ECONOMIC THEORY 7

SOME ASSUMPTIONS UNDERLYING THE INCOME DETERMINATION MODEL

1. The economy produces a single good that can be used both for consumption and for capital accumulation. We refer to such economies as Ricardian "corn" (wheat) economies or as "schmoo" economies. This assumption means that we do not have to worry about relative prices or separate production sectors for consumption and capital goods. The good is infinitely malleable and can be used either for consumption (wheat into flour into bread) or for investment (seed germinates and produces a new crop of wheat next year).

2. The aggregate price level, P, is held constant and set equal to one, i.e. P=1. So in these models there is no distinction between real and nominal magnitudes and firms will **not** raise prices if there is an increase in demand for their output. Alternatively we could think of our economy as producing many goods and services whose relative prices are **fixed** and which are consumed in fixed proportions and so aggregate output can be thought of as a composite commodity.

   The good is a flow commodity measured per unit of time. Be careful to distinguish between the various output, expenditure, and income measures - such as GDP, GDE, and GDI – all of which are flows per unit of time and the various stock magnitudes such as the various measures of the money supply and wealth – all of which can be measured

at any instant of time. In particular be very careful not to use the word money when you mean income.

3. There are no inventories and so production is assumed to be sold immediately that it is produced. We are doing QCS and so the model is **always** in equilibrium and, strictly speaking, we have nothing to say about out of equilibrium situations. The disequilibrium adjustment stories that we told you in Econ 207 are strictly meaningless in the context of QCS models. Inventories *can* be included in macro economic models but they introduce complicated dynamics, which we have neither the time nor the technique to handle here.

4. Order books are held constant and so firms respond to changes in demand by changing output not by delaying or speeding up delivery of their products.

5. Firms react instantaneously to changes in demand by adjusting their outputs. In our macro models in Econ 208 aggregate supply, AS, is a purely passive variable that increases and decreases exactly in line with changes in aggregate demand, AD. The three models we will construct do not attempt to explain the supply side of the economy – there is no labor market and only an implicit production function.

6. All profits are distributed to households as dividends that are, of course, paid in kind. $GDP_{MP} = GDE_{MP} = GDI_{FC.}$

7. There are no financial assets and no monetary sector to worry about. Our models are barter economies in which all transactions take place using the single produced good.

8. The model is short-run and so saving does not appreciably change the stock of real assets held by consumers and investment does not change potential output and there is no change in the size of the labor force.

9. There are enough underutilized resources for firms to be able to expand output whenever AD increases.

10. Initially we will be modeling a closed model although we will open the economy to foreign trade when we put model three together.

11. We will assume that the AD and AS functions are linear, that the vertical intercept of the AD curve lies above the vertical intercept of the AS curve (which is an identity function with zero intercept and a slope of one because AS = GDP_{MP} = GDI_{FC} = Y), and that the slope of the AD curve is less than the slope of the AS curve (=1).

You do **not** have to commit these assumptions to memory.