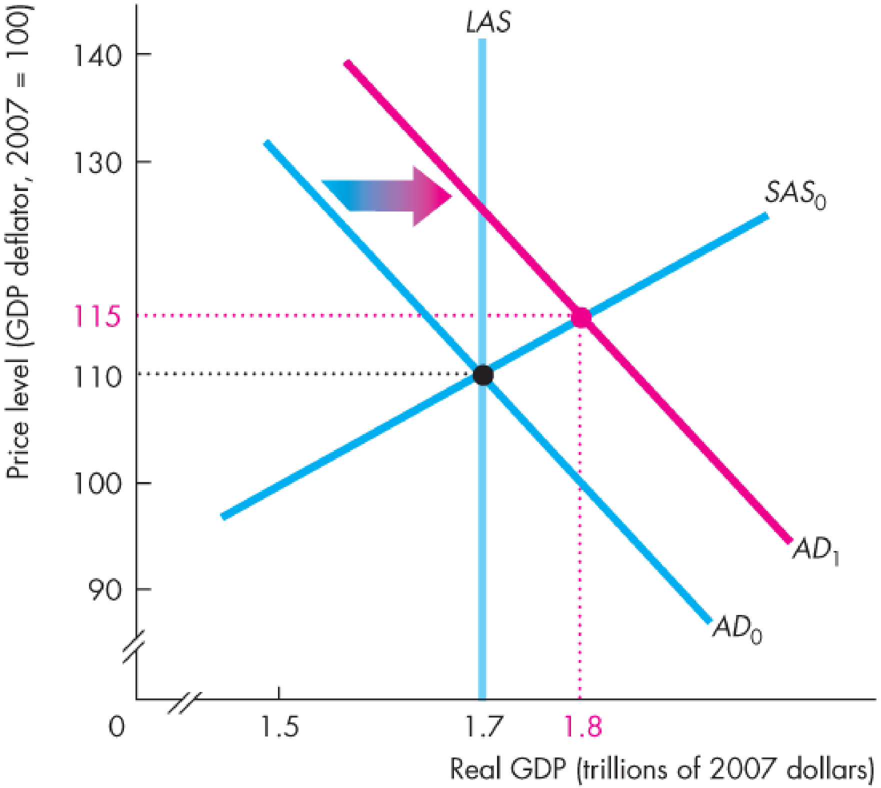
An increase in aggregate demand shifts the *AD* curve rightward.

Firms increase production and the price level rises in the short run.

At the short-run equilibrium,

The money wage rate begins to

The price level continues to



(a) Short-run effect

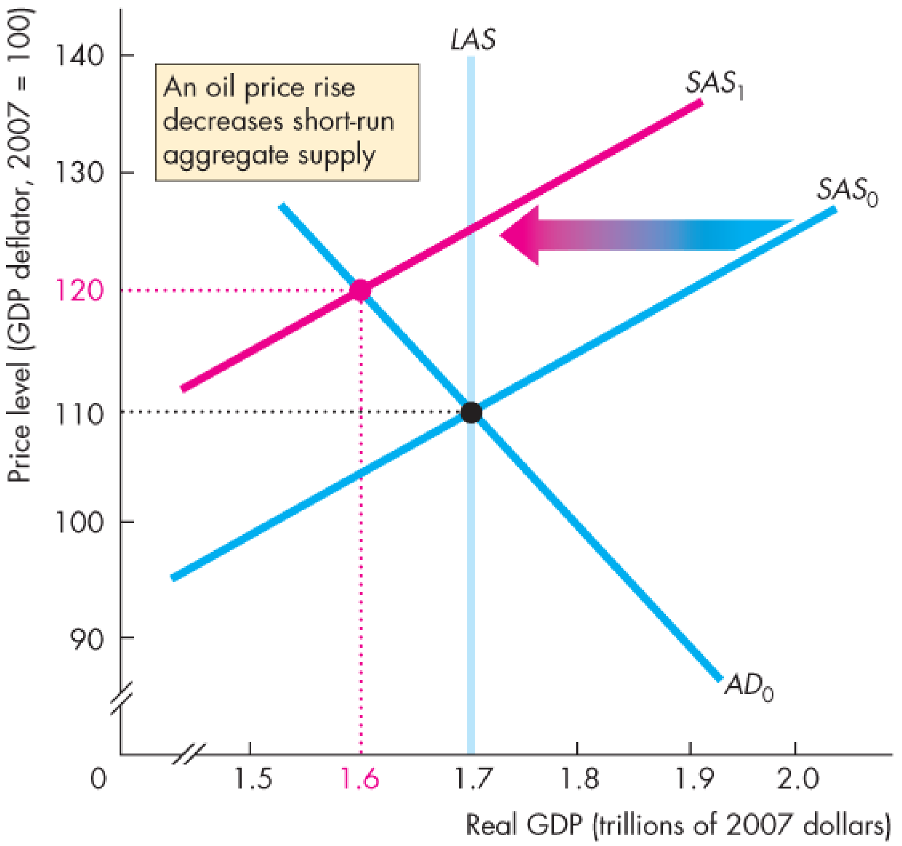
Fluctuations in Aggregate Supply

The effects of a rise in the price of oil.

The *SAS* curve shifts leftward.

Real GDP decreases and the price level rises.

The economy experiences *stagflation*.



Additional Examples: AD and AS

Macroeconomic Schools of Thought

Macroeconomists can be divided into three broad schools of thought:

- Classical
- Keynesian
- Monetarist

The Classical View

A **classical** macroeconomist believes that the economy is self-regulating and always at full employment.

The term “classical” derives from the name of the founding school of economics that includes Adam Smith, David Ricardo, and John Stuart Mill.

A **new classical** view is that business cycle fluctuations are the efficient responses of a well-functioning market economy that is bombarded by shocks that arise from the uneven pace of technological change.

The Keynesian View

A **Keynesian** macroeconomist believes that left alone, the economy would rarely operate at full employment and that to achieve and maintain full employment, active help from fiscal policy and monetary policy is required.

The term “Keynesian” derives from the name of one of the twentieth century’s most famous economists, John Maynard Keynes.

A **new Keynesian** view holds that not only is the money wage rate sticky but also are the prices of goods.

The Monetarist View

A **monetarist** is a macroeconomist who believes that the economy is self-regulating and that it will normally operate at full employment, provided that monetary policy is not erratic and that the pace of money growth is kept steady.

The term “monetarist” was coined by an outstanding twentieth-century economist, Karl Brunner, to describe his own views and those of Milton Friedman.