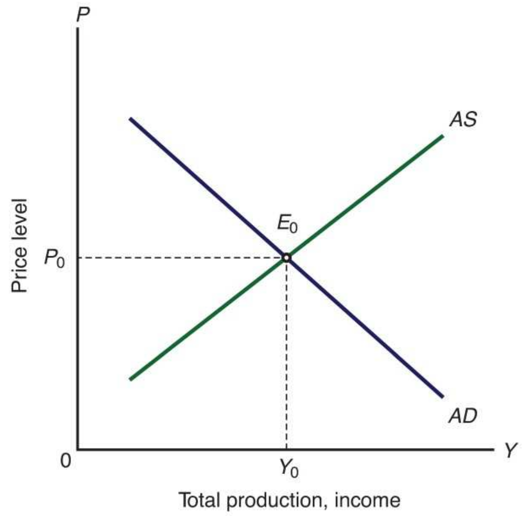
More on macroeconomic theory and policy

Aggregate demand (*AD*) and aggregate supply (*AS*)

- ***Assumptions of AD-AS model***
  - prices, wages and interest rates variable
  - level of income determined by interaction of *AD* and *AS*
- Comparison with microeconomic demand and supply
  - now dealing with general price level (*P*) and total production or income (*Y*)
- Comparison with Keynesian models

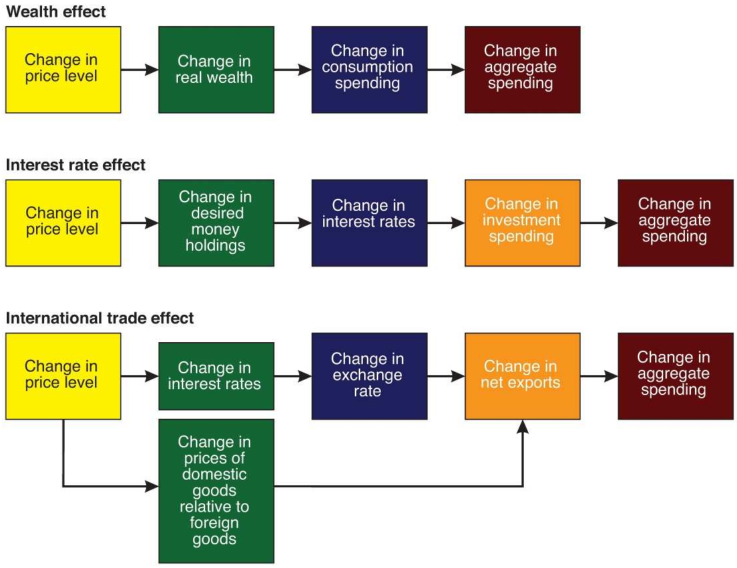
- **Graphical illustration:**



Aggregate demand and aggregate supply

Aggregate demand curve (*AD*)

- Slope (why *AD* curve slopes downward, ie why negative, inverse relationship between *P* & *Y*?)
  - wealth effect (real balance effect)
  - interest rate effect
  - international trade effect

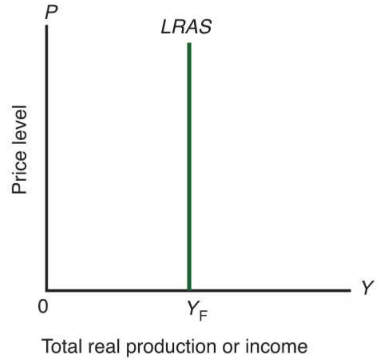


Why the aggregate demand curve slopes downward

- Position (what can cause the *AD* curve to shift?)
  - all non-price determinants of *C*, *I*, *G*, *X* and *Z*
  - change in autonomous *C*
  - change in *I*
  - change in *G*
  - change in (*X* – *Z*)
  - examples on pp 158-159

Aggregate supply curve (*AS*)

- ***Slope of AS curve***
  - **short run:** upward (positive) slope
  - **long run:** vertical



The long-run aggregate supply curve

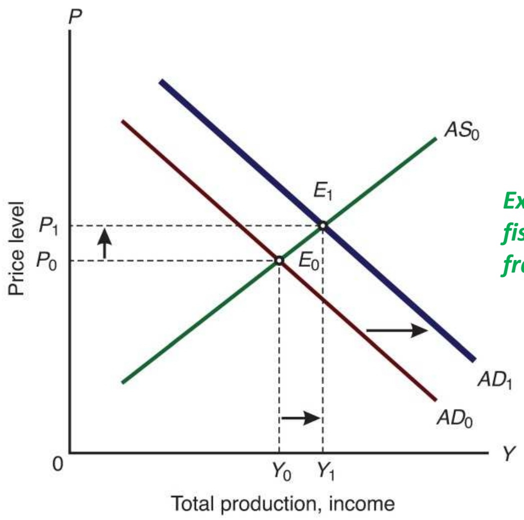
- ***Upward slope of short-run AS curve***
  - if *P* changes, real wage changes; therefore employment and production change

- ***Position of AS curve***
  - determined by prices and productivity of factors of production and other inputs in the production process
  - examples on pp 160-161

Changes in aggregate demand (*AD)*

- ***Increase in AD***
  - illustrated by rightward shift of *AD* curve
  - *Y* increases
  - *P* increases
  - trade-off situation

- **Graphical illustration**



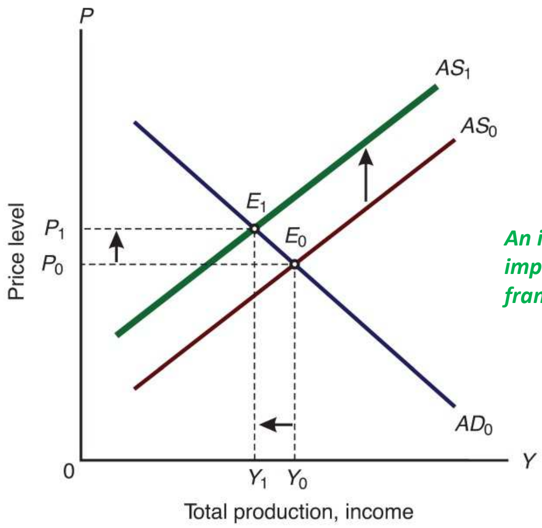
Expansionary monetary and fiscal policy in the AD-AS framework

- ***Decrease in AD***
  - illustrated by leftward shift of *AD* curve
  - *Y* decreases
  - *P* decreases
  - Again a trade-off situation

Changes in short run aggregate supply (*AS*)

- ***Decrease in AS***
  - illustrated by leftward (upward) shift of *AS* curve
  - *Y* decreases
  - *P* increases
  - stagflation

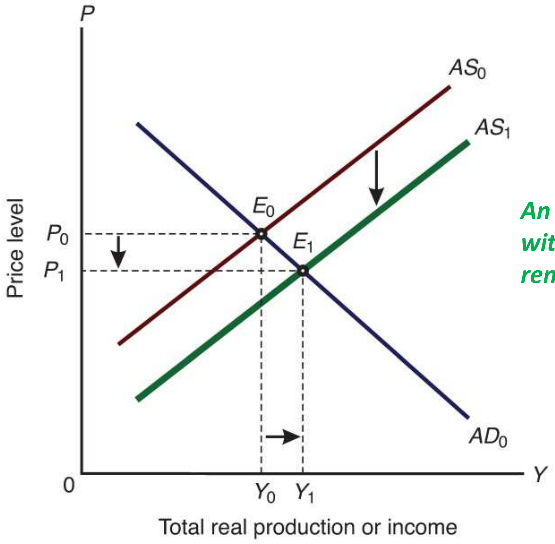
- **Graphical illustration:**



An increase in the price of imported oil in the AD-AS framework

- ***Increase in AS***
  - illustrated by rightward (downward) shift of *AS* curve
  - *Y* increases
  - *P* decreases
  - ideal situation

- **Graphical illustration:**



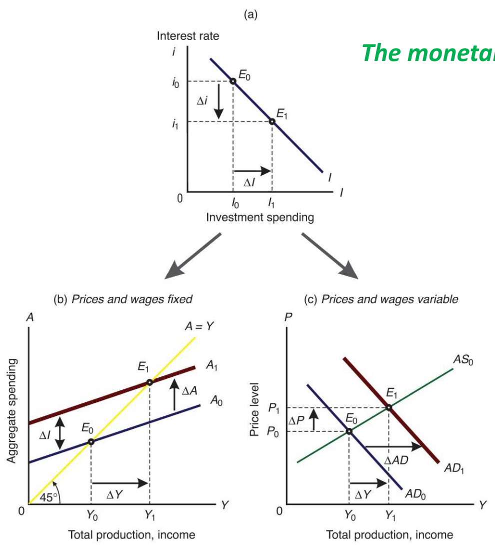
An increase in productivity without any increase in remuneration

Monetary transmission mechanism

- How do changes in the monetary sector affect the rest of the economy?
- Essentially, how do changes in interest rates affect the economy?
- Inverse relationship between interest rates and investment spending
- $\Delta i \rightarrow \Delta I \rightarrow \Delta A \rightarrow \Delta Y$

- ***Keynesian model:*** change in interest rate changes investment spending and therefore aggregate spending and total production and income
- ***AD-AS model:*** *AS* also plays role
- $\Delta i \rightarrow \Delta I \rightarrow \Delta A \rightarrow \Delta AD \rightarrow \begin{matrix} \Delta Y \\ \Delta P \end{matrix}$
- *AS* determines split between ΔY and ΔP

- **Graphical illustration:**



The monetary transmission mechanism

Expanded transmission mechanism

- Interest rates do not affect the economy only via investment
- Transmission mechanism has various channels
  - interest rate channel
  - exchange rate channel
  - asset price channel
  - credit channel

- Expectations also very important
- See ***Figure***
- Complex transmission mechanism
- Outcome uncertain

Monetary and fiscal policy

- ***Expansionary monetary policy*** – decrease repo rate
- ***Restrictive monetary policy*** – increase repo rate
- ***Expansionary fiscal policy*** – increase G, reduce t
- ***Restrictive fiscal policy*** – decrease G, increase t

- ***Policy lags***
  - **recognition lag:** same for monetary and fiscal policy
  - **decision lag:** long for fiscal policy, short for monetary policy
  - **implementation lag:** long for fiscal policy, short for monetary policy
  - **impact lag:** longer for monetary policy than for fiscal policy
- ***Relative effectiveness***
  - fiscal policy for stimulation
  - monetary policy for contraction

Schools of economic thought: overview

- ***Classical economics***
  - Say's law: supply creates its own demand
  - emphasis on supply
- ***Keynes***
  - Great Depression
  - focus on aggregate demand

- ***Monetarists***
  - inflation
  - focus on quantity of money
- ***Supply-side economists***
  - stagflation
  - emphasis on supply side
- ***New classical economists***
  - rational expectations

- ***Post Keynesian economists***
  - go back to Keynes

- ***New Keynesian economists***
  - elements of new classical school and Keynesian school

Monetarism

- Milton Friedman

- ***Classical dichotomy***
  - separation of monetary sector and real sector

- ***Believe in***
  - inherent stability of free-market system
  - minimum government participation in the economy
  - inflation is caused by excessive increases in the quantity of money (quantity theory of money)

- ***Quantity theory of money***
  - *MV* = *PY*
  - change in *P* caused by change in *M*
  - based on certain assumptions

Supply-side economics

- Emphasis on supply side (Reaganomics, Thatcherism)
- Favour market forces; oppose government intervention
- Cut government spending
- Privatisation
- Deregulation
- Lower tax rates

New classical economics

- Robert Lucas
- Importance of microeconomic foundations
- Rational expectations
- Markets always clear
- Oppose government intervention

New Keynesian economics

- Microeconomic foundations important
- Many accept rational expectations
- Emphasise market imperfections
- Favour policy intervention