Short Run Fluctuations

Fluctuations in Aggregate Spending main source of recessionary and expansionary gaps.

Planned vs Actual Spending

C, G, NX: actual = planned

Investment Spending= I^P

planned

Inventory investment
Business Fixed investment

$I \neq I^P$

$I > I^P$: **actual > planned**

sales low

$I < I^P$ **actual < planned**
sales high

Consumption

$$\boxed{C = \overline{C} + c(Y - T)}$$

$\overline{}$ not function of income

-wealth
-real interest rate (more in lec 11)
-consumer confidence

c & Y-T

Disposable income

Incomes - Net Tax

0 < c < 1 MPC marginal propensity to consume

Economic Naturalist 26.2

What effect did 2000 to 2002 decline in stock market have on consumption spending?

13.3 T to 6.5T

$1 fall mean fall in C 3 to 7 cents

Other factors counteract stock market wealth effect

Spending depends on Income

PAE = C + Ip + G + NX

C=620 + 0.8(Y-T)
G=300
NX=20
T=250
Ip=220

PAE = 960 + 0.8Y = autonomous + induced

Output depends on Spending

Meeting demand at set prices

Production = PAE (demand)

Y = PAE

Short-Run Equilibrium Output

(1) Output *Y*	(2) Planned aggregate expenditure *PAE* = 960 + 0.8*Y*	(3) *Y - PAE*	(4) *Y = PAE?*
4,000	4,160	-160	No
4,200	4,320	-120	No
4,400	4,480	-80	No
4,600	4,640	-40	No
4,800	4,800	0	Yes
5,000	4,960	40	No
5,200	5,120	80	No

Y < SR Equil Y

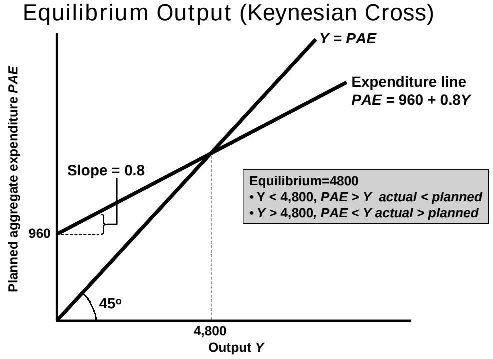
I < Ip

inventory drawn down

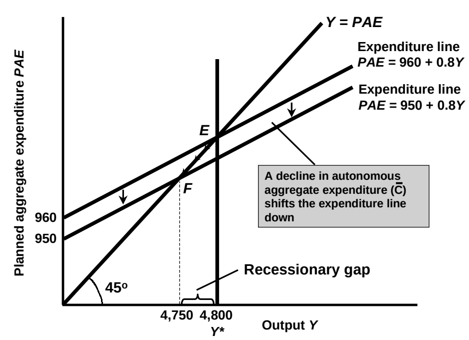
more sales than planned

firms expand production to meet demand

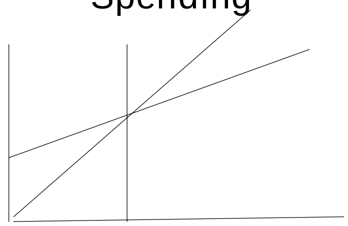
Determination of Short-Run Equilibrium Output (Keynesian Cross)



A Decline In Planned Spending Leads To A Recession



Increase in Planned Spending



Shifts in PAE

$\bar{C}$ shifts
Ip shifts
G
NX

Naturalist 26.3

Cause of 90-91 recession?

Decline in consumer confidence

Credit crunch from 80s bank crises Ip

Naturalist 26.5

Cause of 2001 Recession (Mar 01)?

C high

Ip low

Multiplier

10 unit drop in aut expd
50 unit fall SR output

Multiplier = 1/ 1-0.8 =1/.2=5

Large means spending changes due to income change large.

Likewise for small multipler

C(bar) falls 10

PAE falls 10

Producer’s income (worker, firm owner) falls 10, spending falls 0.8x10

Other producers’ income falls .8(.8x10)

10[1+.8+.8*.8 + .8*.8*.8 +...] = 10[1/1-.8]

=

Closing Output Gaps

Stabilization Policy

Fiscal: G , T
Monetary: (next time)

Expansionary
Contractionary

Close Gap due to fall in Ip

Ip falls 10
PAE shifts down 10

Stabilize: Inc Aut exp by 10,
Fiscal Policy = Inc G by 10

Naturalist 26.7

Does military spending stimulate economy?

Change in T to close gap

Change Y-T
means change C

Dec tax or Inc transfer

Recessionary Gap=50

Shift up PAE by 10 (since 10xmult=50)

Inc C by 10

10 = 0.8(change in T)

change in T = 12.5

Dec in tax
Inc in transfer

Naturalist 26.8

Why did govt send out rebates $300-$600 in 2001?
Total $38B

dec tax

U Michigan survey: actually little effect

Fiscal Policy

1) Affects spending & potential output

Potential Output (if work & saving incentive)

2) Large deficit means low public saving

3) Legislative process: inflexible tool

4) Automatic Stabilizer: fall in GDP , get inc G, inc transfer, dec T