

Economics AP

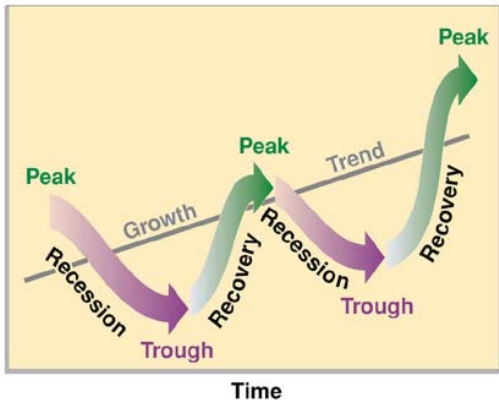
Final Exam Review

Vocabulary and Concepts		
Word	Definition	Covered in Guide
Four factors of production and their costs	Land, Labor, Capital, Entrepreneurship. See below for details.	Unit 1
Land	The natural resources available from nature.	Unit 1
Labor	Human effort used in production which also includes technical and marketing expertise. The payment for labor is a wage.	Unit 1
Capital	Human-made goods which are used in the production of other goods.	Unit 1
Human Capital	The total education and training of workers to increase their productivity and skill.	Unit 1
Physical Capital	The manufactured resources including equipment and natural resources improvements used to aid production.	Unit 1
Entrepreneurship	The factor of production that involves allocating human resources into utilizing other factors of production to make business policies. The entrepreneur takes risk that might lead to more money income.	Unit 1
Trade-offs	Losing one quality or aspect of something in return for gaining another quality or aspect.	Unit 1
Opportunity costs	The cost of something in terms of an opportunity given up and all the benefits that could be received from that opportunity.	Unit 1
Positive economics	The way of analyzing economics through a cause-and-effect relationship and supports it with hard facts. A statement of what is.	Unit 1
Normative economics	The way of analyzing economics through value judgments that predicts what the economy should be like or what actions need to be taken in order to reach a desirable goal.	Unit 1
Absolute advantage	The ability to produce goods or services at a cheaper cost and it is also the ability to produce more with the same amount of resources.	Unit 1
Comparative advantage	The ability to produce goods or services at a lower opportunity cost compared other producers.	Unit 1
Law of demand	An inverse proportion of the amount of demand for a product and the price set on that product. Product price increase then demand decrease and vice-versa.	Unit 1
Normal goods	Goods which rise in demand as income increases.	Unit 1
Inferior goods	Goods which decrease in demand as income increases	Unit 1
Substitutes	Two goods are substitute if you can buy one OR the other. Either will work so if you buy more of one, you buy less of the other. An increase demand in one brings decreased demands in the other.	Unit 1
Complements	Two goods are complements if you buy BOTH at a constant. Buy the same amount of both. An increase demand in one brings increased demands in the other.	Unit 1
What changes demand?	Customer preference / Prices / Complements / Substitutes / Income / Number of potential buyers / Expectations of a price change	Unit 1

Vocabulary and Concepts

Supply	The amount of a good produced given a specific time and production cost.	Unit 1
What changes supply?	Prices of other goods / Number of sellers / Prices of relevant inputs / Technology / Expectations	Unit 1
Price floors	The legal minimum price imposed by the government.	Unit 1
Price ceilings	The legal maximum price imposed by the government.	Unit 1
Shortages	Not enough supply to meet demand.	Unit 1
Surpluses	More supplied than demanded, causing extra to be produced.	Unit 1
Market failures	Occurs when the market fails to allocate resources effectively, preventing the price system from being economically efficient and free. Market failure may be caused by an externality or market power, and is a justification for government regulation of the economy.	Unit 2
Externalities	Impact of one person/firm's action on the well-being of a bystander.	Unit 2
Positive externalities	When a good or service is produced or consumed within private property rights that bestow a benefit on a third party not directly involved in the market transaction	Unit 2
Negative externalities	When a good or service is produced or consumed within private property rights that harms a third party not directly involved in the market transaction	Unit 2
Exclusion principle	The principle that states no one can be excluded from the benefit of public goods.	Unit 2
Free rider principle	When a person receives the benefit of a good but avoids paying for it, assuming others will pay for their portion.	Unit 2
Marginal tax rate	Percentage of additional dollars that must be paid in taxes. Marginal tax rate = change in taxes due/change in taxable income	Unit 2
Proportional taxes	A.k.a. the "flat rate tax." Everyone pays the same proportion of their income for taxes.	Unit 2
Regressive taxes	The marginal tax rate is less than the average tax rate as income rises. Poor = pay more.	Unit 2
Progressive taxes	The marginal tax rate exceeds the average tax rate as income rises. Rich = pay more.	Unit 2
Retained earnings	Earnings that a corporation saves (instead of distributing to stockholders) for investment in other productive activities	Unit 2
Three Economic Questions	1) What and how much will be produced? 2) How will it be produced? 3) For whom will it be produced?	
Unemployment	Total number of adults 16 and older who are both willing and able to work and actively seeking a job.	Unit 2
Frictional unemployment	Applies to people who quit a job to find another, or a recent graduate seeking a first job.	Unit 2
Structure unemployment	Due to displacement by improved technology or diminished demand (fundamental changes in economy's structure). Example: Auto workers being laid off and replaced by more efficient robots	Unit 2
Seasonal unemployment	Due to seasonal pattern of work in specific industries. Applies to people who only work certain times of the year and who KNOW they will lose their job at a certain point. Example: Christmas tree salesmen	Unit 2
Cyclical unemployment	Due to downturn in the business cycle (recession/depression). Example: Auto workers being laid off because of poor car sales	Unit 2
Full unemployment	A.k.a. "natural unemployment rate" and currently about 5%; arbitrary level of unemployment that corresponds to "normal" friction in the labor market. Implies an equilibrium in the ever-shifting labor market.	Unit 2

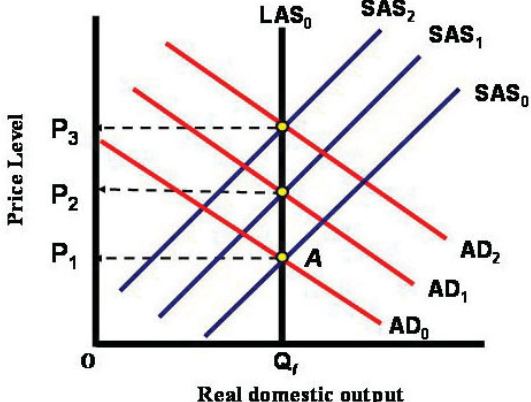
Vocabulary and Concepts

Inflation	Increase of average of all prices of goods/services. Each dollar is worth less overall.	Unit 2
Deflation	Decrease of average of all prices of good/services. Each dollar is worth more overall. Can also apply to individual goods and not necessarily the entire market.	Unit 2
Consumer Price Index (CPI)	Statistical measure of weighted average of prices of a specified set of goods and services purchased by wage earners in urban areas.	Unit 2
Producer Price Index (PPI)	Statistical measure of a weighted average of prices of commodities that firms purchase from other firms (company to company).	Unit 2
Nominal rate of interest	Market rate of interest expressed in today's dollars.	Unit 2
Real rate of interest	Nominal rate of interest minus the anticipated rate of inflation.	Unit 2
Business cycle	Fluctuations in economic activity, such as employment and production. Same as "business fluctuations" 	Unit 2
Expansion	"Spending orgy" where overall business activity is rising at a more rapid rate than previously. Consumption, profit, production, factory orders, and overtime increase. Unemployment and vendor performance decrease.	Unit 2
Peak	Where demand is greater than supply. Prices rise, inflation increases, and people save more	Unit 2
Contraction	Where pace of national economic activity slows down. Consumption, profit, number of orders, and overtime decreases. Unemployment increases.	Unit 2
Trough	The bottom of a contraction; compare with "peak," which is the top of expansion. If a trough is low enough, it can be considered a recession / depression.	Unit 2
Recession	Occurs if the contractionary phase lasts for a long time; period where rate of growth of business activity is consistently less than its long-term trend or negative. Formally defined as when GDP declines for two or more successive quarters.	Unit 2
Depression	An extremely severe or long recession. Unfortunately not "great" in any sense.	Unit 2
National income accounting	A macroeconomic approach to measuring an economy's aggregate performance (GDP, NDP, NI, etc.)	Unit 3
Investment	Any use of today's resources to expand tomorrow's production or consumption.	Unit 3
NNP	Net National Product; total income of a country's residents (GNP) minus losses from depreciation.	Unit 3
GNP (NOT ON PELKEY'S GUIDE, but it's needed to describe NNP)	Gross national product; total income earned by a country's permanent residents. For example, U.S.'s GNP includes money earned by U.S. citizens overseas but NOT money earned by foreigners here. However, GDP and GNP are usually close since most U.S. residents work in the U.S.	Unit 3

Vocabulary and Concepts

NDP (NOT ON PELKEY'S GUIDE)	Net Domestic Product; GDP minus depreciation.	Unit 3
Big long equation for expenditure approach...	GDP - <u>depreciation</u> NDP - <u>indirect business taxes (excise taxes, sales tax, business property taxes)</u> National Income -corporate taxes -retained earnings (undistributed corporate profits) <u>+transfer payments</u> Personal Income <u>-personal income tax</u> Disposable Income	Unit 3
National income	Total income earned by a nation's residents in the production of goods and services.	Unit 3
Personal income	Income households get before they pay personal income taxes.	Unit 3
Disposable personal income	Personal income after personal income taxes have been paid	Unit 3
Depreciation	Wear and tear on the economy's stock of equipment and structures (trucks rusting, etc.); consumption of fixed capital.	Unit 3
Indirect business tax	Sales, excise, and business property taxes.	Unit 3
Transfer payment	Money payments from a government to an individual with no good/service expected in return. Example: welfare, Social Security.	Unit 3
Aggregate demand	Total of all planned expenditures for the entire economy. (See AD/AS Graph)	Unit 3
Aggregate supply	Total of all planned production for the entire economy.	Unit 3
Real balance effect	A.k.a. the "wealth effect"; change in the real value of money balances when price level changes, all other things held constant. When prices levels rise, the real value of total wealth drops, and people as a whole are compelled to spend less on goods and services.	Unit 3
Open economy effect	With a world economy, people have the option to buy products from another country. If domestic price levels rise, they will just buy foreign products as substitutes, thereby reducing net exports (by increasing imports and decreasing exports). Thus, the amount of money being actually spent in the country decreases.	Unit 3
Interest rate effect	When price levels rise, people believe they need to borrow money to compensate. However, more borrowing increases interest rates (and therefore, higher price levels indirectly increase interest rates). Higher interest rates discourage consumption and investment.	Unit 3
Long-run aggregate supply curve (LRAS)	Vertical line that represents total GDP after all adjustments. Also represents the real output of the economy when it is at full employment. Since quantity of output supplied depends on the economy's quantities of labor, capital, natural resources, and technological advances, it does NOT depend on overall price level. Thus, LRAS is vertical at the natural rate of output.	Unit 3

Vocabulary and Concepts

Short-run aggregate supply curve	Relationship between supply and price level. The slope is typically positively sloped.	Unit 3
Demand-pull inflation	Inflation when aggregate demand outpaces aggregate supply, thus shifting off equilibrium.	Unit 3
Cost-push inflation	A.k.a. supply-shock inflation or supply-side inflation; inflation caused by a decreasing SRAS curve. Ex: 1970s oil crisis 	Unit 3
Savings in the classical model	Classical economic theory assumes each dollar saved would be invested by businesses so leakage of saving would equal injection of business investment (additions to the nation's capital stock in this context), or $S=I$. This equilibrium would be in the credit market, where price of credit equals the interest rate.	Unit 4
Marginal propensity to consume (MPC)	Ratio of change in consumption to the change in disposable income. $MPC = \frac{\text{Change in consumption}}{\text{Change in real disposable income}}$	Unit 4
Marginal propensity to save (MPS)	Ratio of the change in savings to the change in disposable income. $MPS = \frac{\text{Change in saving}}{\text{Change in real disposable income}}$ $MPC + MPS = 1$	Unit 4
Fiscal policy	Government's choices regarding overall level of government purchases or taxes. Key to Keynesian economic theory.	Unit 4
Expansionary fiscal policy	Used when there is a recessionary gap (during a recession); the government puts more money in circulation and aggregate demand shifts right. Taxes are cut and/or government spending goes up. Both price and real GDP increase. (See Keynes graph)	Unit 4
Contractionary fiscal policy	Used when there is an inflationary gap; the government takes in more money and aggregate demand shifts left. Taxes go up and/or government spending goes down. Both price and real GDP decrease.	Unit 4
Crowding-out effect	Offset in aggregate demand that results when expansionary fiscal policy raises the interest rate, thereby reducing investment spending.	Unit 4
Ricardian equivalence	An increase in the government budget deficit (a.k.a. tax cuts, deficit spending, etc.) has no effect on aggregate demand. This assumes people consider future government actions beyond this year. This theory was ultimately proved incorrect, since tax cuts create money illusion (belief that a person has more money than he/she actually has; in actuality, money is just inflated) and thereby stimulate consumption	Unit 4

Vocabulary and Concepts

Problems with Keynes theories	Keynesian economic theory does not explain how to fix stagflation (high unemployment and high inflation). It also carries side effects of the crowding-out effect. See Keynesian Fiscal Policy, Assumptions .	Unit 4
National debt	A.k.a. public debt and government debt; money owed by any level of government.	Ch 14
Federal deficit	Occurs when the federal government spends more money than it takes in.	Ch 14
Bond prices and interest rates	Bond prices increase when interest rates are low, and decrease when interest rates are high. Since interest rates are tied to the inflation rate (a high interest rate indicates high inflation), bond prices are a good indication of the inflation rate as well.	Not Covered
Function of money	<ol style="list-style-type: none"> 1) Medium of exchange 2) Unit of accounting 3) Store of value/purchasing power 4) Standard of deferred payment 	Unit 5
Liquidity	Ease with which an asset can be converted into the economy's medium of exchange. Money/cash is the most liquid asset.	Unit 5
M-1	<p>Money supply, taken as the total value of currency plus checkable deposits plus traveler's checks not issued by banks. Stresses the role of money as a medium of exchange (transactions approach).</p> <p>M1 = Money Supply = currency + checkable deposits + traveler's checks</p>	Unit 5
M-2	<p>Liquidity approach; stresses the role of money as a temporary store of value.</p> <p>M2 = Money Supply = M1 + savings and small-denomination time deposits at all depository institutions + overnight repurchase agreements at commercial banks + overnight Eurodollars held by US residents other than banks at Caribbean branches of member banks + balances in retail money market mutual funds + money market deposit accounts (MMDAs)</p>	Unit 5
The Fed	Formally titled the Federal Reserve System. Independent central bank of the United States that oversees the banking system; established under the Wilson administration in 1913. The Fed regulates the quantity of money in the economy.	Unit 5
Functions of the Fed	<ol style="list-style-type: none"> 1) Supplies economy with fiduciary currency. 2) Provides a system for check collection and clearing. 3) Holds depository institutions' reserves. 4) Acts as the government fiscal agent, a.k.a. the government's banker. Also helps the government collect certain tax revenues and helps purchase/sell government securities. 5) Supervises member banks to make sure banks are following government regulations. 6) Acts as the "banker's bank." 7) Regulates money supply. 	Unit 5
Fiduciary currency (NOT ON PELKEY'S GUIDE, but to clarify above)	Equivalent to money because of government law; does not have intrinsic value (ex: currency, check deposits). Compare with commodity money, which does have intrinsic value (ex: gold, silver, books).	Unit 5
Money multiplier	<p>Gives the maximum potential change in money supply due to a change in reserves.</p> <p>Potential money multiplier = 1/ required reserve ratio</p> <p>Actual change in money supply = actual money multiplier x change in excess reserves</p>	Unit 5

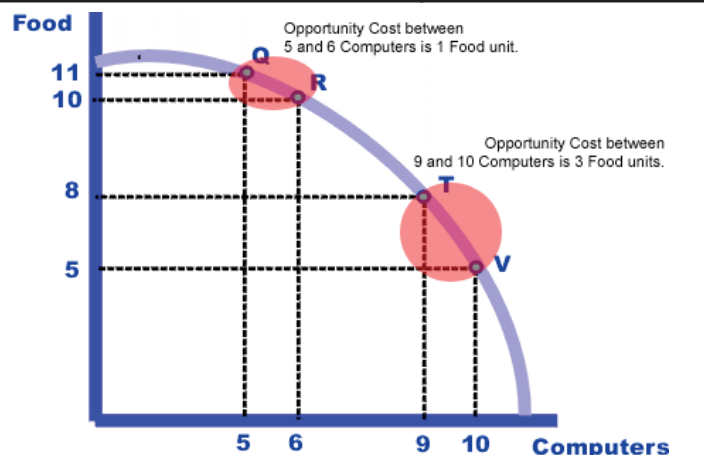
Vocabulary and Concepts

Reserve requirement ratio	Percentage of total deposits in forms of deposits or vault cash that a depository institution must hold with the Fed.	Unit 5
Discount rate	Interest rate on loans that the Fed makes to banks.	Unit 5
Open market operations	Purchase and sale of existing U.S. government securities (ex: bonds) in the private market by the Fed.	Unit 5
Federal funds rate	Interest rate that banks charge one another for short term loans; set by the Fed.	Unit 5
Money supply	Amount of money in circulation. The two ways to defining and measuring money are the transactions approach and liquidity approach.	Unit 5
Transactional demand for money	Holding (using) money as a medium of exchange to make payments. The level varies directly with nominal national income.	Ch 17
Asset demand for money	Holding (using) money as a store of value instead of other assets such as certificates of deposit, corporate bonds, and stocks.	Ch 17
Taylor rule	States that the real short-term interest rate should be determined according to three factors: 1) where actual inflation is relative to the targeted level that the Fed wishes to achieve, 2) how far economic activity is above or below its "full employment" level, and 3) what the level of the short-term interest rate is that would be consistent with full employment. The rule recommends tight monetary policy (a.k.a., a high interest rate) when actual inflation exceeds target inflation, or when the economy is at full employment, and vice versa. The Fed supposedly does not explicitly follow the rule, but the rule does reflect the Fed's monetary policy during the Greenspan era.	Uncovered
Natural rate of unemployment	Normal rate of unemployment around which the unemployment rate fluctuates. Around 5% for the U.S. economy.	Unit 5
Supply side economic theory	Neo-classical economic theory that advocates deregulation and changing tax structure to create incentives and increase productivity. Follows Say's Law that "supply creates its own demand"; also known as "trickle-down economics."	Unit 4
Utility	A measure of relative happiness or satisfaction upon gaining any unit of goods or services.	Unit 1
Marginal utility	The difference in utility between gaining a set number of units and one more than that set of units.	Unit 1
Util	A measure of utility.	Unit 1
Law of diminishing marginal utility	A theory of economics saying that every unit of goods gained after the 1st unit will decrease in marginal utility.	Unit 1
Circular Flow	The general flow of money in a closed economic system.	Unit 3
Comparative Advantage	<p>The theory says that even if one country can produce everything more efficiently than another country, they still should trade because the "comparative advantage" of producing goods is different for each country.</p> <p>In other words, if Country X is more efficient at producing Product A than B, and Country Y is more efficient at producing Product B than A, but Country Y is more efficient than country X at producing both Product A and B, Country X should just produce A and Country Y should produce B even though Country Y is better at both. This way, both Country X and Y can produce A and B and give to each other with maximized GDP increase.</p> <p>(If you can understand that, you have great logic skills. Go do math olympiad :])</p>	Unit 1

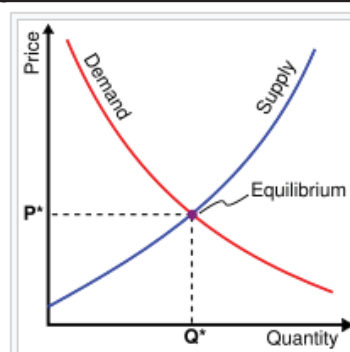
Vocabulary and Concepts

Absolute advantage	When one country can produce goods with more efficiency than another, they have absolute advantage.	Unit 1
Free Trade	Laissez-faire. Trading between countries with no restriction by any government.	Uncovered
Dumping	When another country is selling at an unreasonably low price to "invade" another country and stop their GDP. Government regulations use tariffs and quotas to discourage dumping.	Uncovered
Infant industry argument	Government excuse for putting up tariffs and quotas. Regulations are made to protect these young startup industries.	Uncovered
NAFTA	The North American Free Trade Agreement (NAFTA) is a free trade agreement among Canada, the United States of America, and Mexico.	Uncovered
World Bank	A group of organizations banding together whose purpose is to eliminate world poverty in the name of economic development.	Uncovered
G-8	The Group of Eight (G8) consists of Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States. Together, these countries represent about 65% of the world economy	Uncovered
IMF	The International Monetary Fund (IMF) is an international organization that oversees the global financial system by observing exchange rates and balance of payments, as well as offering financial and technical assistance when requested. Its headquarters are located in Washington, D.C.	Uncovered
Trade deficit	When a county's imports outweigh its exports. Countries with a trade deficit have a negative (X-M) value in their GDP equation. (USA is a prime example)	Uncovered
Foreign exchange rates	How much one currency is worth in relation to another currency.	Uncovered
Gold standard	A monetary system in which all money is backed up by gold.	Uncovered
Market changes in exchange rates	How Consumers and Producers react to changes in foreign exchange rates.	Uncovered
LDC	Least Developed Countries (LDCs or Fourth World countries) are countries which according to the United Nations exhibit the lowest indicators of socioeconomic development, with the lowest Human Development Index ratings of all countries in the world	Uncovered
Property rights	Property designates those real or intellectual goods that are commonly recognized as being the rightful possessions of a person or group.	Uncovered
Tariff	Tax on incoming foreign goods.	Uncovered

PPC (Production Possibility Curve)

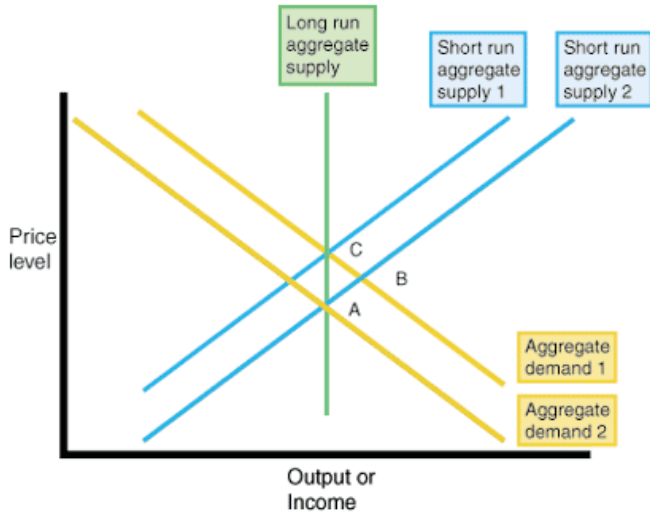


Supply and Demand



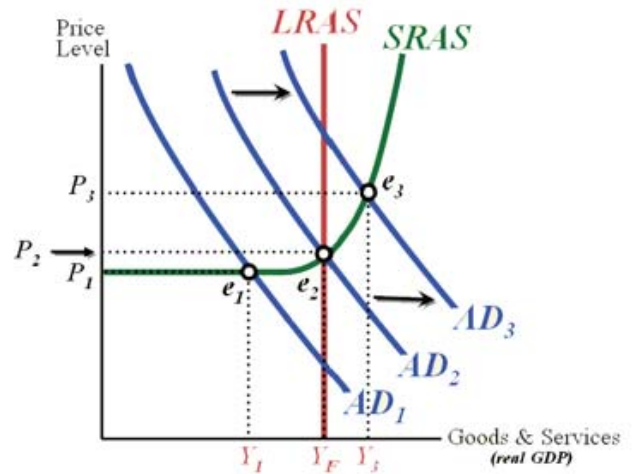
General supply and demand curves, with intersection showing free market equilibrium

AD and AS (Short + Long)



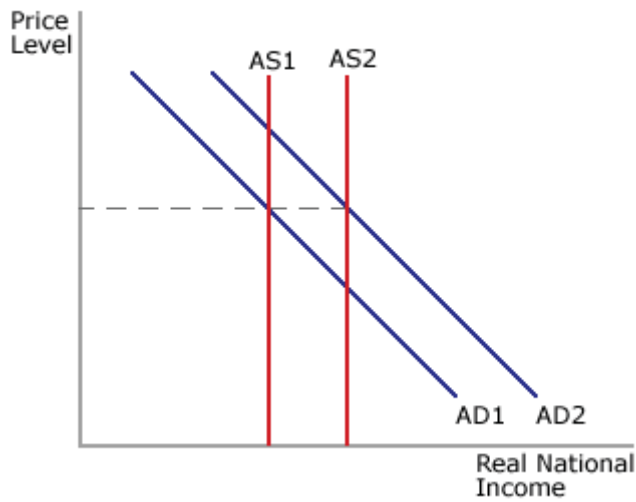
The X axis is also more commonly called the "Real GDP"

Keynesian aggregate supply



Sticky SRAS

Supply side aggregate supply

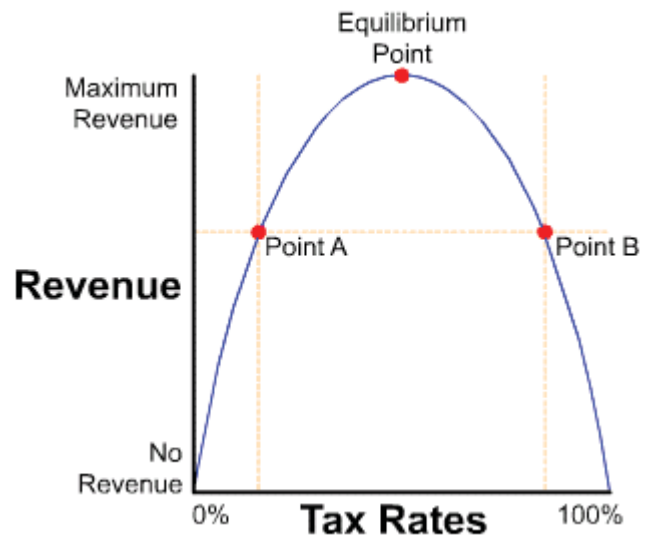


Vertical Aggregate Supply Curve

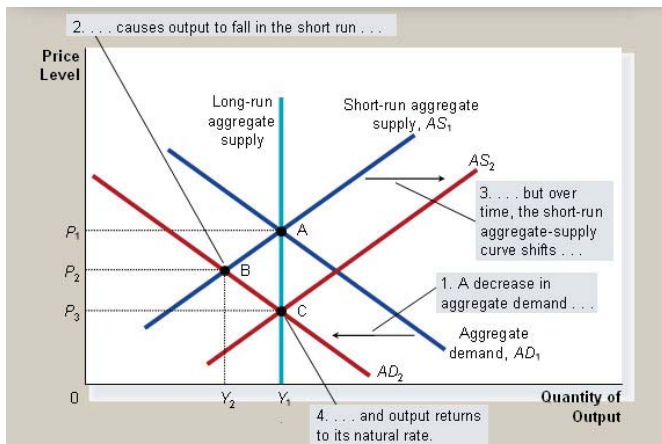
Exchange rates

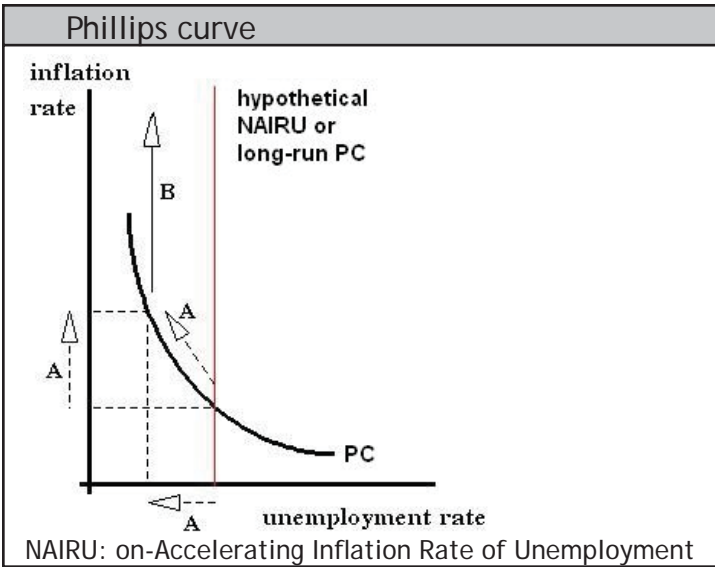
Look on page 764 and 765 in Econ book :(

Laffer Curve



A Contradiction in Aggregate Demand





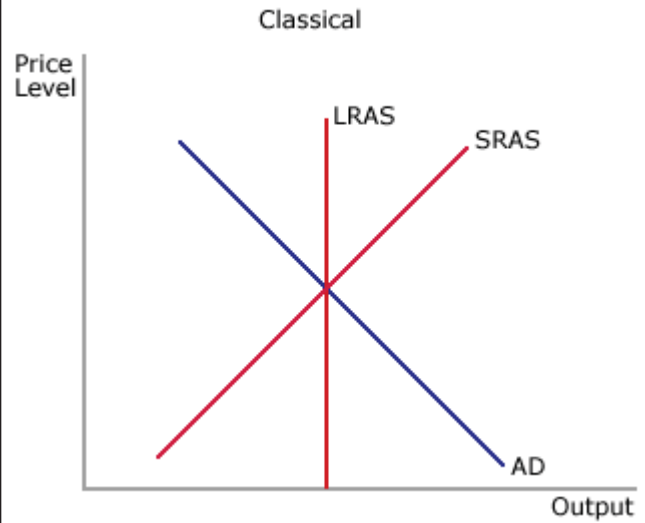
Formulas	
Money multiplier	1/ratio of reserve requirement
$GDP = C + I + G + (X-M)$	Gross Domestic Product = Consumption + Investment + Government + (Export - Import)
Calculating GDP using expenditure method	$GDP = C + I + G + (X-M)$
Calculating GDP using the income method	Using $GDP = R + I + P + SA + W$ R = rents I = interests P = profits SA = statistical adjustments (corporate income taxes, dividends, undistributed corporate profits) W = wages
Laws and Rules	
Say's law	There can be no demand without supply
Gresham's law	Gresham's law says that any circulating currency consisting of both "good" and "bad" money, where both forms are required to be accepted at equal value under legal tender law, quickly becomes dominated by the "bad" money. Bad money being the money that is not worth actual government regulated value.
Law of demand / Law of supply	In general, the theory claims that where goods are traded in a market at a price where consumers demand more goods than firms are prepared to supply, this shortage will tend to increase the price of the goods.
Law of increasing opportunity costs	Producing more of one good will sacrifice more and more of another good.
Calculating CPI	The percentage difference of average prices between one year and another.
GDP deflator	$GDP\ deflator = \frac{Nominal\ GDP}{Real\ GDP}$ GDP Adjusted for inflation

Classical Theory

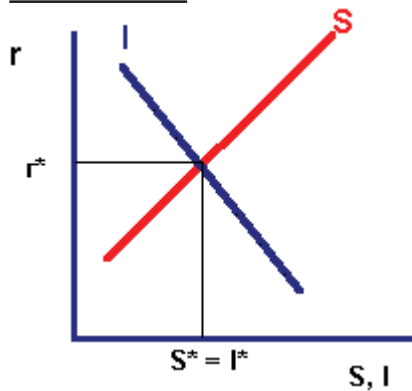
Assumptions:

- Pure competition exists. No single buyer/seller of a commodity or input can affect its price.
- Wages and prices are flexible. Individuals can't set a price, but a community of buyers/sellers can cause price level to rise or fall to equilibrium.
- People are motivated-by self interest.
- People cannot be fooled by money illusion.

Equilibrium:



Interest rates:



The interest rate (percent) is on the y-axis and the amount savings and investment is on the x-axis. As interest rates increase, people save more but businesses invest less.

Phillip's Curve:

See Phillips curve graph.

How classical theorist handles recession and inflation:

Do nothing; will adjust eventually by itself.

Real-business Cycle Theory (Neo-classical)

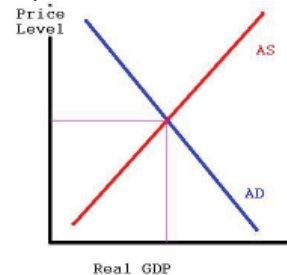
Assumptions:

- Business cycles are driven entirely by technology shocks and not monetary shocks/changes in expectations

Aggregate Supply:

Recessions and depressions are good because it causes unemployed people to retrain and learn new skills and the economy to become more efficient, thereby shifting out LRAS and the PPC in the long-run.

Equilibrium



Other notes:

- Definition: Business cycle is caused by random fluctuations in productivity

Keynesian (Fiscal Policy)

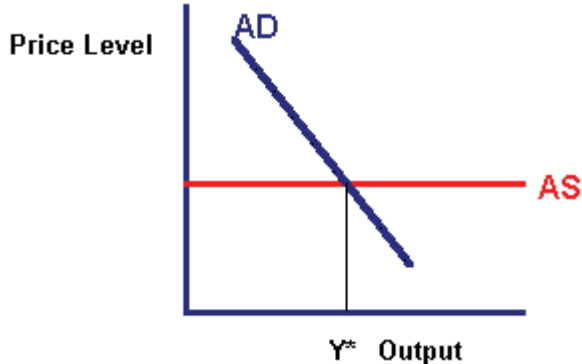
Assumptions:

- Rigid/inflexible prices. Prices are “sticky.”
- Effective demand. Aggregate demand determines output/GDP. Consumption expenditures are based on actual income available, not full employment income or equilibrium income.
- Saving and investment are influenced by factors other than interest rates (disposable income, expectations, etc.). Such factors can offset the equality between investment and savings, or perhaps allow equilibrium ONLY at a negative interest rate.

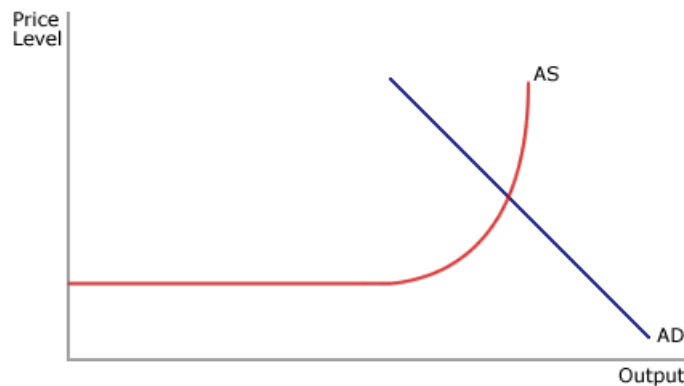
Determination of interest rates:

- A decrease in interest rates causes an increase (upward shift) of the aggregate expenditures line.
- An increase in interest rates causes a decrease (downward shift) of the aggregate expenditures line.
- An increase in interest rates causes a decrease (leftward shift) of AD.
- A decrease in interest rates an increase (rightward shift) of AD.

Keynesian short-run aggregate supply curve



Keynesian



Note the horizontal short-run aggregate supply curve; this is because wages are “sticky downward.”

Keynesian consumption multiplier:

$$\text{Multiplier} = \frac{1}{1-MPC} = \frac{1}{MPS}$$

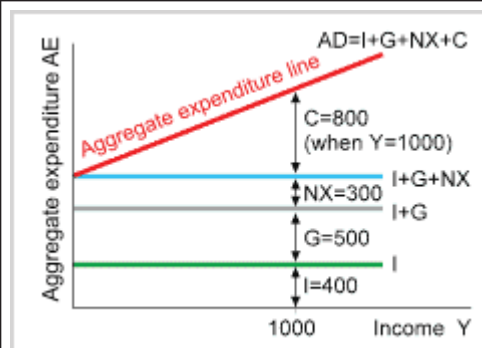
$$\text{Tax multiplier} = \frac{-MPC}{MPS}$$

How Keynes handles a recession or depression:

Keynes says that aggregate demand is practically equivalent to GDP. Therefore, an increase in AD is needed to get out of a recession/depression. AD can be stimulated by expansionary fiscal policy, a.k.a. cutting taxes and/or increasing government spending.

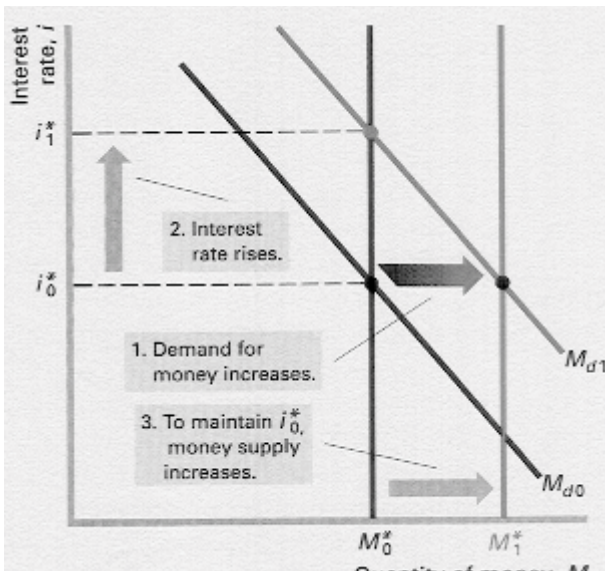
Aggregate expenditure model:

Graphical models that identify Keynesian equilibrium as the intersection of the aggregate expenditures line and the 45-degree line. Differences among the specific models are based on which sectors are included (household, business, government, and foreign) and whether expenditures are induced or autonomous. Aggregate expenditure is the sum of all planned spending on domestically produced goods/services.



Economic Theories

Monetarist Theory

<p>Assumptions:</p> <ul style="list-style-type: none"> • Money supply is the biggest influence on aggregate demand. • Velocity of money is constant. 	<p>Method of control of money supply:</p> <ol style="list-style-type: none"> 1. Open market operations (buying/selling government bonds; this one is primarily used) 2. Discount rate 3. Reserve requirements
<p>Quantity theory of money/equation of exchange:</p> <p>Belief that changes in money supply lead to proportional changes in the price level.</p> $M \cdot V = P \cdot Q$ <p>, where: M=total money supply V=velocity of money P=average price level for the economy during the month Q=total number of items that M purchased during the month</p>	<p>Inflation:</p> <p>Solve with “tight money” policy; contractionary policy, or “brake” where Fed decreases money supply. Fed sells bonds, interest rates go up, and consumption and investment decrease. It is “tighter” for people to get money.</p>
<p>Money supply and money demand:</p> 	<p>Recession:</p> <p>Solve with “easy money” policy; expansionary policy, or the “gas pedal” where Fed increases money supply. Fed buys bonds, interest rates go down and consumption and investment increase. It is “easier” for people to get money.</p> <p>Money Multiplier:</p> $\text{Multiplier} = \frac{1}{\text{Reserve Rate}}$

“Rational Expectations” Model (Neo-classical)

<p>Assumptions:</p> <ul style="list-style-type: none"> • Outcomes that are being forecast do not differ systematically from the market equilibrium results (people do not make systematic errors when predicting the future) 	<p>Ricardian Equivalents (pure/extreme)</p>
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Economic Theories

Supply-side Theory (Neo-classical)

Assumptions:

- Say's law ("supply creates its own demand"). Therefore, supply-side theory encourages production (unlike Keynesian, which emphasizes demand and is "demand-side" theory)

Laffer curve:

See Laffer curve graph.

Inflation/depression:

Solve with deregulation (tax cuts, increasing free trade, etc.) or investment in education/technology/creation of further production incentives. See Laffer curve for support.

Changes in aggregate supply

Primarily affected by increases and decreases in taxes. Creating more incentives to work and save will shift LRAS in the long-run. Examples of incentives include:

- Improved education and training
- Reducing trade union power to increase the flexibility of wage-setting
- Reducing taxes to encourage investment and risk-taking
- Reducing the level of tax to motivate people to work harder
- Removing unnecessary regulations from markets that may hinder efficiency/innovation