02/27/12

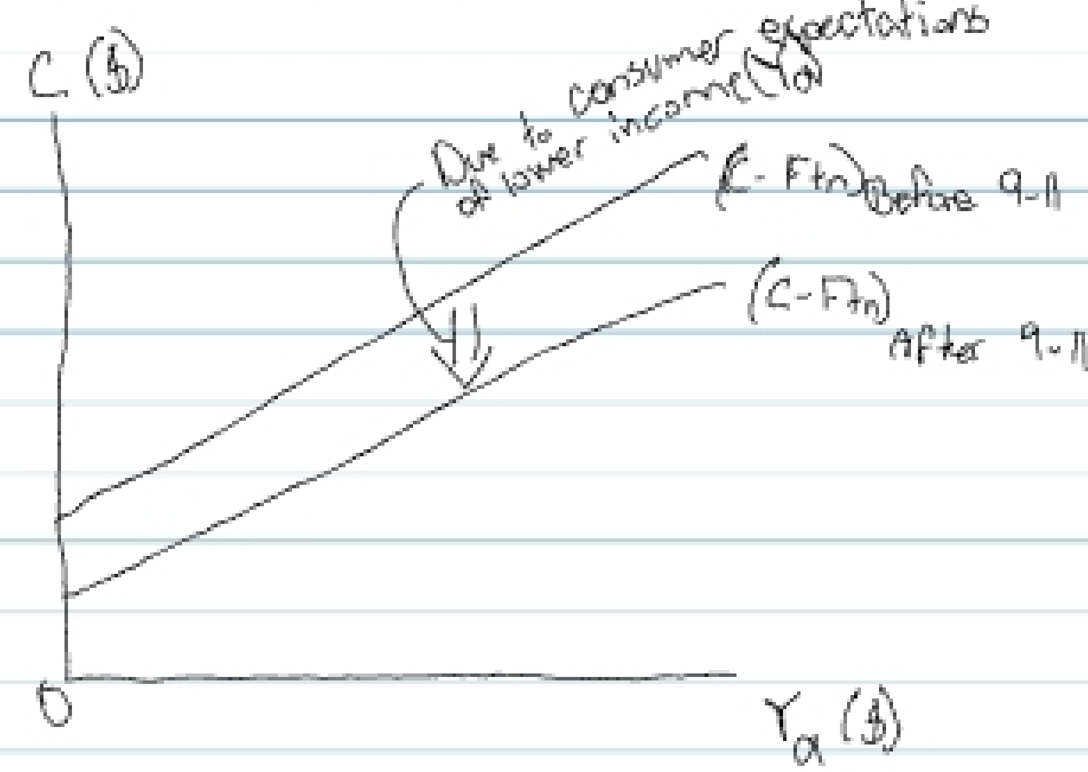
I. SHIFTS in the Consumption Function
  a. Case Study 1: 9-11 Shock to Consumer Spending
  b. Case Study 2: Credit Conditions and the Federal Reserve's Reaction to 9/11
  c. Case Study 3: Post World War 2 "boom" and Consumer Wealth

II. The Keynesian Cross Model
  a. Planned Total Expenditure
  b. Keynesian Aggregate Supply
  c. Inventory Adjustments and Short-Run equilibrium

Determinants of C

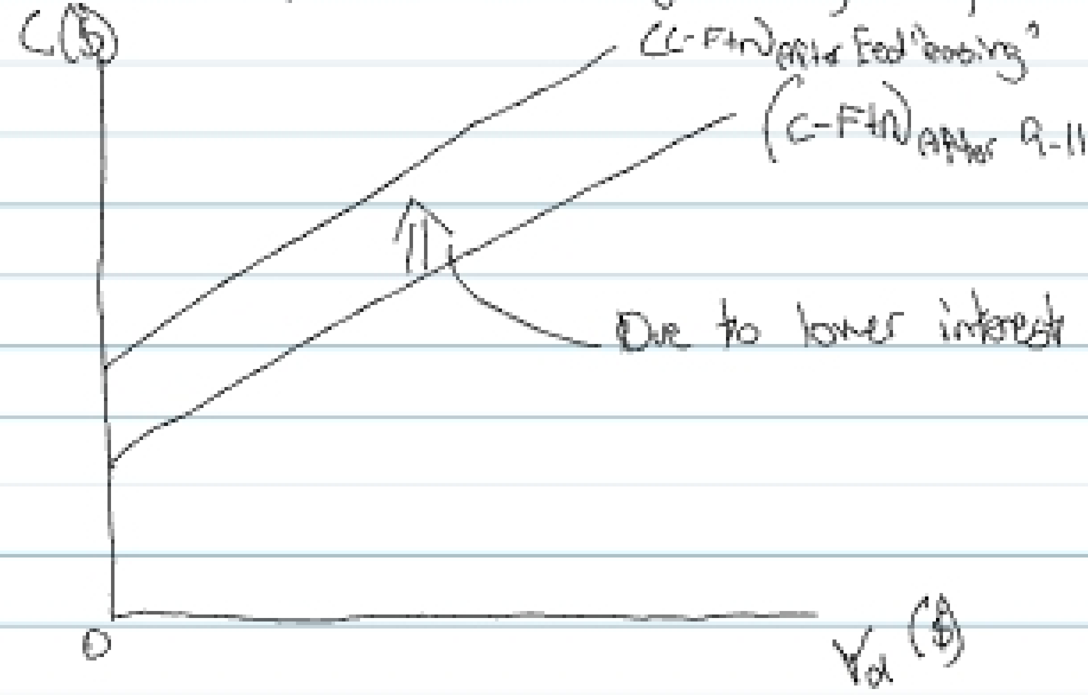
1. After tax on Disposable Income (Y_d)
2. Credit Conditions as reflected by interest rate
3. Consumer Expectations About Future Y_d and Future Consumer Goods prices
4. Consumer Wealth
   a. Financial Assets (like stocks, bonds, savings account)
   b. Consumer Durable Goods (like cars, refrigerator, furniture)

I.a. 9-11 attacks reduce consumer confidence. i.e. consumers expect lower future incomes.



C↓ ⇒ Lower Planned Total expenditure
⇒ lower level of overall economic activity, i.e., a recession

I.b. In an effort to prevent a recession, the Fed "eased" credit conditions by lowering interest rates to, hopefully, increase spending on "big ticket" consumption goods like cars, appliances, furniture, etc. (which generally require borrowed money)

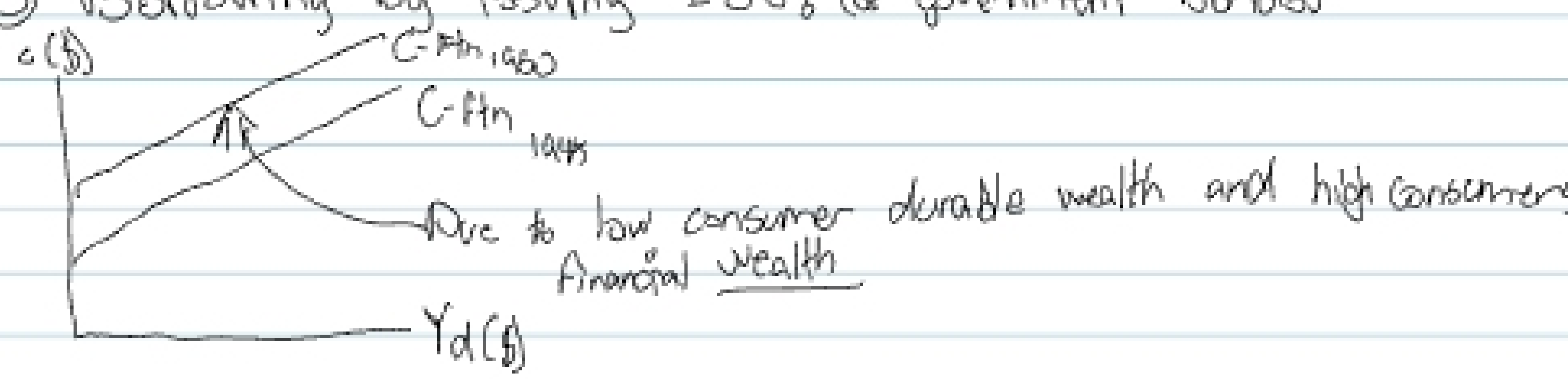


I.c. Post WWII "Boom" and Consumer Wealth.

Prediction: as Government spending (G)↓ after the war, planned total expenditure and the overall level of economic activity will also go down i.e. return to the unemployment of the Great Depression

end of WWII
① Very low levels of consumer goods wealth
② Very high levels of consumer financial wealth in the form of Government War Bonds

3 ways to finance a war
① Printing money (called seigniorage
② Taxation
③ Borrowing by issuing IOUs (or government bonds)

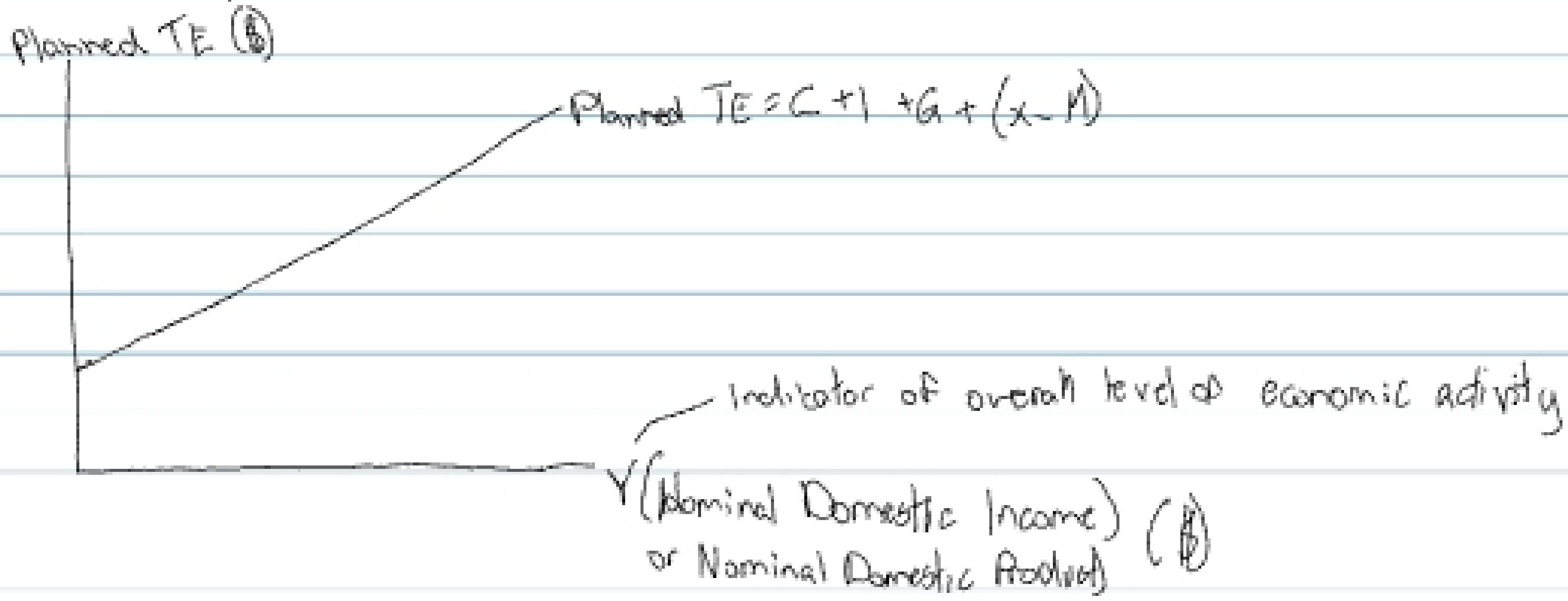


II Keynesian Cross Model

Overall level of Economic Activity Depends on Planned T.E.

$$\text{Planned TE} = C + I + G + (X - M)$$

- Assume Only C depends on the level of domestic ~~national~~ income (or domestic ~~national~~ product) $\equiv Y$ while I, G, X and M do not.



Keynesian Aggregate Supply (AS_K)

<u>intuition:</u> the economy's supply will produce (in current dollar or nominal terms) exactly as much as people are collectively planning on buying