ANNOUNCEMENTS:

~show text book. Who still doesn't have it?

~have some flexibility on quiz:

1. We can have it next week
2. If you all do badly we can have another next week on ch2 and ill split the %

How was your weekend?

Why Macro Economists Disagree:

***Positive analysis –** examines the economic consequences of a policy but doesn't address the question of whether those consequences are desirable.

E.g. - What would happen if a nuclear bomb were detonated?

Normative analysis – tries to determine whether a certain policy should be used.

E.g. - Should a nuclear bomb be detonated?

In addition we have the following physical limitations:

- Gödel's Incompleteness Theorem: any logical model of reality is incomplete (and possibly inconsistent) + must be continuously refined/adapted in the face of new observations.
- Heisenberg's Uncertainty Principle: there is a limit on our ability to observe reality with precision.
- Second Law of Thermodynamics: The measure of uncertainty of any closed system always tends to increase no matter what.

AND PSYCOLOGICAL Limitations:

Black swan events - *The event is a surprise (to the observer) and has a major impact. After the fact, the event is rationalized by hindsight*.

Keeping these limitations in mind we will attempt to analyze the implications of the two main schools of thought in economics.

Two main macroeconomic schools of thought:

THE CLASSICAL VS. KEYNESIAN DEBATE

School:	**1) Classical (Fresh Water)**	**2) Keynesian (Salt Water)**
Key Figure:	Adam Smith (1723 - 1790)	John Maynard Keynes (Kaynz) (1883 - 1946)
Main publication:	The Wealth of Nations (1776)	The General Theory of Employment, Interest, and Money (1936)
Key Idea:	The Invisible Hand:	The great depression rendered the invisible hand of free markets ineffective
	When individuals pursue self interest the aggregate economy maximizes the general welfare of all economic agents.	Persistent high unemployment based on market frictions in wage and price adjustment e.g. Retail gas prices.
Key Point:	No market frictions affecting equilibrium adjustment	Slow adjustment = disequilibrium for long periods of time.
Normative Argument:	Government policy should have at most a limited role	Gov. should have a role in market failures
Positive Argument:	Government policies are ineffective or counter productive	Fiscal stimulus lowers high unemployment because by increasing gov. purchases of goods and services demand for output increases & businesses have to employ more workers.

Q: What would a classical economist have to say about business cycles?

They are an efficient response to exogenous changes in the real economic environment.

A Unified Approach – focus on the commonality between the two schools of economic thought

1) Individuals, firms, and the government interact in goods markets, asset markets, and labor markets.

2) The models macroeconomic analysis is based on the analysis of individual behavior (AKA micro foundations).
    a. Individuals/firms try to maximize their own economic satisfaction, given:
        i. Needs
        ii. Desires
        iii. Opportunities
        iv. And resources

3) In the long run prices and wages fully adjust to achieve equilibrium in the market for goods, assets, and labor. Q: How long is the long run?

4) *Basic models presented may be used with classical or Keynesian assumptions:
    a. Classical – prices/wages are flexible
    b. Keynesian - prices/wages slow to adjust.
        i. See p.13 developing and testing economic theory

CH2 – The Measurement and Structure of the National Economy

3 Economic Agents:

1. Individuals
2. Firms
3. the government

Interacting in three markets:

1. goods market
2. asset market
3. labor market.

Analysis of each market alone is partial equilibrium; all together general equilibrium

Adding up all the actions of all market participants in all markets to obtain an economy wide total is called aggregation.

The national income accounts are the accounting framework used in measuring current economic activity. Ours are called The National Income and Product Accounts or NIPA. These accounts were developed in the 1930s as a result of macroeconomists trying to solve the problems of the great depression and realizing accurate aggregate data was needed.

The fundamental identity of National Income Accounting states:

The same value of total economic activity is obtained whether activity is measured by total production of final goods and services, the amount of income generated by the economic activity, or the expenditure of final goods and services.

Total Production = Total Income = Total Expenditure = Y

Q: Which method is the easiest to track?

Which gives us the **Income – Expenditure Identity**:

Production = Income = Expenditure = Y = C + I + G + NX

where,

C = consumption -> individuals

I = Investment -> firms

G = Government -> government purchases

NX = Net exports = exports – imports, with:

> exports = goods and services produced within a country that are purchased by foreigners
>
> & imports = goods and services produced abroad that are purchased by a countries residents.
>
> If NX = 0 then we have a closed economy which is an economy which doesn't trade with other countries.

Q: Is the USA a closed economy?

Can you think of a country that was at one time? Japan 1633 to 1853 no foreigner could enter or Japanese leave on penalty of death. This ended when we showed up with warships and requested that Japan open trade with the west, otherwise known as gunboat diplomacy.

Consumption about 2/3 of GDP and Investment 1/3:

See table 2.1, pg 31