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LECTURE 7 – CH7

- *Short term*: analysing a fluctuation around trend
  - Short run – no change in pricing behaviour
  - Medium run – some price response to a new demand
  - Long run – prices fully reflect the new demand
- *Long term*: analysing the trend itself
- *Equilibrium*: total spending equals total consumption… injections = leakages

- Fluctuations
  - Changes in spending cause fluctuations in production and therefore fluctuations in GDP
    - → Other disturbances: bad weather, shifts in government policies, war, investment surges from new technology, structural changes, crises of confidence, reckless over-lending and its sudden collapse, etc.
  - In slumps, real GDP falls below potential. Firms produce less, lay off workers so unemployment rises. If demands stay low, firms will cut prices (reducing rate of interest) and real GDP moves toward the potential – medium and long run involves the economy returning to the potential
  - Remember MV=PY is only valid for the long term and is not suited to/does not explain the short term; if MV (nominal spending) rises, then PY (the value of output) rises
    - → Essentially P is 'sticky' so you 'put a lid on it' and Y is affected and fluctuates
    - → If a demand increases/decreases for a G/S, firms are unable to change pricing so quickly due to menu costs and implicit contracts
      - – Menu costs: administrative and marketing costs of changing the price of output i.e. reprinting menus, billboards, catalogues, brochures, etc.
      - – Implicit contracts: implied 'promise' to customers that certain things will remain the same i.e. prices, recipes, menu items, etc.

- Aggregate Expenditure Model (SHORT RUN MODEL)

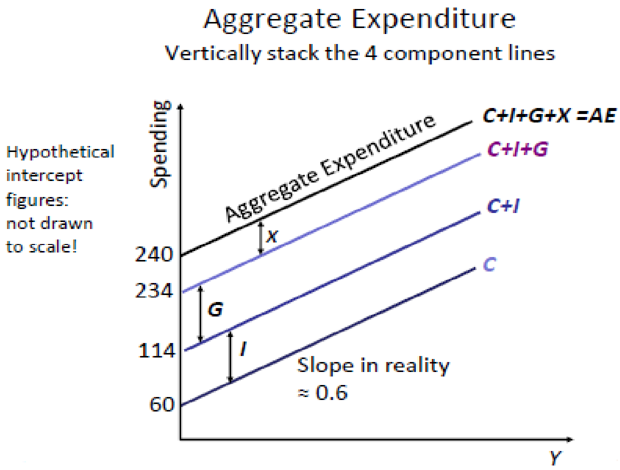
$$AE = C + I + G + NX$$

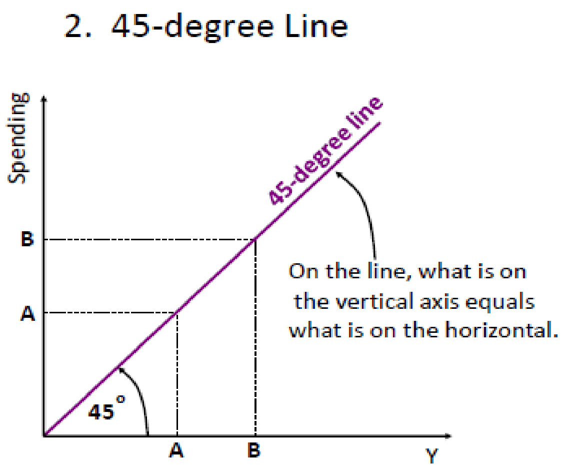
$$AE = Y$$

Where C = autonomous consumption *(subsistence spending)*
PLUS (+) MPC(Y) *(marginal propensity to spend)*
NX = NX autonomous net exports
MINUS (-) MPI(Y) *(marginal propensity to import)*

→ The aggregate expenditure (AE) line
→ The 45-degree line

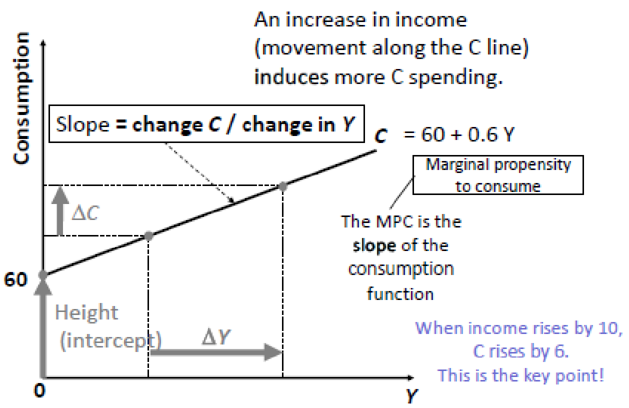
NOTE: GDP tends to converge to where these 2 lines cut… at equilibrium



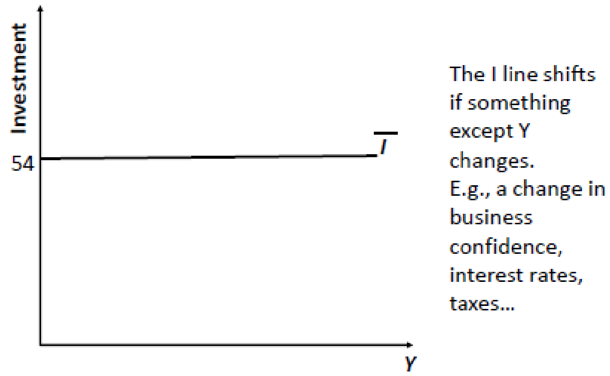


- In reality, firms adjust output (i.e. quantity) to meet sudden changes in aggregate demand (demand shocks)
  - → For example, if inventories unexpectedly falls, firms will increase output
- Suppliers don't have time to change their pricing behaviour
- More investment creates more consumption in the short run

A model: the Consumption Function

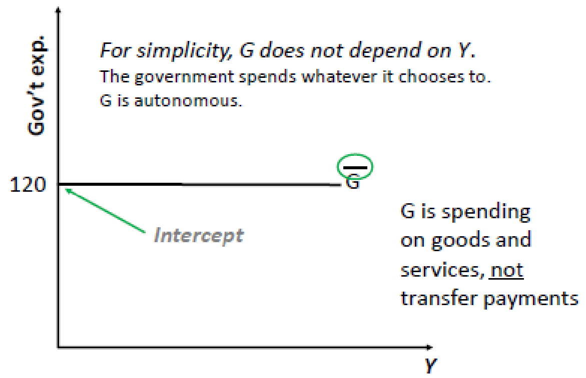


Investment Function (I)



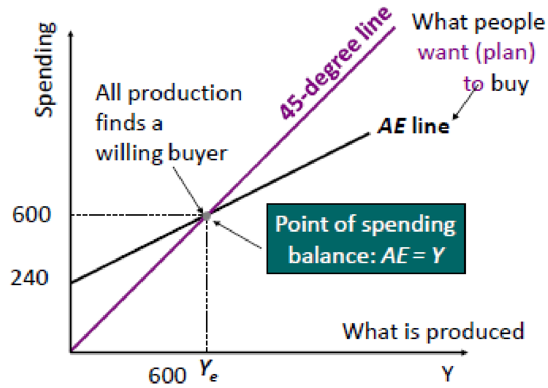
Gov't spending (G) Function

Gov't 'purchases' or 'expenditure'

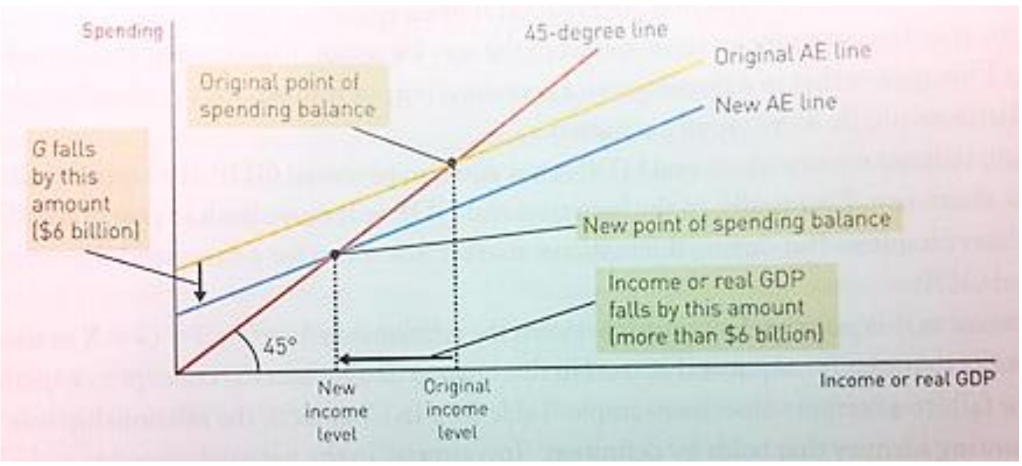


Spending Balance: 'short-run equilibrium' GDP (Y)

Equilibrium depends on the intercept (height) of the AE line and on its slope: Y need not = Y*, booms and slumps occur



- A shift from one point of spending to another



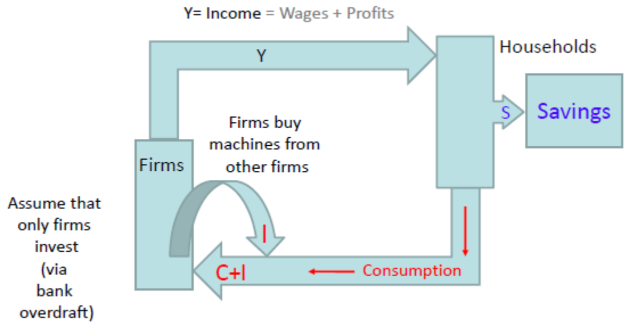
NOTE: a shift in the AE line (from C+I+G+NX factors, consumer confidence, taxes or transfer payments) leads to a new level of spending balance

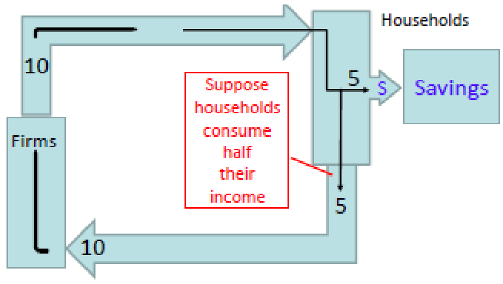
Upwards shifts raise real GDP over the potential (vice versa)

- 2-sector circular flow (re-visited)

Re-visiting the 2-sector circular flow

No government or foreign sector

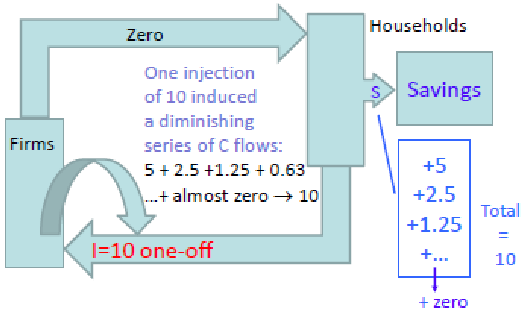




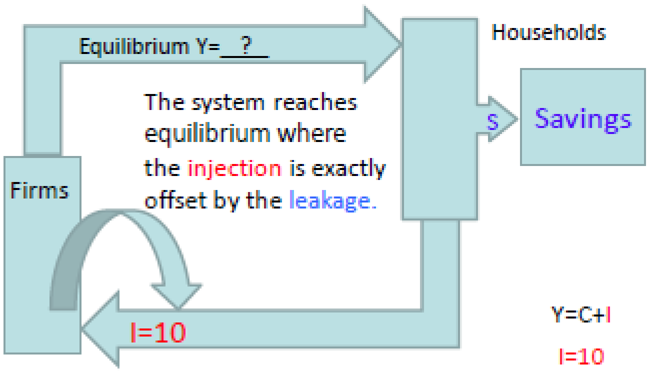
Suppose firms borrow 10 and invest 10, a one-off injection of spending

What if I=10 is *sustained*?

Eventually all flows (output and income) revert to zero



Eventually the <u>one-off</u> investment turns into savings: it all leaks out
The system returns to its initial equilibrium [Y = zero]



Y=C+I
I=10
C=0.5Y
S=0.5Y

- GDP responds in a measurable way to specified changes in components of AE
    - In principle macroeconomists can precisely manipulate AE to achieve desired GDP outcomes but in reality this is harder to achieve…