

# ECONOMICS 2





NEW

SZÉCHENYI PLAN

# ECONOMICS 2

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# ECONOMICS 2

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# ECONOMICS 2

Week 10

## **Aggregate supply**

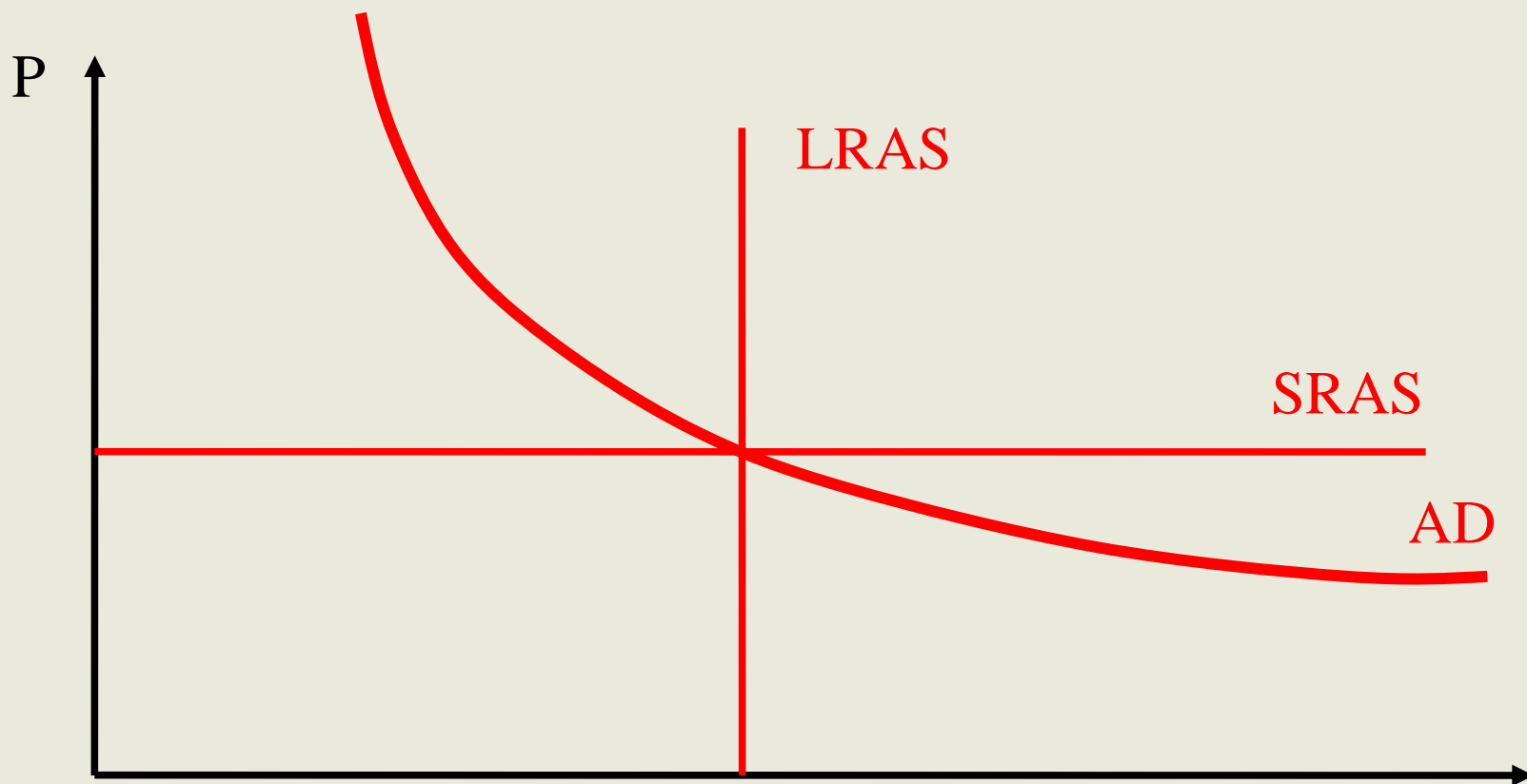
Chapter 12

Anikó Bíró, Gábor Lovics

# Outline

- Models of aggregate supply
- The Phillips curve
- Inflation expectations

# What we said up to now



# 4 short run models of aggregate supply

- Model of sticky wages
- Model of misconceptions
- Model of limited information
- Model of sticky prices

$$Y = \bar{Y} + \alpha(P - P_e)$$



# 1. Model of sticky wages

- Observation: nominal wages adjust slowly, especially in those sectors where trade unions are strong.
- If nominal wages are rigid then rising price level decreases real wages and increases the levels of employment and output.

# Formal relations

$$W = w \times P_e$$

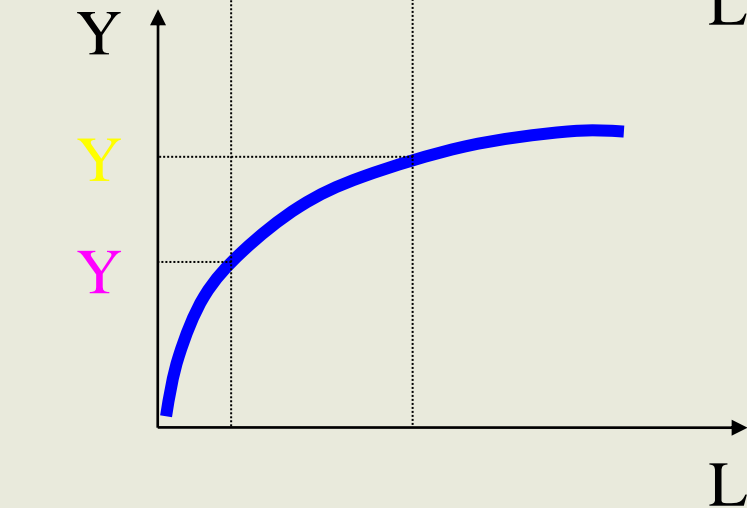
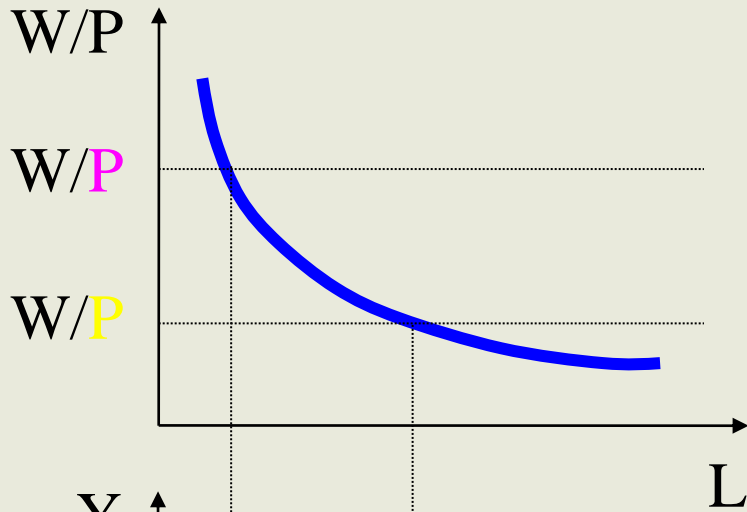
Nominal wage = planned real wage x expected price

$$W/P = w \times P_e/P$$

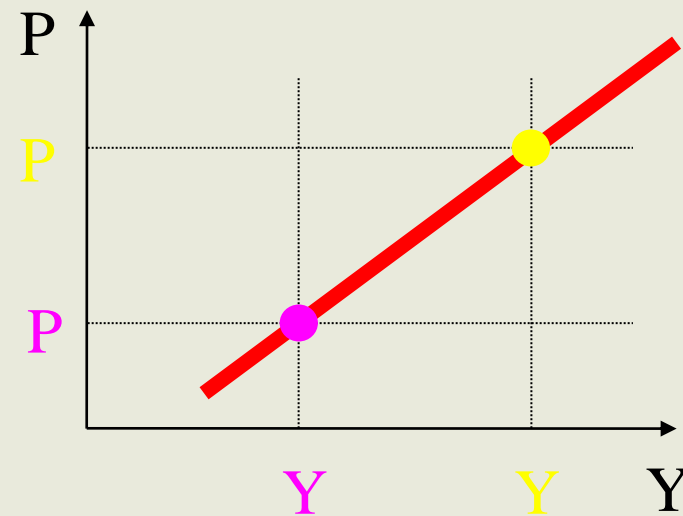
$$L = L_d(W/P)$$

$$Y = F(L)$$

# Derivation of supply



$$Y = \bar{Y} + \alpha(P - P_e)$$



## 2. Model of misconceptions

- Demand and supply are always in equilibrium in the labor market.
- The employees temporarily consider the nominal wage as real wage.

$$L_d(W/P) = L_s(W/P_e)$$

# Formal derivation

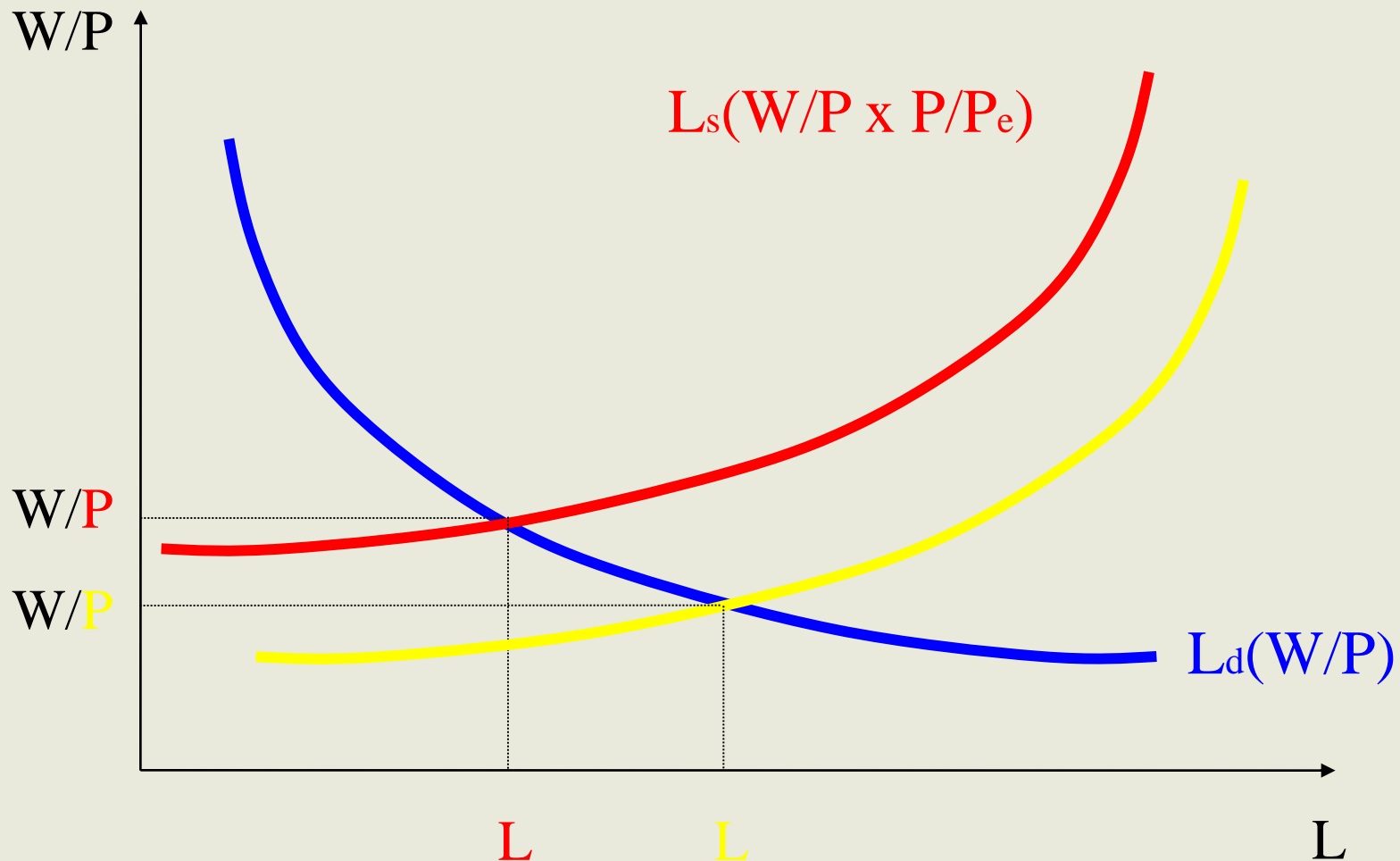
$$W/P_e = W/P \times P/P_e$$

$$L_d(W/P) = L_s(W/P \times P/P_e)$$

The price level can increase according to or differently from the expectations of the workers.

In the first case nothing changes, in the second case the supply curve shifts.

# Labor market equilibrium



# Conclusions from the first two models

- The starting point was imperfect labor market in the first two models.
- In both cases the higher than expected inflation resulted in lower real wages and thus higher output.
- Accordingly high output goes together with low real wages, thus the real wage is **contracyclical** in these models.
- This result is not confirmed by empirical observations.

# 3. Model of limited information

- In this model everyone produces one product but consumes infinite products.
- The producer is informed about the price of his/her own product, but has limited information on the prices of other products.
- If the price level changes, the producer mistakenly might conclude that the price of his/her product increased relative to the other products (if the price level rose more than expected).
- If everyone thinks the same way, the output becomes larger than the potential output.



# 4. Model of sticky prices

## Assumptions:

- $s$  ratio of the firms can change prices,  $1 - s$  ratio can not.
- Higher price level ( $P$ ) results in higher costs, thus the price of the product of the firm increases with the price level.
- Higher income level ( $Y$ ) increases the demand for the product of the firm, thus its price also increases.

# The model formally

s ratio of firms have flexible prices:

$$p = P + a(Y - \bar{Y})$$

(1 – s) ratio of firms can not change prices flexibly, thus their price is:

$$p = P_e + a(Y_e - \bar{Y}_e)$$

Simplifying assumption:

$$Y_e = \bar{Y}_e$$

thus the second type of pricing is:

$$p = P_e.$$

# Formal derivation

$$P = sP_e + (1 - s)(P + a(Y - \bar{Y}))$$

$$sP = sP_e + (1 - s) a (Y - \bar{Y})$$

$$P = P_e + (1 - s) a/s (Y - \bar{Y})$$

Rearranging the equation we get that

$$Y = \bar{Y} + \alpha(P - P_e),$$

where  $\alpha = s/((1 - s)a)$ .

# Explanation of the model

$$P = P_e + (1 - s) a/s (Y - \bar{Y})$$

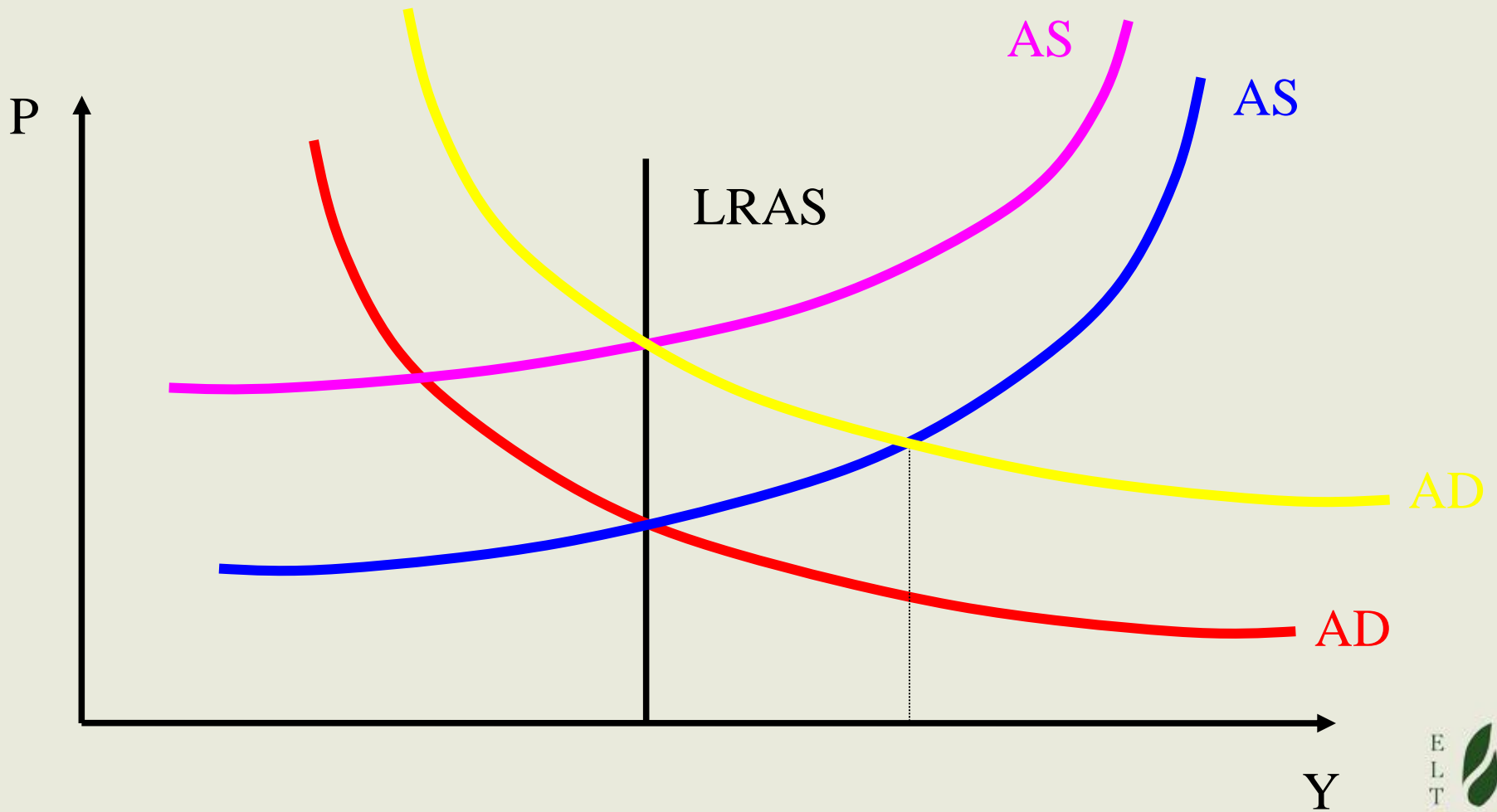
According to the formula the price level can increase due to two reasons:

- Expected price level increases, thus firms that can not change prices flexibly raise the prices now.
- Output increases, thus firms that can change prices flexibly set higher prices.

# What happens on the labor market?

- If income decreases then the demand for the products of firms decreases.
- The firms can not change the prices, thus they sell less and want to employ less workers.
- Given real wages the demand curve of labor shifts (unlike in the first two models), and thus the real wages decrease.
- Therefore in this model the real wages can change **procyclically**.

# Short run and long run



# The Phillips curve

According to the Phillips curve the inflation depends on three factors:

1. Expected inflation
2. Deviation of unemployment rate from its natural rate
3. Supply shocks

Formally:

$$\pi = \pi_e - \beta(u - u_n) + \varepsilon$$

# From the aggregate supply to the Phillips curve

$$Y = Y + \alpha(P - P_e)$$

$$P = P_e + (1/\alpha)(Y - \bar{Y})$$

$$P - P_{-1} = P_e - P_{-1} + (1/\alpha)(Y - \bar{Y})$$

$$\pi = \pi_e + (1/\alpha)(Y - \bar{Y})$$

Using Okun's law.

$$\pi = \pi_e - \beta(u - u_n)$$

$$\pi = \pi_e - \beta(u - u_n) + \varepsilon$$



# Adaptive expectations

If expectations are adaptive then

$$\pi_e = \pi_{-1}$$

The Phillips curve in this case is:

$$\pi = \pi_{-1} - \beta(u - u_n) + \varepsilon$$

# Conclusions

$$\pi = \pi_{-1} - \beta(u - u_n) + \varepsilon$$

- Inflation is persistent: it can be high just because it was high before.
- The second term in the equation relates cyclical unemployment to inflation. If inflation is caused by this term then it is called **demand inflation**.
- If inflation is caused by the third term, thus it is generated by a supply shock then it is called **cost inflation**.

# Sacrifice ratio

- Based on what we learned up to now the economic policy decisions affect the aggregate demand.
- If the aim of the economic policy is to mitigate the inflation rate then it can achieve it only through increasing the unemployment or decreasing the output.
- The % of GDP which disappears due to 1 percentage point decrease in the inflation is called the sacrifice ratio.

# Rational expectations and disinflation without harm

- If inflation expectations are not based on the past then the economic policy can influence that as well.
- The model of rational expectations assumes that the economic agents use all the available information in order to predict inflation.
- Then it is enough for a credible economic policy to promise that the inflation will be reduced, then the inflation will decrease by itself.