

ECON1102 (004)
Principles of Macroeconomics
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Topic 6: Supply-Side Equilibrium: Unemployment and Inflation

Already knew recessionary gap vs. inflationary gap

But question is which sort of gap will arise?

Only AD cannot solve this question, need to bring AS in.

1. The Aggregate Supply Curve and Equilibrium of AS-AD

(1). The AS Curve

Why upward slope?

To answer this question need to look at firm's profit maximization problem.

(2). Shifts of AS Curve

- wage rate: wage higher \Rightarrow shift inward
- prices of other inputs, say energy
- technology and productivity
- availability of labor and capital

(3). Equilibrium of AS-AD

(4). Recessionary and Inflationary Gaps Revisited

2. Self-Correcting Mechanism of Economy

(1). Adjustment to a Recessionary Gap

recessionary gap \Rightarrow cyclical unemployment $\uparrow \Rightarrow$ wage $\downarrow \Rightarrow$ AS shifts outward \Rightarrow
 $Y \uparrow, P \downarrow$

But the process might be slow, why?

Wage rigidity

- Institutional factors: minimum wage law, union contracts
- Psychological reason: workers have a psychological resistance to accepting a wage reduction
- "efficiency wage"

(2). Adjustment to an inflationary gap

inflationary gap \Rightarrow over employment \Rightarrow wage $\uparrow \Rightarrow$ AS shifts inward $\Rightarrow Y \downarrow, P \uparrow$
inflation + unemployment, we call it "stagflation".

(3). Stagflation from a Supply shock

Real Business cycle

3. Inflation and Multiplier

Inflation reduces the size of the multiplier!