

Macroeconomics - Week 1

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What is Economics

Macroeconomics is the study the economics of the aggregate, including monetary & fiscal policy, national output, exchange rates, rates of employment and inflation, etc. These are Issues of first order importance, having real economic effects on people and governments. Understanding the modern world requires an understanding of macroeconomics.

Modern economics goes back to “General Theory of Employment, Interest and Money” written by John Maynard Keynes in 1936. This was during the Great Depression and sought to provide a new toolset to understand and analyze the macro economy.

Economics is the science and art of decision making. In general, the needs and wants of a society are *infinite*, yet the resources required to fulfill these wants and needs are *finite*. This requires a certain allocation of resources to best meet society’s needs. Economists study how these choices are made and the effects of these choices, as well as whether these choices will require public policy in order to improve the outcomes.

The Market Mechanism

societies have used different mechanisms to allocate their resources.

Command economies (Russia) are where the government planning agencies made decisions as to where scarce resources will be put. Market economies allow for a decentralized approach, one where the price system is used for resource allocation decision making. Consumers and producers try to optimize their interests, by reacting to the demand and supply produced by the other, reaching an *equilibrium*. This is called the *magic of markets*. This is a highly efficient way of dealing with the allocation of scarce resources.

Micro vs Macro

Most economists see themselves as working in one of the two disciplines, though the precise definition of each are a little fuzzy.

Microeconomic analysis emphasizes individual units of the markets and the decisions each player makes in response to the market.

Example micro questions:

- * With a limited budget, how should members of an individual household organize spending across goods and services to make best use of limited resources?
- * Given market conditions, how does a firm choose how much to produce?
- * Will prices coordinate household spending and firms production in a way that best allocates society's limited resources across competing uses?

Macroeconomics shifts the focus to the larger aggregate.

Example Macro questions:

- * What factors determine how much output a nation produces?
- * Why do recessions occur?
- * Why do different economies have different rates of inflation?
- * What roles do monetary and fiscal policy play in managing the economy?

Fundamental Welfare Theorems

There are two fundamental welfare theorems. These place the study of macroeconomics in context.

The first fundamental theorem states that under ideal conditions, decentralized decision making conducted through the mechanism of the market will lead to an optimal allocation of resources. Optimal outcome is a situation where there exists no possible reallocation of resources which will make any one person better off without harming at least one other person. This outcome is often known as Pareto optimality.

The second states that there exists a market determined outcome that will support any Pareto efficient allocation.

These are important intellectual foundations in the economists view that undermine the view that market based allocations produce highly desirable outcomes.

A great deal of ME deals with market based economies that do not allocate resources at an optimal level, where the theorems break down. There is not complete consensus amongst scholars. There are many additional models which seek to attribute these departures.

Some analysis attempts to view "new-classical economics" or "real business cycle theory".

Keynes saw much of macroeconomic outcomes being a result of market failure. The traditional theory was only a special case of the actual world. The key

is careful management of the economy, recognizing there are limits of what governments can achieve.

Macroeconomic Themes

Indicators and Performance

What indicators of performance are there?

1. Gross Domestic Product - a measure of goods and services produced in an economy over a specified time period

Looking at GDP data, there is a long term trend upward. Much exciting research has been recently done in this area known as “growth economics”. There is also occasional interruptions in the long run growth, known as recessions. These interruptions are addressed in business cycle theory and by Keynesian theory.

2. Rate of inflation - a measure of how much the economy is changing Looking at GDP data, there is a long term trend upward. Much exciting research has been recently done in this area known as “growth economics”. There is also occasional interruptions in the long run growth, known as recessions. These interruptions are addressed in business cycle theory and by Keynesian theory.

There is a correlation between an economies GDP and its rate of inflation

3. Rate of unemployment - increases rapidly during recessions. Human cost to the business cycle. Avoiding recessions, is something governments can do to avoid the large scale human loss during economic recessions, as the human cost to unemployment can be huge.

Models

Models provide a key way to provide testable hypotheses which can be applied to real world data to give us an insight as to the validity of a model. models can simplify abstract concepts and allow us to

Public Policy

A central tenant of economics is that markets under ideal conditions allocate resources efficiently. Where the markets dont allocate efficiently, there is a place for policy to adjust the market such as an optimal allocation is achieved.

Central banks are responsible for the monetary policy of an economy.

Types of Policy:

- Monetary Policy: The setting or influencing of financial variables by a nation's central bank to manage aggregate demand in the short to medium term
- Fiscal Policy: The setting of government budgetary variables - expenditure, taxation and public debt

The aims of macroeconomic policy:

- Rising living standards
- Avoiding extremes of macroeconomic performance
- Maintaining the real value of currency
- Ensuring sustainable levels of public and private debt
- Balancing current expenditure against the need to provide resources for the future
- Providing employment for all individuals seeking work

Links

<http://databank.worldbank.org/data/home.aspx>