Summary and Conclusions

Agenda

- Summary
  - The IS-LM, DAD-SAS, and SGM together.
  - Macroeconomic Rules of Thumb.
- Conclusions

Final Exam

- Thursday, May 22nd
- 12:30 – 3:30 p.m.
- 100 Haas Pavilion

CORRECTION on Fiscal Policy

- Automatic Stabilizers (slide 24-8):
  - Because of automatic stabilizers, the government budget balance will rise during recessions and fall during booms.
  - Because of automatic stabilizers, the government budget balance will fall during recessions and rise during booms.
Summary

• Three models of economic activity:
  - The IS-LM model.
  - The DAD-SRAS model.
  - The Solow Growth model.

Summary

• The IS-LM Model:
  - Short-run orientation.
  - Determination of Y and r.
  - Prices are exogenous.
  - Y can deviate from Y* in the short-run.
  - Adjustment mechanism is through inventory change and changes in r.

Summary

• The DAD-SAS Model:
  - Medium-run orientation.
  - Determination of Y and π.
  - Wage and price adjustment is sticky.
  - Y can deviate from Y* in the short-run but not in the intermediate-run.
  - Adjustment mechanism is through π, changes in the real Ms, and r.

Summary

• The Solow Growth Model:
  - Long-run orientation.
  - Determination of Y*/N, Y*, and y-dot.
  - Wages and prices are fully flexible.
  - Y does not deviate from Y* in the long run.
  - Adjustment mechanism is through adjustments in investment-per-worker and the capital-to-labor ratio.
Summary

- The IS-LM, DAD-SAS, and SGM are fully consistent with one another.
  - Changes in one model **MUST** be transmitted to the other models in a fully consistent manner.

Changes in fiscal policy

Changes in monetary policy

Changes in productivity
Macroeconomic Rules of Thumb

- Based on Okun’s Law and the DAD – SAS Model (with only demand shocks).

Macroeconomic Rules of Thumb

- Economic output:
  - If the output ratio \( Y/Y^* \) is rising, then \( \Delta Y/Y > \Delta Y^*/Y^* \).
  - If the output ratio \( Y/Y^* \) is falling, then \( \Delta Y/Y < \Delta Y^*/Y^* \).

Macroeconomic Rules of Thumb

- Economic output and unemployment:
  - If \( Y > Y^* \), then \( U < U^* \).
  - If \( Y < Y^* \), then \( U > U^* \).

Macroeconomic Rules of Thumb

- Implications:
  - If \( Y/Y^* \) is rising, then \( U \) is falling.
  - If \( Y/Y^* \) is falling, then \( U \) is rising.

- Conclusion:
  - Changes in the unemployment rate depend on changes in the output ratio, NOT on its level.
### Macroeconomic Rules of Thumb

**• Implications:**
- If U is falling, then Y/Y* is rising.
- If U is rising, then Y/Y* is falling.

**• Conclusion:**
- Changes in the output ratio depend on changes in the unemployment rate, NOT on its level.

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### Macroeconomic Rules of Thumb

**• Economic output, unemployment, & inflation:**
- The relationship between economic output and inflation is more subtle than the relationship between economic output and unemployment.
- It depends on whether the economic output is above or below its full-employment level.
  - That is, whether the output ratio (Y/Y*) is > or < 1.

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### Macroeconomic Rules of Thumb

**• Implications:**
- If Y/Y* > 1, then inflation will accelerate.
- If Y/Y* < 1, then inflation will decelerate.

**• Conclusion:**
- Changes in inflation depend on whether the output ratio is above or below 1, NOT on whether the output ratio is rising or falling.

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### Macroeconomic Rules of Thumb

**• Implications:**
- If U < U*, then inflation will accelerate.
- If U > U*, then inflation will decelerate.

**• Conclusion:**
- Changes in inflation depend on whether the output ratio is above or below 1, NOT on whether the output ratio is rising or falling.
Conclusions about Macroeconomics:

- Conclusions about Macroeconomics:
  - What we know.
  - Questions searching for better answers.

What We Know:

- In the long-run, a country’s standard of living is determined by its capacity to produce.
- In the short-run, changes in aggregate demand influence a country’s production.

What We Know:

- In the long-run, changes in the money supply influence inflation but not unemployment.
- In the short-run, policymakers face a trade-off between inflation and unemployment.

Questions Searching for Better Answers:

- Exactly how should a country go about attempting to raise its standard of living?
- How and should policymakers try to stabilize the economy?
Conclusions about Macroeconomic

- Questions Searching for Better Answers:
  - Exactly how costly is inflation and how costly is it to reduce inflation?
  - How big a problem are substantial budget and/or trade imbalances?