Our topic for this term will be the interaction between the financial and real wings of an economy during economic recessions, with an emphasis on understanding financial crises like the Great Depression and the recent (1997-98) financial crises in much of East Asia, as well as the current downturn in the U.S.

**Topic Outline:**

I. Money and credit as lubricating trade

We’ll begin by getting an idea of how money and credit work in an economy, starting from the microeconomic level and building up to the macroeconomic. The theme for this first segment will be that money and credit help lubricate the real economy, as pictured below.

```
  money and credit
        |        | real economy
       | lubrices|
```

A. Basics: Money, credit, and trust

B. Velocity (V) and the demand for money

C. The big circle of exchange, and the equation of exchange 
   \( MV = PY \). Theme: The liquidity in the economy depends on both \( M \) and \( V \).

**Readings:**

- Meir Kohn’s *Money, Banking, and Financial Markets*, Chapter 22 (On RESERVE with Ryan)

...PLEASE TURN PAGE
II. The interaction between the real and money wings of an economy during recessions: Mr. Keynes versus the Classics

We’ll use the IS-LM short-run macro model as our basic building block for understanding recessions. The IS curve can be thought of as analyzing the real side of aggregate demand, while the LM curve analyzes the monetary side of aggregate demand. A short-run equilibrium occurs at an IS-LM crossing, that is, when the economy is operating on both its IS curve (so the output market is in equilibrium) and on its LM curve (so the money market is also in equilibrium). If one visualizes an economy as a bird with a “real wing” (analyzed in the IS) and “money wing” (analyzed in the LM), then in any short-run equilibrium the bird’s 2 wings are in balance, but it may be flying high (an expansion with high real output $Y$) or flying low (a recession with low real output $Y$), as pictured below.

![Diagram of IS-LM model showing money wing and real wing](image)

A. Classical economics: Classical Quantity Theory (CQT) asserts velocity $V$ is a constant, hence the LM curve is vertical, and disturbances on the money wing are the only cause of recessions (a monetary theory of business cycles).

B. Mr. Keynes’s revolt against classical economics: According to Mr. Keynes, disturbances on the real wing ⇒ agents’ Liquidity Preference will go up ⇒ $V$ will go down ⇒ real shocks can cause recessions too.

C. Textbook Keynesian explanation why $V \downarrow$ after a real shock: $r\downarrow$ ⇒ opportunity cost of holding money $\downarrow$ ⇒ Short-Term Cash Management (STCM) $\downarrow$ ⇒ $V \downarrow$ ⇒ the LM curve is upward sloping.

D. Criticism of standard textbook explanation: STCM by households and firms may not be very interest sensitive because (a) for households there is not much to gain from STCM. On the other hand, (b) for firms there is a lot to gain, so their short-term cash may already be managed to the hilt—regardless of small changes in $r$. This suggests the LM is almost vertical. So we will have to find some other, more interesting reasons why $V \downarrow$ during recessions, that is, some other ways to escape from classical straitjacket.

Readings:
- IS-LM review using your intermediate macro textbook

...TO BE CONTINUED!