Flow Diagrams, Aggregate Demand, Aggregate Supply and Equilibrium

Outline of Class:

- Model (circular flow) an economy to understand how is the wealth generated and moved in an economy.

- Develop some tools to address the question: how can we tell if an economy is doing well?
    - **We say an economy is doing well if total short run production is equal to the ideal* total long run production, ie if short run equilibrium is equal to long run equilibrium.**

- Explain the elements of the equilibrium of the economy:
    - Aggregate Demand:
        - Components: C, G, I, NX
        - Negative slope: micro economic reasons (income and substitution effects) do not explain it. DA is downward sloped because of: wealth effect, interest rate effect and exchange rate effect.
        - Movements of DA: (1) Shfters, (2) The multiplier effect.
    - Aggregate Supply:
        - All goods and services produced in the economy.
        - Distinction between short run (positive slope) and long run (there is a natural level of output).
        - Shifters
    - Equilibrium: where AD=AS.
        - Remark in the long run there is a natural level of output, ie a fixed quantity of goods and services that the economy can produce given technological and physical constraints.
        - **The ideal* long run level of output we introduced in how to tell if the economy is doing well is this natural level of output.**
        - **Prices in an economy adjusts such that at this level of output aggregate supply is equal to aggregate demand**
        - Remark#2: at this level of output there is unemployment, we refer to this as the natural level of unemployment.

- Comparative Statics on the equilibrium of the economy:
    - First: show the AD-AS diagram to see how do demand and supply determine equilibrium quantities and supply?
    - Second: introduce some changes (shift of AD, shift of AS) to analyze what can disrupt an economy's equilibrium? And how does it readjust in the long-run?