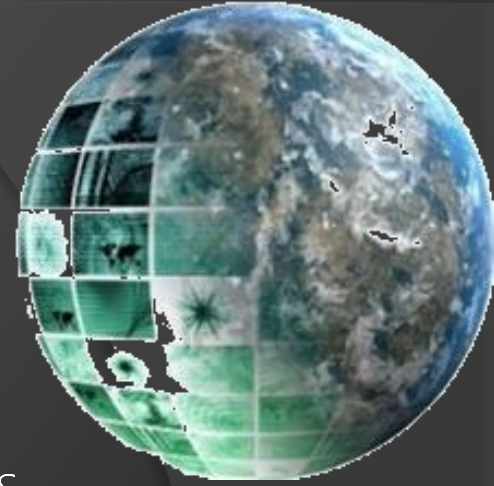
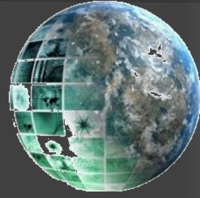


There is no evidence that the business cycle has been repealed.

Alan Greenspan

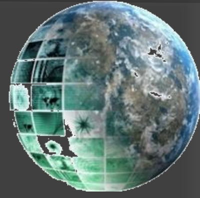
THE BUSINESS CYCLE PART II



Aggregate Supply

Aggregate supply is the total quantity of output producers are willing and able to supply at alternative price levels in a given time period, *ceteris paribus*.

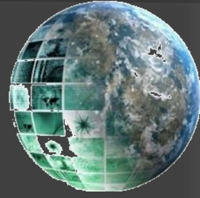
Chart: Aggregate Supply



Aggregate supply

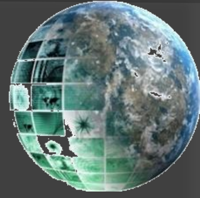
PRICE LEVEL (average price)

REAL OUTPUT (quantity per year)



Aggregate Supply

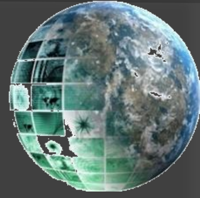
- Two reasons explain the upward slope of the aggregate supply curve:
  - the profit effect
  - the cost effect



Profit Effect

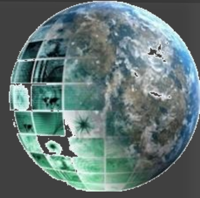
- Changing price levels will affect the profitability of supplying goods.
- We expect the rate of output to increase when the price level rises.

Cost Effect

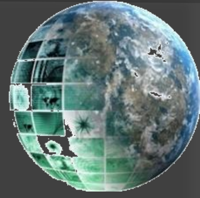


- Costs go up as output expands.
- Producers are willing to supply additional output only if prices rise at least as far as costs.

Cost Effect



Cost pressures are minimal at low rates of output but intense as the economy approaches capacity.



Macro Equilibrium

Macro equilibrium is the combination of price and output that is compatible with both buyers' and sellers' intentions.

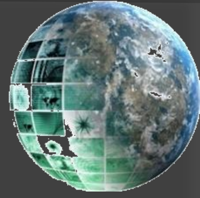


Chart: Macro Equilibrium

Aggregate supply

P_1

E

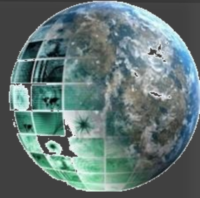
P_E

Aggregate demand

PRICE LEVEL (average price)

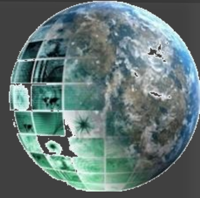
D_1 Q_E S_1

REAL OUTPUT (quantity per year)



Macro Failures

- There are two potential problems with macro equilibrium:
  - Undesirability - The price-output relationship at equilibrium may not satisfy our macroeconomic goals.
  - Instability – Even if the designated macro equilibrium is optimal, it may be displaced by macro disturbances.



Undesirability

- Full-employment GDP is the total market value of final goods and services that could be produced in a given time period at full employment; potential GDP.
- If equilibrium is below full-employment GDP, we have failed to achieve our goal of full employment.

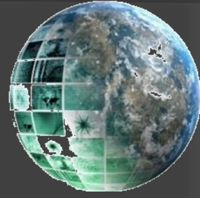
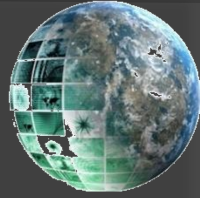


Chart: An Undesired Equilibrium



Undesirability

- Similar problems may arise from the equilibrium price level.
  - Inflation is an increase in the average level of prices of goods and services.

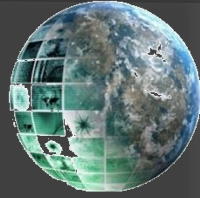
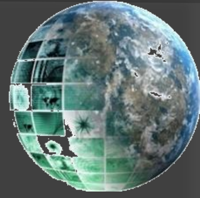
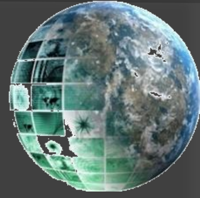


Chart: An Undesired Equilibrium

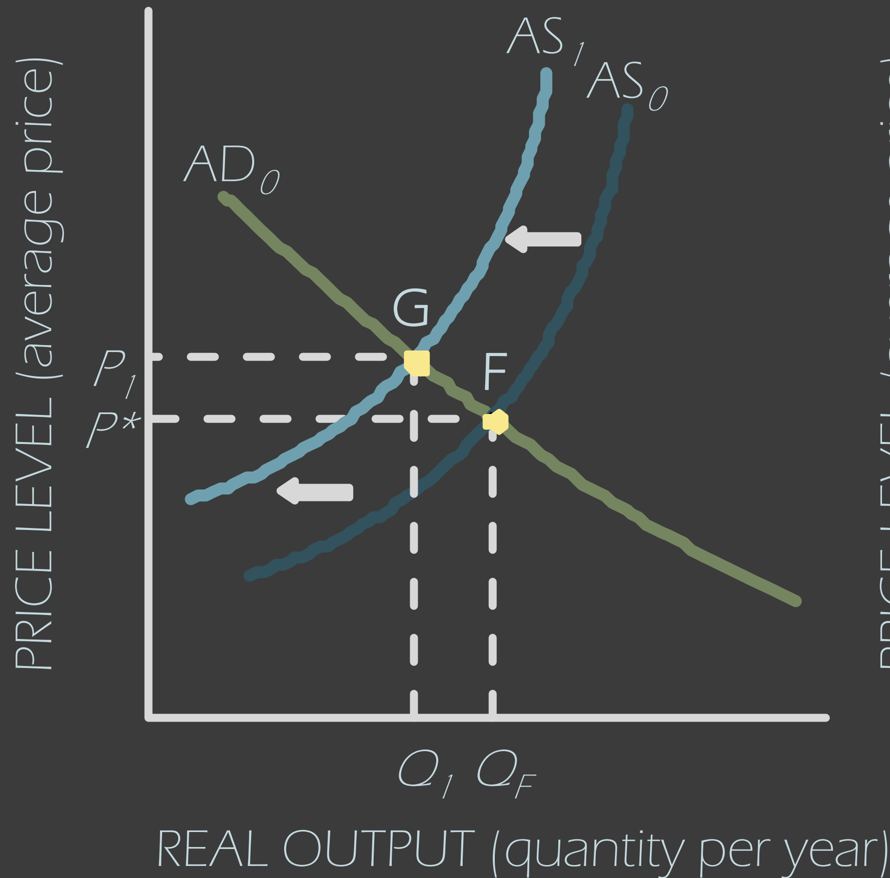


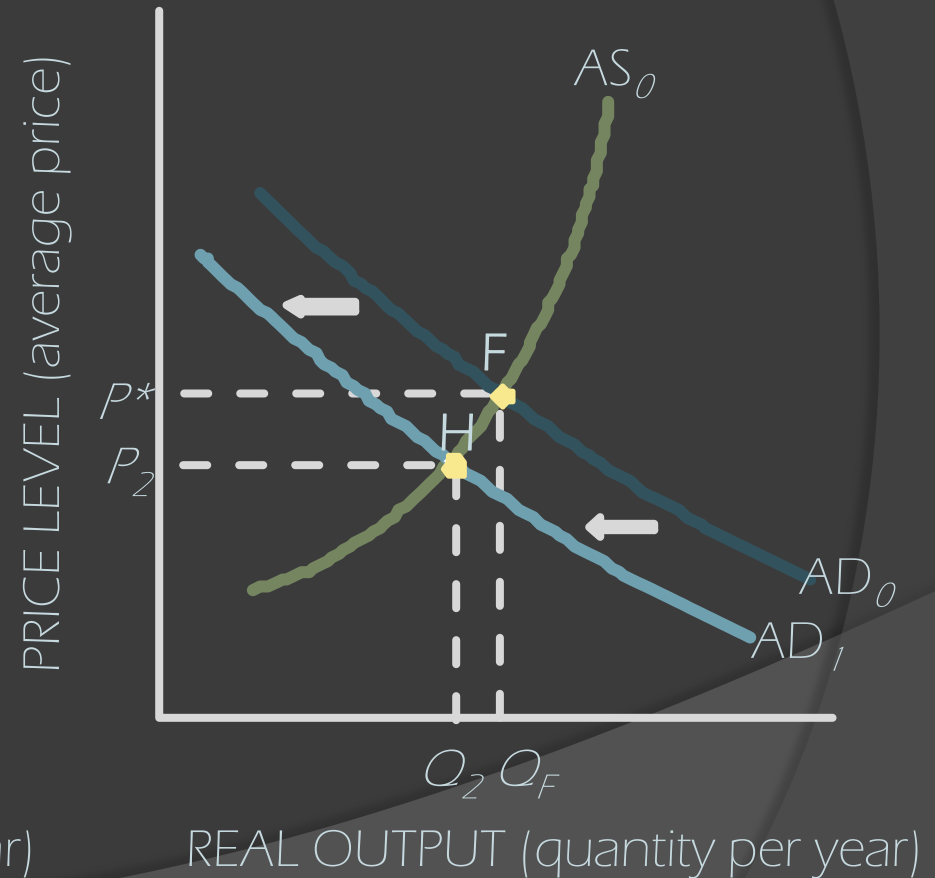
Instability

- The macroeconomic equilibrium will change when there are macroeconomic disturbances.
- Business cycles result from recurrent shifts of aggregate supply and demand curves.
- The aggregate supply curve shifts to the left when there is an increase in production costs.
- The aggregate demand curve shifts when volatility in currencies cause significant changes in import and export prices.

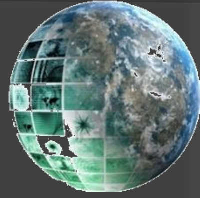


Charts: Macro Disturbances

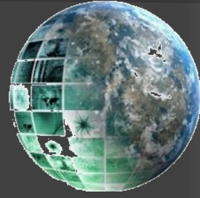




Competing Theories of Short-Run Instability

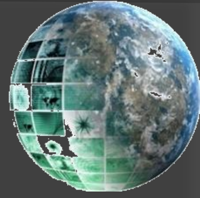


Macro controversies focus on the shape of aggregate supply and demand curves and the potential to shift them.



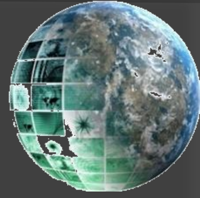
Demand-Side Theories

- Keynesian theory and Monetary theory are the two basic demand-side theories.
  - Both theories emphasize the potential of aggregate-demand shifts to alter macro outcomes.



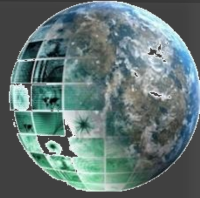
Keynesian Theory

- Keynes argued that deficiency of spending would tend to depress an economy.
- Keynes concluded that inadequate aggregate demand would cause persistently high unemployment.



Monetary Theories

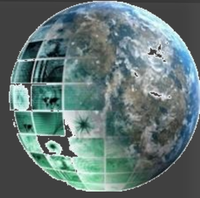
- Money and credit affect the ability and willingness of people to buy goods and services.
- If credit isn't available or is too expensive, consumers curtail credit purchases and businesses might curtail investment.



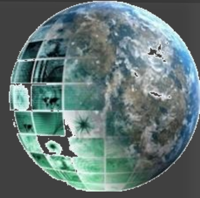
Supply-Side Theories

- Decreases in aggregate supply cause inflation and higher unemployment.
- Increases in aggregate supply move us closer to both our price stability and full employment goals.

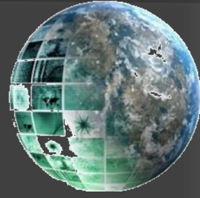
Chart: Supply-Side Theories



Eclectic Explanations



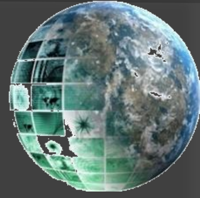
Eclectic explanations of macro failure draw from both the demand-side and the supply-side of the economy.



Long-Run Self Adjustment

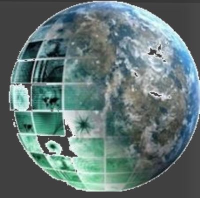
- Some economists argue that short-run fluctuations in real output or prices are just statistical noise.
- They assert that there is a long-run aggregate supply curve that is vertical and that is anchored at the natural rate of output (O_N).

Long-Run Self Adjustment



A vertical long-run AS curve means that aggregate-demand shifts affect prices but not output in the long run.

Chart: The Natural Rate of Output



PRICE LEVEL (average price)

AS

P_2

P_1

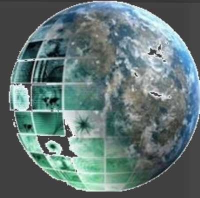
AD_2

AD_1

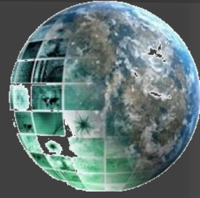
O_N

REAL OUTPUT(quantity per year)

Short- vs. Long-Run Perspectives

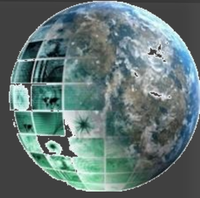


- The long-run aggregate supply curve is likely to be vertical.
- The short-run aggregate supply curve is likely to be upward-sloping.



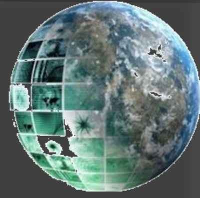
Macro Policy Options

The real challenge for macro theory is to determine which curves or shifts best represent reality.



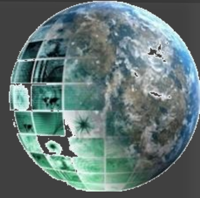
Three Basic Policy Strategies

- Shift aggregate demand curve - Find and use policy tools that stimulate or restrain total spending.
- Shift the aggregate supply curve - Find and implement policy levers that reduce the costs of production or otherwise stimulate more output at every price level.
- Laissez-faire - If we can't identify or control the determinants of aggregate supply and aggregate demand, then we shouldn't interfere with the market.



Specific Policy Options

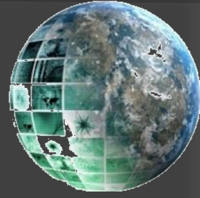
- All the following policy strategies have been tried at one time or another:
  - classical approaches
  - fiscal policy
  - monetary policy
  - supply-side policy
  - trade policy
  - eclecticism



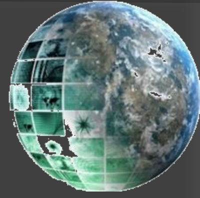
Classical Approach

- We embraced the laissez-faire approach prior to the Great Depression.
- The economy was believed to self-adjust to full employment.

Classical Approach

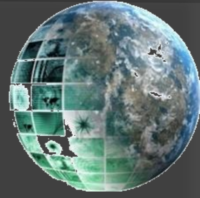


New classical economists stress the market's "natural" ability to self-adjust to long-run equilibrium and government's inability to improve short-run market outcomes.



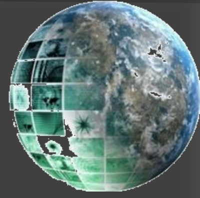
Fiscal Policy

- Fiscal policy is an integral part of modern economic policy.
- Fiscal policy is the use of government taxes and spending to alter macroeconomic outcomes.



Monetary Policy

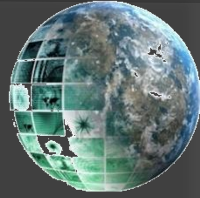
- Monetary policy is the use of money and credit controls to influence macroeconomic outcomes.
- The Federal Reserve increases or decreases the money supply to change macro equilibrium.



Monetary and Fiscal Policy

One caution: Although the Federal Reserve is technically part of the government, the Fed's economic policy tools (open market operations, the discount rate and reserve requirements) are considered *monetary* policy.

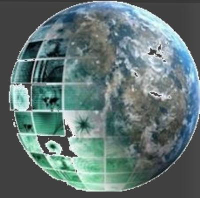
Fiscal policy includes those economic policy tools (taxing and spending) utilized by Congress and the President.



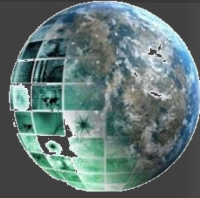
Supply-Side Policy

- Supply-side policy seeks to shift the aggregate supply curve.
- Supply-side policy is the use of tax incentives, (de)regulation and other mechanisms to increase the ability and willingness to produce goods and services.

Trade Policy



International trade and money flows can be changed to shift the aggregate demand and/or the aggregate supply curves.



Eclecticism

- Presidents are often willing to embrace a mix of policies.
- Eclecticism, in part, reflects a “do-whatever-it-takes-to-win” attitude on the part of politicians.

THE END