LECTURE ONE - PART TWO

Macroeconomics Defined

- *Macro* means big or large
- Macroeconomics focuses on the big economic picture
  - How the overall national economy performs.
- *Microeconomics* deals with the behavior of individual markets and the businesses, consumers, investors, and workers that make up the economy.

The “Big Four” Macro Issues

- Inflation
- Unemployment
- The Rate of Economic Growth
- Forecasting Movements in the Business Cycle

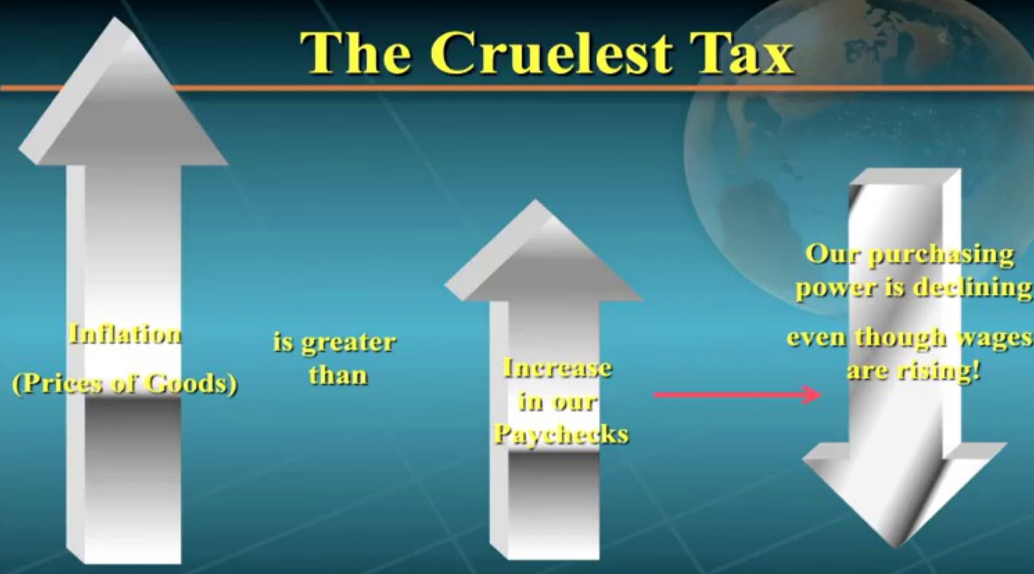
Macro Problem #1: Inflation

- An upward movement of prices from one year to the next.
- Measured by the percentage change in price indices:
  - Consumer Price Index (CPI)
  - Producer Price Index (PPI)
  - GDP deflator

Some Inflation Indices

- Producer Price Index or "PPI"
  - Based on a number of important raw materials.
- Consumer Price Index or "CPI"
  - Calculated by pricing a basket of goods and services purchased by a typical household.
  - Includes prices of items like food, clothing, shelter, fuel, transportation, and college tuition.

The Cruelest Tax



Not Everyone Loses From Inflation

- Unanticipated inflation can actually <u>benefit</u> borrowers at the expense of lenders.
- How can borrowers gain from inflation?

?

An Example

- Suppose you borrow $1,000 from a bank and promise to repay it in two years.
- If the price level doubles because of inflation, the $1,000 which you repay will have only half of the purchasing power of the $1,000 originally borrowed.
- Borrowers can win from inflation! Lenders can lose!

Macro Problem #2: Unemployment

- The unemployment rate:
  - The number of unemployed persons divided by the number of people in the labor force.

Three Kinds of Unemployment

- Frictional
- Cyclical
- Structural

Frictional Unemployment

- The least of the macroeconomist’s worries.
- A natural part of the job-seeking process.
- People quit their jobs just long enough to look for, and find, another one.

Cyclical Unemployment

- A much more serious problem.
- Cyclical unemployment occurs when the economy dips into a recession.
- Macroeconomists spend most of their time trying to solve cyclical unemployment.
- A third type of unemployment, structural unemployment, poses major challenges, too.

Structural Unemployment

- Occurs when a change in technology makes someone's job or job skills obsolete.
  - An auto worker replaced by a robot.
  - A telephone operator replaced by a computerized voice synthesizer.
- Structural unemployment is VERY hard to cure!

Macro Problem #3: The Rate of Economic Growth

- Measured by growth in the Gross Domestic Product or "GDP."
- GDP defined as the market value of all the *final* goods and services produced in a country in a given year.
- Economists have two ways of measuring GDP
  - "Flow-of-cost" or "income" approach.
  - "Flow of product" or "expenditures" approach.

Flow of Product Approach AKA
Flow of Expenditures Approach

Consumption by households
plus
Investment expenditures by businesses
plus
Government purchases
plus
Net exports = Exports - Imports

=GDP=

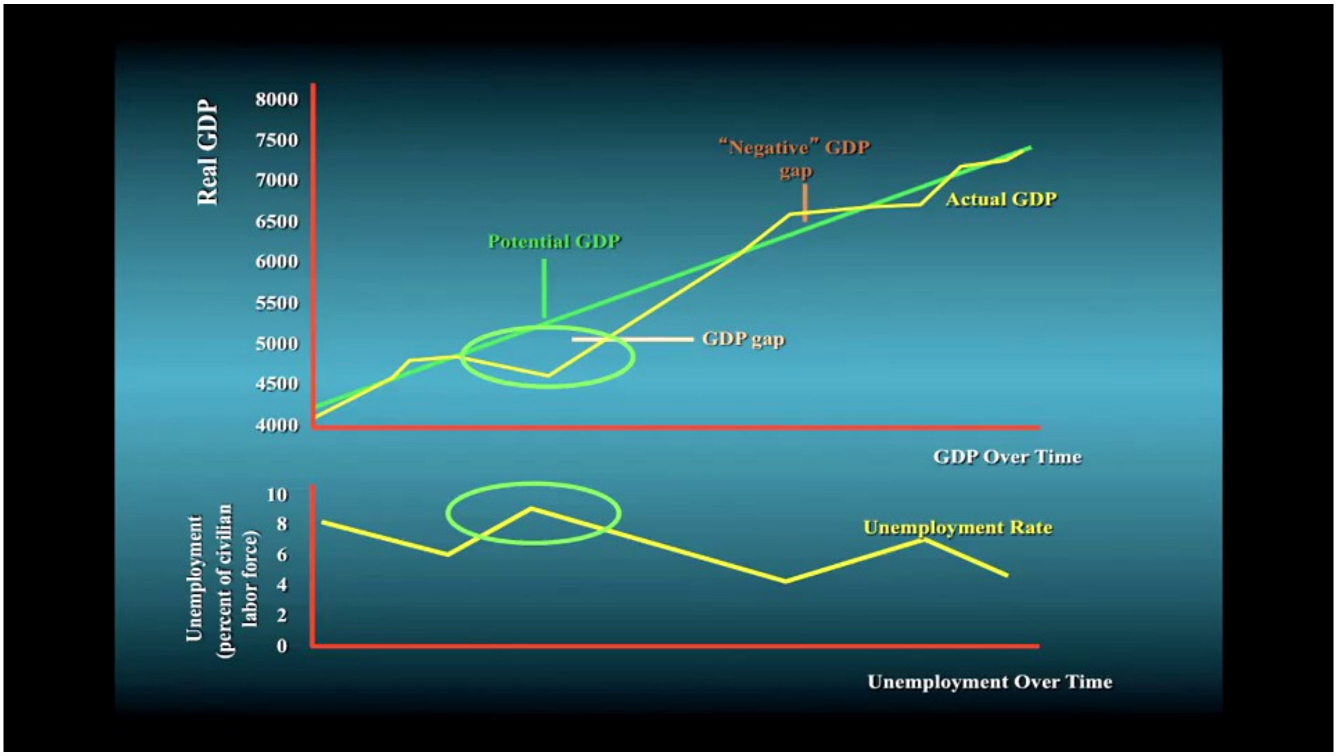
Flow of Cost Approach AKA
Flow of Income Approach

All income people earn in a year

Wages for workers
plus
Rents for property owners
plus
Interest for lenders
plus
Profits for firms

Actual vs. Potential GDP

- Actual GDP*:* What we produce.
- Potential GDP: Maximum economy can produce without causing inflation.
- When actual GDP is *less* than potential GDP, we are in the recessionary range of the economy.
- When actual GDP is *above* potential GDP, we run the risk of inflation.



Nominal vs. Real GDP

- Nominal GDP: Measured in market prices.
- Real GDP: Nominal GDP adjusted for inflation.
- GDP Deflator = Nominal GDP/Real GDP
- GDP Deflator: Another valuable inflation index besides CPI and PPI.

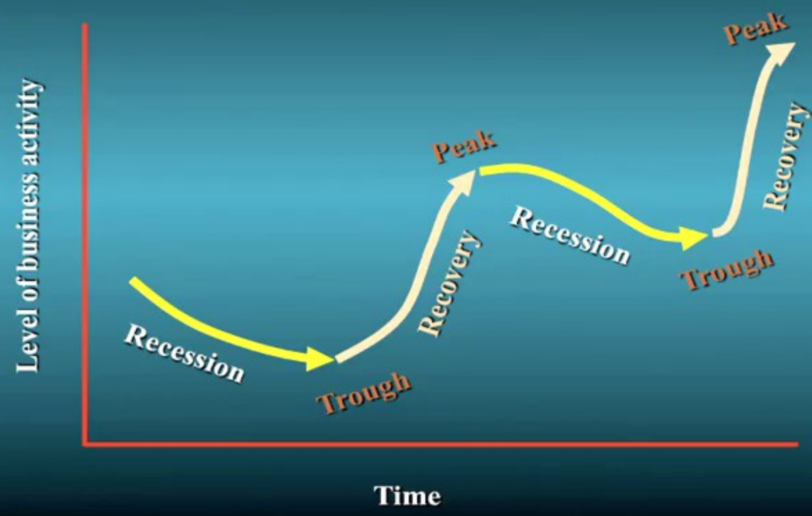
Output Growth

- GDP: Best measure of the level and growth of output in the economy.
- Real GDP: Following its movements gives us the best pulse on our economy

Macro Problem #4: Business Cycles & Economic Growth

- The term business cycle refers to the recurrent ups and downs in real GDP over several years.
- Forecasting the business cycle is an important part of successfully managing an organization or investment portfolio.

Phases of the Business Cycle



Forecasting for Public Policy

- What forces are behind movements in the business cycle?

Central Point: Both macroeconomists & our political leaders want to know what macroeconomic policies may be used to harness the expansionary ups and recessionary downs of the business cycle.

Forecasting for Business

- Business executives want to know if the economy is going to expand or go into recession.
- Forecasting business cycle movements allows executives to plan things like production and inventory levels.
  - If a business bets on an economic expansion and increases production but then gets a recession, it could fail!
- That's why businesses use forecasters – to lower their business cycle risk!