

25th Class

4/1/11

mention econ dept. seminar next Wed. "Better Living Through Economics" 4:15 pm PAC004

<http://www.hup.harvard.edu/catalog.php?isbn=9780674036185>

can see whole seminar series each semester at

<http://www.wesleyan.edu/econ/newseminar2011s.htm>

take a look at the current state of the economy, particularly the labor market

http://money.cnn.com/2011/03/30/news/economy/adp_challenger_jobs_report/index.htm

the official BLS report for March (report bland, but UR did fall from 8.9 to 8.8%):

<http://www.bls.gov/news.release/empsit.nr0.htm>

Last time we added aggregate supply into our model of the economy
now we will differentiate between short-run and long-run equilibrium
we will do this by differentiating between SR and LR AS

in the LR, the economy must be at full employment output \bar{Y} , where $\bar{Y} = f(\bar{L})$
the economy-wide production function (\bar{L} is full employment)

in the SR, the economy can be above or below this level.

we'll also specify the SRAS curve more fully:

$$\text{SRAS} = f(P, P^e, w, \dots)$$

changes in w , the nominal wage, are the mechanism for shifting SRAS: workers care about their real wage w/P

Labor market demand (and supply) determine w

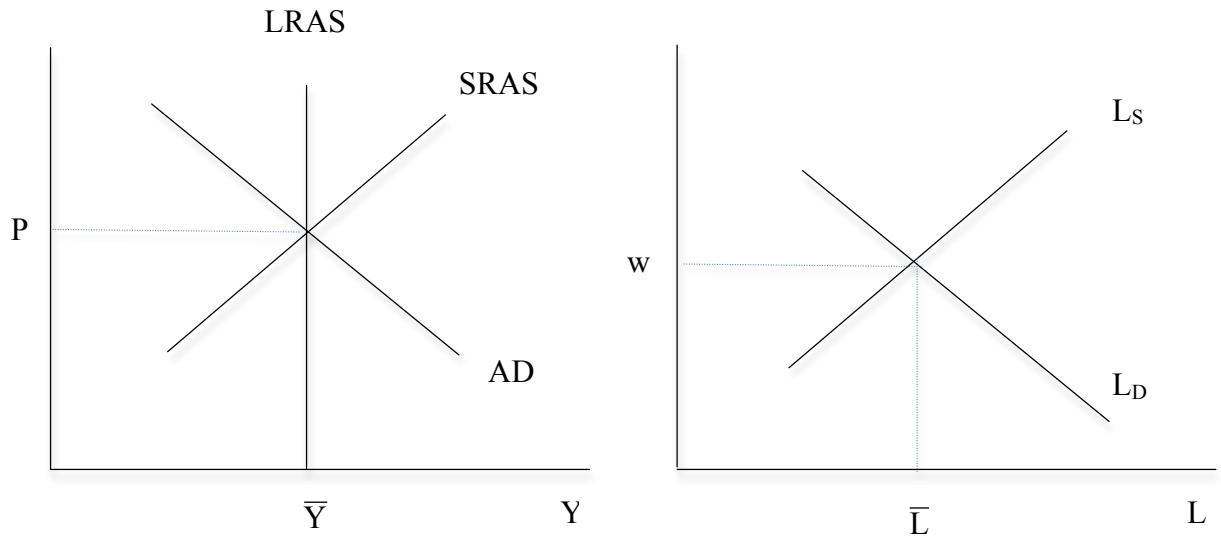
if P rises, workers want w to rise as well to offset the inflation

if P falls, they resist cuts in w , but may be forced to accept them eventually in order to maintain jobs

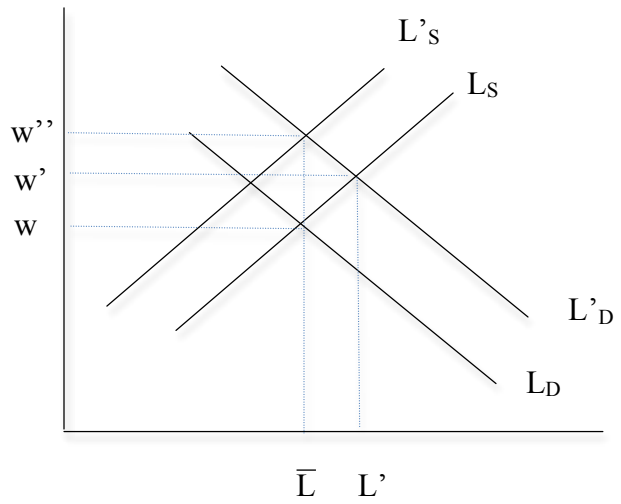
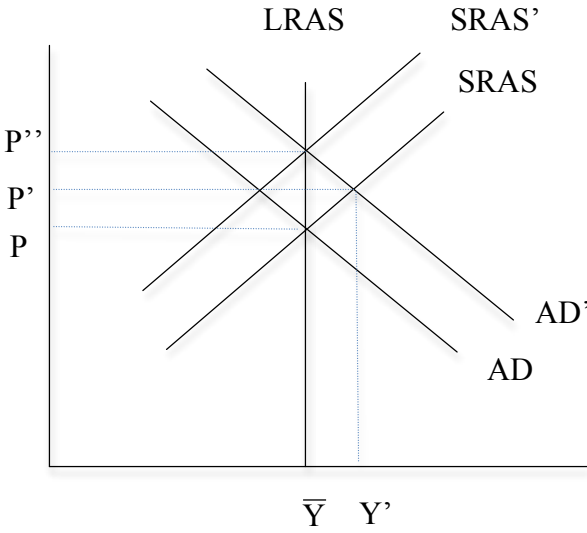
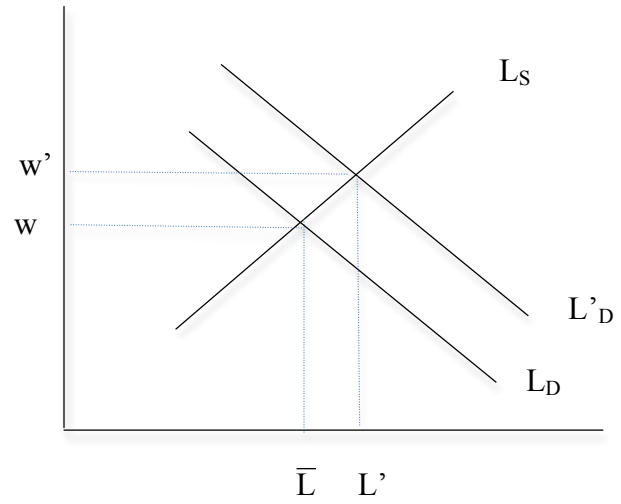
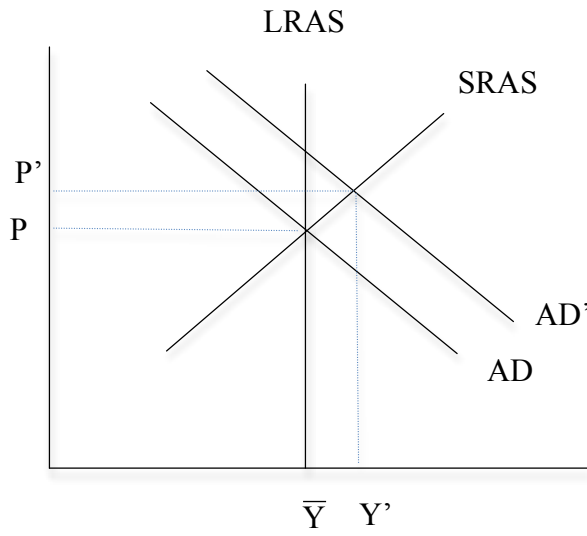
So one view is that SRAS is more likely to shift up than shift down (another reason to think about why it might be flat as GDP/Y falls)

Let's go through four cases considering what the automatic adjustment mechanism is in each case, in each case starting at LR equilibrium and having a shock move us away from it:

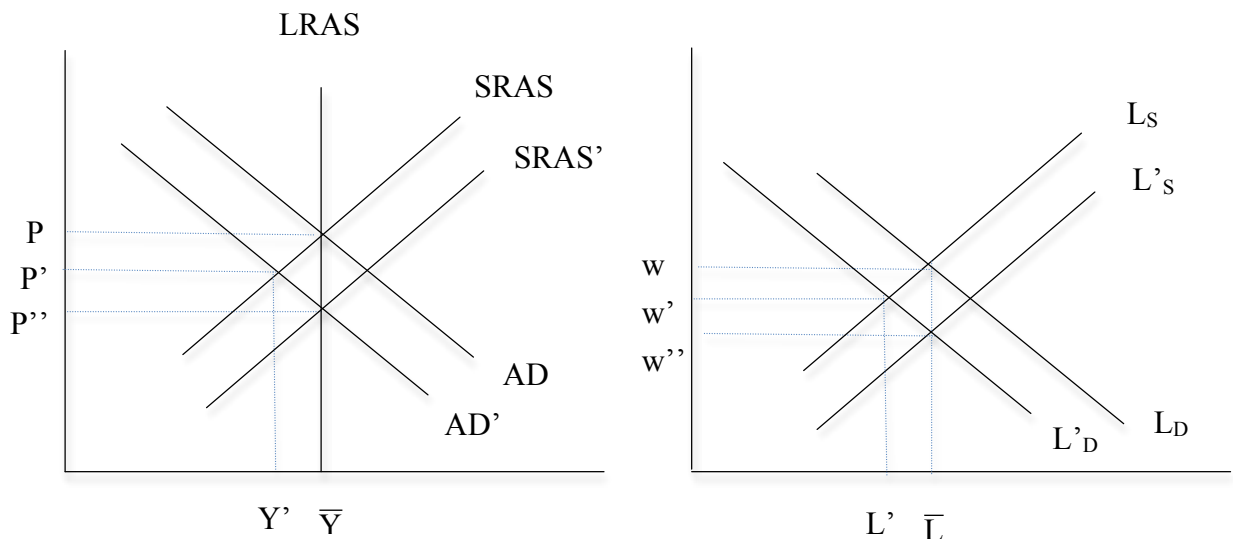
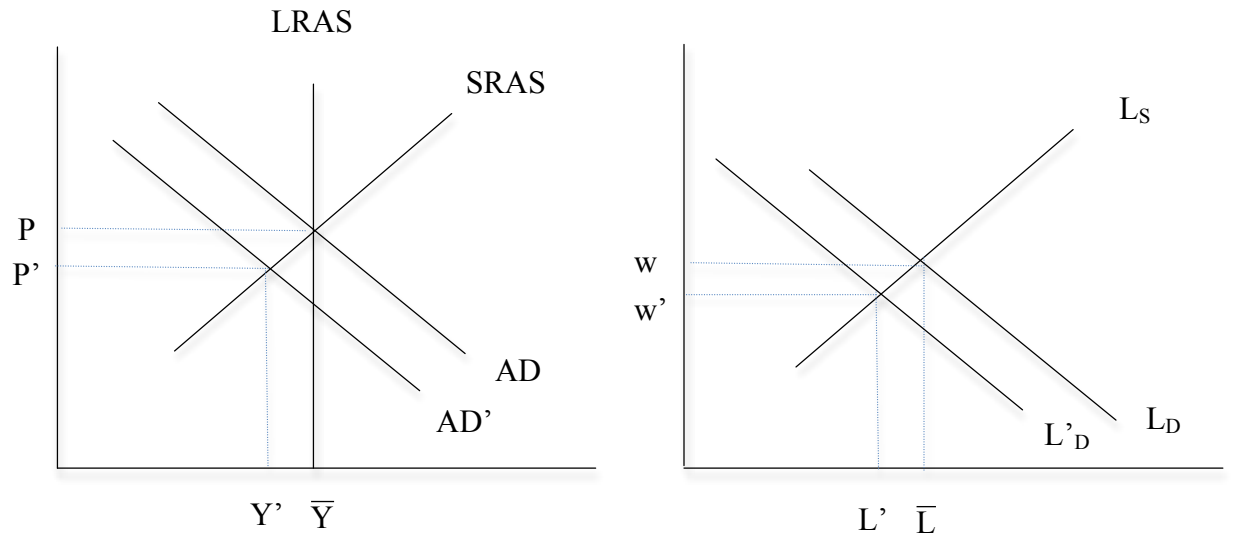
here is our base case where we are initially in long-run equilibrium in both the output market and the labor market:



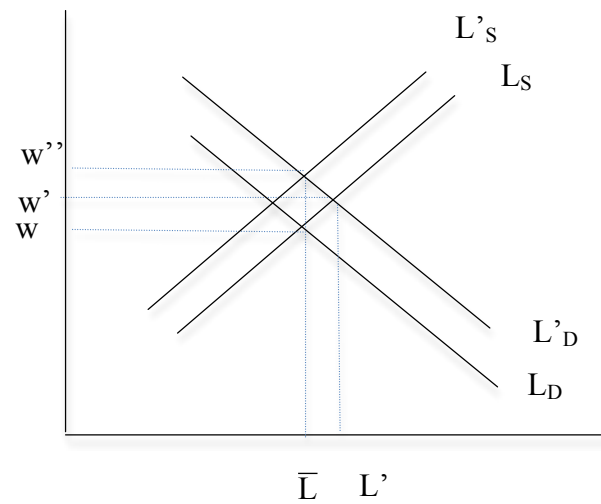
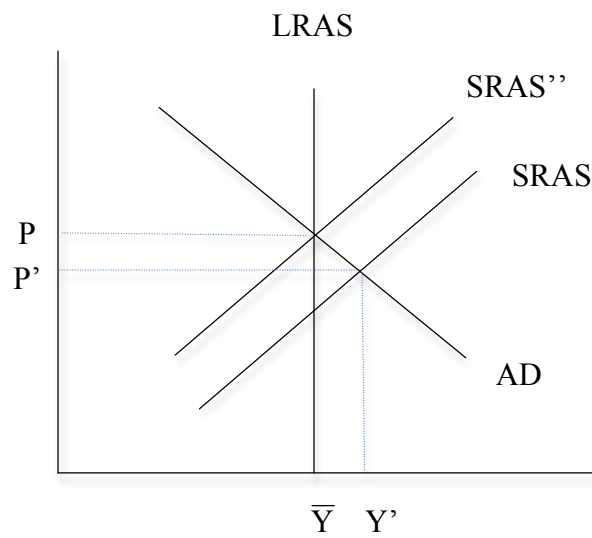
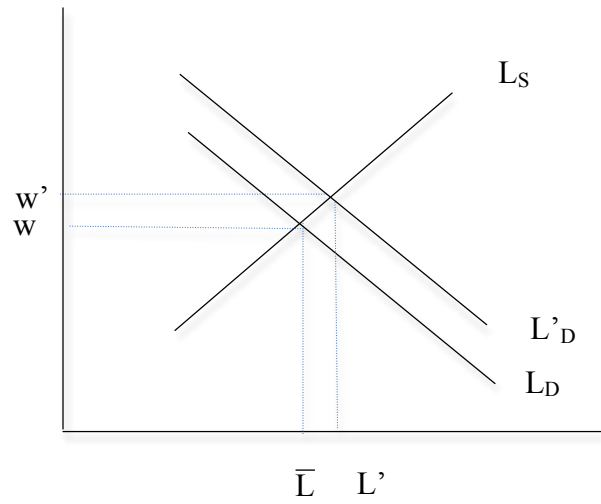
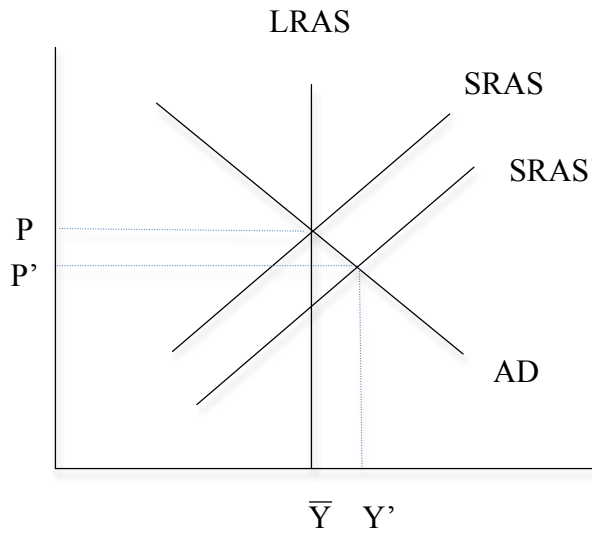
1) positive AD shock, so $Y > \bar{Y}$ and P rises; SRAS must shift up (price expectation rises, then price rises more and Y falls; real wage w/P ends up at initial level)



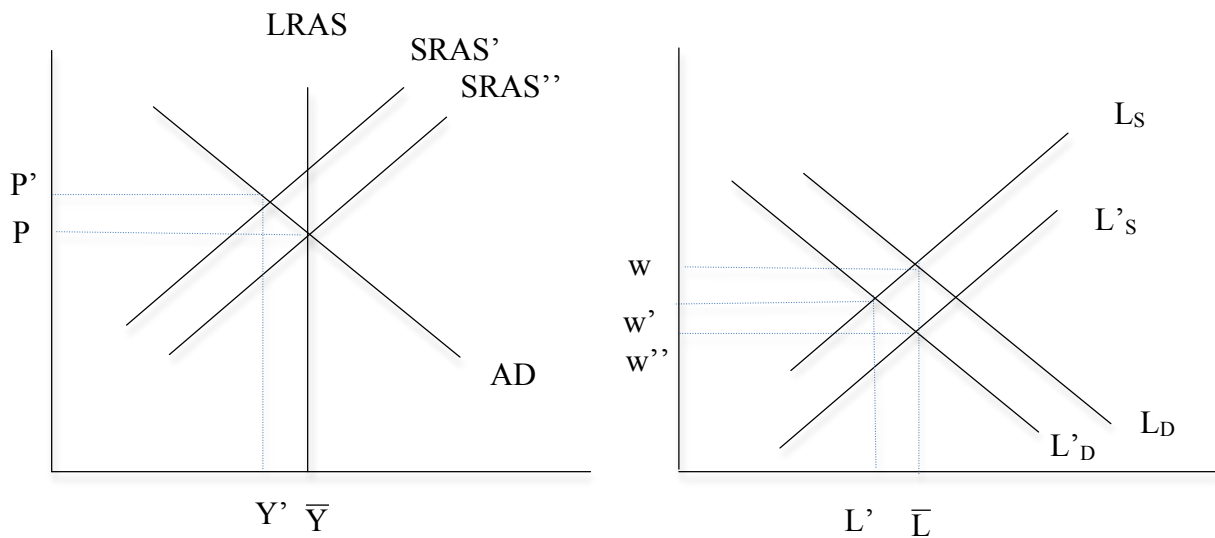
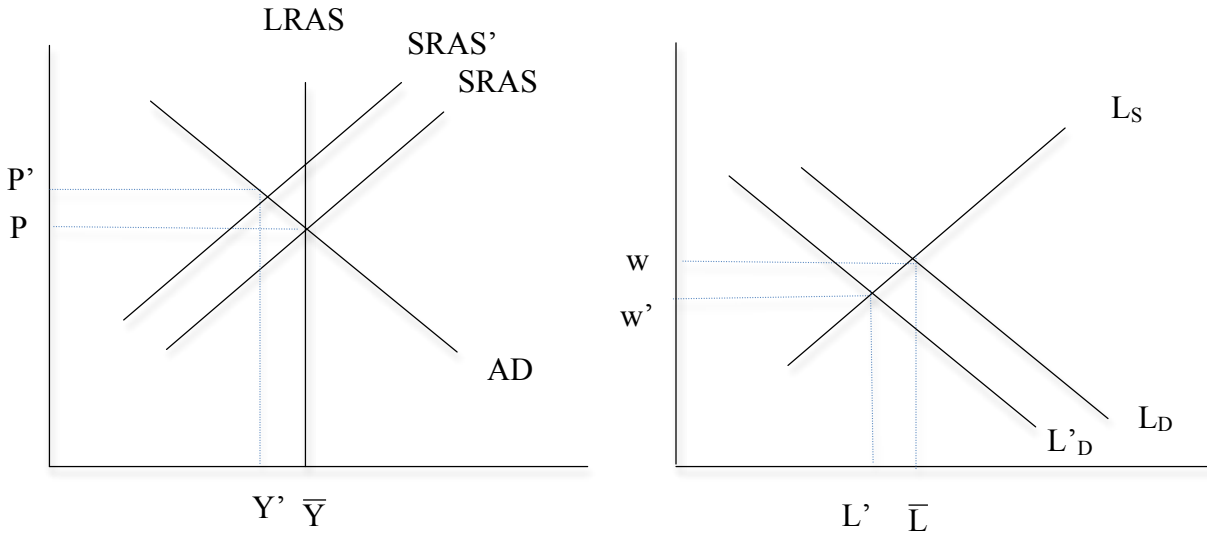
2) negative AD shock, so $Y < \bar{Y}$ and P falls; adjustment is that SRAS must shift down (price expectation drops, then price drops more and Y rises; real wage w/P ends up at initial level)



3) positive SRAS shock, so $Y > \bar{Y}$ and P falls; SRAS must shift up (w rises, then w and prices rise and Y falls; real wage w/P ends up higher)



4) negative SRAS shock, so $Y < \bar{Y}$ and P rises; adjustment is that SRAS must shift down (w drops and thus P falls and Y rises; real wage w/P ends up lower)



what causes AD shocks? what causes SRAS shocks? brainstorm

Over the next three classes we will move out of our closed economy model into a model that incorporates trades with other economies, in other words an open economy model

Answers to Practice Problems from 3/30/11

I. 1) $Y = 1200; r = 14; P = 1$

2) $Y = 1100; r = 17; P = 2$

II. 1) $Y = 1200; r = 14; P = 1$

2) $Y = 1100; r = 17; P = 2$

III. 1) $Y = 1200; r = 14; P = 1$

2) $Y = 1100; r = 17; P = 2$