

## Economics – Chapter 8 – The Self Regulating Economy

1. **Says Law** – supply creates its own demand. Production creates demand sufficient to purchase all goods and services produced. A producer will not want to produce more than he can sell. When he's making his products, he takes into consideration how much he believes he can sell. After he sells, he gets something back (ie, money), which will be used to create demand for something else
2. A general overproduction or underproduction of goods in the overall economy is impossible. However, under or overproduction in a specific market is possible
3. In order for Say's law to hold, the amount that people save, which isn't creating more demand, must equal total investments, due to the fluctuation of interest rates.
4. Markets are always competitive, and supply and demand will set prices and create balance
5. Markets are self-regulating. They operate off supply and demand, and prices will be set by either shortages or surpluses. In time, the market will always come back to equilibrium.
6. If the market is operating at full employment, it is producing Natural Real GDP
7. **Natural Real GDP** – the GDP when the measured unemployment rate equals the natural unemployment rate
8. **Recessionary Gap** – the condition where the Real GDP the economy is producing is less than the Natural Real GDP and the unemployment rate is greater than the natural unemployment rate. When the economy is in a recessionary gap, wages will fall until unemployment decreases to the natural unemployment rate.
9. **Inflationary Gap** – the condition where the Real GDP the economy is producing is greater than the Natural Real GDP and the unemployment rate is less than the natural unemployment rate. When the economy is in an inflationary gap, wages tend to rise due to a shortage of workers seeking jobs.
10. **Long Run Equilibrium** – when the Real GDP the economy is producing is equal to its Natural Real GDP
11. Institutional constraints, such as the minimum wage law, make an unemployment rate lower than the natural unemployment rate possible
12. **Laissez Faire Principle** – a public policy of not interfering with market activities in the economy

Added 10/2002 – For those in High School, you may not need this stuff, but it might be nice to know anyways

1. **The Spending Allocation Model** – GDP can be split into 4 shares, each a percentage of the total GDP
  - a. **Consumption Share** – Consumption/GDP
  - b. **Investment Share** – Investment/GDP
  - c. **Net Exports Share** – net exports/GDP
  - d. **Government purchases Share** – Government Purchases/GDP
2. If the GDP does not rise or decline, then all the shares are inversely proportional to each other, and add to = 1
3. **Consumption and the interest Rate** – Inversely proportional
  - a. If the interest rate goes up, there is more of an incentive to save (more return), hence people consume less and save more.
  - b. If the interest rate goes down, saving becomes less lucrative, so people spend more now
4. **Investment and the interest Rate** – Inversely Proportional
  - a. If the interest rate goes up, borrowing money for investments become more expensive, hence people invest less.
  - b. If the interest rate goes down, people are more willing to invest in houses, capital, etc.
5. **Net Exports** – inversely proportional
  - a. If the interest rate goes up, net exports goes down because a higher interest rate would make it more profitable to put money in the United States. Hence, by more foreigners putting their money in the US, the demand for US dollars will rise, hence causing the exchange rate to rise. So, instead of 10 yen to 1 US dollar, the price goes to 12 yen for 1 US dollar. That makes it more expensive for others to buy US goods (a computer chip that costed 20 yen before now costs 24 yen), so exports drop. It makes it cheaper to buy foreign goods, so imports rise. Since net exports = Total Exports – total imports, net exports drops considerably.
  - b. If the interest rate goes down, the demand for US dollars drop, exchange rate goes down, it's now cheaper to buy US goods, so exports go up. It's more expensive to buy foreign goods, so imports drop, and net exports rises.
6. The government purchases share balances the economy. If the government uses 22 % of GDP that means 78% is available for non-government use. Once again, assuming that the GDP does not rise (meaning we're producing the same amount), if the sum of consumption, investment, and net exports begins to rise above 78% of the total gdp, then interest rate rises and discourages people to consume, invest, and export to bring it back to 78%. If it drops below 78%, then the interest rate drops to encourage people to spend and invest more.
7. To find the interest rate, use a supply/demand model with a vertical supply curve at the amount of GDP available for non-government use (in our case, that's 78%). The demand for consumption, investment, and exports fluctuates w/ interest rates, but there is only 78% of gdp available. Hence, wher those two lines meet is the equilibrium interest rate.

8. Interest rate changes usually take several years for its full effect, and usually it's the real interest rate (interest rate adjusted for inflation) that changes.
9. **Changes in government Spending**
  - a. If the government decides to spend more (say, 25% instead of 22% of gdp), then there is less for the other three sectors (namely, 75% instead of 78%). Hence, the vertical "supply" line shifts to the left, interest rates rise, and consumption, investments, and exports fall.
  - b. If the government spends less (say, 20% instead of 22%), then there is more for the other three sectors, so the supply line shifts to the right, interest rates fall, and consumption, investments, and exports rise.
10. **Crowding out** – an increase in government purchases "pushing out" investment because consumption is not as easily hurt by interest rates as investments
11. **Changes in consumption**
  - a. If people suddenly decide to start spending more because for some reason they're more wealthy, then the consumption curve shifts. People are now willing to spend more at every interest rate. Since consumption rises, and government purchases must stay the same, the interest rate also rises, which brings down Investments and net exports
12. **National Savings Rate** – Savings = GDP – Consumption – Government purchases = Investments + Net Exports
  - a. Divide the savings by the total gdp to get the national savings rate