

Macroeconomics: Principles & Applications

CHAPTER 10

Economic Fluctuations

Robert E. Hall
Mark Lieberman

PowerPoint slides prepared by:
Andreea Chiritescu
Eastern Illinois University

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Economic Fluctuations

- **Economic fluctuations**
 - Recessions
 - Output declines, occasionally sharply
 - Employment falls
 - Expansions
 - Output rises quickly - faster than potential output
 - Employment rises
- **Boom**
 - Output often exceeds potential output

Economic Fluctuations

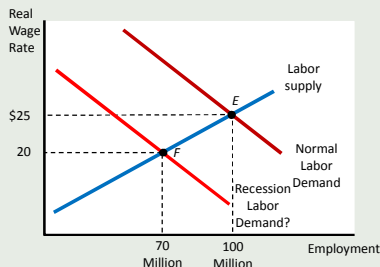
- **Economic fluctuations**
 - Employment and output move very close together
 - Expansions and recessions don't last forever
 - Three things to explain:
 - Why they occur in the first place
 - Why they sometimes last so long
 - Why they do not last forever

Can Classical Model Explain Economic Fluctuations?

- **Recession**
 - Might be caused by a leftward shift of the labor demand curve
 - Sudden change in spending
 - Workers – less productive
- **Shifts in the labor demand curve**
 - Are not very large from year to year
 - The classical model cannot explain real-world economic fluctuations through shifts in labor demand

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Figure 3: A Recession Caused by Declining Labor Demand?



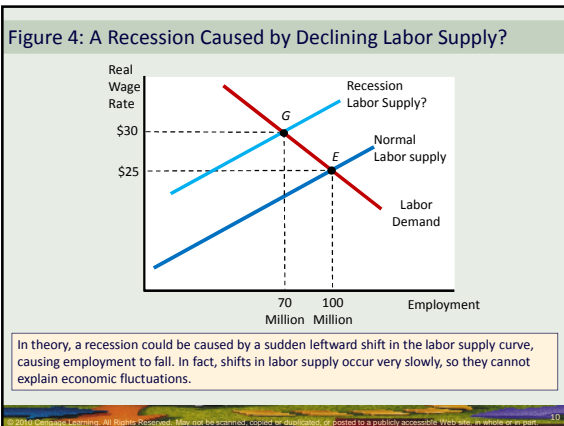
In theory, a recession could be caused by a sudden leftward shift in the labor demand curve, causing employment to fall. In fact, large, sudden shifts in labor demand are an unlikely explanation for real-world fluctuations.

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Can Classical Model Explain Economic Fluctuations?

- **Recession**
 - Might be caused by a leftward shift of the labor supply curve
- **Sudden shifts in the labor supply curve**
 - Are unlikely to occur
 - Could not accurately describe the facts of the economic cycle
 - The classical model cannot explain fluctuations through shifts in the supply of labor

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Can Classical Model Explain Economic Fluctuations?

- **Classical model**
 - Assumes that the market always clears
 - Does a poor job of explaining the economy in the short run
 - We cannot explain the facts of short-run economic fluctuations with a model in which the labor market always clears

What Triggers Economic Fluctuations?

- **Macroeconomic fluctuations**
 - Change in production
 - Lower production – recession
 - Higher production – expansion
 - Change in spending
 - More saving – recession
 - More spending – can trigger a boom

What Triggers Economic Fluctuations?

- **Say's law doesn't prevent recessions**
 - In the long run:
 - Interest rate adjusts until saving = business and government borrowing
 - Lower consumer spending – will not threaten the economy
 - In the short run:
 - Interest rate may not adjust

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What Triggers Economic Fluctuations?

- **Total spending will drop below total income**
 - Violating Say's law
 - Ceteris paribus
 - When households spend less (save more)
 - But do not supply all of their additional saving to the loanable funds market

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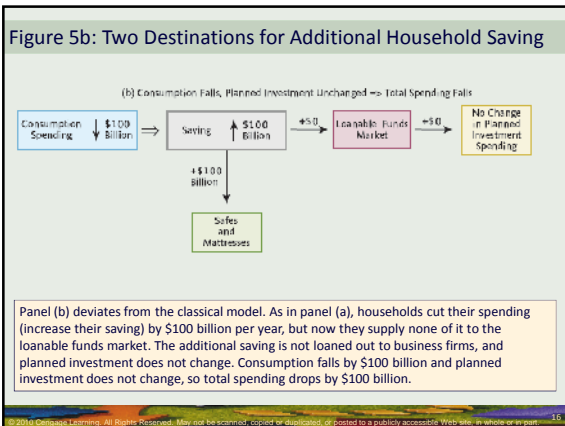
Figure 5a: Two Destinations for Additional Household Saving

(a) Consumption Falls & Planned Investment Rises ⇒ Total Spending Unchanged

Consumption Spending ↓ \$100 Billion	>	Saving ↑ \$100 Billion	→ +\$100 Billion	Loanable Funds Available ↑ \$100 Billion	→ +\$100 Billion	Planned Investment Spending ↑ \$100 Billion
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In panel (a), the loanable funds market behaves according to the classical model. Households cut their spending (increase their saving) by \$100 billion per year, and supply it all to the loanable funds market. The funds are loaned out to business firms, and planned investment rises by \$100 billion. Consumption falls by \$100 billion and planned investment rises by \$100 billion, so there is no change in total spending

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What Triggers Economic Fluctuations?

- Total spending will drop below total income
 - When households save more (spend less)
 - But financial intermediaries do not lend out all of the additional saving
 - If households save more (spend less)
 - But other factors prevent the interest rate from falling to its market-clearing level
 - Then some of the additional saving will not be borrowed and spent by others

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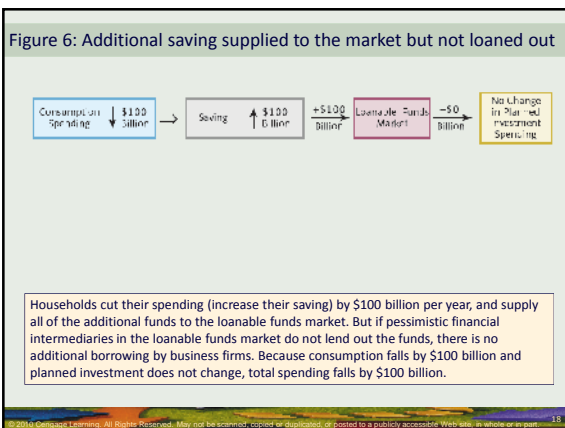


Table 1: Expansions and Recessions in the Last 50 Years

Period	Expansion/Recession	Event	Initial Spending Changes
Late 1960s	Expansion	Vietnam War	Defense spending ↑
1970	Recession	Change in Federal Reserve policy	Spending on new homes ↓
1974	Recession	Dramatic increase in oil prices	Spending on cars and other energy-using products ↓
1980	Recession	Dramatic increase in oil prices	Spending on cars and other energy-using products ↓
1981-82	Recession	Change in Federal Reserve policy	Spending on new homes, cars, and business investment ↓
Early 1980s	Expansion	Military buildup	Defense spending ↑
Late 1980s	Expansion	Dramatic decline in oil prices	Spending on energy-using products ↑
1990	Recession	Large increase in oil prices; collapse of Soviet Union	Spending on cars and other energy-using products ↓ Defense spending ↑

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Table 1: Expansions and Recessions in the Last 50 Years

Period	Expansion/Recession	Event	Initial Spending Changes
1999-2000	Expansion	Technological advances in computers; development of the Internet; high-wealth creation	Spending on capital equipment ↑; Consumption spending ↓
2001	Recession	Investment in new technology slows; technology-fueled bubble of optimism bursts; wealth destruction	Spending on capital equipment ↓
2002-2007	Expansion	Changes in fiscal and Federal Reserve policies; rapid rise in housing wealth	Consumption spending ↑
2008-?	Recession	Oil price rise; housing bubble bursts; financial crisis	Spending on cars and new homes ↓

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