Review: Short and Long Run Compared

	Long Run	Short Run
What determines GDP?	Technology and the quantities of factors of production available to the economy; behavior and institutions in the labor market that determine the fraction of the labor force employed (the natural rate of unemployment).	The interaction of aggregate demand (C, I, G, NX) with short-run aggregate supply.
What determines the rate of unemployment?	Institutions that limit the ability of labor to move between separate labor markets and that keep the wage above its market-clearing level.	GDP, and hence aggregate demand.
What determines the rate of inflation?	The rate of growth of the money supply in comparison to the rate of growth of real GDP.	The expected rate of inflation together with the actual rate of unemployment in comparison to the natural rate of unemployment
What are the effects of an increase in the money supply	The price level rises, along with other nominal variables, but all real variables remain unchanged.	The interest rate falls to clear the money market. This stimulates investment, which is a component of aggregate demand, and therefore increases GDP and reduces unemployment. Depending on the initial situation, there will also be either a rise in the price level or a rise in the rate of inflation.

What are the effects of an increase in government purchases?	This reduces government saving, thus reducing the supply of loanable funds increasing the interest rate, and reducing investment (crowding out). Reduced investment will mean that the capital stock and thus real GDP grow more slowly.	Government purchases are a component of aggregate demand, and this stimulus to AD causes GDP and also the price level to rise. (Crowding out occurs here too, with the rise in Y and P raising the demand for money and thus the interest rate, which reduces investment partially offsetting the increase in aggregate demand.
What are the effects of an increase in taxes on income?	This increases government saving, thus increasing the supply of loanable funds, decreasing the interest rate, and increasing investment. Increased investment will mean that the capital stock and thus real GDP grow more rapidly.	Increased income taxes reduce the disposable income of consumers out of any given GDP, causing them to reduce their consumption, a component of aggregate demand. GDP and the price level therefore fall.
What are the effects of an inflow of capital from abroad (not caused by a change in the domestic interest rate)?	The capital inflow constitutes a reduction in net foreign investment, and thus a reduction in the demand for loanable funds in the domestic economy, reducing the interest rate and stimulating domestic investment and growth. The real exchange rate also appreciates due to the accompanying decline in the supply of dollars on the market for foreign currency exchange, and this causes a reduction in net exports.	In the short run, the real appreciation also occurs, but now the fall in net exports is a decline in aggregate demand, causing a fall in GDP.