

Topic 11:  
**Aggregate Supply**  
(Chapter 13)

macroeconomics  
fifth edition

**N. Gregory Mankiw**

PowerPoint® Slides  
by Ron Cronovich

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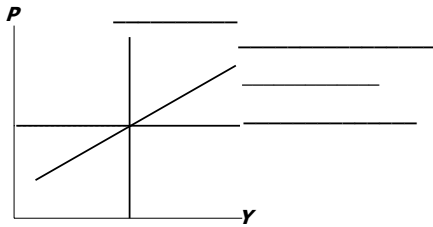
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**A new and improved short run AS curve**



Consider a more realistic case, in between the two extreme assumptions we considered before.

CHAPTER 13 Aggregate Supply

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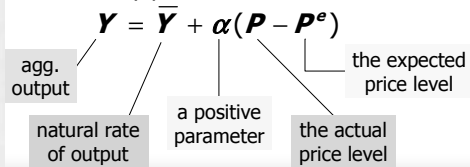
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**Three models of aggregate supply**

Consider 3 stories that could give us this SRAS:

1. The sticky-wage model
2. The imperfect-information model
3. The sticky-price model



CHAPTER 13 Aggregate Supply

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## The sticky-wage model

- Assumes that firms and workers negotiate contracts and fix the nominal wage \_\_\_\_\_.
- The nominal wage,  $W$ , they set is the product of a target real wage,  $\omega$ , and the expected price level:

$$W = \omega \times P^e$$

⇒ \_\_\_\_\_

CHAPTER 13 Aggregate Supply

slide 3

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## The sticky-wage model

$$\frac{W}{P} = \omega \times \frac{P^e}{P}$$

If it turns out that \_\_\_\_\_ then \_\_\_\_\_

unemployment and output are at their natural rates  
 Real wage is less than its target, so firms hire more workers and output rises above its natural rate  
 Real wage exceeds its target, so firms hire fewer workers and output falls below its natural rate

CHAPTER 13 Aggregate Supply

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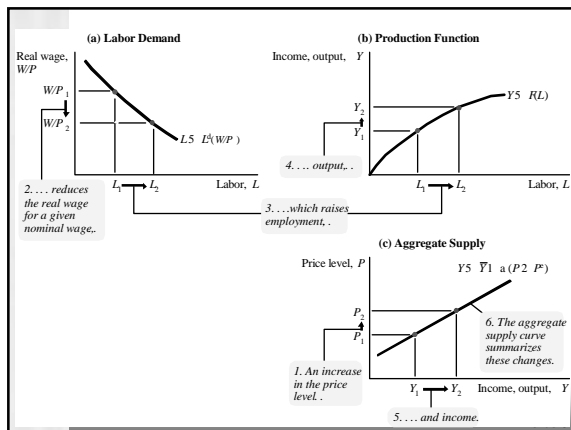
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## The sticky-wage model

- Implies that the real wage should be \_\_\_\_\_  
\_\_\_\_\_, \_\_\_\_\_  
\_\_\_\_\_ over the course of business cycles:
  - In booms, when  $P$  typically rises, the real wage should fall.
  - In recessions, when  $P$  typically falls, the real wage should rise.
- This prediction does not come true in the real world:

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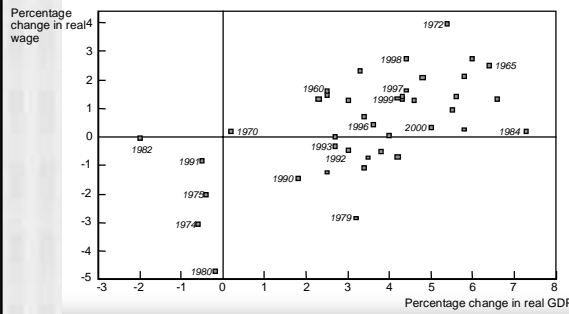
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## The cyclical behavior of the real wage




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## The imperfect-information model

### Assumptions:

- all wages and prices perfectly flexible, \_\_\_\_\_
- each supplier produces one good, consumes many goods
- each supplier knows the nominal price of the good she produces, \_\_\_\_\_  
\_\_\_\_\_

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### The imperfect-information model

- Supply of each good depends \_\_\_\_\_  
\_\_\_\_\_ : the nominal price of the good divided by the overall price level.
- Supplier \_\_\_\_\_ at the time she makes her production decision, so uses the expected price level,  $P^e$ .
- Suppose  $P$  rises but  $P^e$  does not. Then supplier thinks her relative price has risen, so she produces more. With many producers thinking this way, \_\_\_\_\_.

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### The sticky-price model

- Reasons for sticky prices:
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  -
- Assumption:
  - Firms set their own prices (e.g. as in monopolistic competition)

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### The sticky-price model

- An individual firm's desired price is  $p = P + a(Y - Y^e)$  where  $a > 0$ .
- Suppose two types of firms:
- firms with \_\_\_\_\_ prices, set prices as above
  - firms with \_\_\_\_\_ prices, must set their price before they know how  $P$  and  $Y$  will turn out:

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### The sticky-price model

$$p = P^e + a(Y - \bar{Y}^e)$$

- Assume firms w/ sticky prices expect that output will equal its natural rate. Then,
- To derive the aggregate supply curve, we first find an expression for the overall price level.
- Let  $s$  denote the fraction of firms with sticky prices. Then, we can write the overall price level as

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### The sticky-price model

$$P = sP^e + (1-s)[P + a(Y - \bar{Y})]$$

price set by sticky price firms

price set by flexible price firms

- Subtract  $(1-s)P$  from both sides:  

$$sP = sP^e + (1-s)[a(Y - \bar{Y})]$$
- Divide both sides by  $s$ :

$$P = P^e + \left[ \frac{(1-s)a}{s} \right] (Y - \bar{Y})$$

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### The sticky-price model

$$P = P^e + \left[ \frac{(1-s)a}{s} \right] (Y - \bar{Y})$$

- If firms expect high prices, then firms who must set prices in advance will set them high. Other firms respond by setting high prices.
- When income is high, the demand for goods is high. Firms with flexible prices set high prices. The greater the fraction of flexible price firms, the smaller is  $s$  and the bigger is the effect of  $\Delta Y$  on  $P$ .

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### The sticky-price model

$$P = P^e + \left[ \frac{(1-s)a}{s} \right] (Y - \bar{Y})$$

- Finally, derive AS equation by solving for  $Y$ :

where  $\alpha = \frac{s}{(1-s)a}$

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### The sticky-price model

In contrast to the sticky-wage model, the sticky-price model implies a \_\_\_\_\_:

Suppose aggregate output/income falls. Then,

- Firms see a fall in demand for their products.
- Firms with sticky prices reduce production, and hence reduce their demand for labor.
- The leftward shift in labor demand causes the real wage to fall.

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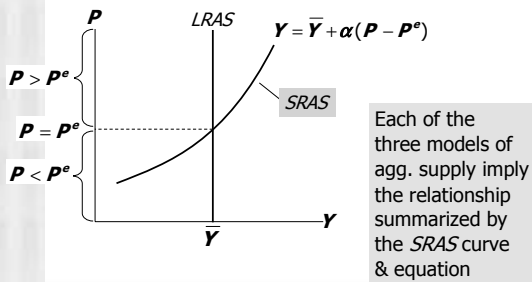
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### Summary & implications




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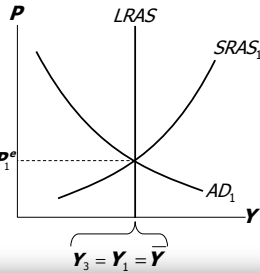
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## Summary & implications

$$SRAS \text{ equation: } Y = \bar{Y} + \alpha(P - P^e)$$

Suppose a positive AD shock moves output above its natural rate and  $P$  above the level people had expected.

Over time,  $P^e$  rises,  $SRAS$  shifts up, and output returns to its natural rate.



CHAPTER 13 Aggregate Supply

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## Inflation, Unemployment, and the Phillips Curve

The **Phillips curve** states that  $\pi$  depends on

- \_\_\_\_\_
- \_\_\_\_\_: the deviation of the actual rate of unemployment from the natural rate
- \_\_\_\_\_  $v$

$$\pi = \pi^e - \beta(u - u^n) + v$$

where  $\beta > 0$  is an exogenous constant.

CHAPTER 13 Aggregate Supply

slide 19

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## Deriving the Phillips Curve from SRAS

- (1)  $Y = \bar{Y} + \alpha(P - P^e)$
- (2)  $P =$
- (3)  $P = P^e + (1/\alpha)(Y - \bar{Y}) + v$
- (4)  $(P - \underline{\quad}) = (P^e - \underline{\quad}) + (1/\alpha)(Y - \bar{Y}) + v$
- (5)  $\pi = \pi^e + (1/\alpha)(Y - \bar{Y}) + v$
- (6)  $(1/\alpha)(Y - \bar{Y}) = -$
- (7)  $\pi = \pi^e - \beta(u - u^n) + v$

CHAPTER 13 Aggregate Supply

slide 20

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## The Phillips Curve and SRAS

$$\text{SRAS: } Y = \bar{Y} + \alpha(P - P^e)$$

$$\text{Phillips curve: } \pi = \pi^e - \beta(u - u^n) + v$$

- *SRAS* curve:  
output is related to \_\_\_\_\_  
\_\_\_\_\_.
- Phillips curve:  
unemployment is related to \_\_\_\_\_  
\_\_\_\_\_.

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## Adaptive expectations

- **Adaptive expectations:** an approach that assumes people form their expectations of future inflation based on \_\_\_\_\_  
\_\_\_\_\_.
- A simple example:  
Expected inflation = last year's actual inflation

$$\pi^e = \underline{\hspace{1cm}}$$

- Then, the P.C. becomes

$$\pi = \underline{\hspace{1cm}} - \beta(u - u^n) + v$$

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## Inflation inertia

$$\pi = \pi_{-1} - \beta(u - u^n) + v$$

- In this form, the Phillips curve implies that inflation has inertia:
  - In the absence of supply shocks or cyclical unemployment, inflation will \_\_\_\_\_  
\_\_\_\_\_.
  - Past inflation influences expectations of current inflation, which in turn influences the wages & prices that people set.

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### Two causes of rising & falling inflation

$$\pi = \pi_{-1} - \beta(u - u^n) + v$$

- \_\_\_\_\_**: inflation resulting from supply shocks.  
 Adverse supply shocks typically raise production costs and induce firms to raise prices, "pushing" inflation up.
- \_\_\_\_\_**: inflation resulting from demand shocks.  
 Positive shocks to aggregate demand cause unemployment to fall below its natural rate, which "pulls" the inflation rate up.

CHAPTER 13 Aggregate Supply

slide 24

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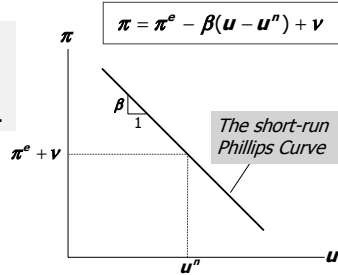
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### Graphing the Phillips curve

In the short run, policymakers face a trade-off between \_\_\_\_\_.



CHAPTER 13 Aggregate Supply

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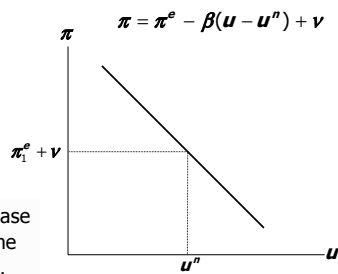
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### Shifting the Phillips curve

People adjust their expectations over time, so the tradeoff only holds in the short run.



E.g., an increase in  $\pi^e$  shifts the short-run P.C. upward.

CHAPTER 13 Aggregate Supply

slide 26

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### The sacrifice ratio

- To reduce inflation, policymakers can contract agg. demand, causing unemployment to rise above the natural rate.
- The **sacrifice ratio** measures the \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_.
- Estimates vary, but a typical one is 5.

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### The sacrifice ratio

- Suppose policymakers wish to reduce inflation from 6 to 2 percent.  
If the sacrifice ratio is 5, then reducing inflation by 4 points requires a loss of \_\_\_\_\_ of one year's GDP.
- This could be achieved several ways, e.g.
  - reduce GDP by 20% for one year
  - reduce GDP by \_\_\_\_\_
  - reduce GDP by 5% for each of four years
- The cost of disinflation is lost GDP. One could use Okun's law to translate this cost into unemployment.

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### Rational expectations

Ways of modeling the formation of expectations:

- **adaptive expectations:**  
People base their expectations of future inflation on recently observed inflation.
- **rational expectations:**  
People base their expectations on \_\_\_\_\_  
\_\_\_\_\_, including information about current and prospective future policies.

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### Painless disinflation?

- Proponents of rational expectations believe that \_\_\_\_\_:
- Suppose  $u = u^n$  and  $\pi = \pi^e = 6\%$ , and suppose the Fed announces that it will do whatever is necessary to reduce inflation from 6 to 2 percent as soon as possible.
- If the announcement is credible, then  $\pi^e$  will fall, perhaps by the full 4 points.
- Then,  $\pi$  can fall \_\_\_\_\_.

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### The sacrifice ratio for the Volcker disinflation

- 1981:  $\pi = 9.7\%$       Total disinflation = 6.7%
- 1985:  $\pi = 3.0\%$

year	$u$	$u^n$	$u - u^n$
1982	9.5%	6.0%	3.5%
1983	9.5	6.0	3.5
1984	7.4	6.0	1.4
1985	7.1	6.0	1.1
Total			9.5%

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### The sacrifice ratio for the Volcker disinflation

- Previous slide:
  - inflation fell by 6.7%
  - total of 9.5% of cyclical unemployment
- Okun's law: each 1 percentage point of unemployment implies lost output of 2 percentage points. So, the 9.5% cyclical unemployment translates to 19.0% of a year's real GDP.
- Sacrifice ratio = (lost GDP)/(total disinflation) =  $19/6.7 = 2.8$  percentage points of GDP were lost for each 1 percentage point reduction in inflation.

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## The natural rate hypothesis

Our analysis of the costs of disinflation, and of economic fluctuations in the preceding chapters, is based on the **natural rate hypothesis**:

Changes in aggregate demand affect output and employment

In the long run, the economy returns to the levels of output, employment, and unemployment described by the classical model (chapters 3-8).

CHAPTER 13 Aggregate Supply

slide 33

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## Chapter summary

1. Three models of aggregate supply in the short run:

- sticky-wage model
- imperfect-information model
- sticky-price model

All three models imply that output rises above its natural rate when the price level rises above the expected price level.

CHAPTER 13 Aggregate Supply

slide 34

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## Chapter summary

2. Phillips curve

- derived from the SRAS curve
- states that inflation depends on
  - expected inflation
  - cyclical unemployment
  - supply shocks
- presents policymakers with a short-run tradeoff between inflation and unemployment

CHAPTER 13 Aggregate Supply

slide 35

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