LSE EC1B5 Macroeconomics

Handout 14

Economic Fluctuations (II)

Key Ideas

1. Economic recovery due to market forces and expansionary government policies
2. Three key factors contributed to the 2007–2009 recession: a collapsing housing bubble, a fall in household wealth, and a financial crisis.

Economic Recovery

After the recession…

Forces that tend to reverse the effects of recession in the medium run (2 to 3 years):

1. Market forces
2. Expansionary government policies

Recovery due to market forces

1. Market forces from

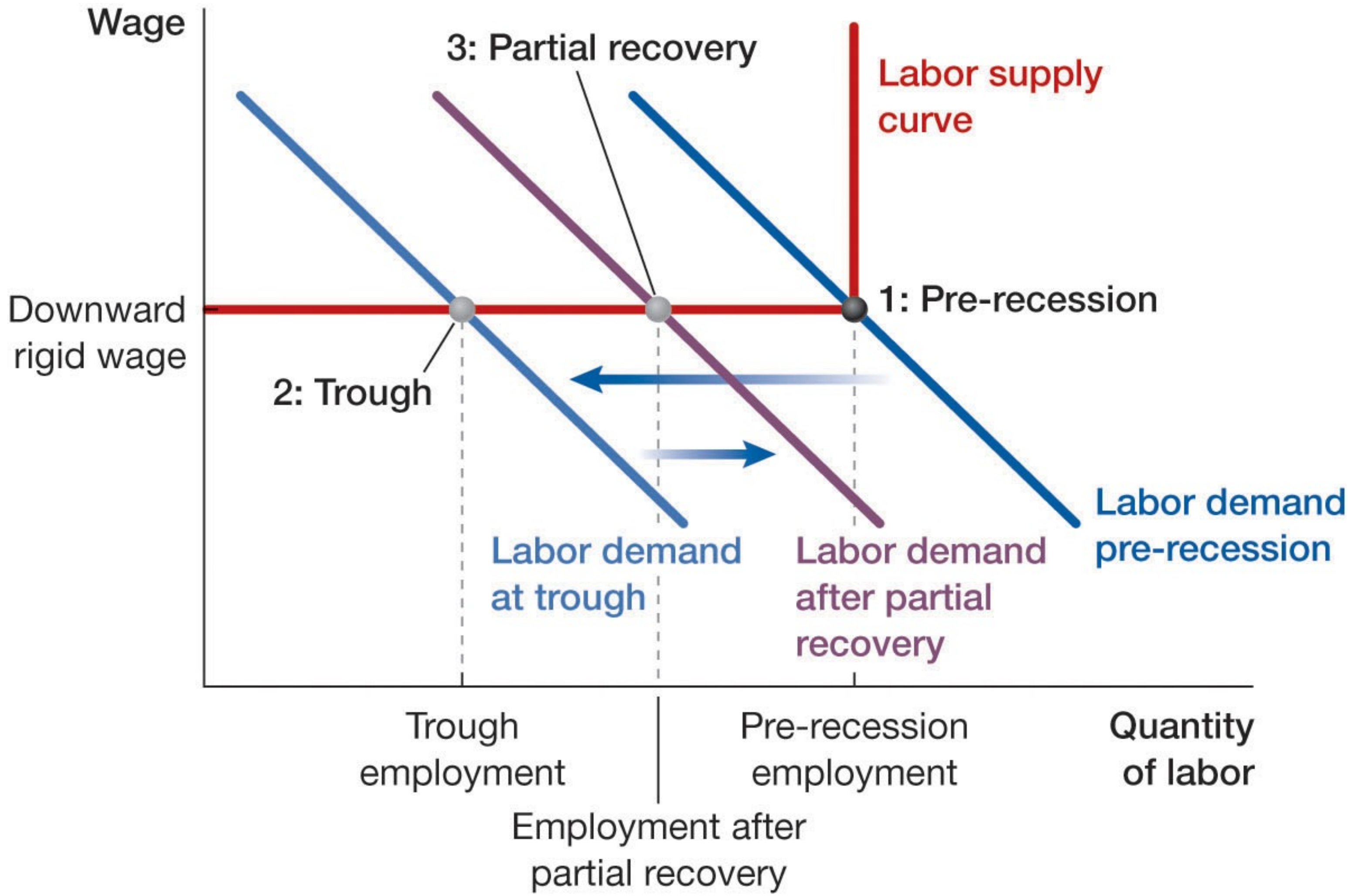
   (a) inventory rebuilding,

   (a) technological advances

   (c) financial intermediation

   shift the labor demand curve to the right for a partial recovery.

Partial Recovery Due to a Partial Rightward Shift in the Labor Demand Curve



Recovery due to expansionary government policies

2. Expansionary government policies:

- Expansionary monetary policies – lower the central bank interest rate.

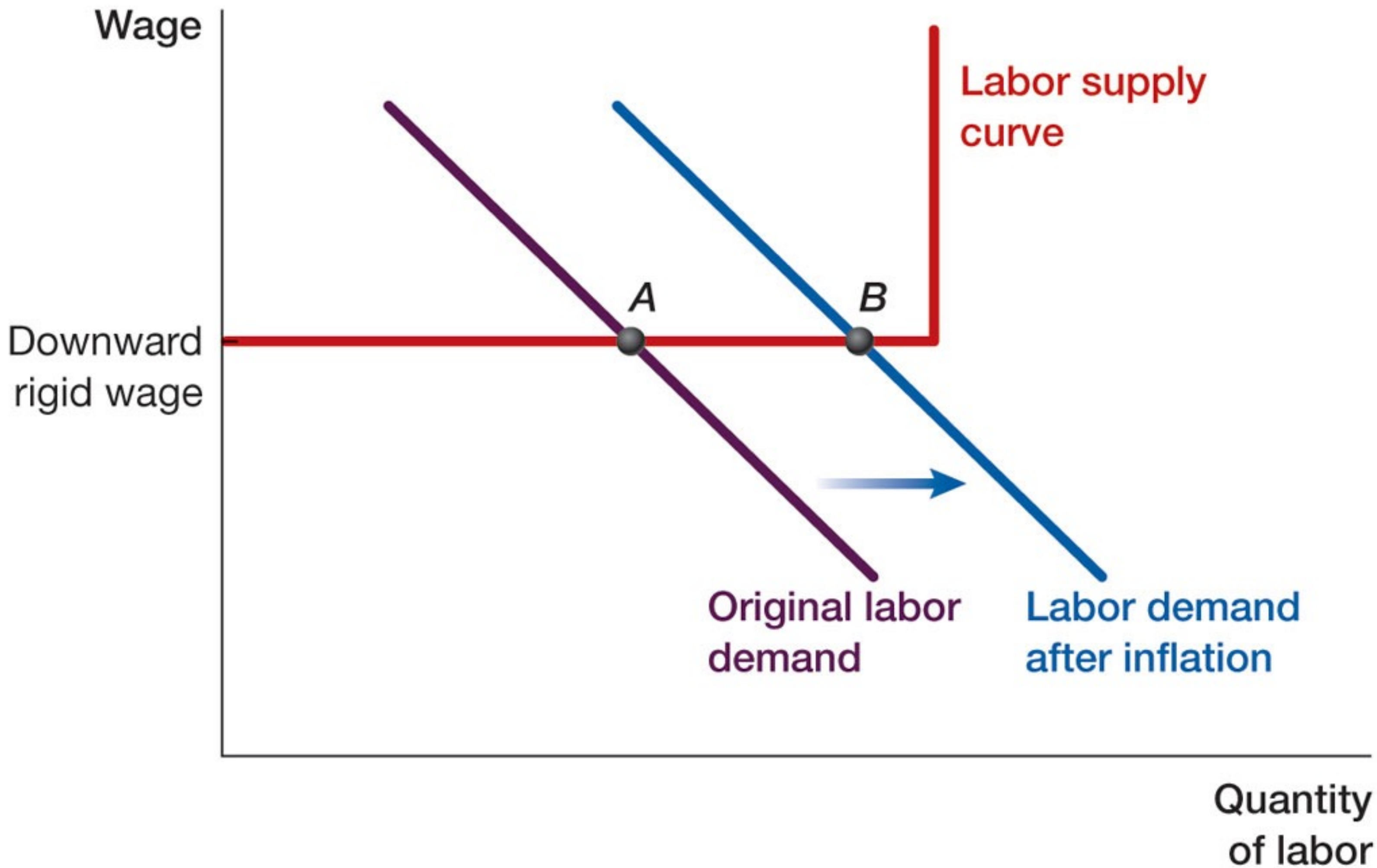
- Expansionary fiscal policies – increasing government spending or decreasing taxes.

Recovery due to expansionary monetary policies

Expansionary monetary policy

- It will lower interest rates and raise inflation.
- Lower interest rates will raise spending, which shifts the labor demand curve to the right.
- Higher inflation will lower real wages, which shifts the labor supply curve to the left.

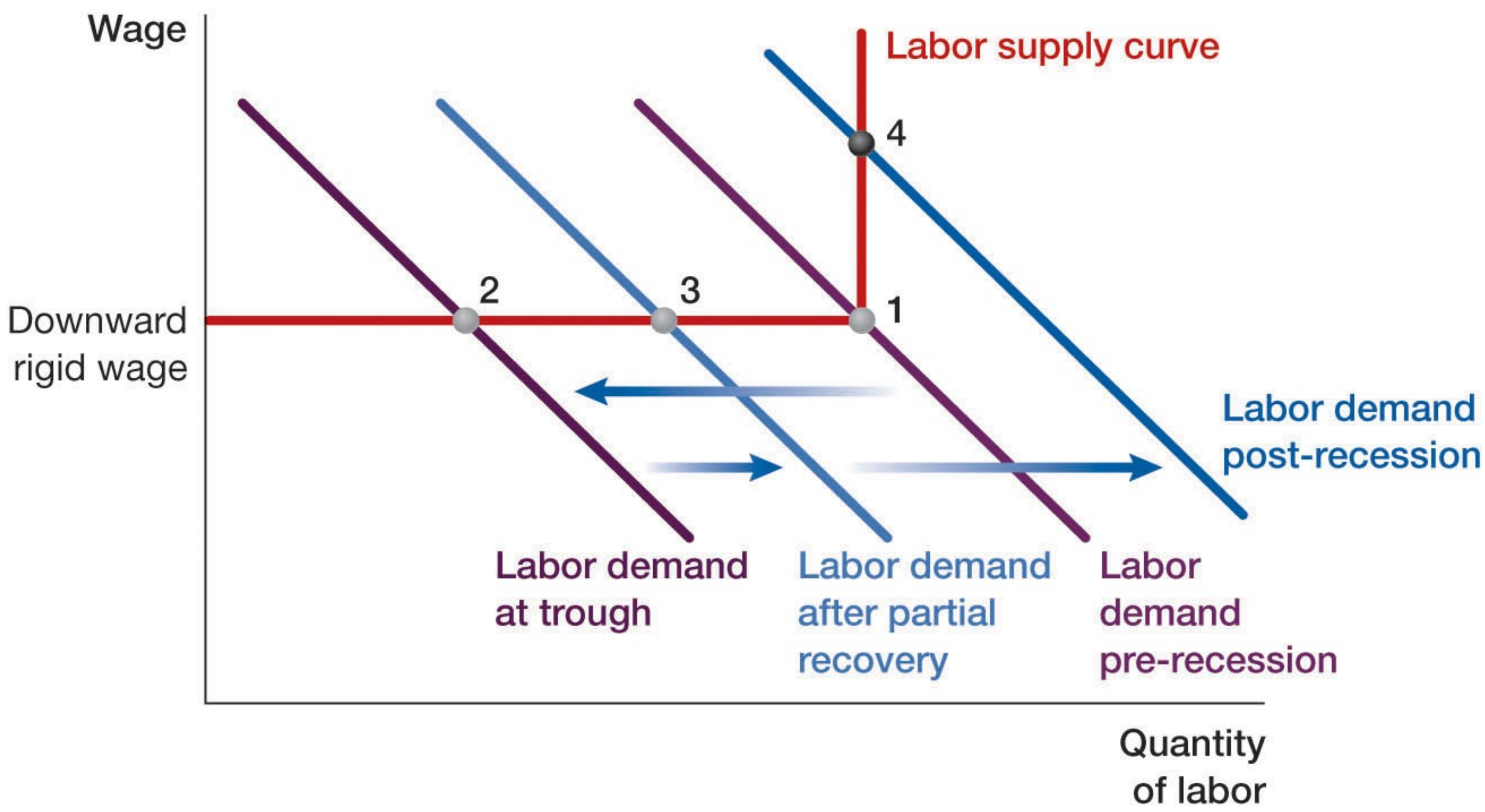
The Effect of Inflation on the Labor-Market Equilibrium



The following diagram puts all these effects together:

1. Pre-recession starting at point 1 to…
2. Recessionary trough at point 2 to…
3. Partial recovery at point 3 to…
4. Full recovery at point 4

Full Recovery



Business cycle

- At point 4, i.e. after going through the cycle of recession and recovery (where expansionary monetary policy played a role), wages is higher.
- Important to note that this is nominal wage – wages actually paid to workers. It is higher because of higher price resulting from inflation.
- Real wages is the nominal wages adjusted for inflation.

Expansion

Expansions

The focus so far has centered on recessions. We now shift to economic expansions.

Suppose that Apple and other technology firms become optimistic about the future demand for their products.

Question: What happens to its demand for labor?

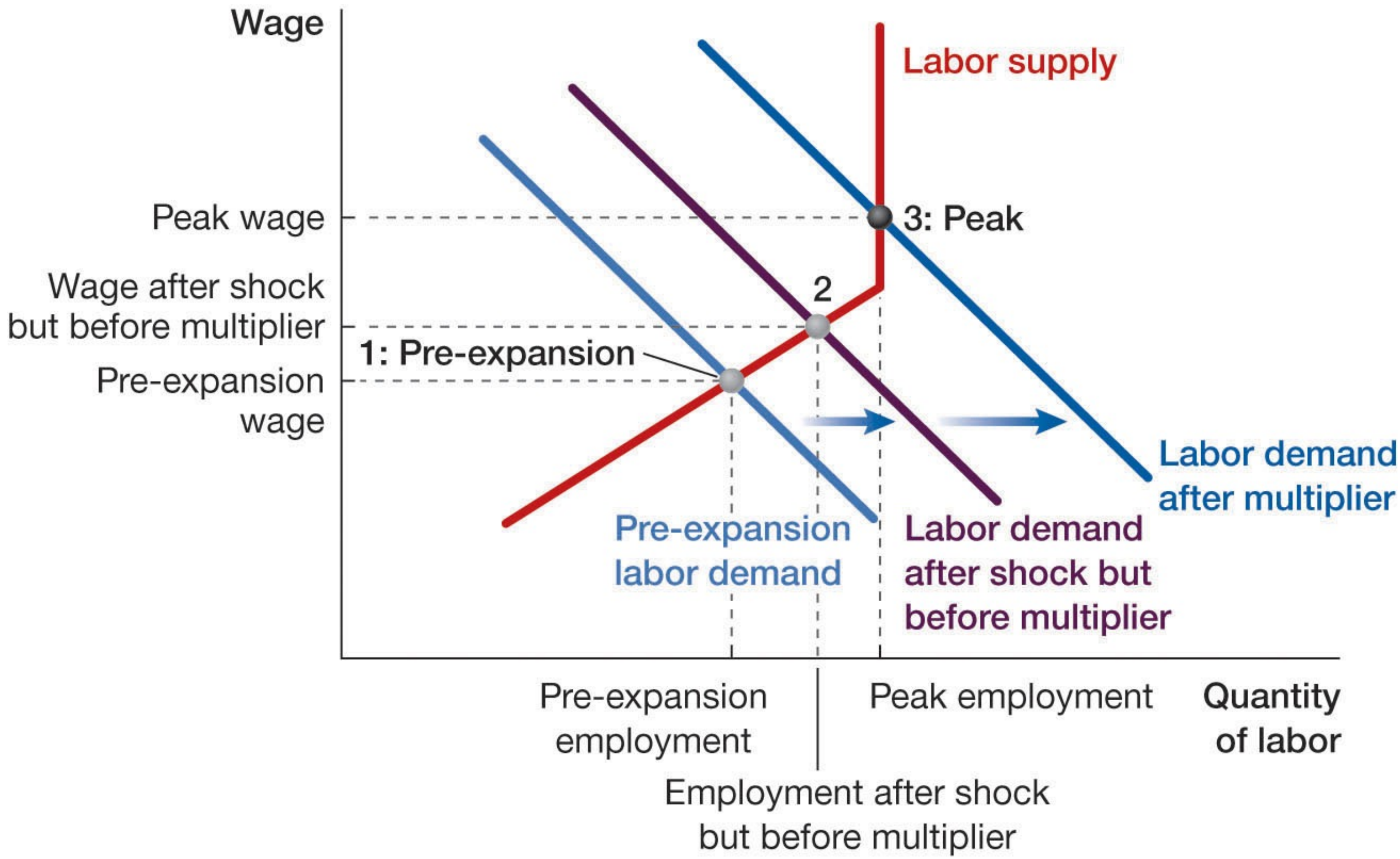
Expansions

In response, firms that supply the technology get higher sales, and consumers start to spend more.

Question: What happens in the labor market?

Modeling Expansions

Rightward Shift in the Labor Demand Curve



Short-Run Fluctuations

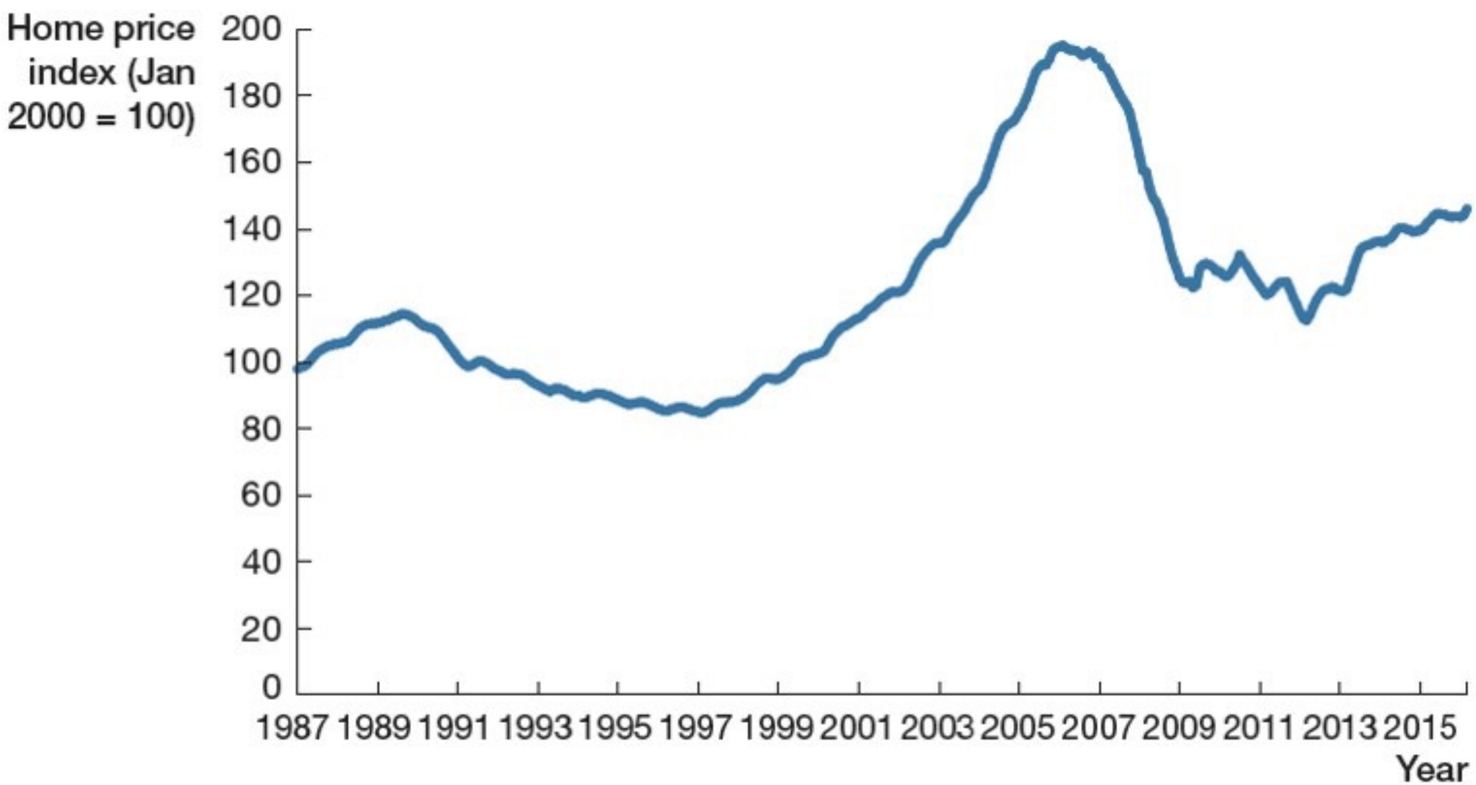
Question: What caused the recession of 2007–2009?

Data: Historical data on housing prices (Case-Shiller home price index), residential investment (NIPA), foreclosure rates (Mortgage Bankers' Association), and bank balance sheets (FDIC and Lehman Brothers).

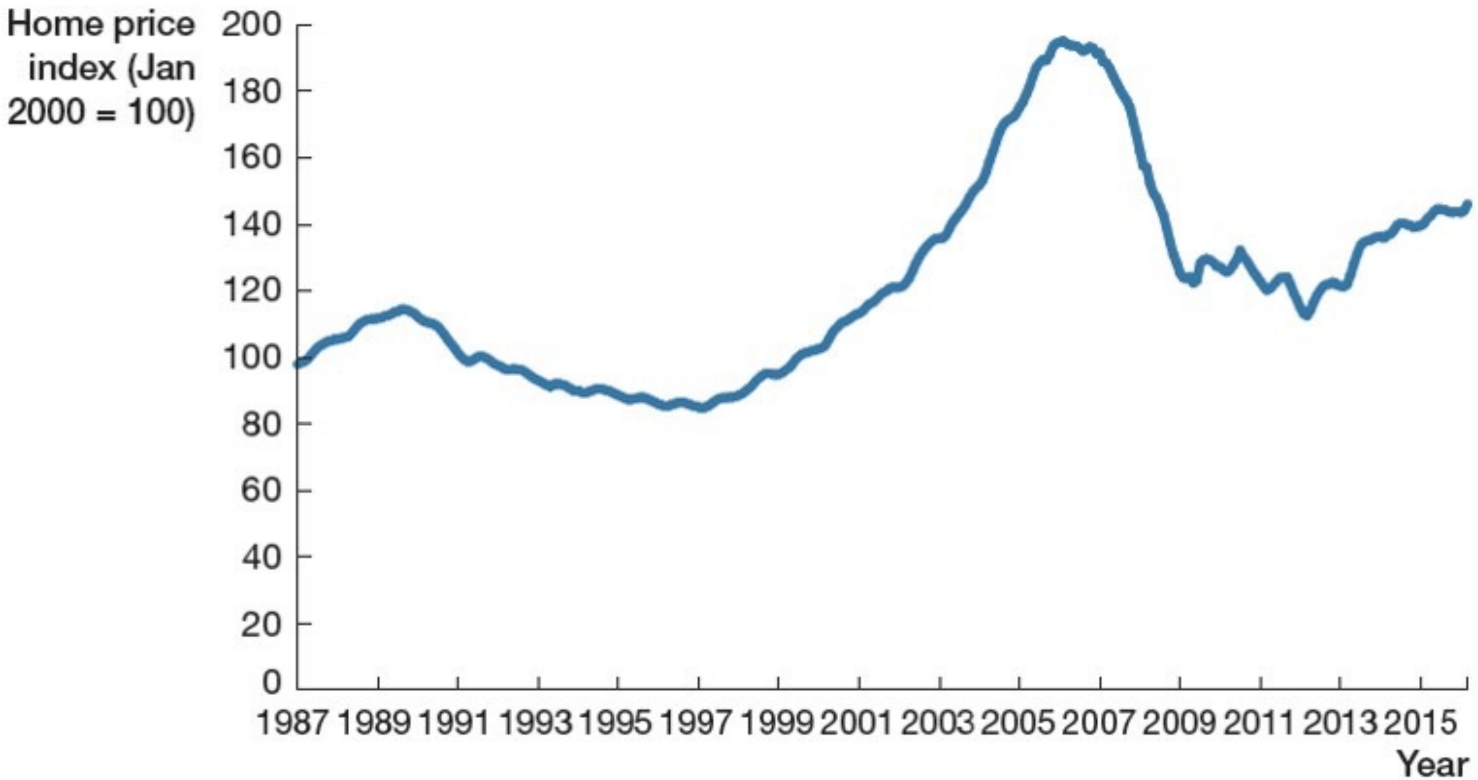
Answer: Three key factors appear to have played central roles in the crisis:

1. A fall in housing prices, which caused a collapse in new construction

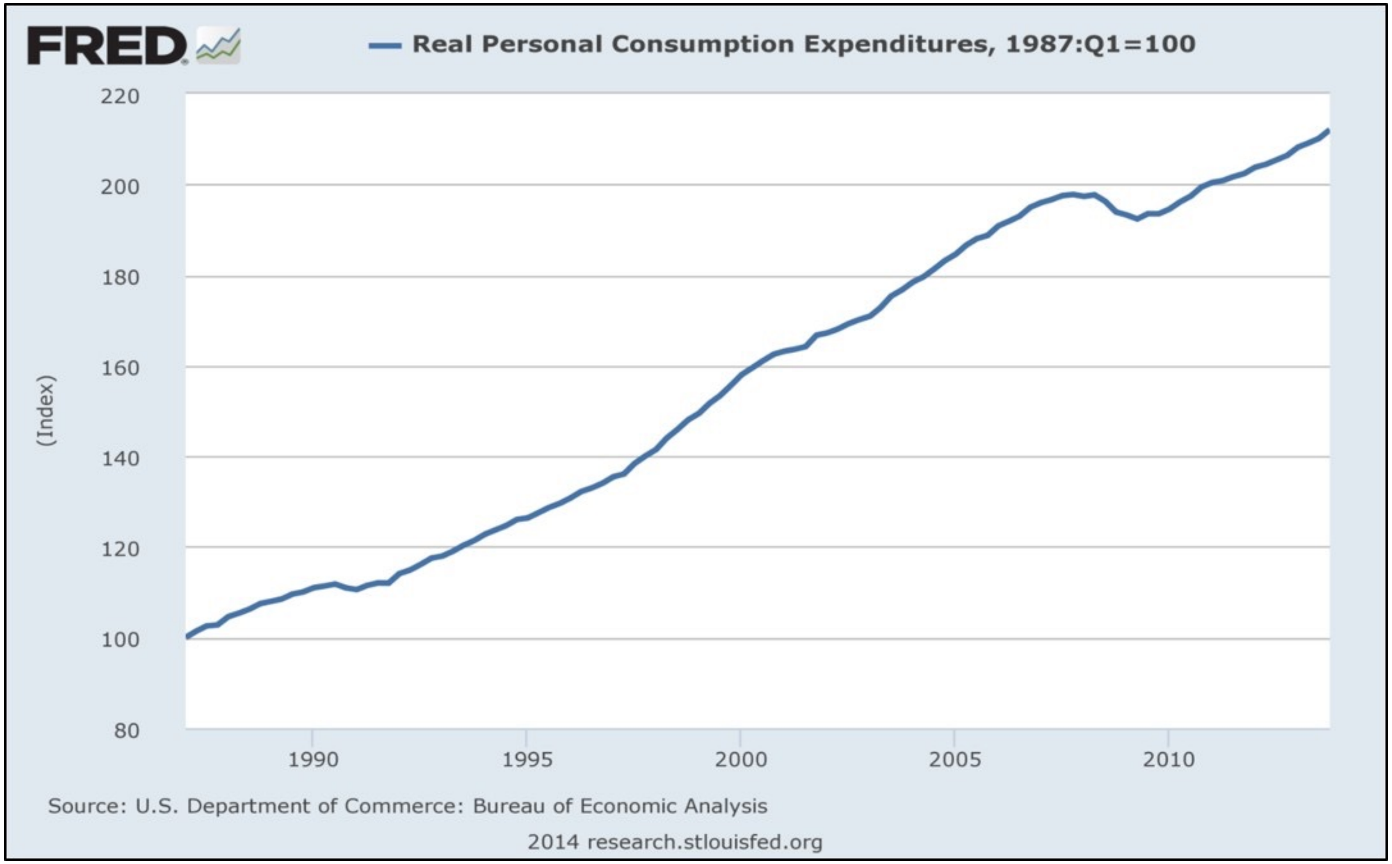
Index of Real Home Prices in Ten Major U.S. Cities (January 1987–March 2016)



Real Investment in Residential Construction (1995:Q1–2016:Q1; normalized to 100 in 2009)

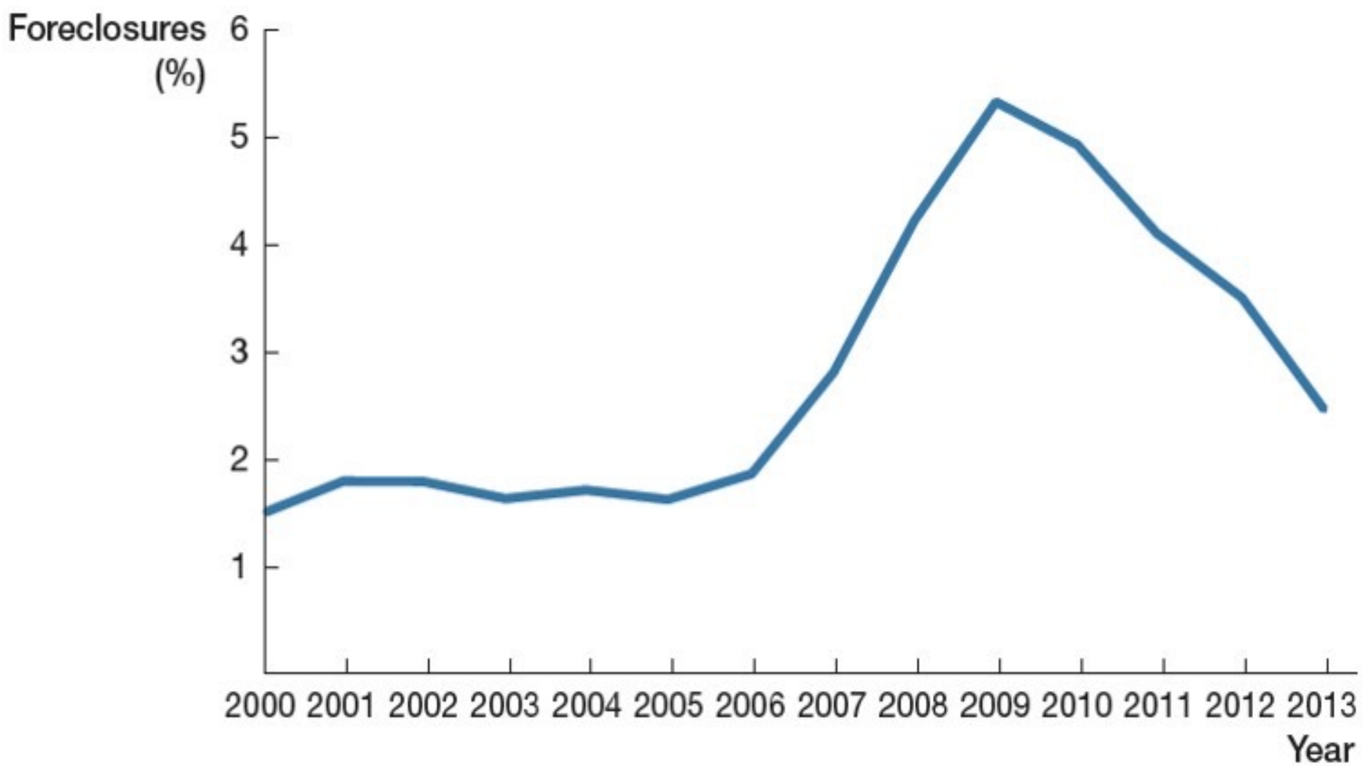


2. A sharp drop in consumption



3. Spiraling mortgage defaults that caused many bank failures, leading the entire financial system to freeze up

Percentage of U.S. Home Mortgages That Began Foreclosure Proceedings (2000–2013)

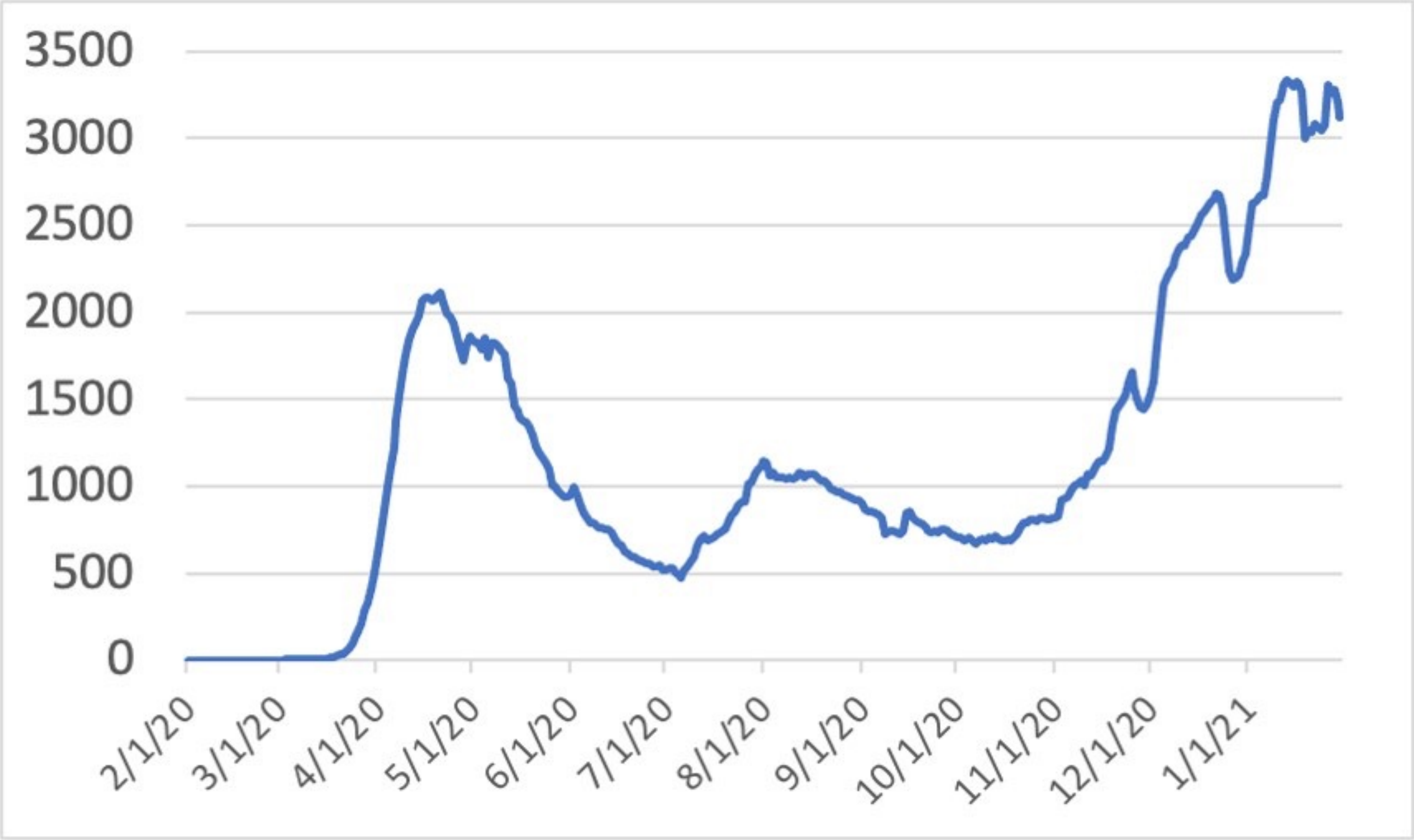


Evidence-Based Economics Example:

Question: What caused the recession of 2020?

Data: Coronavirus deaths (Covid Tracking Project, the Atlantic), unemployment rates (Bureau of Labor Statistics)

Daily Deaths from Covid-19 in the United States (February 2020 through January 2021)



Answer: The recession of 2020 was caused by a sharp leftward shift in labor demand during the first (March-May) wave of the coronavirus pandemic.

Unemployment Rate in the United States from 2007-2020 (monthly)