Aggregate Demand Shocks with Fixed Inflation

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Comparative statics: Effect of a permanent, unexpected shock.

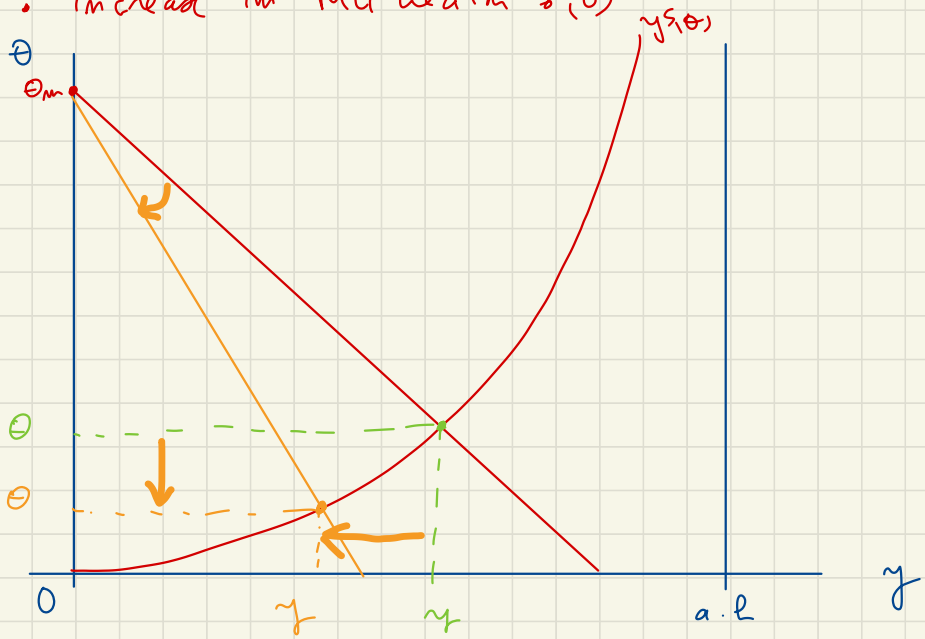
Negative AD shock.

$$y^d(\theta) = \left[\frac{\delta - r}{\sigma'(0)}\right]^{\varepsilon} \frac{1}{[1+\tau(\theta)]^{\varepsilon-1}}$$

discount rate

MU wealth

- decrease in discount rate δ
- increase in MU wealth $\sigma'(0)$



Negative AD shock: $\delta \downarrow$ or $\sigma'(0) \uparrow$

tightness: $\theta \downarrow$

output: $y \downarrow$

employment: $\ell = y/a$ so $\ell \downarrow$

unemployment rate: $u = \frac{\lambda}{\lambda + f(\theta)}$ so $u \uparrow$

$\sigma'(0) \uparrow$ then $y \downarrow$

$\Rightarrow$ Keynesian paradox of thrift

Everybody wants to once more to climb social ladder, but relative position is fixed b/c everybody behaves the same, so people end up spending less & save the same as their neighbors