**Discussion Handout #7** | **TA: John Stromme**
Econ 102 | UW Madison, Fall 2016
Prof. Eudey | Date: 10/21/16

## Goals for this session

- Understand the background behind how the AD/AS model is derived.
- Investigate short run dynamics of the AD/AS model

## Vocabulary

- Short run vs. Long run
- Endogenous vs. Exogenous
- Ceteris Paribus

## Foundations of the Keynesian Model

- Marginal Propensity to Consume (MPC) and Marginal Propensity to Save (MPS)
- Aggregate Expenditure Multiplier (1/(1-MPC))
  - Note: This is also referred to as the Keynesian Multiplier
  - It is about 1.5 in the US, what does that mean the implied MPC is?
- Aggregate Demand (AD)
  - What are the four components of AD?
  - Why does the AD curve slope downwards?
  - Where do shifts come from?
- Aggregate Supply (AS)
  - Note: For today we are NOT going to worry about long-run aggregate supply, or shifts to AS
- Sticky Prices/Wages

## Problems

1. What might cause a person's MPC to be larger (or smaller)?
2. Draw a graph to show how a bigger Aggregate Expenditure Multiplier makes the AD shifts larger.
3. AD shifts in the Keynesian model.
   (a) Draw the Keynesian model as it appears without any shifts.

(b) A popular suggestion to balance the budget of state governments is through **austerity measures** (raise taxes, cut government spending). If a large number of states do this, it will affect aggregate demand at the national level. Use the Keynesian model to demonstrate graph what will happen to the aggregate demand curve at the national level.

- Keynes argued that these short run shifts to AD cause business cycles.

(c) Suppose sanctions against North Korea are dropped, and as a result they are allowed to trade with the US. They demand a lot of american made luxury goods. Illustrate the effects of this in the Keynesian model.