In section II, we constructed two theoretical models -- the classical and Solow growth models -- that explain how the level and growth rates of income and prices are determined in the long-run. These two models found that the path or trend of real output or GDP is determined by the three factors of production: labor, capital and technology. However, as figure 9-1 in your text illustrates, real GDP rarely grows at the long-run average of 3.0% per year. Instead, real GDP tends to cycle around the 3.0% trend line, dipping below during recessions and rising above during expansions.

In section III, we look at income and price determination in the short-run. First, we discuss the ‘stylized facts’ of the business cycle and build the aggregate demand-aggregate supply model to explain these ‘facts.’ Second, we construct the workhouse of macro models -- the IS-LM model. The IS-LM model is a theory of aggregate demand. Third, we open the IS-LM model to international trade and build the Mundell-Fleming model. Fourth, we investigate business cycle theory or ideas behind the aggregate supply.

The required reading in this part is chapters 9 of your text. While you read the material, keep in mind the following questions:

1. What is the difference between market-clearing (flexible-price) models and sticky-price models? What time horizon (short- or long-run) does each assumption apply to?
2. What is a business cycle? What are the statistical properties or “facts” of a business cycle?
3. What is the aggregate demand (AD) curve? Why does the AD curve slope downward? What shifts the AD curve?
4. What is the long-run aggregate supply (LRAS) curve? Why is the LRAS vertical?
5. What is the short-run aggregate supply (SRAS) curve? Why is the SRAS horizontal?
6. In the aggregate demand-aggregate supply model, how does one find the short-run equilibrium?
7. What happens to the price level ($P$) during the adjustment period? What link then does the price level ($P$) provide?
8. In the aggregate demand-aggregate supply model, how does one find the long-run equilibrium?