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Matthew Rizzi 10/24/21

Econ Chapter 9: Classical Macroeconomics and the Self Regulating Economy

- Classical Economics is often used to refer to an era in the history of economic thought that stretched from 1750 to the early 1900s.

9-1a) Say's Law: The economy cannot have a general surplus because Say's Law states that supply creates its own demand. (In a BARTER ECONOMY... NO MONEY)
  - Production creates enough demand to purchase all the goods and services the economy produces.
    - Ex. Suppose Matt bakes bread in an economy. Matt is the supplier of the bread. As Matt works at his trade, he plans to demand other goods. As Matt is baking bread, he is thinking of the goods and services he will obtain in exchange for the bread.
      - Thus, Matt's supplying of bread is linked to his demand for other goods. Supply creates its own demand.
  - If supplying of goods leads to a simultaneous demand for other goods, then Say's Law implies that there cannot be either:
    1. A general overproduction of goods (supply in economy > demand)
    2. A general underproduction of goods (demand in economy > supply)
  - What about if we are in a money economy?
    - Due to the fact that we know that the baker (Matt) may spend less than his full income, so we think that Say's Law would NOT hold in a money economy because the act of supplying goods and services (money) does not create an equal amount of demand.
      - Classical Economists disagreed and believed that even in a money economy, where individuals spend less than their full incomes, Say's Law still holds.
      - Their reasoning was based on the assumption of Interest Rate Flexibility.

9-1b) Interest Rate Flexibility
- For Say's Law to hold in a money economy, the funds saved must give rise to an equal amount of funds invested.
  - What leaves the spending stream through one door must enter it through another door.
    - If not, some income earned from supplying goods may not be used to demand goods. As a result, goods will be overproduced.
- Classical Economists argued that saving is matched by an equal amount of ~~spending funds invested~~ investment because of interest rate flexibility in the credit market.

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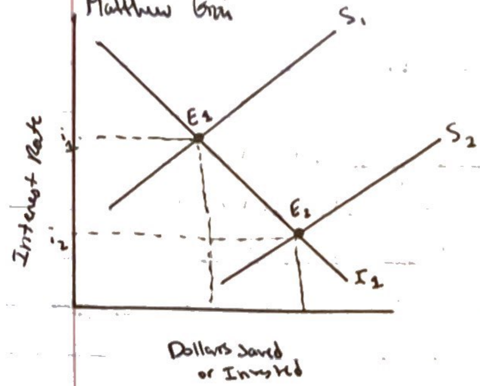

· Investment curve is downward sloping due to inverse relationship between Dollars invested and Interest rate.

· Saving curve is upward sloping due to direct relationship between Dollars saved/invested and interest rate. (Higher the interest rate, higher the reward for saving)

· Market equilibrating forces move the credit market to interest rate i_1 and the equilibrium point to E_1. At E_1 the number of dollars saved equals number of dollars firms invest.

· If saving increases at each interest rate level:

- S_1 has a rightward shift to S_2
- Classical economists believe that an increase in saving puts downward pressure on the interest rate; accordingly, it would move to E_2, thereby increasing the number of dollars firms invest.
- Ultimately, the number of dollars households save once again equals the number of dollars firms invest
  - Again, interest rate flexibility ensures that saving equals investment.

☆ - Changes in the interest rate uphold Say's Law in a money economy in which there is saving.
  - Interest rates will adjust to equate savings and investment.
    - Therefore, any fall in consumption will be matched by an equal rise in investment.
      - In essence, at a given price level, total expenditures will not decrease as a result of an increase in saving

- An increase in saving, since it does not lead to a change in spending, Aggregate Demand does not change.

9-1d Classical Economists on Prices and Wages: Both are Flexible.

- In the same way that wages decline or increase to meet the needs of labor, prices increase and decrease to adjust to surpluses or shortages, and equilibrium will be re-established.

9-2a Real GDP and Natural GDP: Three Possibilities

· Real GDP = GDP produced at natural unemployment Rate.

· Real GDP at that rate is produced when the country is in long-run equilibrium

Three possible states of the economy when relationship between Real GDP and Real Natural GDP considered:

① Real GDP < Natural Real GDP

② Real GDP > Natural Real GDP

③ Real GDP = Natural Real GDP

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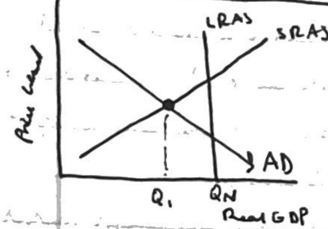
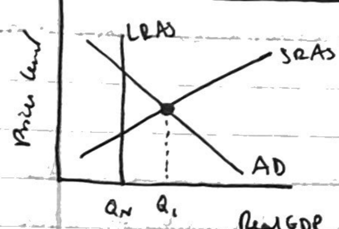
Real GDP is Less than Natural Real GDP (Recessionary Gap)



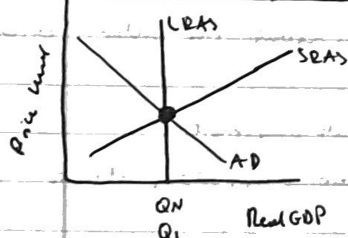
- The economy is currently producing a level of Real GDP in the short run that is less than its Natural Real GDP level. $[U > U_N]$
- When the Real GDP that the economy is producing is less than its Natural Real GDP, the economy is in a __recessionary gap__

Real GDP is Greater than Natural Real GDP (Inflationary Gap)



- The economy is currently producing a level of Real GDP in the short run that is greater than its Natural Real GDP level. $[U < U_N]$
- When the Real GDP that the economy is producing is greater than its Real GDP, the economy is in an __inflationary gap.__

Real GDP is Equal to Natural Real GDP (Long-Run Equilibrium)



- The economy is producing a level of Real GDP that is equal to its Natural Real GDP.
- When the Real GDP that the economy is producing is equal to its Natural Real GDP, the economy is in __long-run equilibrium__

9.2b). Like a goods market, the labor market can manifest ① Equilibrium ② A Shortage ③ A surplus.

- Equilibrium: The quantity demanded of labor is equal to the quantity supplied.
- Shortage: The quantity demanded of labor is greater than the quantity supplied.
- Surplus: The quantity demanded of labor is less than the quantity supplied.

Recessionary Gap and the Labor Market

- When an economy is in a recessionary gap, the unemployment rate is higher than the natural unemployment rate.
- This conclusion implies a surplus in the labor market.

Inflationary Gap and the Labor Market

- When an economy is in an inflationary gap, the unemployment rate is lower than the natural unemployment rate.
- This conclusion implies a shortage in the labor market.

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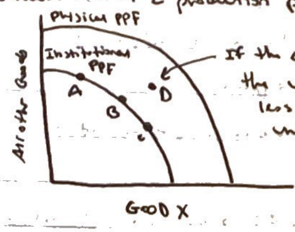
Long Run Equilibrium and the Labor Market

- The economy is producing a Real GDP level equal to Natural Real GDP.
  - This conclusion implies that the labor market has neither a shortage or a surplus, but is in equilibrium.

Common Misconceptions About the Unemployment Rate and the Natural Unemployment Rate.

- How can the Unemployment Rate be lower than the Natural Unemployment Rate?
  - We must look at 2 production possibility frontiers



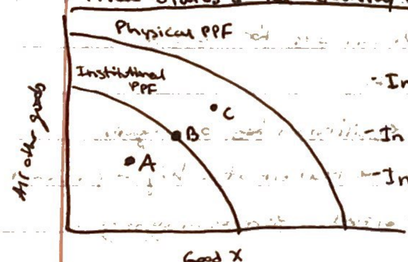
If the economy is here, then the unemployment rate is less than the natural unemployment rate.

- Physical PPF illustrates different combinations of goods that the economy can produce given the physical constraints of ① finite resources and ② current state of technology
- Institutional PPF illustrates different combinations of goods that the economy can produce given the two physical constraints of ① finite resources, ② current state of technology, ③ any institutional constraints.

Economic Constraint - Anything that prevents economic agents from producing the maximum Real GDP that is possible. (Ex. Minimum Wage Law)

- An economy can operate beyond the institutional PPF, but not beyond the Physical PPF.

Three States of the Economy and Two PPFs



- In (A), there is a Recessionary Gap (unemployment > natural unemployment)
- In (B), there is long run equilibrium (unemployment = natural unemployment)
- In (C), there is an Inflationary Gap (unemployment < natural unemployment)

The Self Regulating Economy

- If in a Recessionary Gap:
  - It is producing a Real GDP less than the Natural Real GDP
  - The unemployment rate > the natural unemployment rate
  - A surplus exists in the labor market
    - Due to a surplus in the labor market, wages will fall, the SRAS will shift to the right and the economy will move to long-run equilibrium.

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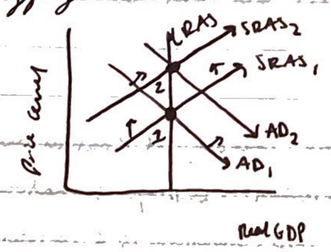
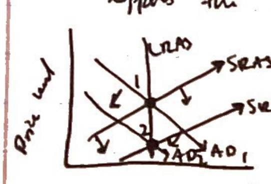
- If in an Inflationary Gap:
  - It is producing a Real GDP level that is greater than the Natural Real GDP Level
  - The unemployment rate is less than the natural unemployment rate
  - A shortage exists in the labor market
    - ∴ Due to a shortage in the labor market, wages rise, SRAS curve shifts left, and the economy moves into long-run equilibrium.
- Flexible Wage Rates play a critical role in the self-regulating economy
  - If wage rates were not flexible they would not be able to adjust for inflationary and recessionary gaps and move us into long-run equilibrium.
  - Economists believe that wage rates fall when there is a surplus and that they will rise when there is a shortage
- The whole idea of our economy self correcting itself is based on the <u>Laissez-Faire Principle</u>: A public policy of not interfering with market activities in the economy.
  - Government has no economic management role to play.

<u>Changes in a Self-Regulating Economy: Short Run and Long Run</u>

- In the long run, we only have higher prices to show for an increase in aggregate demand:



- When AD moved to AD2 we have moved into an inflationary gap, which will call for SRAS to simultaneously shift left.
  - We see that long-run equilibrium has once again been reached, but we now sit at a higher price level
- In the long run, we only have lower prices to show for [redacted] a decrease in aggregate demand.
  - when aggregate demand decreases we move into a recessionary gap. When this happens the SRAS curve will shift right and our price level will be lower.



∴ In the short run we see Prices ↓, Quantity of GDP ↓, but in the long run we see Prices ↓, Quantity of GDP not change.

Matthew Grijo 10/24/21

<u>Business Cycle Macroeconomics</u>

- Deals with up and down changes in GDP around a <u>fixed</u> LRAS curve.

<u>Economic Growth Macroeconomics</u>

- Deals with the factors that can lead to a <u>rightward shift in</u> the LRAS curve.