ECON 2: Principles of Macroeconomics

Lecture 10: Short-Run Macroeconomics

Additional Types of Spending

Spending by businesses

Planned Investment Spending (I^P)

Two Major Categories:

1.

2.

What is “unplanned investment”?

Determinants of Planned Investment Spending (I^P):

1.
2.
3.

Assumption: Output today (Y) doesn't directly affect I^P

As Y changes, I^P is constant!

Spending by the Government (G)

What is included?
- Military
- Fire and Police
- Public Education
- Parks and Rec
- Highway infrastructure

Industries that produce necessary goods/service, but have trouble making a profit

Does not include *Transfer Payments* such as:
- Social Security/Welfare
- Financial Aid
- Subsidies

Assumption: Output today (Y) doesn't directly affect G

As Y changes, G is constant!

Additional Types of Spending

Spending by the Foreigners

Net Exports (NX) = Exports (X) – Imports (M)

Assumption:

Output (Y) in the short-run does not directly affect Net Exports (NX)

Aggregate Expenditures

Total Spending in the Economy = Aggregate Expenditures = AE

AE = Consumption + Planned Investment + Gov't Expenditures + Net Exports

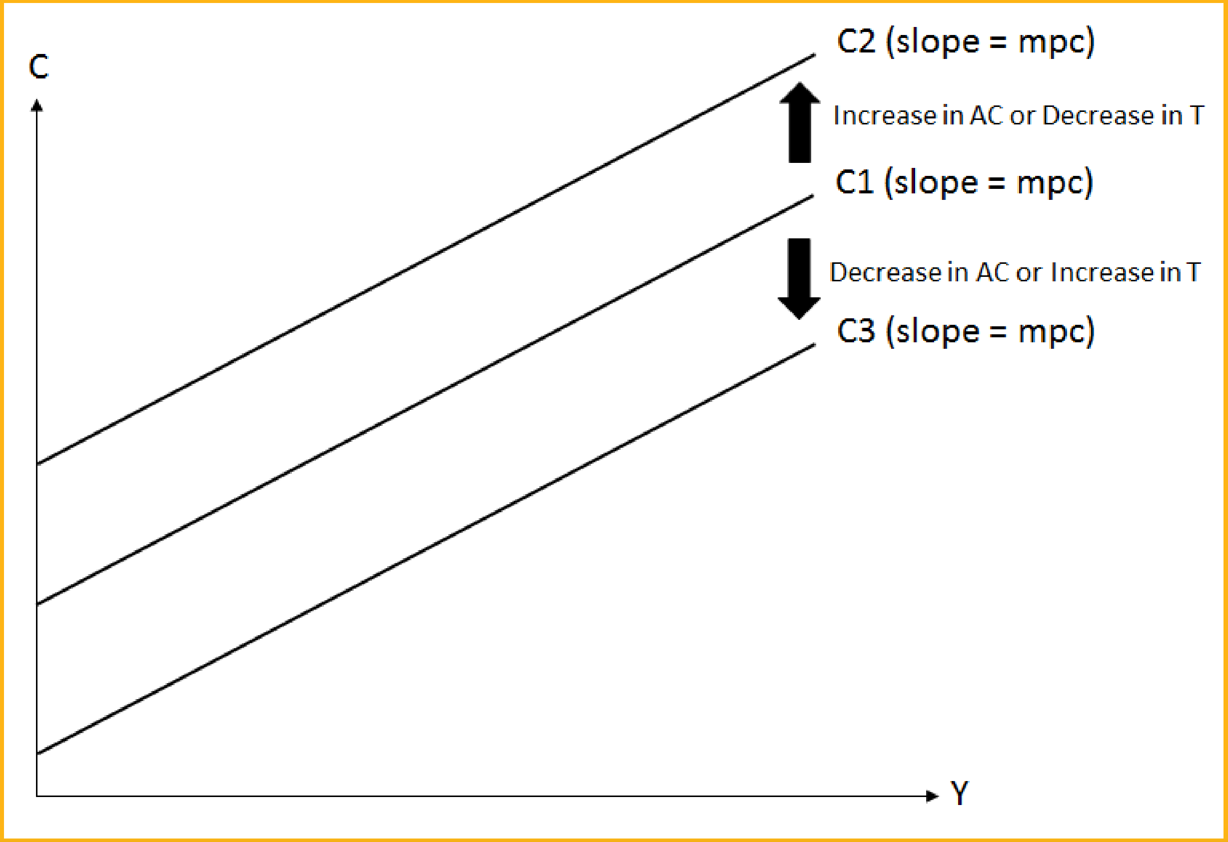
AE = C + I^P + G + NX (Note: I^P = I when change in inventories = 0)

Show how spending (AE) changes when Y changes and find where Y = AE

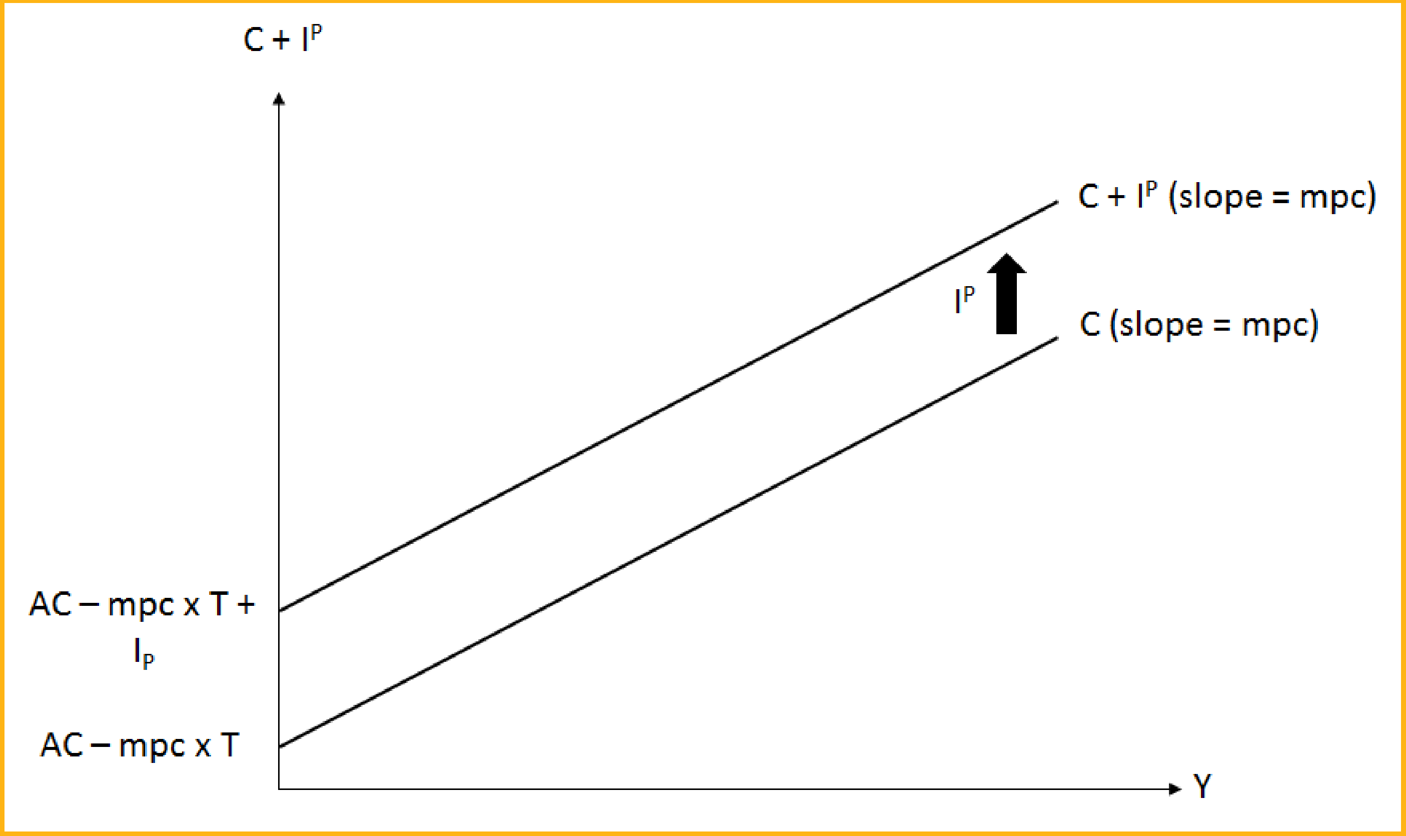
AE = AC + mpc (Y – T) + I^P + G + NX

Building the Aggregate Expenditure Curve

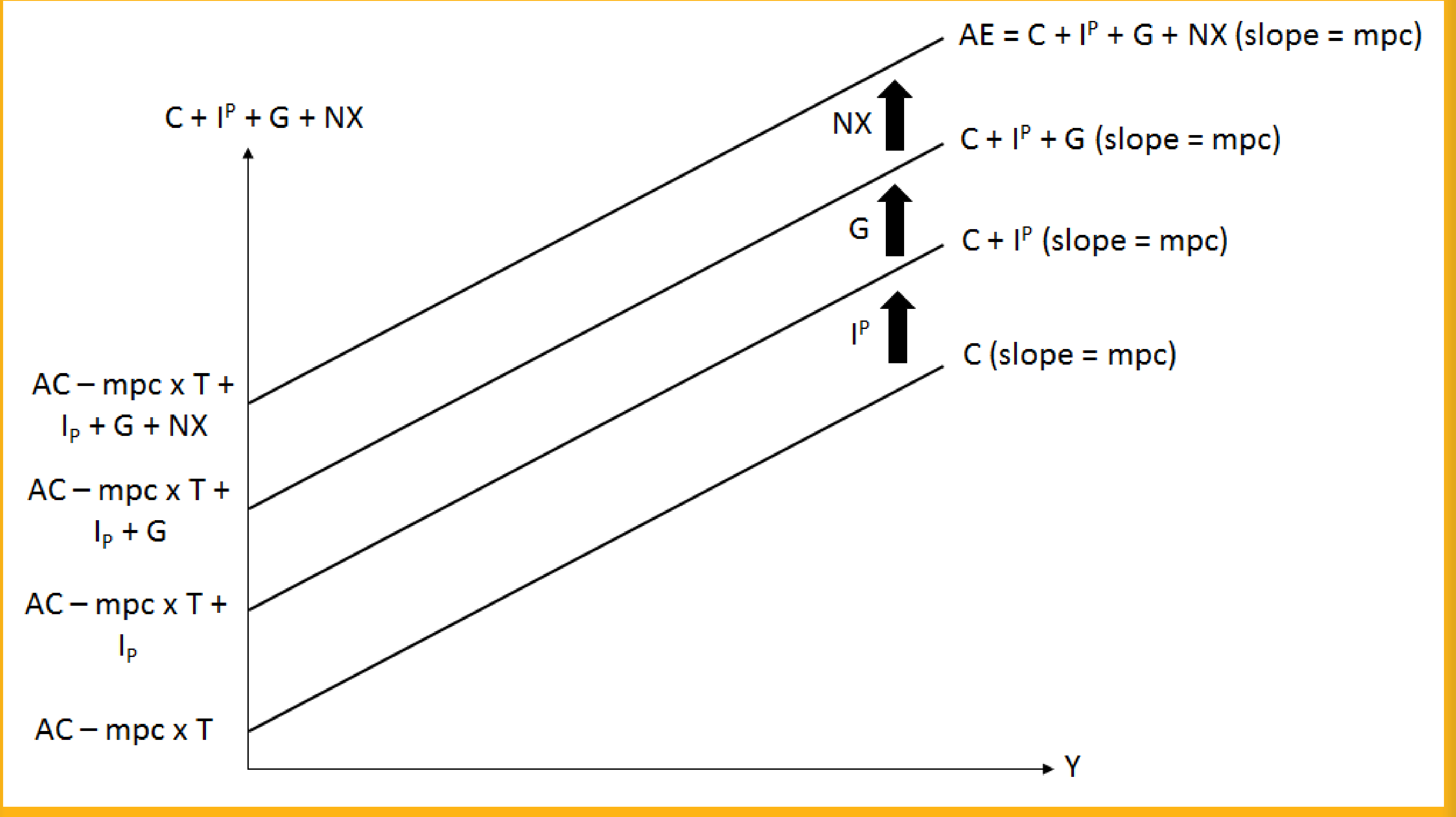
Start with Consumption



Building the Aggregate Expenditure Curve



Building the Aggregate Expenditure Curve



Where is equilibrium?

- Scenario 1: Y = 12000, but AE = 11000
  - Unsold production?
- Scenario 2: Y = 8000, but AE = 9000
  - Meeting consumer demands without production?
- Scenario 3: ?

Graphing Equilibrium

Finding Equilibrium

- Economy:
- $I^P = 10$; $G = 10$; $NX = 5$

Real GDP (Y)	Consumption (C)	Planned Investment (I^P)	Government Expenditures (G)	Net Exports (NX)	Aggregate Expenditures (AE)	Change in Inventory
200	200	10				
300	275					
400	350			5		
500	425					
600	500		10			

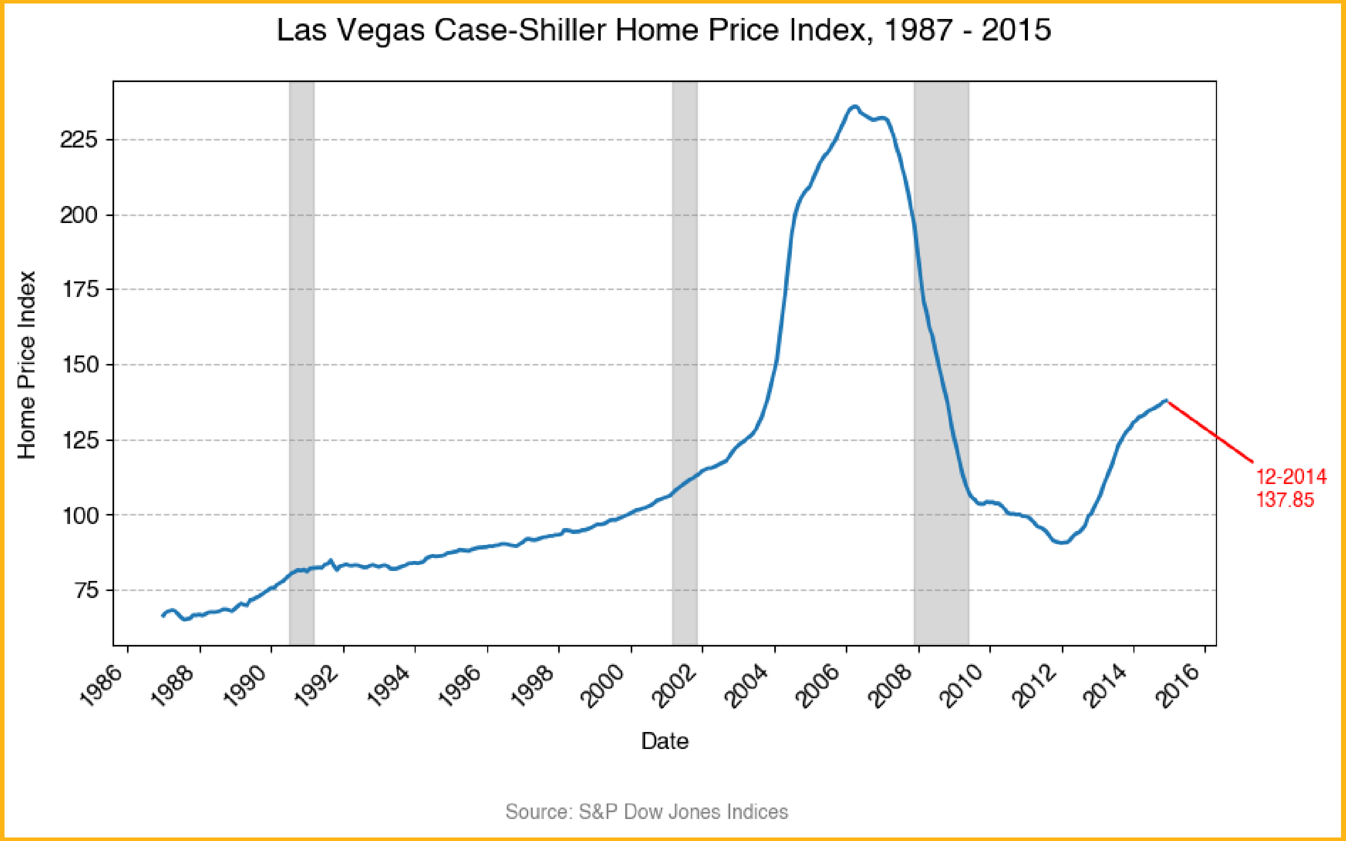
Graphing Equilibrium

Changes in Equilibrium

- Start at Y* = 10,000 (full-employment output)

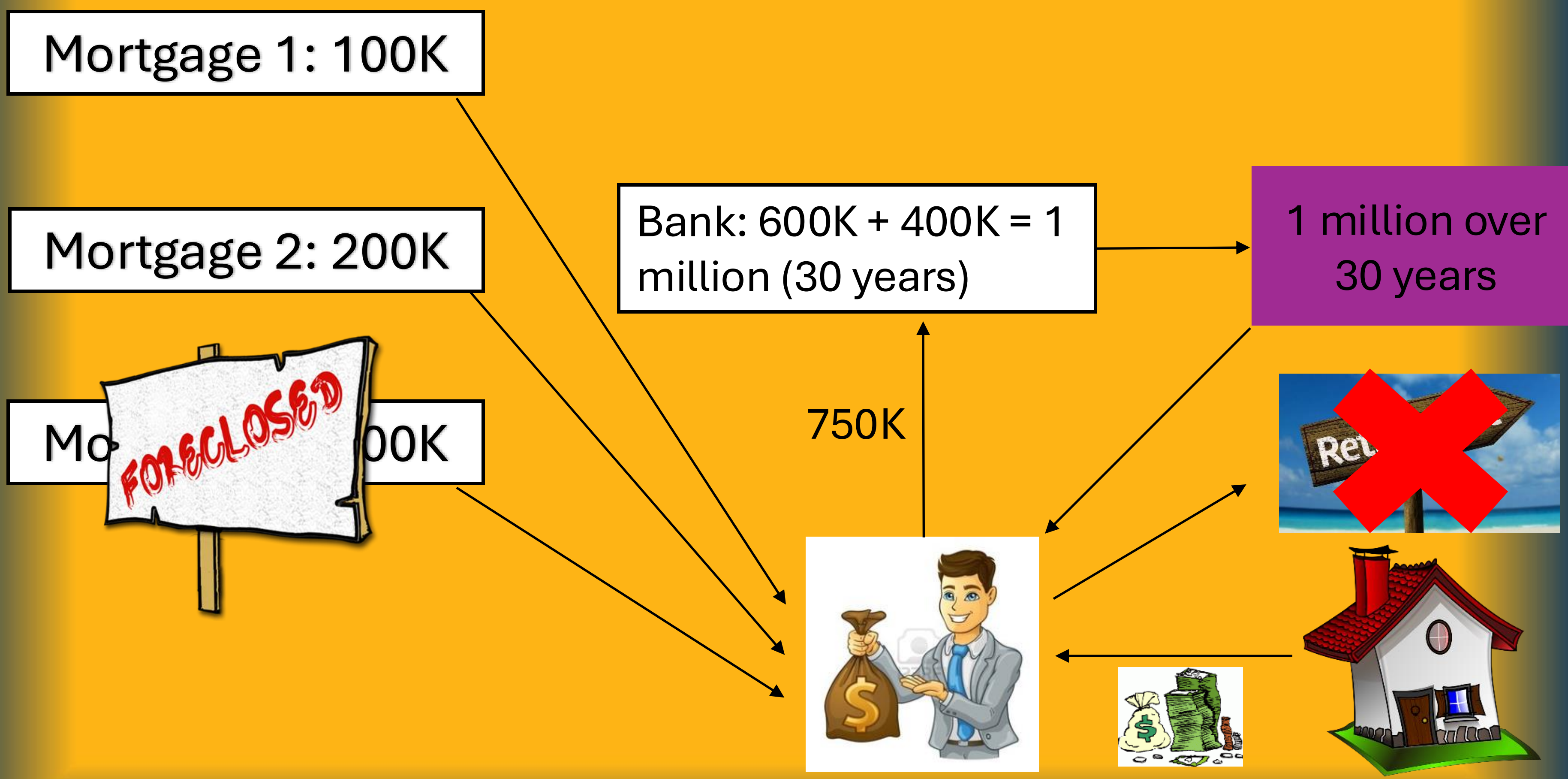
Housing Market Equilibrium

- Las Vegas Housing Prices Over Time

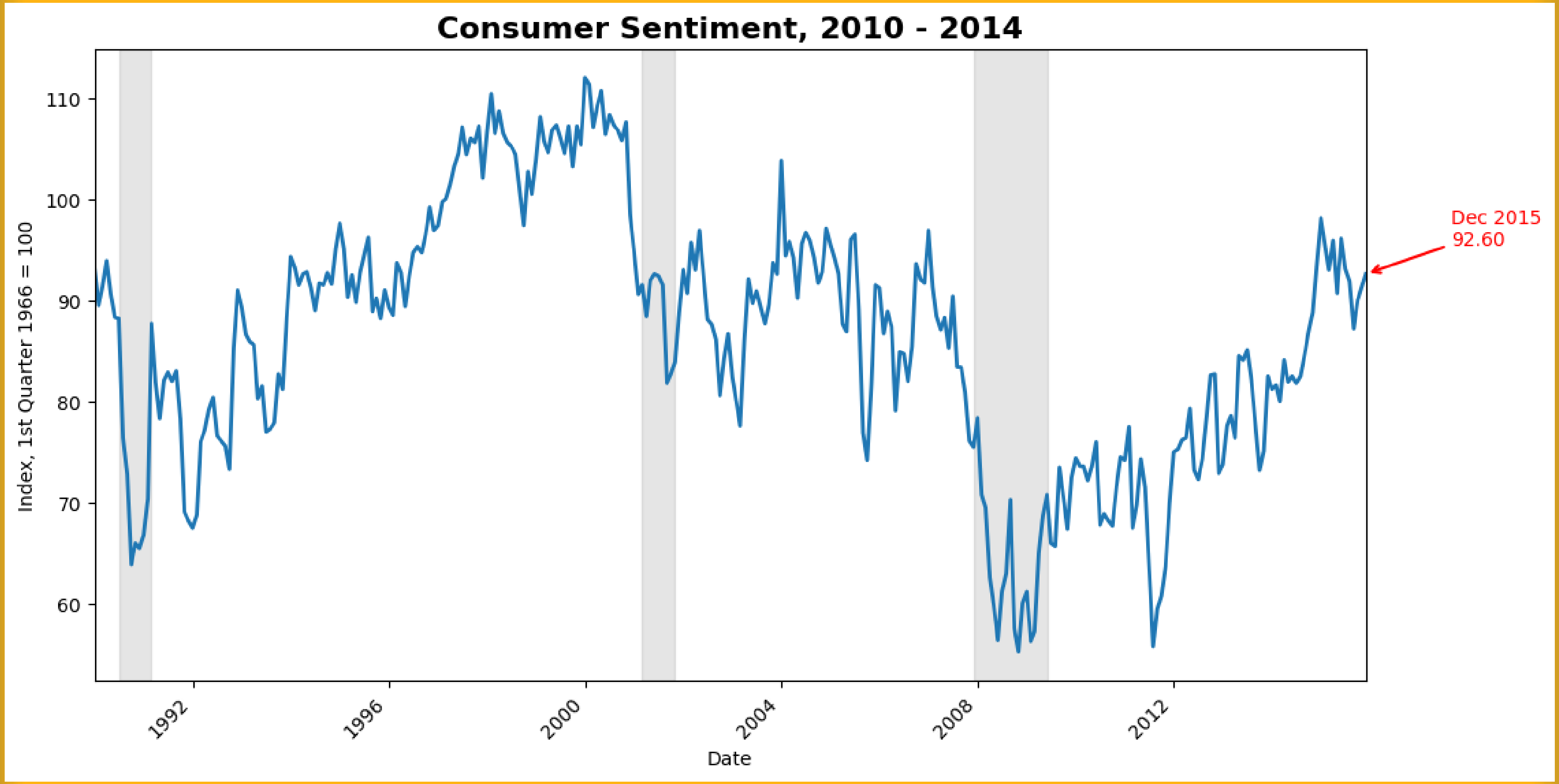


Consequences of the Housing Crash

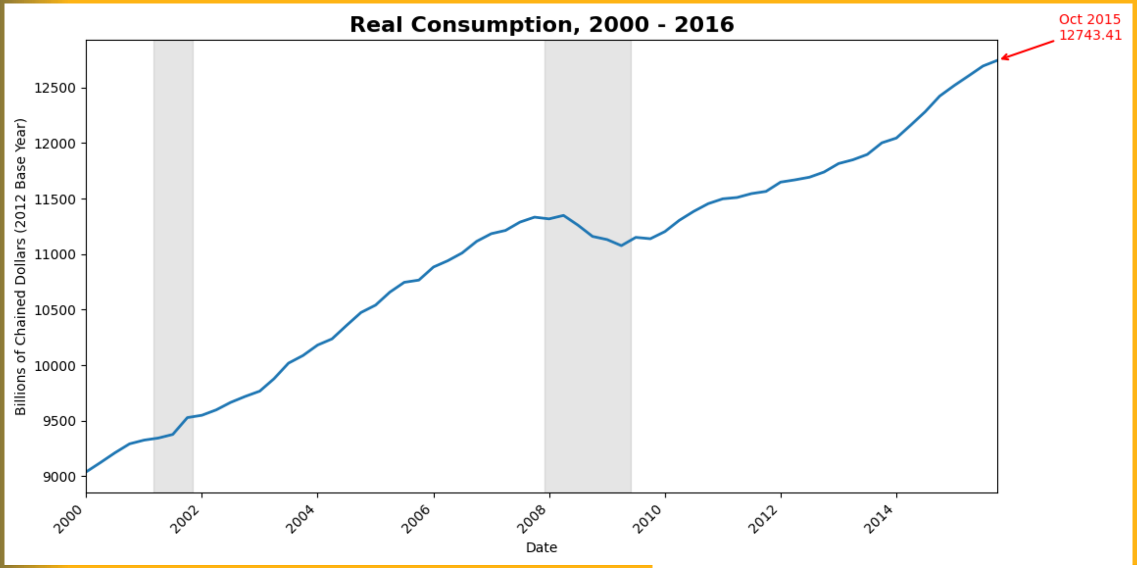
- Mortgage Backed Securities

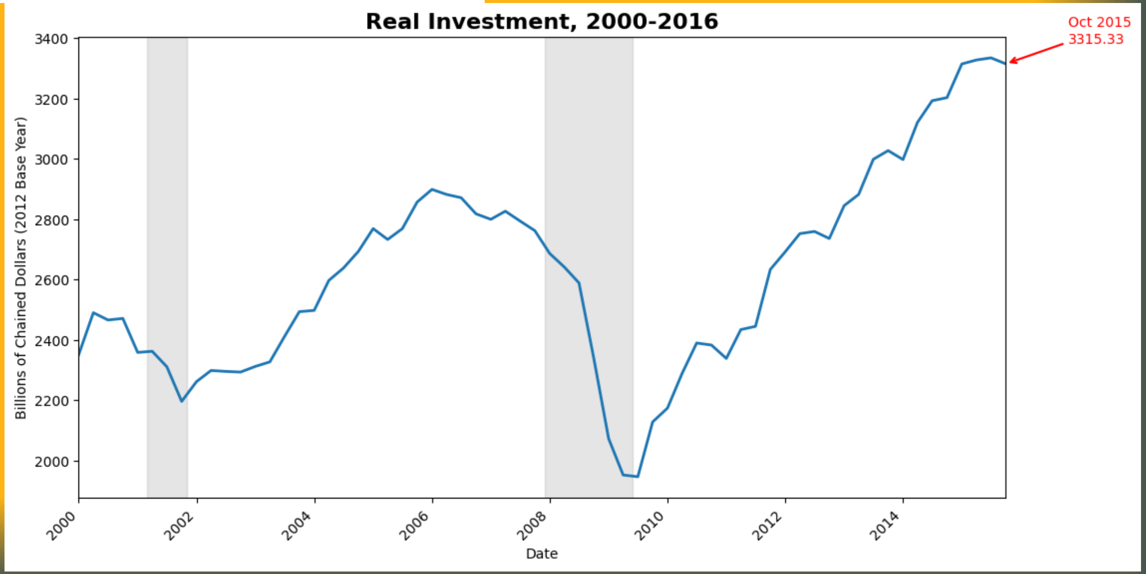


Consumer Confidence Decreased

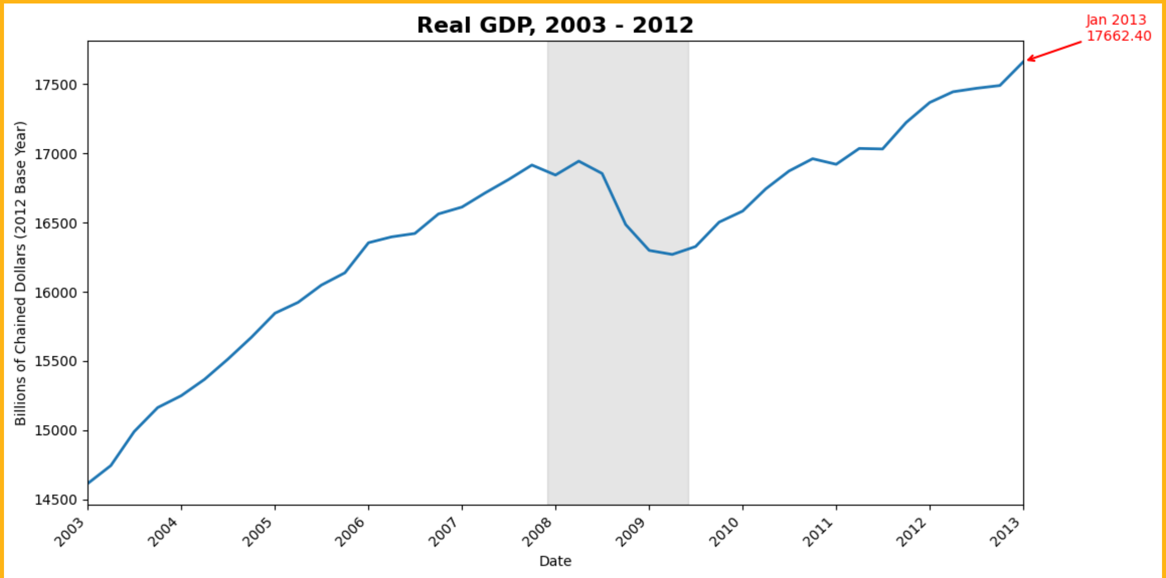


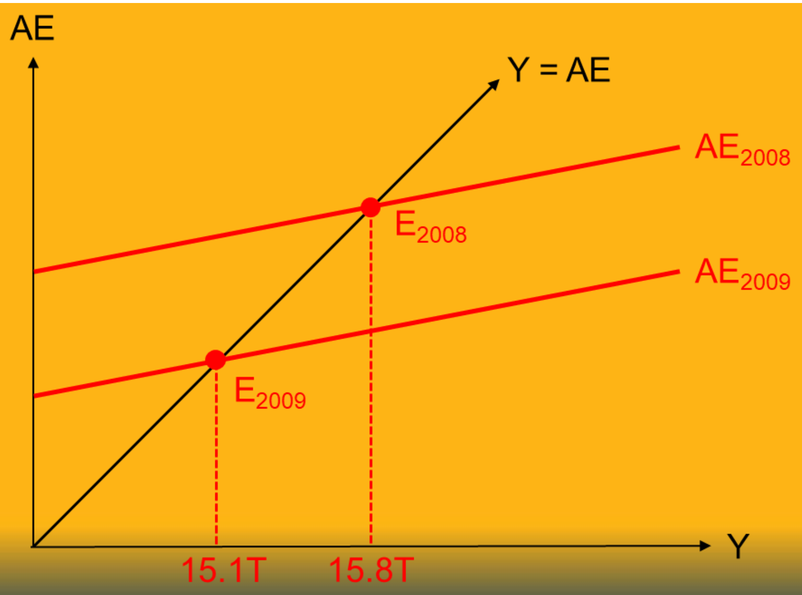
Housing: Decrease in AC and I





Great Recession





Changes in Equilibrium

- Start at Y* = 10,000 (full-employment output)
  Housing Crash! (assume mpc = 0.8)

Recovering from a Crash

- Option 1: … es (I^P)

$500 in machines = increase I^P by $500
Incomes increase by $500

Recovering from a Crash

- Option 1: Rich person buys \$500 worth of machines (I^P)

Round 1:
Y up \$500

\$500 in machines = increase I^P by \$500
Incomes increase by \$500

Round 2:
Y up \$400 more,
\$900 total

Spend mpc x 500 =
0.80 x 500 = \$400
Consumption increase

Save mps x 500 =
0.20 x 500 = \$100

Recovering from a Crash

- Option 1: Rich person buys $500 worth of machines ($I^P$)

Round 1:
Y up $500

$500 in machines = increase I^P by $500
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Incomes rise by $400

Recovering from a Crash

- Option 1: Rich person buys $500 worth of machines ($I^P$)

Round 1:
Y up $500

$500 in machines = increase I^P by $500
Incomes increase by $500

Round 2:
Y up $400 more,
$900 total

Spend mpc x 500 =
0.80 x 500 = $400
Consumption increase

Save mps x 500 =
0.20 x 500 = $100

Incomes rise by $400

Round 3:
Y up $320,
$1,220 total

Spend mpc x 400 =
0.80 x 400 = $320
Consumption increase

Save mps x 400 =
0.20 x 400 = $80