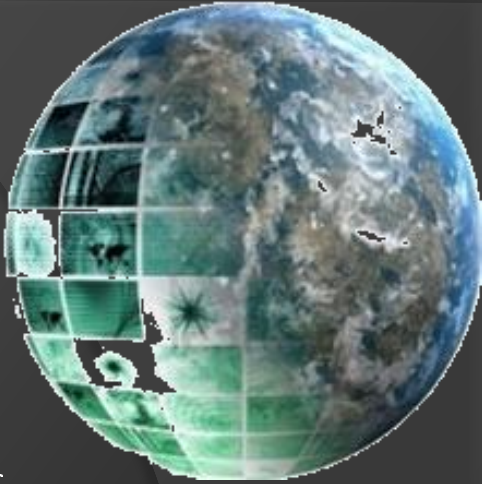


There is no evidence that the business cycle has been repealed.

Alan Greenspan

THE BUSINESS CYCLE PART I

Macroeconomics

Macroeconomics is the study of aggregate economic behavior, of the economy as a whole.

Macroeconomics

- Macroeconomic *theories* try to *explain* the business cycle, economic *policies* try to *control* it..
- Business cycles are alternating periods of economic growth and contraction.

Stable or Unstable?

- Prior to the 1930s, macroeconomists thought there could never be a Great Depression.
- They believed that a market-driven economy was inherently stable and that government intervention was unnecessary.

Classical Theory

Laissez faire is the doctrine of "leave it alone," of nonintervention by government in the market mechanism.

A Self-Regulating Economy

- According to the classical view, the economy "self-adjusts" to deviations from its long-term growth trend.
- The cornerstones of classical optimism were flexible prices and flexible wages.

A Self-Regulating Economy

- The Classical view of the macro economy was summarized in Say's Law.
- According to Say's Law, supply creates its own demand.

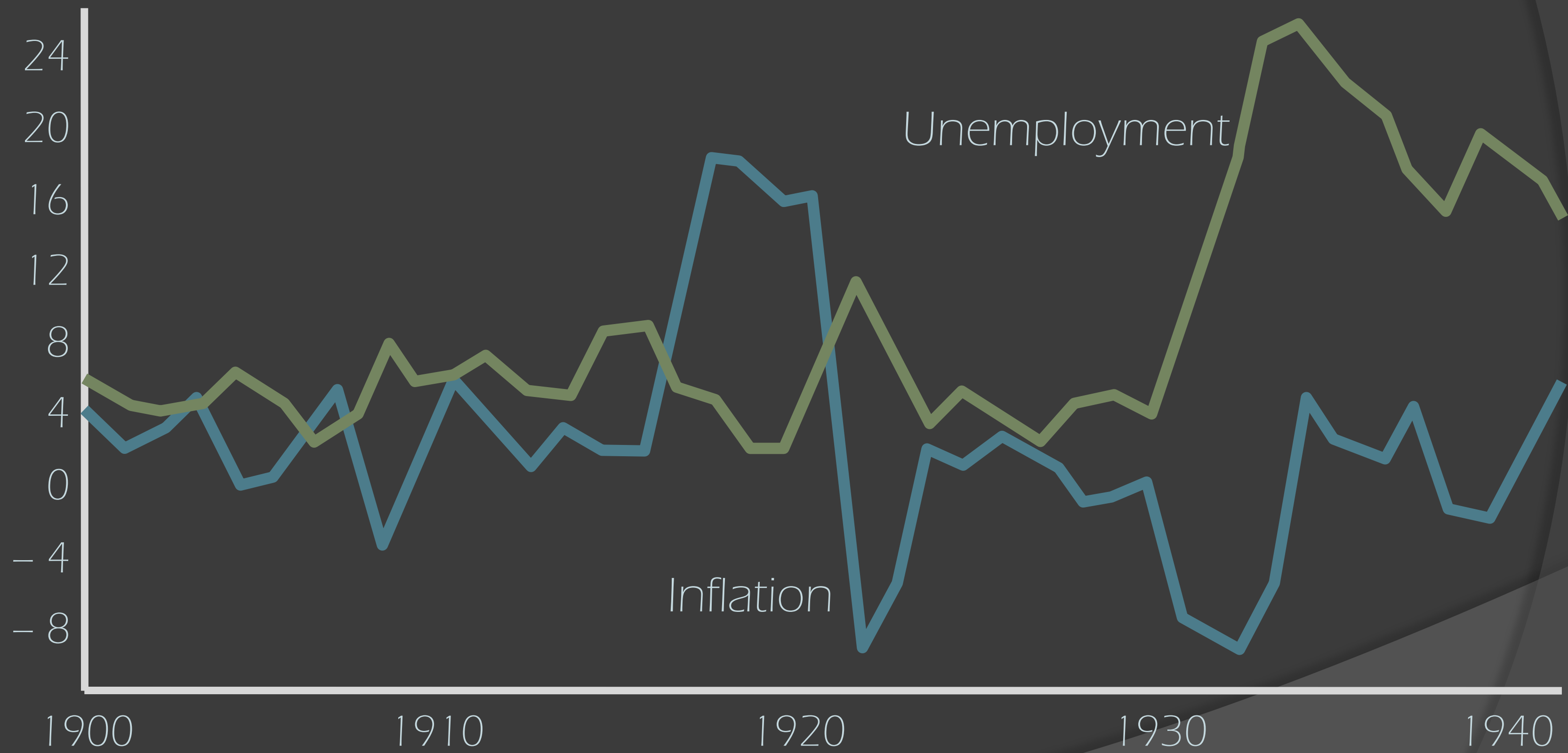
Say's Law

- Unsold goods and unemployed labor could emerge in this classical system.
- Both would disappear as soon as people had time to adjust prices and wages.

Macro Failure

- The Great Depression was a stunning blow to classical economists.
- Unemployment grew and persisted despite falling prices and wages.

Chart: Inflation and Unemployment: 1900-1940



The Keynesian Revolution

- British economist John Maynard Keynes developed an alternate view of the macro economy.
- Keynes asserted that a market-driven economy is inherently unstable.

Government Intervention

In Keynes' view, the inherent instability of the marketplace *required* government intervention.

Historical Cycles

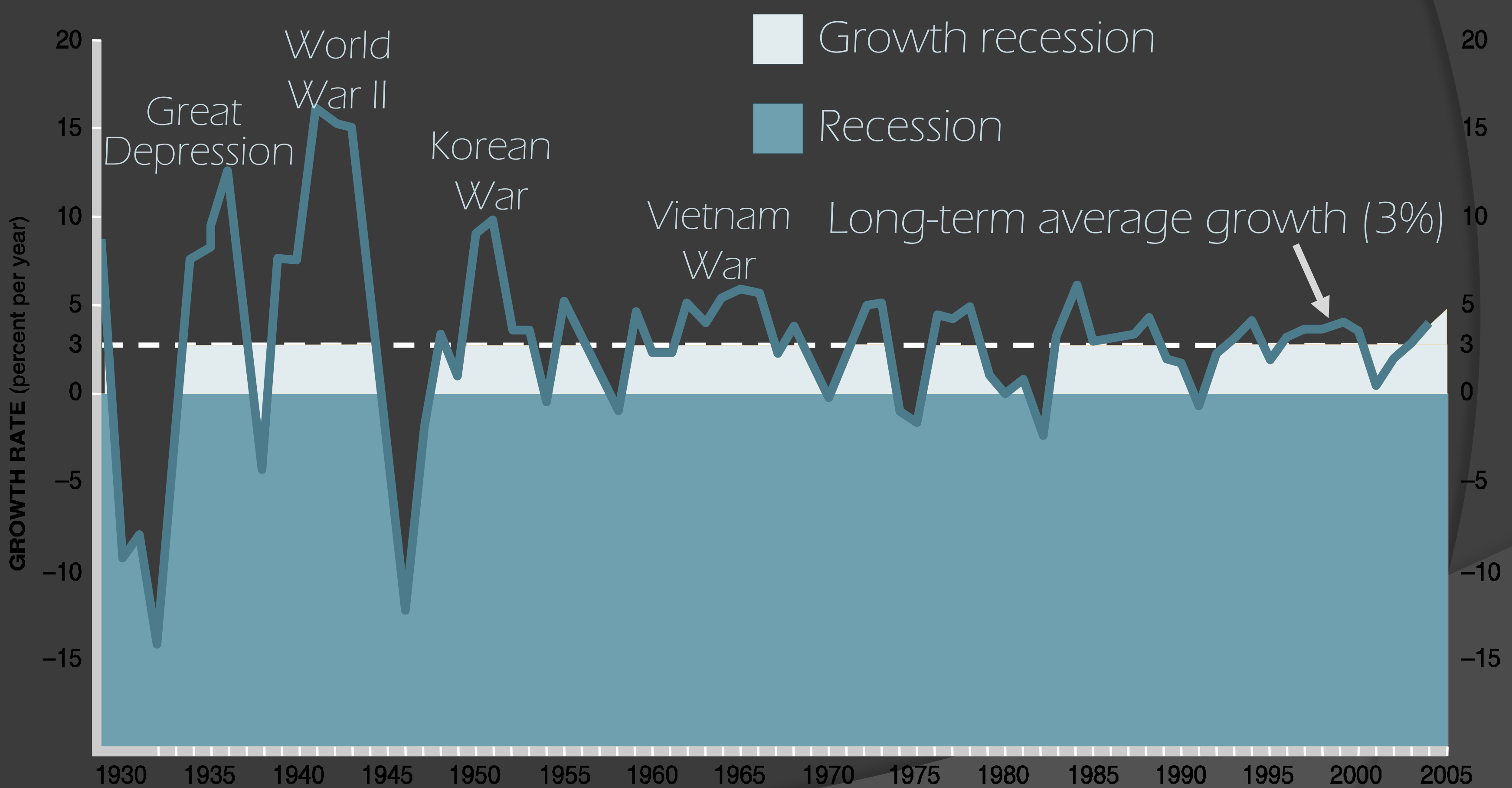
- Swings in the business cycle are gauged in terms of changes in total output (real GDP).
  - Real GDP is the value of final output produced in a given period, adjusted for changing prices.

Chart: The Business Cycle

The Business Cycle

The growth path of the US economy is not a smooth rising trend, but instead a series of steps, stumbles and setbacks.

Chart: The Business Cycle in US History



The Great Depression

- The Great Depression was the most prolonged departure from the long-term growth path.
  - Between 1929 and 1933, real GDP contracted a total of nearly 30%.
  - At the end of the decade GDP per capita was lower than it had been in 1929.

World War II

- World War II ended the Great Depression by greatly increasing the demand for goods and services.
- Real GDP grew an unprecedented 19% in 1942.

The Postwar Years

- A recession occurred after World War II.
  - A recession is a decline in real GDP that continues for at least two or more consecutive quarters.
- The Korean War (1950-1953) increased demands for goods, accelerating growth.

The 1980s

- The economy experienced a growth recession from July 1981 - November 1982.
  - A growth recession is a period during which real GDP grows, but at a rate below the long-term trend of 3%.
  - A growth recession occurs when the economy expands too slowly.
  - A recession occurs when real GDP actually contracts.

The 1980s

- In November 1982, the US economy began an expansion that lasted over 7 years.
- It was the second longest peacetime expansion in history.

The 1990s and 2000

- A growth recession of 1989 became a full recession in July 1990.
- The recession officially ended in February 1991.
- In 1992, the economy started growing faster but unemployment rates stayed high.

The 1990s and 2000

- From 1992 through the fall of 2000, total output kept increasing as unemployment fell to a low of 3.9%.
- In 2001, economic growth slowed as the economy experienced another growth recession.

A Model of the Macro Economy

- Both Keynes and the Classical economists agreed that business cycles occur.
- They disagreed on whether they're an appropriate target for government intervention.

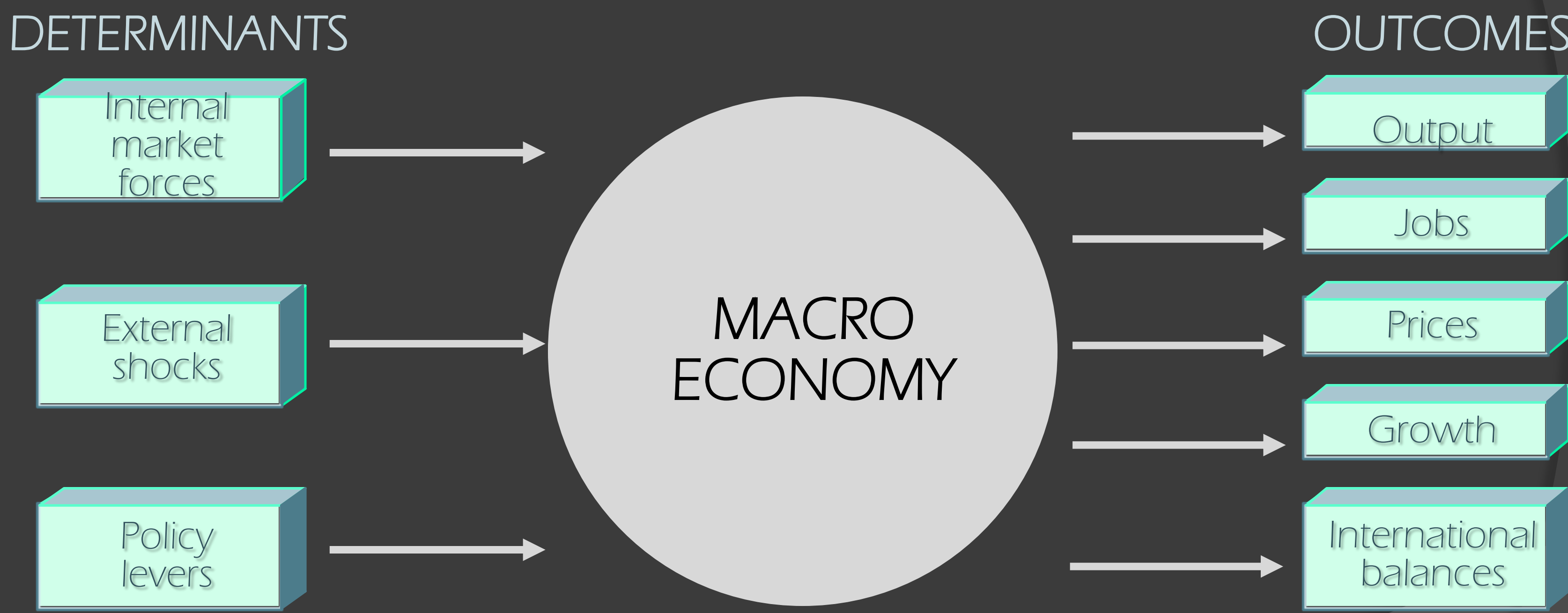
Macroeconomic Performance

- Macro outcomes include:
  - output - total value of goods and services produced
  - jobs - levels of employment and unemployment
  - prices - average price of goods and services
  - growth - year-to-year expansion in production capacity
  - international balances - international value of the dollar; trade and payments balances with other countries

Macroeconomic Performance

- Determinants of macro performance include:
  - internal market forces - population growth, spending behavior, intervention and innovation
  - external shocks - wars, natural disasters, trade disruptions, etc
  - policy levers - tax policy, government policy, changes in the availability of money, credit regulation, etc

Diagram: A Model of the Macro Economy



A Model of the Macro Economy

The crucial macro controversy is whether pure, market-driven economies are inherently stable or unstable.

Aggregate Demand and Supply

Any influence on macro outcomes must be transmitted through supply or demand.

Aggregate Demand

- Aggregate demand is the total quantity of output demanded at alternative price levels in a given time period, *ceteris paribus*.
- It is used to refer to the collective behavior of all buyers in the marketplace.

Aggregate Demand

The aggregate demand curve illustrates how the real value of purchases varies with the average level of prices.

Chart: Aggregate Demand

Aggregate Demand

- Three separate reasons explain the downward slope of the aggregate demand curve:
  - the real-balances effect
  - the foreign-trade effect
  - the interest-rate effect

Real-Balances Effect

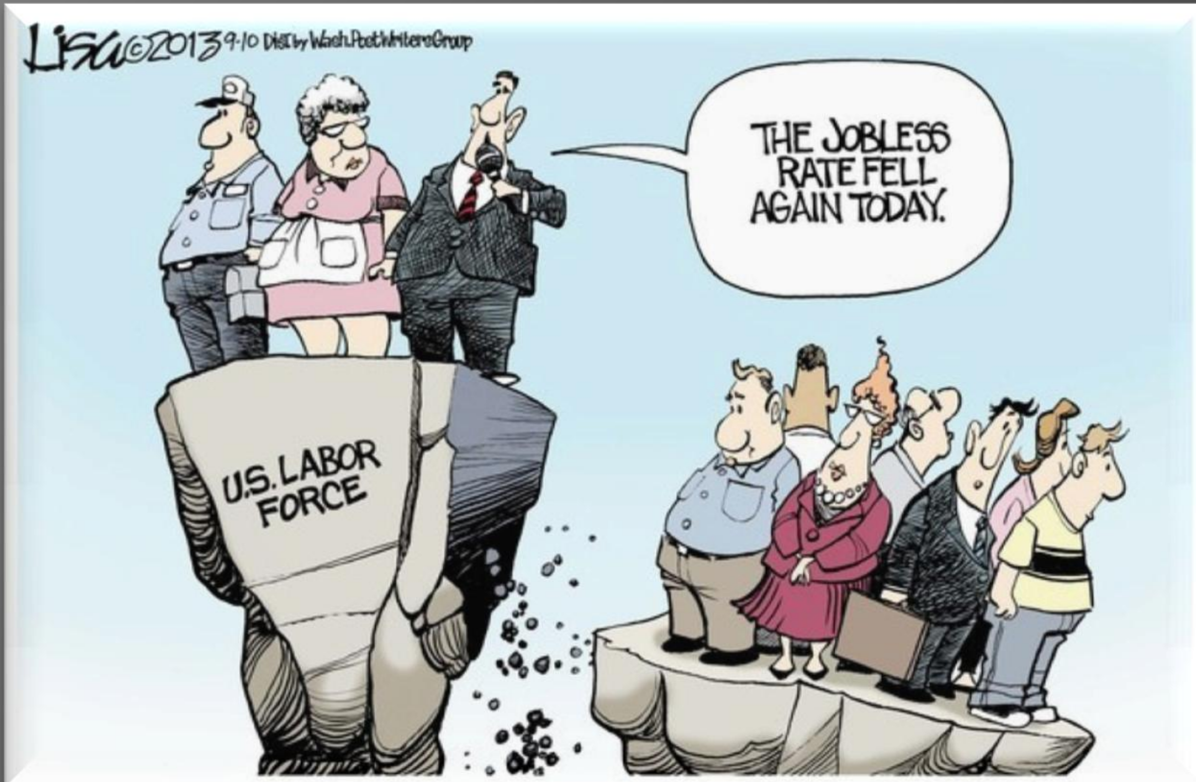
- The real value of money is measured by how many goods and services your money will buy.
  - The cash balances you hold in your pocket, in your bank account or under your pillow are worth more when the price level falls.

Foreign-Trade Effect

- This effect reinforces the downward sloping curve by changes in imports and exports.
  - When the US price level falls, Americans buy fewer foreign produced goods and foreigners buy more US produced goods.

Interest-Rate Effect

With lower prices, consumers need to borrow less, the demand for loans diminishes, so interest rates drop.



Continued in The Business Cycle Part II