The Classical Theory Using AD-AS Model

Created: Sept 2007 by Jim Luke.

Classical Theory Assumptions

All markets, goods, resources, and financial, are competitive. Prices go up and go down in all markets to make sure no shortages or surpluses exist.

Governments have balanced budgets: G=T. Therefore government does not borrow.

Households spend all their income unless interest rates are high enough to get them to save.

Firms borrow just enough to finance I. The financial markets make sure S = I.

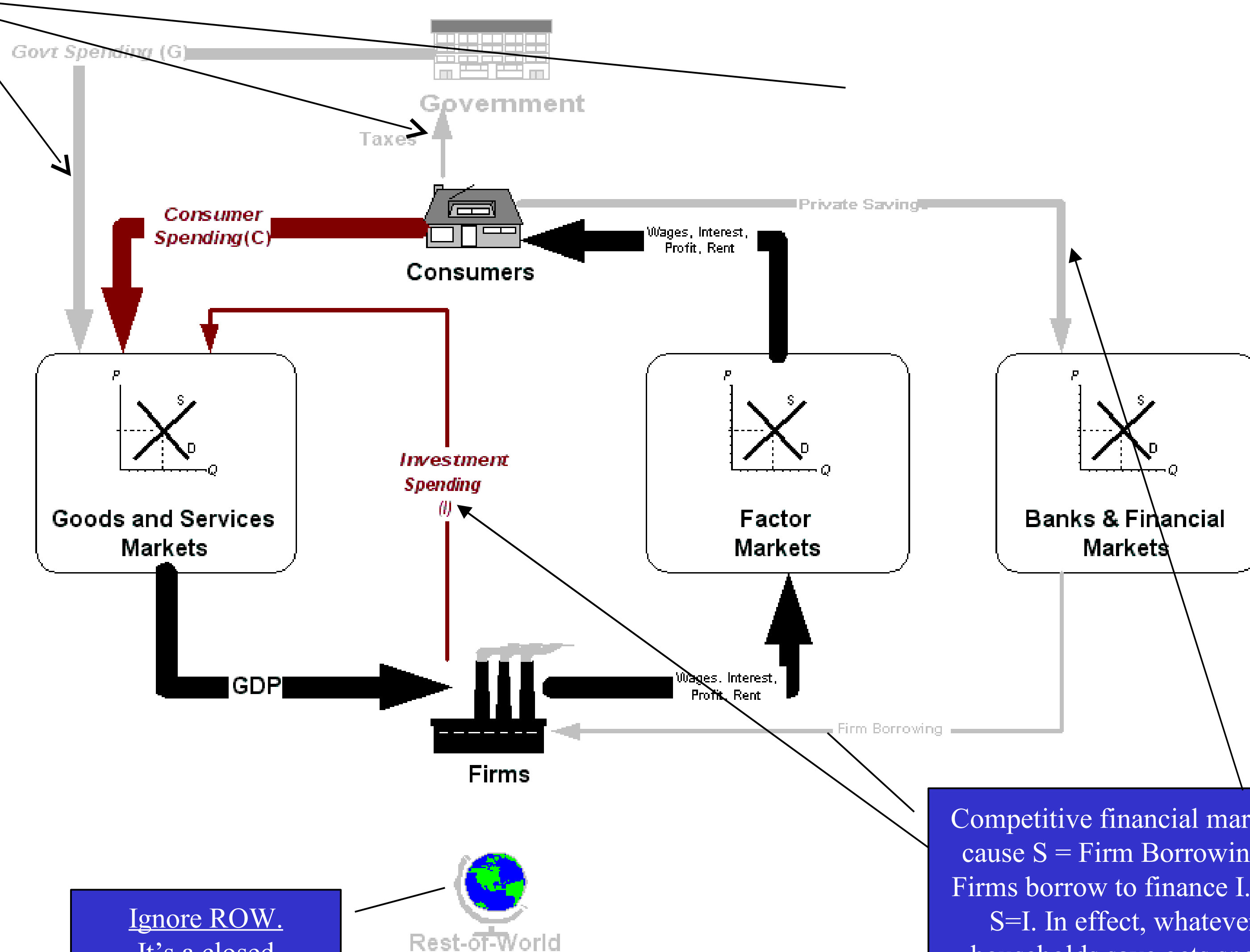
There are no significant trade or flows with R.O.W.

A Circular Flow view of the Classical Economy.

Balanced Budget:
G =T. What ever is taken away from consumers as taxes gets spent anyway as G.
There is no govt borrowing.

In the Classical model, whatever firms pay for resources (wages, etc.) gets spent on GDP. This is Say's Law.

The big question is how much will Firms choose to employ and produce?



Ignore ROW.
It's a closed economy model.

Competitive financial markets cause S = Firm Borrowing.. Firms borrow to finance I. So, S=I. In effect, whatever households save gets spent eventually as I anyway..

Implication of the Classical Model Assumptions

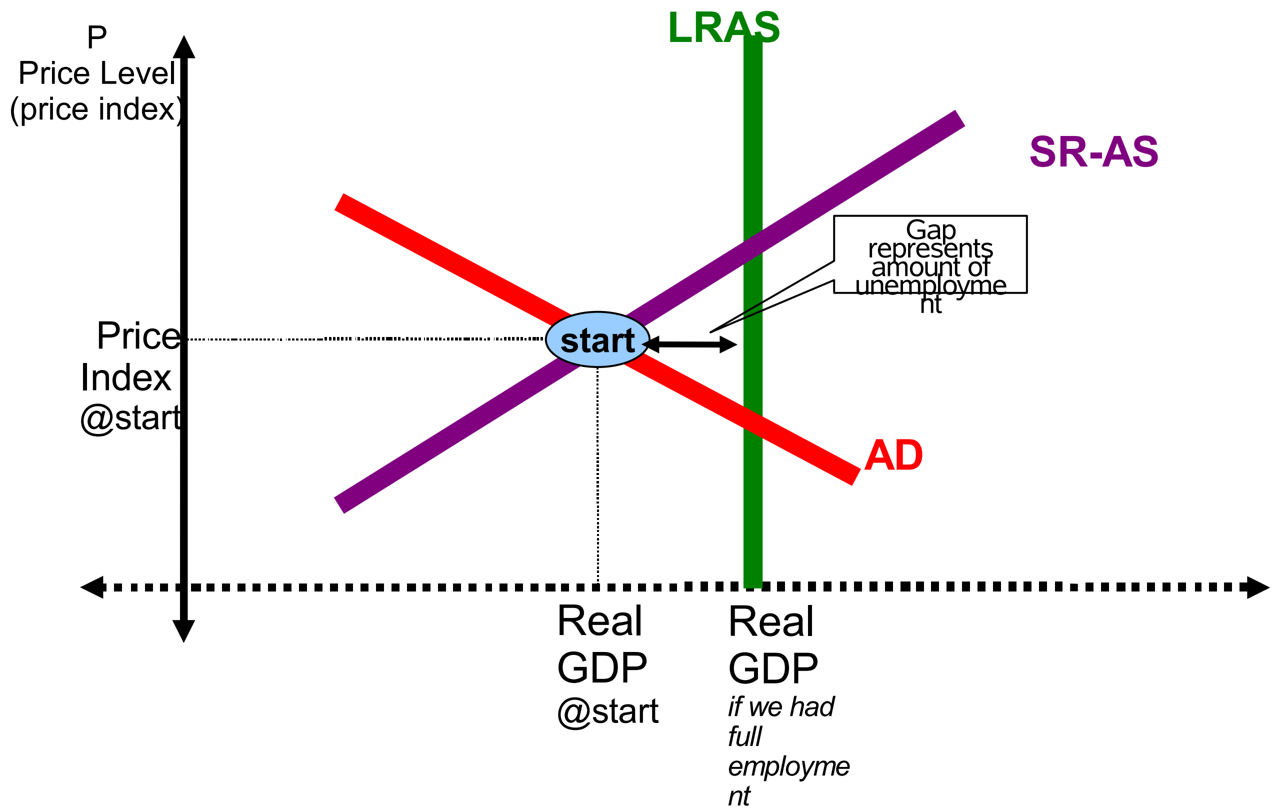
Questions of how much Real GDP (real output) will be produced really just depend on Firms' decisions about how much to produce (their production plans). Therefore, everything depends on the SRAS and LRAS. AD is unimportant.

Next: let's look at how Classical Theory predicts the economy will handle a Recession.

Recessionary Gap: High unemployment

If the economy is in a recessionary gap, there is high unemployment and a surplus of resources.

Competitive Resource Markets force the price of resources down and wages down.

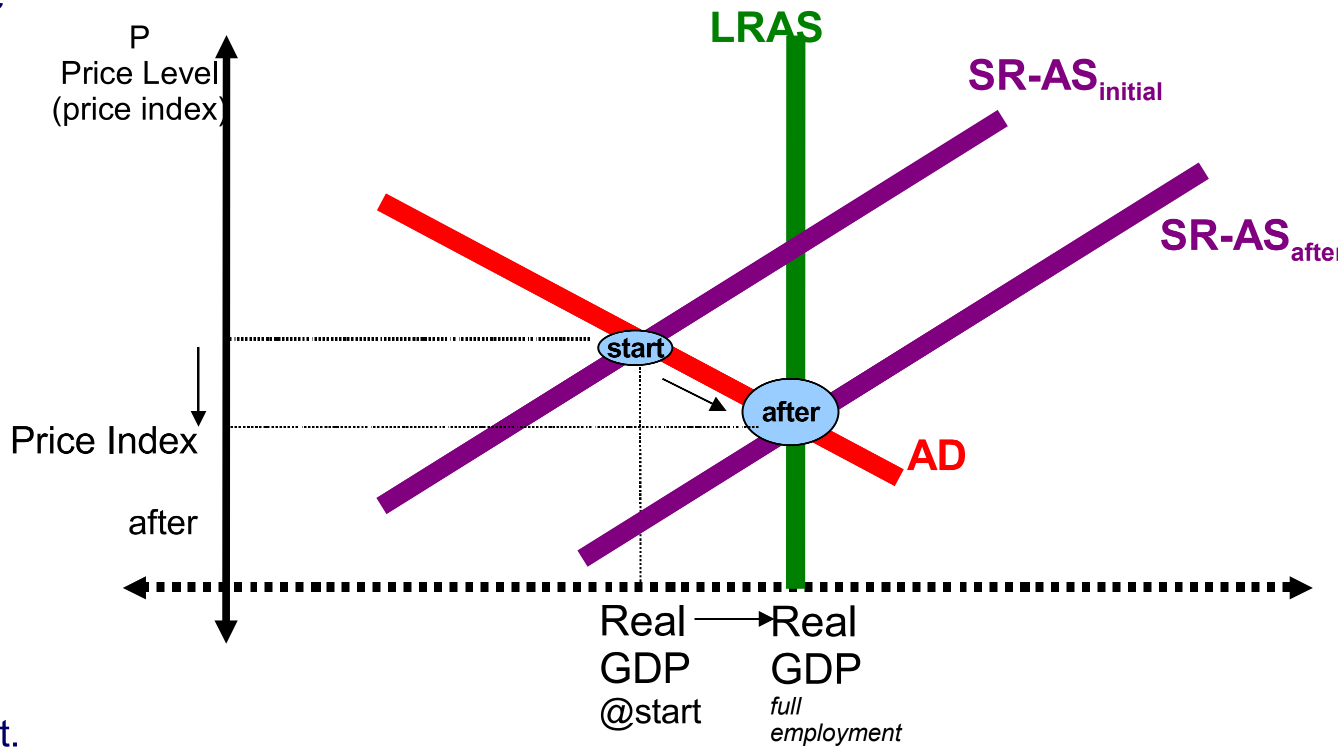


Recessionary Gap: Classical Adjustment

As wages and resource prices drop, the profitability of production improves. ***SRAS shifts right***.

As firms hire more workers, firms produce more. Newly hired households spend more.

Result:
- one-time drop in price level (deflation)
- increase in Real GDP
- return to full employment.



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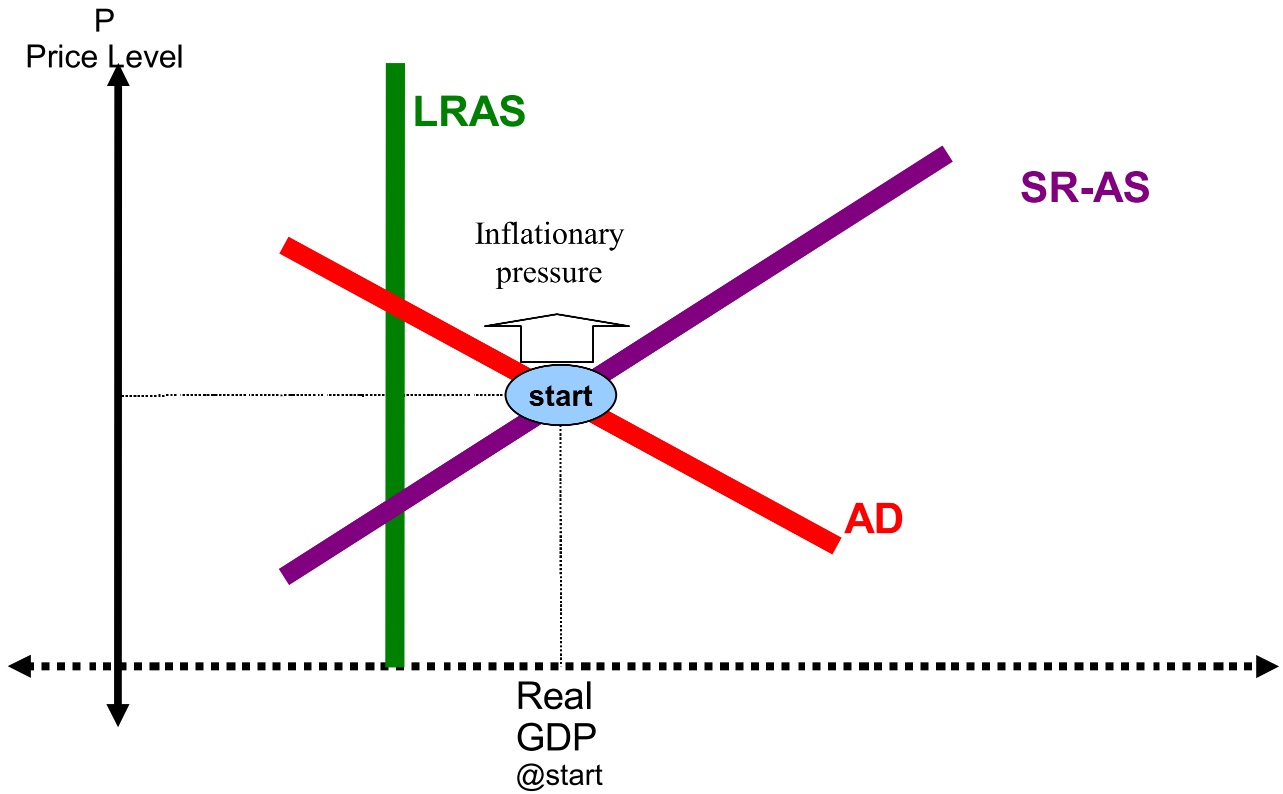
Expansionary Gap: Shortages of workers and resources

If the economy is in an Expansionary gap, then the aggregated plans of all firms' production plans requires more resources than the economy has. Of course firms don't know this so they try to obtain the resources they need by bidding up the price of resources and raising wages.

Individually, firms are just trying to attract workers. But, the aggregate effect of all firms increasing wages and resource prices is to generate inflation.



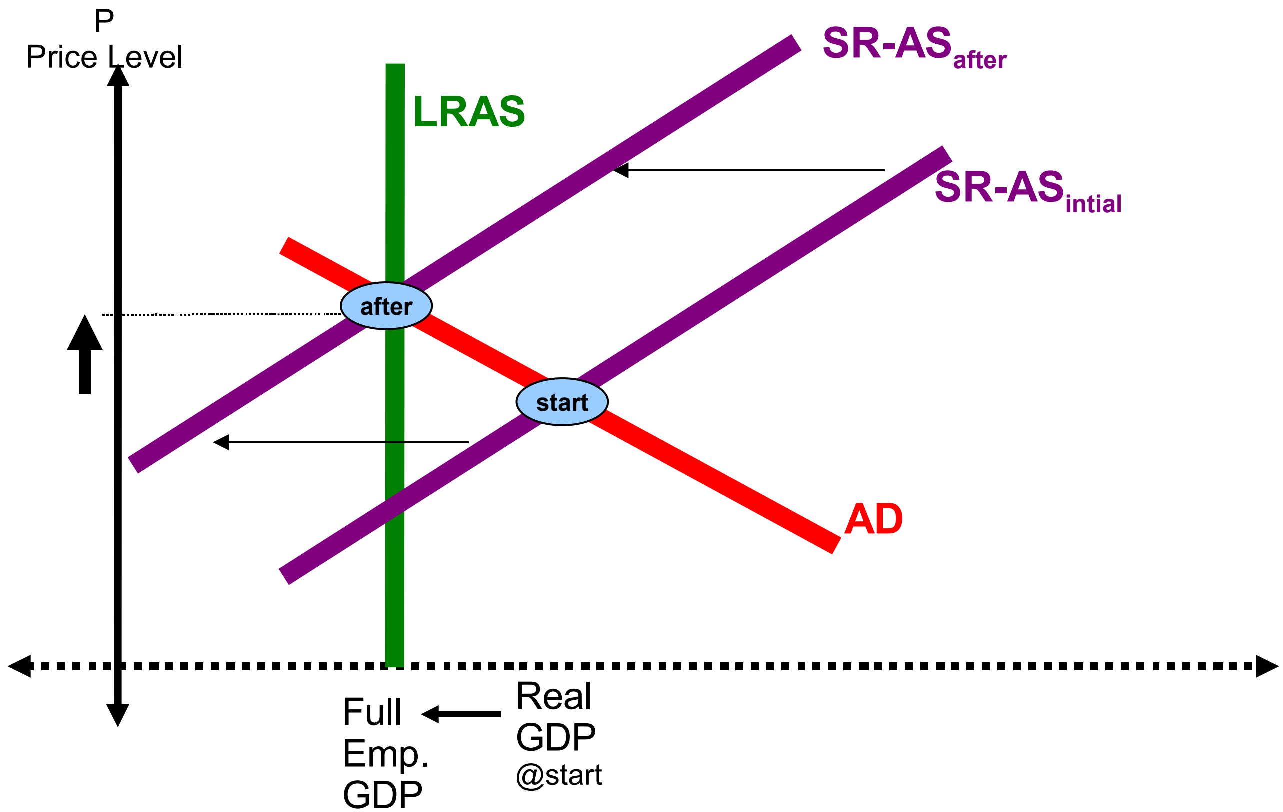
Expansionary Gap: The Classical Adjustment

The wages and resource price increases force firms to re-think profitability.

SRAS shifts to the left, reflecting the lower profitability of firms.

Firms also raise product prices to try to recover the cost increases.

Result:
- one-time increase in price level (inflation)
- decrease in Real GDP
- return to full employment.
- Shortages of workers and resources end.



So what causes a gap?

In the Classical model, whenever the economy is in a "gap", either contractionary or expansionary, a one-time adjustment in the price level will always quickly bring the economy back to a
full employment, stable price equilibrium.

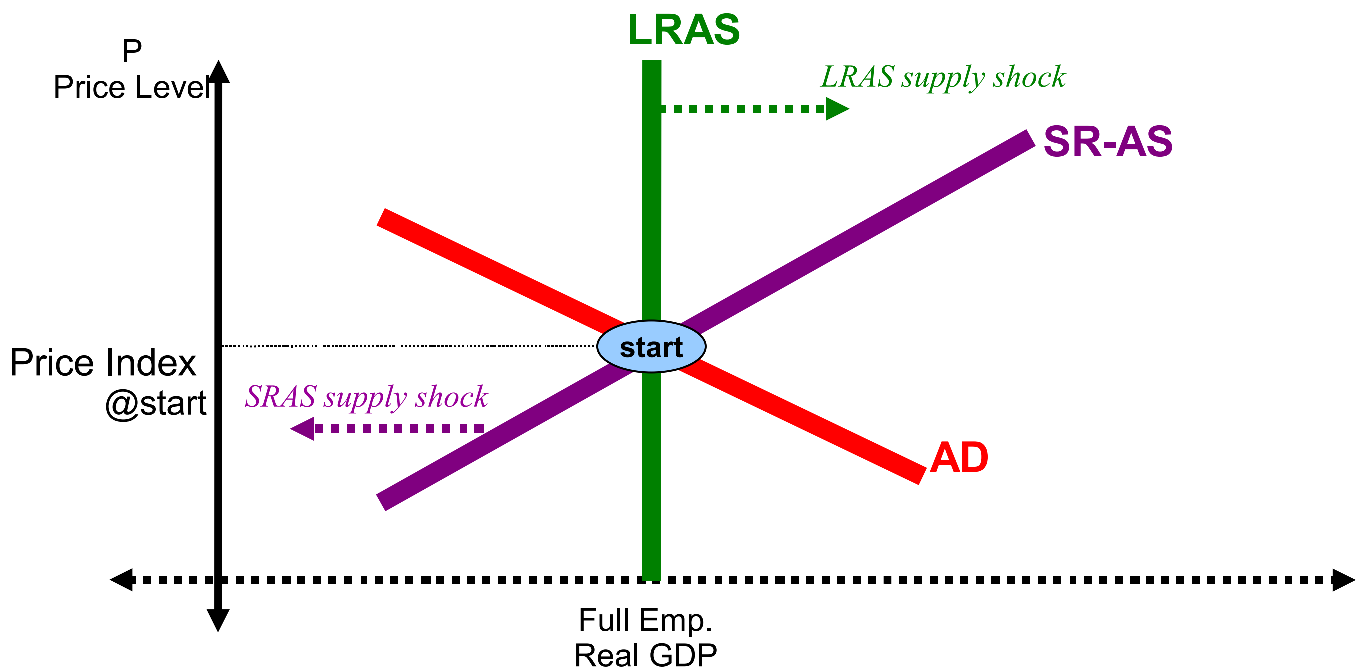
So the question arises: If the economy is so stable on it's own, how did it ever get into a contractionary or expansionary gap to begin with?

The answer involves "supply shocks".

Supply Shocks: How a Contractionary Gap Happens

The economy starts at a stable price level at full employment GDP. *"Life is good in a macro-sense".*

Then a supply shock happens. Long-run supply shocks shift the LRAS to the right. Short-run supply shocks shift the SRAS to the left. Either way, the economy now finds itself in a contractionary gap.



What creates a "supply shock"?

For LRAS:

- Create or acquire of more labor & resources (right shift)
- Discover or create better technology (right shift)
- War & disaster (left shift)

For SRAS:

- Cost increase of basic resource acquired from outside (shift left)
- Increase in business taxes (shift left)
- Cut business taxes (shift right)

Classical Theory Policy Recommendations

- Keep government small and keep it out of the economy (laissez-faire)
- Keep government budget balanced
- Let the economy "correct itself" when a recession or inflation occurs.