Causes of the Great Recession:
- Largest house price bubble in history, financial panic, oil price shock

- Inflation rate on the y-axis and current level of output on the x-axis
  - Slopes downward because an increase in the inflation rate causes planned consumption, investment, and net exports to fall -- PAE and output to fall
  - Aggregate demand curve shows the amount of output consumers, firms, government, and customers abroad want to purchase at each inflation rate
  - Higher real interest rate causes consumption, investment, and net exports to fall
  - When inflation rate rises, the Federal Reserve increases the real interest rate

Long-Run Equilibrium: a situation in which the AD and AS curves intersect at potential output $Y^*$

Short-Run Equilibrium: a situation where the AD and AS curves intersect at a level of real GDP that is above or below potential

Demand Shocks: changes in planned spending that are not caused by changes in output or the inflation rate

Shifts result due to available resources, technology, expected inflation rates, and inflation shocks)

Shifts result from demand shocks, monetary, and fiscal policy

Aggregate demand shocks do not increase inflationary expectations

Aggregate supply shocks force a tradeoff between decreased output and increased inflation

Aggregate Demand - Aggregate Supply Model
  - Slopes upward because when firms increase their output, inflation rate rises
  - Aggregate supply curve shows the relationship between the amount of output firms want to produce and the inflation rate

Inflation seems to be inertial, tending to remain roughly constant as long as the economy is at potential output and there are no external shocks to the price level

Firms raise prices to cover costs
  - High rate of expected inflation tends to lead to high rate of actual inflation

Shifts result due to available resources, technology, expected inflation rates, and inflation shocks)

If inflation expectations increase, aggregate supply will decrease

Long-term contracts serve to build in wage and price increases that depend on inflation expectations at the time the contracts were signed
  - Reinforce inflation inertia

If output gap is zero, the rate of inflation will remain the same

- When there is an expansionary gap, the rate of inflation will rise
- When there is a recessionary gap, the rate of inflation will fall

Current inflation = expected inflation + change in inflation caused by an output gap

- Resources and technology shift the aggregate supply curve outward
- Inflation Shock: a sudden change in the normal behavior of inflation, unrelated to the nation's output gap
  - Negative: causes an increase in inflation
  - Positive: causes a decrease in inflation

An economy with an expansionary gap sees the bidding up of wages and production costs
  - Causes a leftward shift in AS which results in higher inflation and decreased output

Self-Correcting Economy and Stabilization Policy

Self-Correcting Property: the fact that output gaps will not last indefinitely, but will be closed by rising or falling inflation
  - Keynesian thinks it can only be done through fiscal/monetary policy
  - Keynesian focuses on the short run period where prices and inflation do not adjust

Stabilization policies are most useful when the size of the output gap is large and the self-correction process is slow

- When firms face menu costs, they face a burden of altering prices
  - Will increase output to take advantage of higher demand and raise prices later

- When inflation rate increases, household wealth falls, which reduces PAE
  - National income falls --> output decreases

- If the Fed expects second-round effects, it will counteract the inflation (i.e. lower target if high rate) and tighten policy