Other Macro Models (4/19/2011) Econ 310-008

Definitions

- ***expectations*** – economic actor prediction of future macroeconomic conditions (especially inflation)
- ***static expectations*** – (classical) play no role in decisions
- ***erratic expectations*** – (Keynesian) animal spirits; all over the map; exogenous in an unpredictable way
- ***adaptive expectations*** – (monetarist) use historical data
- ***rational expectations*** – (new classical) use all information; no systematic error
- ***Say's Law*** – total supply of goods and services will equal total demand derived from consumption; a general glut (economy-wide over-supply) is impossible
- ***money illusion*** – nominal vs. real confusion (wages or prices)
- ***crowding out*** – fiscal policy is ineffective because a rise in government spending induces an opposing decline in private investment and net exports, with the net effect being unchanged output
- ***menu costs*** – because reprinting menus costs money, there are rigidities preventing price flexibility due to inflation or deflation
- ***efficiency wage*** – managers pay workers more than the market clearing wage to increase productivity
- ***structure of production*** – produced goods can be lower order (little capital, short production time) or higher order (more capital, long production time)
- ***present discounted value (PDV)*** – today's value of future payment

Principles

- Classicals and neoclassicals believed Say's Law implies the economy must always be at full employment.
- Under new classical theory the economy is always at equilibrium: all unemployment is voluntary.
- Under real business cycle theory supply side shocks cause what appear to be business cycles. These shocks consist of shocks to consumer taste, technology, productivity, government regulation, etc.
- Producers try to orient the structure of production to match consumers' savings preferences (prefered higher/lower order mix).
- The present discounted value of an investment is higher with lower interest rates.
- Austrian business cycle theory predicts a boom phase (or bubble) caused by artificially low interest rates and a bust phase caused by interest rates correcting themselves.
    - Government expansion of the money supply leads to lower interest rates. Companies re-orient their structure of production toward more roundabount production (more investment) as a result (due to belief that consumer preferences changed and due to PDV rising). When interest rates later rise back from their temporary bank (loan) rate to the natural rate, past investments are revealed to be malinvestments. Companies then have to abandon some of these bad investments, shrinking output.

macroeconomic models

- classical
- orthodox Keynesian
- monetarist
- new classical
- real business cycle
- new Keynesian
- Austrian business cycle

AS/AD analysis rules

- At LR equilibrium, LRAS, SRAS, AD intersect.
- Shifts in LRAS bring SRAS with it.
- Shifts in AD bring SRAS with it.
- Shifts in SRAS bring AD with it.

classical model

- no LR / SR distinction
- prices perfectly flexible
- Say's Law
- static expectations
- hands off policy

orthodox keynesian model

- no LR / SR distinction
- prices rigid down
- W money illusion
- sticky prices justified IS/LM model
- Philip's Curve tradeoff
- erratic expectations
- use fiscal policy

monetarist synthesis model

- LR / SR distinction
- SR Philip's tradeoff
- LR natural rate U
- W money illusion
- adaptive expectations
- crowding out
- use monetary policy

new classical model

- LR / SR distinction
- P money illusion
- equilibrium always
- no involuntary U
- rational expectations
- hands off policy

real business cycle

- supply side shocks cause cycles
- no SR
- money neutrality
- equilibrium always
- no involuntary U
- rational expectations
- hands off policy

new keynesian model

- LR / SR distinction
- P&W money illusion
- real & nominal rigidity
- micro-foundations
    - menu costs
    - efficiency wage
- rational expectations
- fiscal/monetary policy

austrian business cycle theory

- bubble theory
- malinvestments
- LR / SR distinction
- P money illusion
- interest rate too low
    - natural vs. loan
- adaptive expectations
- hands off policy

Model	Expectations	Policy
classical	static	hands off
orthodox Keynesian	erratic	fiscal
monetarist	adaptive	monetary
new classical	rational	hands off
real business cycle	rational	hands off
new Keynesian	rational	fiscal, monetary
Austrian business cycle	adaptive	hands off