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CONCEPT: THE DYNAMIC AD-AS MODEL

● The **dynamic AD-AS model** fixes some of the issues with the AD-AS model by removing some key assumptions

□ The standard AD-AS model assumes:

- > *No long-run inflation*
- > *No long-run growth*
- > *Potential GDP (LRAS) is static*

□ The standard AD-AS model incorrectly predicts:

- > Recessions caused by decreased aggregate demand lead to lower price levels
 - Has not occurred since the 1930s

□ The dynamic AD-AS model attempts to fix these issues:

- > Potential GDP increases over time → LRAS shifts _____
 - Increases to the labor force, capital stock, and technology
- > Aggregate supply tends to increase over time → SRAS shifts _____
 - The variables that increase LRAS also increase the SRAS
- > Aggregate demand tends to increase over time → AD shifts _____
 - Increases in population and income over time lead to higher consumption
 - A growing economy also leads to higher investment from firms
 - Growth in the population and economy generate a need for more government services

Dynamic AD-AS – Expansion and Equilibrium



CONCEPT: THE DYNAMIC AD-AS MODEL – INFLATION AND RECESSION

- **Inflation** occurs when total spending increases faster than total production

Dynamic AD-AS – Inflation



- The **recession of 2007-2009** can also be visualized with the dynamic AD-AS model:

1. *The end of the housing bubble* led to only a small year-over-year increase in Aggregate Demand
 - As housing prices declined, spending on residential construction (investment spending) declined
2. *The financial crisis* followed the crash of the housing market
 - The unavailability of credit led to even smaller increases in Aggregate Demand
3. *Increasing oil prices* due to international competition caused a supply shock, shifting SRAS to the left

Dynamic AD-AS – Recession



CONCEPT: DYNAMIC AD-AS MODEL – EXPANSIONARY AND CONTRACTIONARY FISCAL POLICY

● The **dynamic AD-AS model** fixes some of the issues with the AD-AS model by removing some key assumptions

□ The dynamic AD-AS model incorporates:

- > Potential GDP increases over time → LRAS shifts _____
- > Aggregate supply tends to increase over time → SRAS shifts _____
- > Aggregate demand tends to increase over time → AD shifts _____

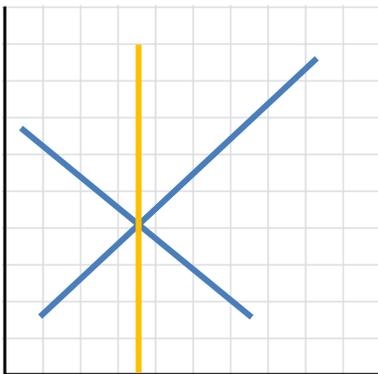
□ When the economy is **in recession**, real GDP is below its potential output

> **Expansionary fiscal policy** – Government _____ spending to stimulate economy

- The government can also _____ taxes (which _____ consumption)

Expansionary Fiscal Policy

Dynamic AD-AS Model



1. Equilibrium is initially at Point A on the graph
2. Dynamic model increases to AD, SRAS, and LRAS
3. AD did not grow enough to reach the new LR equilibrium
4. New SR equilibrium is at Point B
5. Expansionary Fiscal Policy boosts AD
6. Economy is at potential GDP (LR equilibrium; Point C)

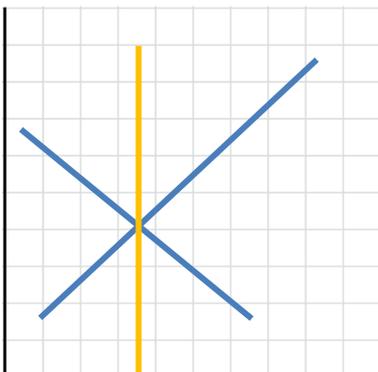
□ When the economy is experiencing **rising inflation**, real GDP is above its potential output

> **Contractionary fiscal policy** – Government _____ spending to reduce inflation

- The government can also _____ taxes (which _____ consumption)

Contractionary Fiscal Policy

Dynamic AD-AS Model



1. Equilibrium is initially at Point A on the graph
2. Dynamic model increases to AD, SRAS, and LRAS
3. AD grew too much and passed the new LR equilibrium
4. New SR equilibrium is at Point B
5. Contractionary Fiscal Policy reduces AD
6. Economy is at potential GDP (LR equilibrium; Point C)

CONCEPT: DYNAMIC AD-AS MODEL – EXPANSIONARY AND CONTRACTIONARY MONETARY POLICY

● The **dynamic AD-AS model** fixes some of the issues with the AD-AS model by removing some key assumptions

□ The dynamic AD-AS model incorporates:

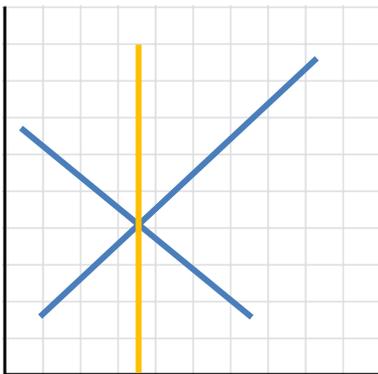
- > Potential GDP increases over time → LRAS shifts _____
- > Aggregate supply tends to increase over time → SRAS shifts _____
- > Aggregate demand tends to increase over time → AD shifts _____

□ When the economy is **in recession**, real GDP is below its potential output

- > **Expansionary monetary policy** – Fed _____ interest rates to stimulate economy
- Expansionary = more GDP

Expansionary Monetary Policy

Dynamic AD-AS Model



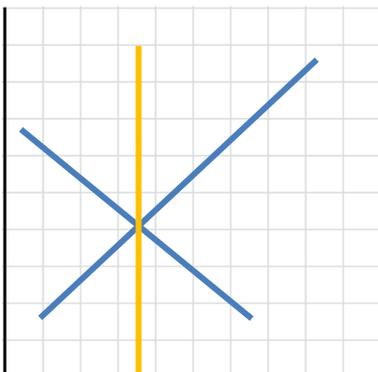
1. Equilibrium is initially at Point A on the graph
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5. Expansionary Monetary Policy boosts AD
6. Economy is at potential GDP (LR equilibrium; Point C)

□ When the economy is experiencing **rising inflation**, real GDP is above its potential output

- > **Contractionary monetary policy** – Fed _____ interest rates to reduce inflation
- Contractionary = less GDP

Contractionary Monetary Policy

Dynamic AD-AS Model



1. Equilibrium is initially at Point A on the graph
2. Dynamic model increases to AD, SRAS, and LRAS
3. AD grew too much and passed the new LR equilibrium
4. New SR equilibrium is at Point B
5. Contractionary Monetary Policy reduces AD
6. Economy is at potential GDP (LR equilibrium; Point C)