Stabilisation

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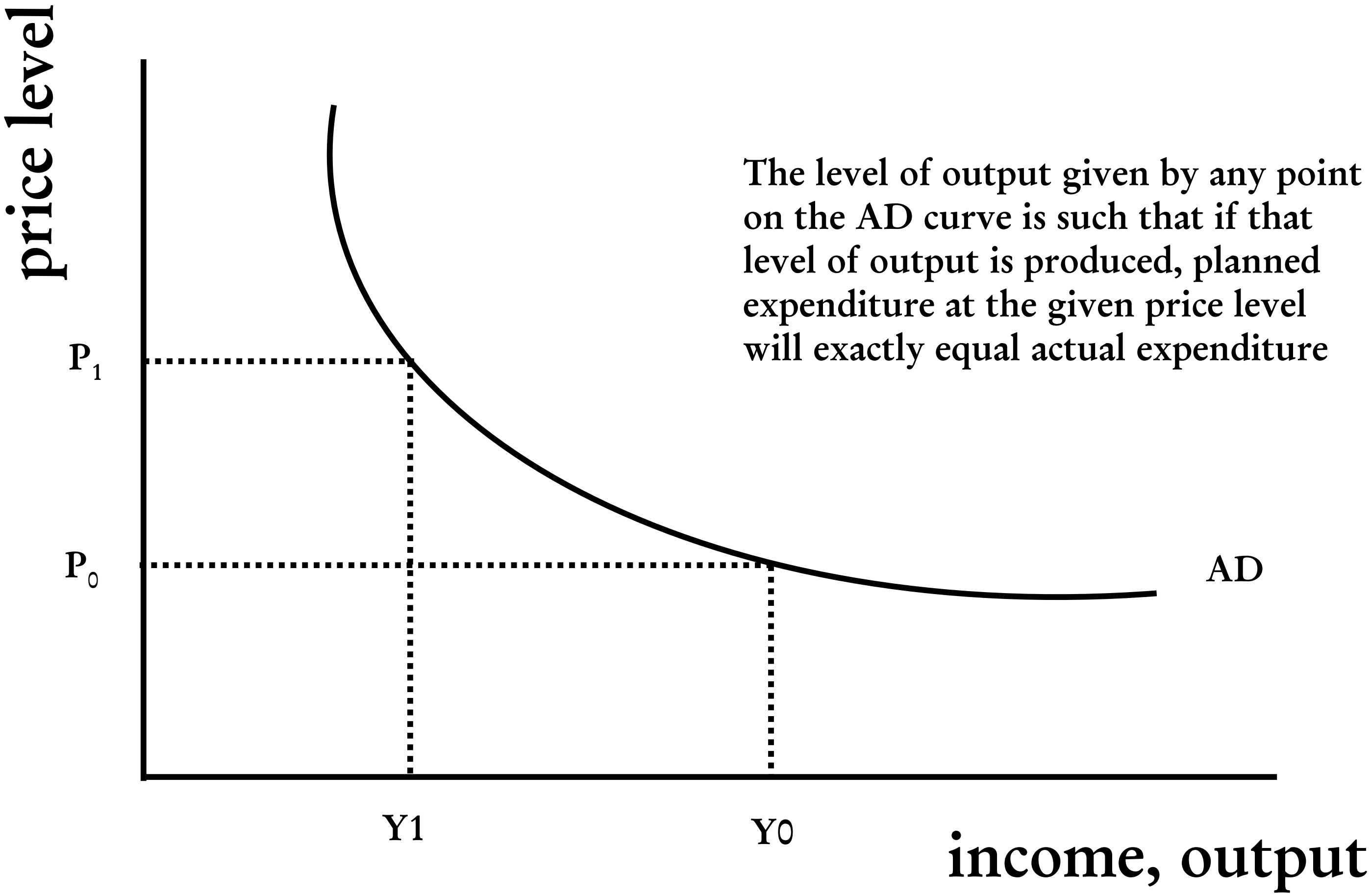
aggregate demand revisited

- Aggregate demand comprises four components:
  - Consumption
  - Investment
  - Primary government spending (i.e. net of transfers)
  - Net exports
- The level of income is a major determinant of consumption, government spending and net exports.
- The real exchange rate is a major influence on net exports.
- The interest rate is also an influence on consumption and investment (with the latter being also dependent upon output expectations and 'animal spirits').

aggregate demand in price:output space



why does the AD curve slope down?

- Three reasons why the aggregate demand curve slopes downwards:
- The first is the Real Balance Effect. When prices fall, the real value of assets whose prices are fixed in nominal terms (such as some government bonds, money, and gold) rises. This leads to more consumer spending.
- The second is the real exchange rate. When prices fall, the real exchange rate falls (if the nominal exchange rate is fixed). This leads to an improvement in the primary current account.
- The third is the Keynes effect. When prices fall people need less money for day to day transactions and so switch their money balances into bonds and shares. This reduces the interest rate and hence increases interest-sensitive spending, such as investment.

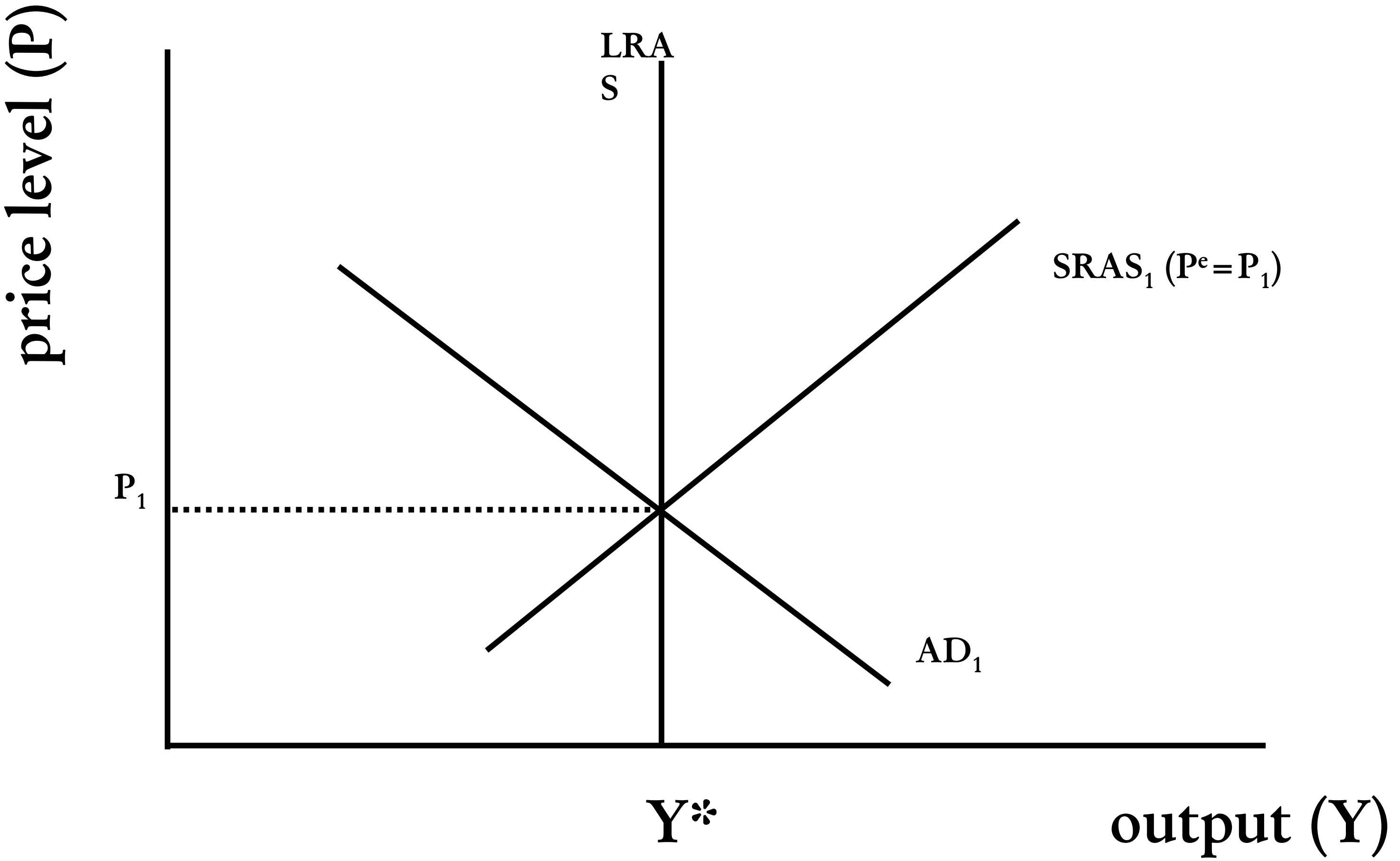
long-run aggregate supply revisited

- We say that the labour market is in equilibrium when inflation is stable.
- At the equilibrium unemployment rate, there will be both voluntary unemployment (workers who do not wish to work at the current real wage) and involuntary unemployment (workers who would like to work but cannot find jobs at the current real wage).
- If there is a unique and stable level of equilibrium unemployment, then there is also a unique and stable equilibrium rate of output.
- In the long-run, the economy should return to its equilibrium rate of output, ‘money is neutral’.

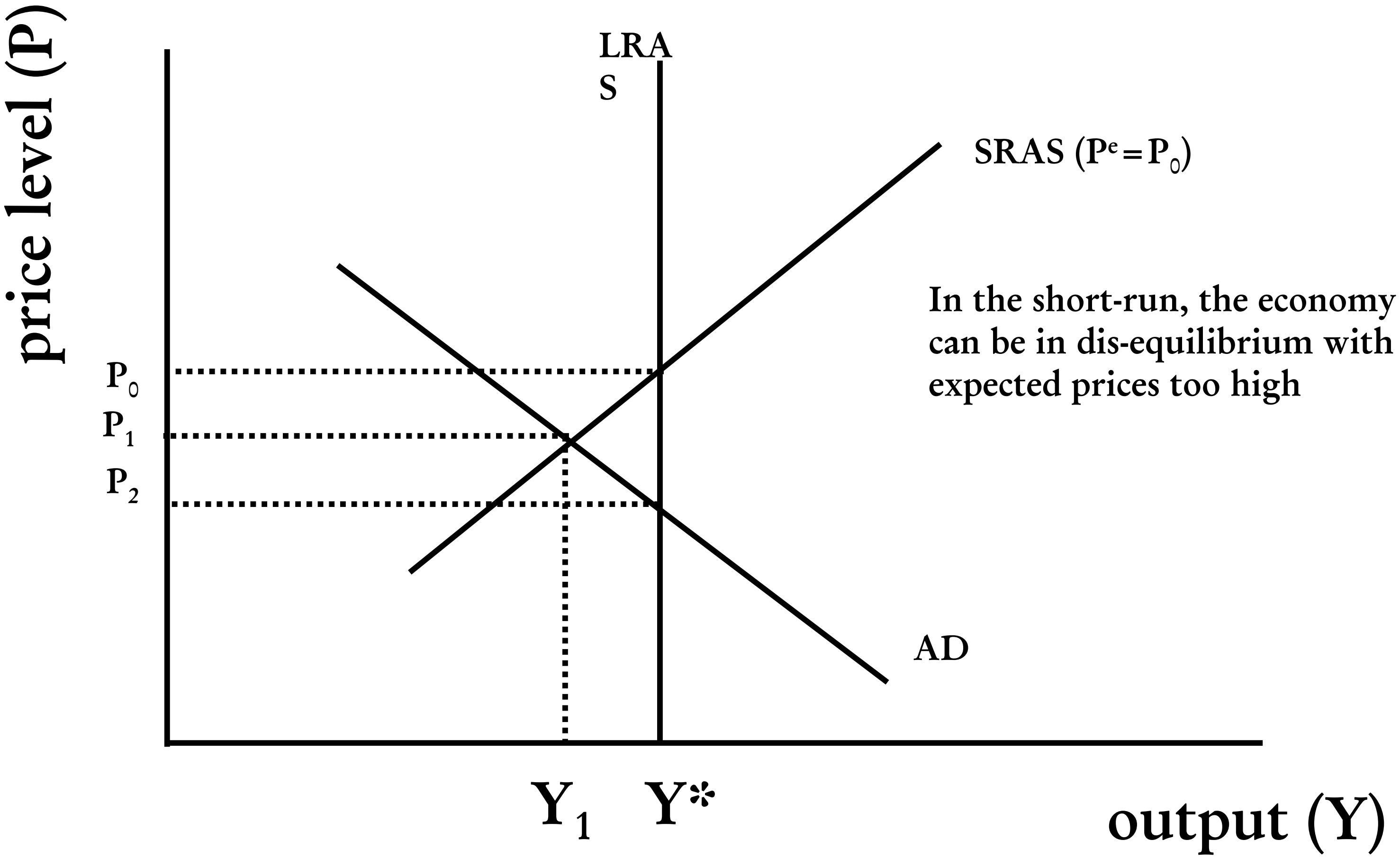
short-run aggregate supply revisited

- In the short-run, there is no reason to expect actual output to equal its equilibrium rate.
- Here are four reasons why changes in nominal variables may lead to temporary changes in real output:
  - sticky-wages
  - worker-misperception
  - imperfect information
  - sticky-prices
- All of these lead to a 'surprise-supply' function, where output =equilibrium output + b(prices – expected prices)

AS-AD in long-run equilibrium



AS-AD in dis-equilibrium

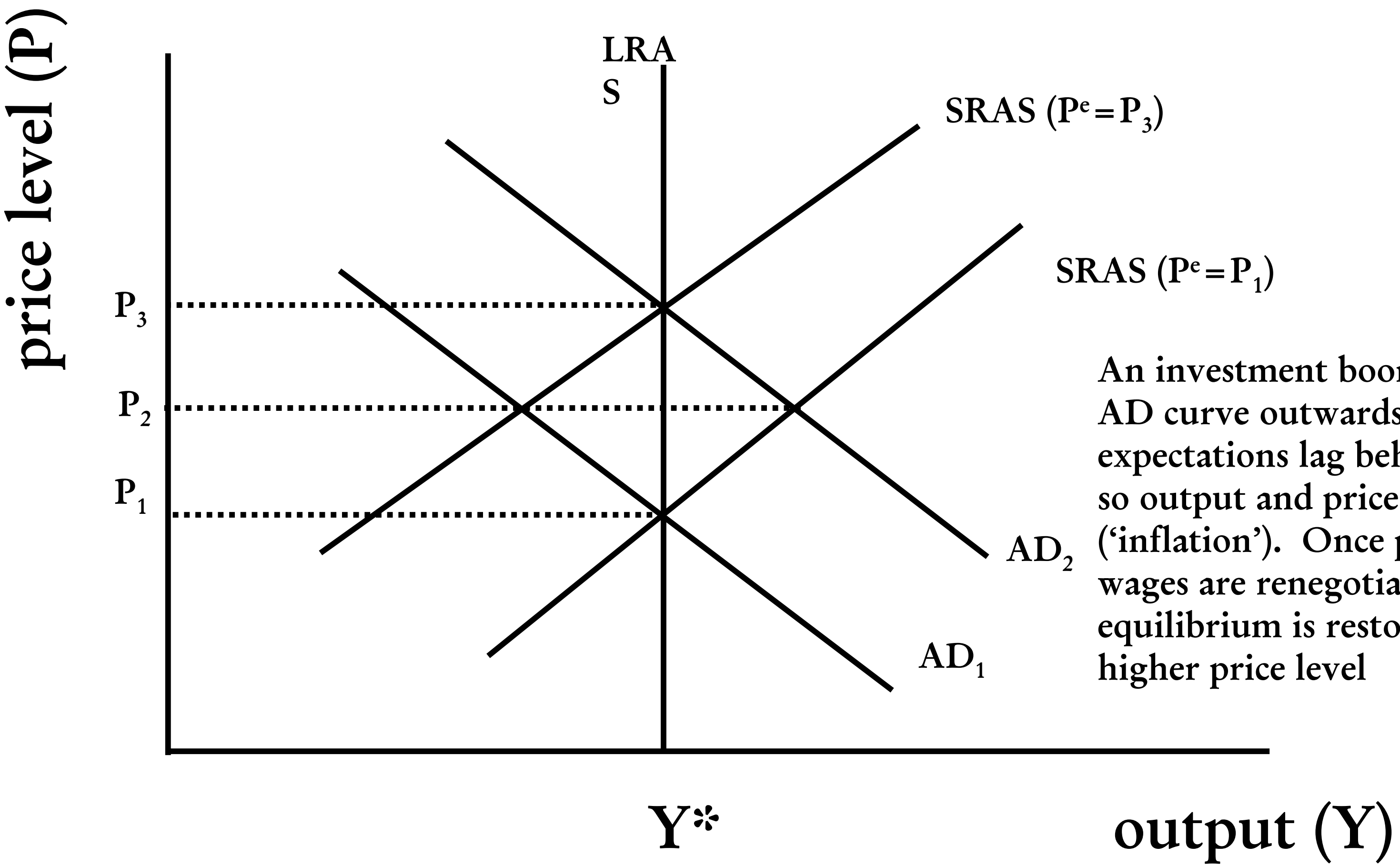


In the short-run, the economy can be in dis-equilibrium with expected prices too high

shocks to the economy

- Why might the economy get ‘shocked’ away from equilibrium?
- Aggregate demand shocks
  - an investment boom
  - a pre-election government spending spree
  - a sudden rise in the real exchange rate
  - a consumer boom abroad
  - a boom in the housing market
  - the Bank of England cuts base rates
- Aggregate supply shocks
  - a sudden rise in oil prices
  - the invention and diffusion of a new technology

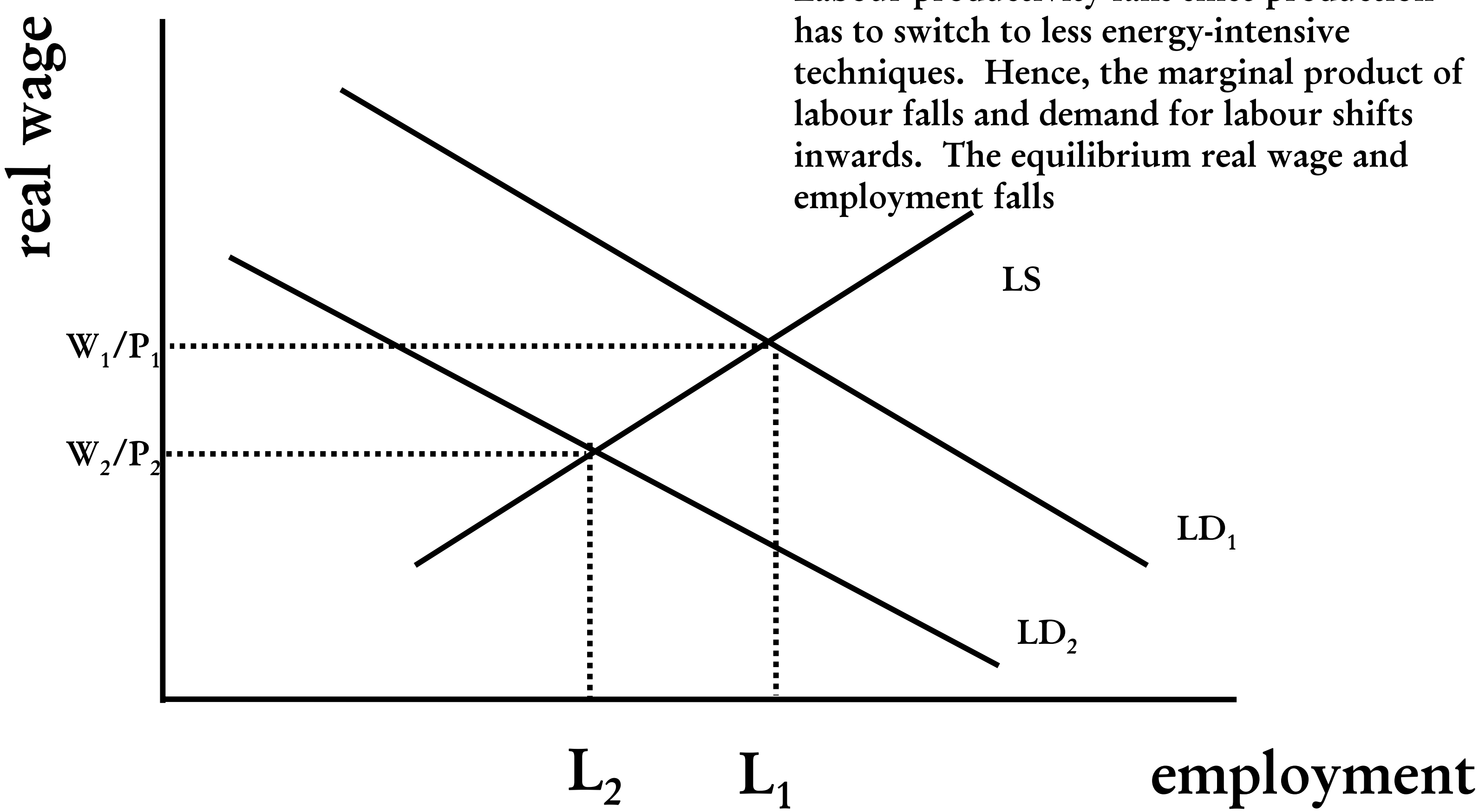
an investment boom



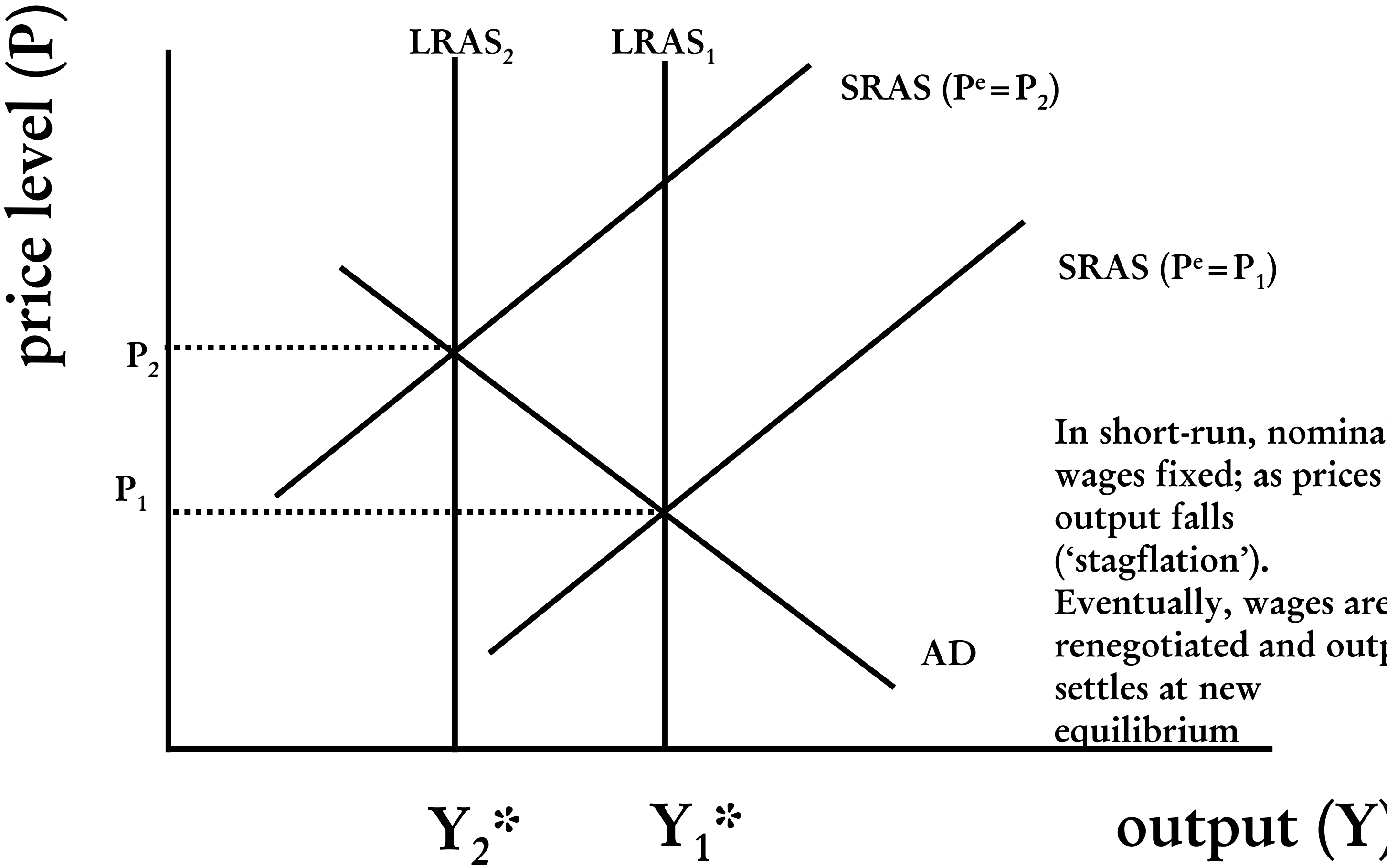
An investment boom shifts the AD curve outwards. At first, expectations lag behind events, so output and prices rise ('inflation'). Once prices and wages are renegotiated, equilibrium is restored with a higher price level

an ‘oil price shock’ & labour

Labour productivity falls since production has to switch to less energy-intensive techniques. Hence, the marginal product of labour falls and demand for labour shifts inwards. The equilibrium real wage and employment falls



an ‘oil price shock’ and AS-AD



In short-run, nominal wages fixed; as prices rise, output falls (‘stagflation’). Eventually, wages are renegotiated and output settles at new equilibrium

Log Real Oil Price and US Price Level (1995=1)
1959 to 1999

fiscal policy

- ‘If the Treasury were to fill old bottles with bank notes, bury them at suitable depths in disused coal mines which are then filled up with town rubbish, and leave them to private enterprise… to dig them up again, there need be no more unemployment…’ J.M. Keynes.
- Changes in the government’s fiscal stance (that is, the difference between government spending and taxation) will shift the aggregate demand curve and will tend to push interest rates upwards.
- If economy is at equilibrium output, increases in spending (or tax cuts) will lead to an inflationary boom, which eventually will lead only to higher prices.
- If economy is below equilibrium output, increases in spending (or tax cuts) will tend to raise output (as well as prices) and shift the economy back towards equilibrium.

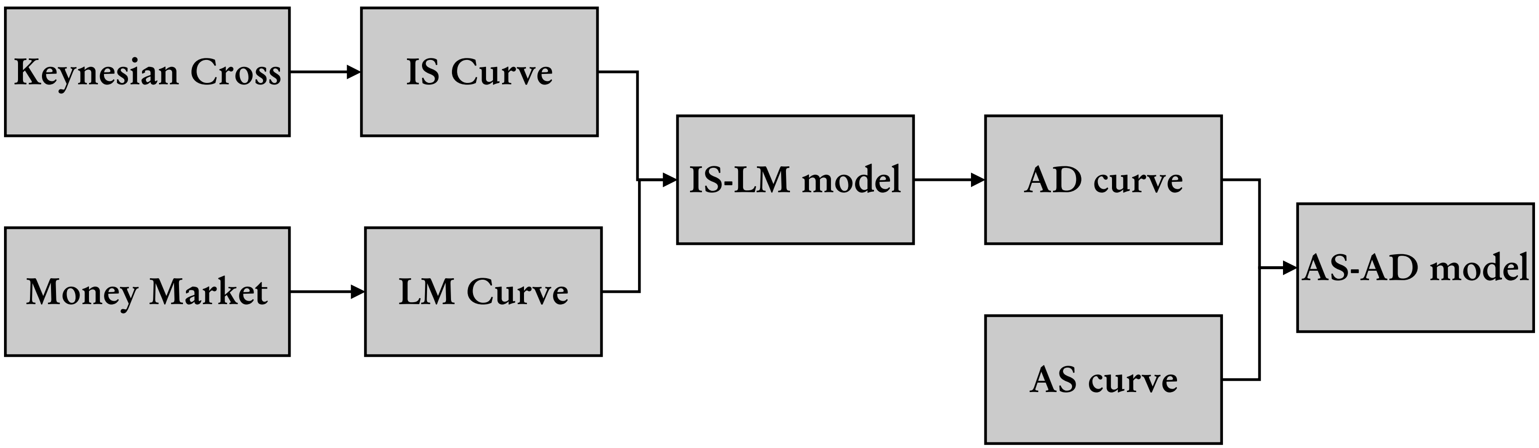
monetary policy

- ‘Having regard to human nature and our institutions, it can only be a foolish person who would prefer a flexible wage policy to a flexible money policy, unless he can point to advantages from the former that are not obtainable from the latter’ J.M.Keynes.
- Monetary policy can work either through changes in the money supply or interest rate. A cut in the interest rate leads to a rise in the money supply.
- Changes in the interest rate will shift the aggregate demand curve.
- If economy is at equilibrium output, interest rate cuts will lead to an inflationary boom, which eventually will lead only to higher prices.
- If economy is below equilibrium output, interest rate cuts will tend to raise output (as well as prices) and shift the economy back towards equilibrium.

the limits to active policy

- **But there are problems with the use of active policy:**
  - Measurement of output: Where are we? Where are we going? How fast? Will we know when we get there?
  - Lags in the policy process: measurement, decision, execution, effectiveness.
  - What kind of fiscal policy? Spending (on what?) or tax cuts (for whom?)
  - Will spending (fiscal policy) 'crowd-out' other spending, either directly or indirectly?
  - Will consumers pierce the veil? Will they attempt to offset the actions of the government? ('Ricardian Equivalence').
  - Will policy affect other objectives? Such as the exchange rate, balance of payments, public services.
  - Fiscal policy is weak when investment is very sensitive to interest rates.
  - Monetary policy is weak when consumers are willing to hold large quantities of money and unwilling to purchase more bonds ('liquidity trap').

the theory of short-run fluctuations



summary

- Equilibrium in the economy is determined by the interaction of aggregate demand (the goods and money market) and aggregate supply (the labour market).
- In the long-run, a country's capacity to produce goods and services determines the standard of living of its citizens.
- In the short-run, aggregate demand influences the amount of goods and services the a country produces.
- In the long-run, the rate of money growth determines the rate of inflation but does not affect the rate of unemployment.
- In the short-run, policymakers face a trade-off between inflation and unemployment.

syndicate topics

- Should policymakers try to stabilize the economy?
- How costly is inflation, and how costly is reducing inflation?
- How big a problem are government deficits?
- Can the economy get 'stuck' away from equilibrium?
- Might there be more than one equilibrium for the economy?