<u>Day 25</u>

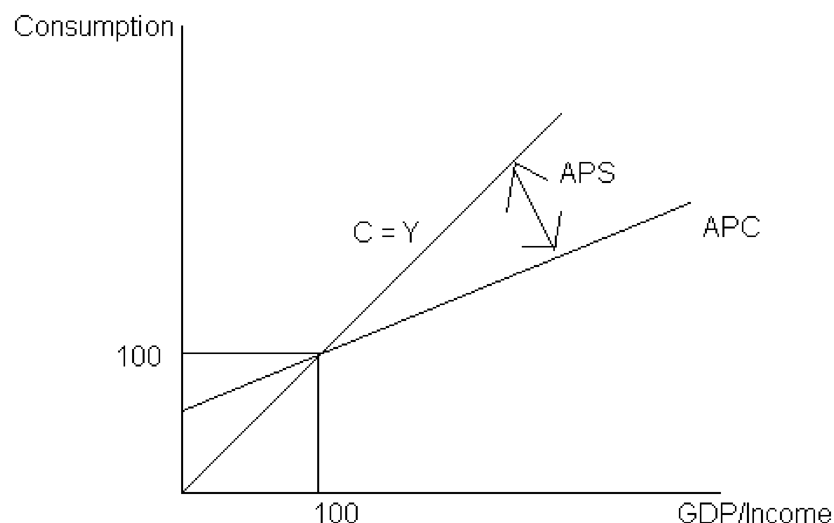
- Level of economic activity varies; Why?
- Why does the business cycle occur?
- Classical Model
    - Instability is not because of capitalism
    - World is unstable and economy reacts to this instability
    - Economy, however, is self-correcting
    - If that was true, policy implication is laissez faire
    - Worked
    - Say's Law and Self regulating market
        - Say's: Supply creates its own demand
        - Always would be enough demand
    - 2 markets
    - Savings is a problem with classical market
        - Banks borrow loanable funds and <u>businesses</u> spend it, so supply creates its own demand
    - Seemed to be supported by empirical evidence until the great depression
- Depression
    - Everything went down
    - But employers didn't seem to hire although wages went down
    - Economy didn't seem to fix itself
- Keynes came along
    - General Theory (of employment interest and money)
    - Book challenges classical model
    - Presents his own model
    - The Keynesian Model
        - Attempting to explain the great depression
        - Challenged savings and investment, so everyone would have to react to interest rates
            - Confidence is a factor
            - People may save because they are afraid
            - Investment in Great Depression
        - Wages and prices are often sticky downward; more likely to cut production
        - In the long run we're all dead
        - Maybe things would fix themselves, but how long would it take
            - Are we willing to wait?

- 3 Premises for Keynesian model
    - Level of output will be where aggregate expenditures = GDP
    - At this level, full employment not necessarily at equilibrium
    - Demand creates supply
- Aggregate Expenditures = GDP
    - What determines GDP?
        - C + Ig + Xn + G
- How do expenditures determine output
- Total Spending = Output
- Consumption = 2/3 of everything spent
- Income is biggest determinant in how much you spend
    - Keynes called this the consumption function
    - The more you make the more you spend, but not as much more (thus, the more you save)

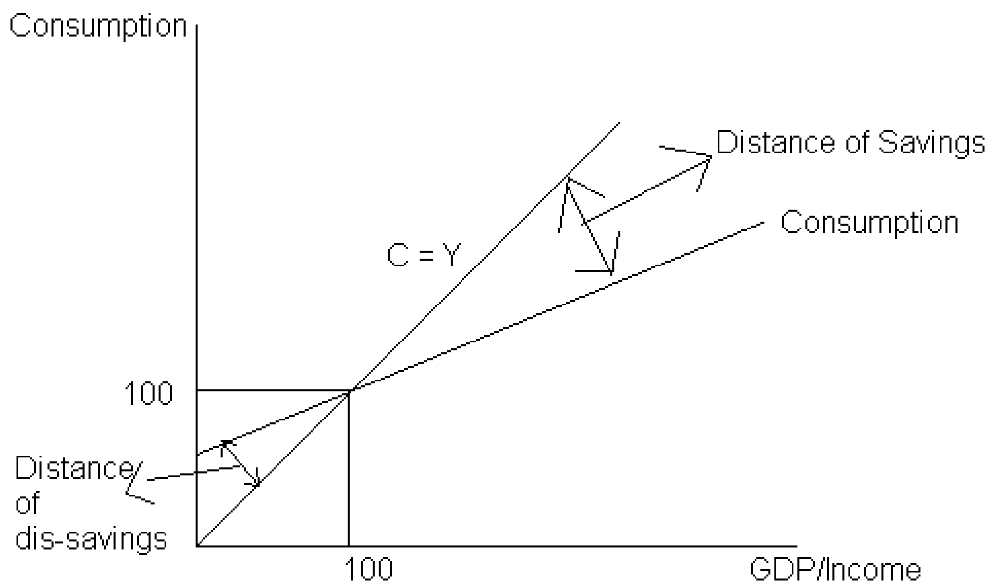
Y (Income)	C (Consumption)	S (Savings)
100	100	0
150	125	25

<u>Day 26</u>

- Great Depression challenged ideology of classical economists
- Keynesian Economics
    - Macro-economic equilibrium
        - Society wants to buy <u>exactly</u> what is produced
        - Not necessarily full employment
    - Demand creates supply



- What determines consumption
    - Biggest determinant is income
    - Consumption Function
    - Income changes, consumption changes, but not as much
- Average Propensity to Consume (APC) + Average Propensity to Save (APS) = 100% of income
- As income goes up, APC goes down, APS expands
- Economy naturally gravitates toward equilibrium
    - Total Spending = GDP
- What happens if Y = 50?



- How could people spend more than produced?
    - Use savings
    - Dis-savings
- Where is the product coming from?
    - Drawing on inventories
    - Dis-Savings = Inventory decrease
    - Classical would say firms want to <u>increase prices</u>
    - Keynes said <u>increase output</u>
    - Then firms @ equilibrium don't need to increase output further
- Firms more likely to increase output than to increase prices
- @ 150, people want to buy 125

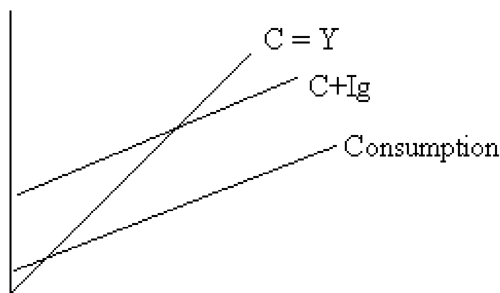
- Difference is savings
- Firms producing 150, goes to inventory
- Cut production

Day 27

- Keynesian Model/Aggregate Expenditures
  - Society seeks to purchase all that is being produced

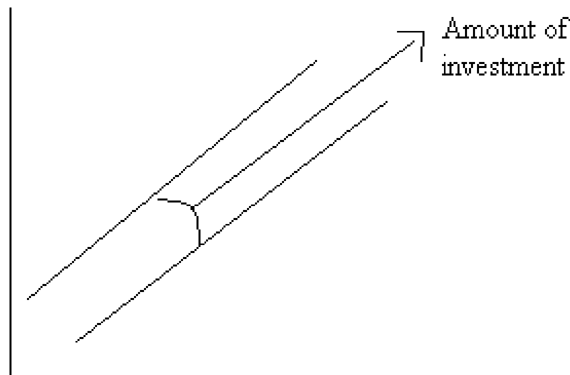
Y	C	S
50	75	-25
75	85	-10
100	100	0
125	115	10
150	125	25

- Firms more likely to adjust production than prices
- Consumption increases or decreases @ every level
- There are things that could make people spend more or less if income is held the same but rarely and not often
- When shift does occur, has dramatic effect on the economy
- Things that can make that happen
  - Wealth Effect
    - Difference between income and wealth
    - Wealth = What you have
    - Income = What you make
    - Possible if wealth changes and income stays the same, might spend more or less
  - Expectations
    - For holidays for example
- But line does not move often
- Consumer spending has been historically stable



- Line that does move is C + Ig

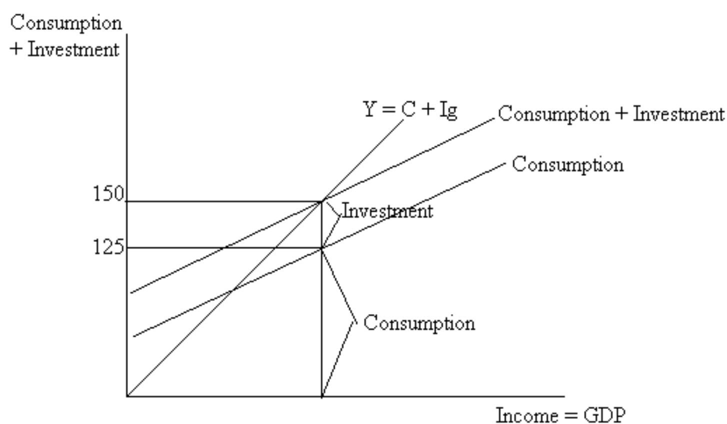
- C + Ig is parallel to consumption
- For consumption there is a relationship between income and consumption; What is capital in relation to income?



- Amount of investment is the same at every price level
- No reliable relationship between capital and GDP
    - Level of investment is not a function of GDP
- Ig will be the same until something else changes it, not GDP
- Dollars saved borrowed by business at equilibrium

Day 28

- Notion of Keynesian Equilibrium
    - Society wants to buy exactly what is being produced



- At every level of GDP, Investment spending is the same
- Below equilibrium Ig > S, at equilibrium Ig = S, above equilibrium Ig < S
- Investment spending; Business spending on capital
- Investment spending varies dramatically, but the line shifts up and remains parallel

- Keynes argue this is reason for economic instability

- Determinants of investment spending
    - Interest rates
    - Future expectations
    - Technological innovations