Chapter 6(21): Macroeconomics - The Big Picture

Key Learning Objectives

- Understand the difference between **macroeconomics and microeconomics**.
- Learn about **business cycles** and why policymakers try to reduce their severity.
- Analyze how **long-run economic growth** affects a country's standard of living.
- Examine **inflation and deflation**, and why price stability is preferred.
- Understand **international macroeconomics** and how economies interact through **trade deficits and surpluses**.

The Nature of Macroeconomics

- **Macroeconomics** studies the **economy as a whole**, focusing on aggregate outcomes like total employment, inflation, and national income.
- **Microeconomics** focuses on **individual decision-making** by firms and consumers.
- Macroeconomic outcomes are **not simply the sum of microeconomic decisions**.

Key Differences Between Micro and Macro Questions

- **Micro:** "Should I go to business school?" → **Macro:** "How many people are employed?"
- **Micro:** "What salary does Google offer to an MBA?" → **Macro:** "What determines overall wage levels?"
- **Micro:** "Should Citibank open a new office?" → **Macro:** "What determines global trade balances?"

Macroeconomics: The Whole is Greater Than the Sum of Its Parts

- **Paradox of Thrift:** If individuals **cut spending** to save money, **overall demand falls**, leading to economic downturns.
- Individual behaviors **don't always translate** into beneficial macroeconomic outcomes.

Macroeconomic Theory and Policy

- **Pre-1930s Economic Thought:** The economy was believed to be **self-regulating**, requiring **minimal government intervention**.
- **Post-1930s (Keynesian Economics):** Economic downturns result from **inadequate spending**, and government policies (monetary & fiscal) can stabilize the economy.

Macroeconomic Policy Tools

1. **Monetary Policy**: Uses **money supply** adjustments to influence **interest rates and spending**.
2. **Fiscal Policy**: Uses **government spending and taxation** to influence **overall demand**.

Historical Comparison

- **Great Depression (1930s):** Governments **let the economy self-correct**, worsening the slump.
- **Great Recession (2008):** Governments **cut interest rates, increased spending, and reduced taxes** to stabilize the economy.

The Business Cycle

- **Business Cycle:** Alternates between **recessions (downturns)** and **expansions (recoveries)**.
- **Recession:** Period when **output and employment decline**.
- **Expansion:** Period when **output and employment rise**.
- **Business Cycle Peak:** Highest point before a **recession**.
- **Business Cycle Trough:** Lowest point before an **expansion**.

Effects of Recessions

- **Job losses**, lower incomes, reduced corporate profits, and increased bankruptcies.
- Policymakers aim to **minimize recession frequency and severity**.

Smoothing the Business Cycle

- Since the **Great Depression**, economists **(Keynes, Friedman)** have recommended **policy interventions** to stabilize the economy.

Long-Run Economic Growth

- **Sustained upward trend** in an economy's output over time.
- **Increases the standard of living** by expanding access to goods and services.
- **Historical Perspective:**
  - Economic growth is a **modern phenomenon** (e.g., Britain in 1650 had similar wealth levels as two centuries earlier).
  - Growth rates **vary across countries** (e.g., the U.S. overtook Britain in economic wealth after 1875).

Inflation and Deflation

- **Inflation:** A **rise** in the overall price level.
- **Deflation:** A **fall** in the overall price level.

Causes of Inflation and Deflation

- Inflation **rises during booms** and **falls during downturns**.
- In the **long run**, inflation is primarily driven by **money supply changes**.

Economic Effects

- **Inflation:** Reduces **cash value**, discourages saving, and can lead to **hyperinflation**.
- **Deflation:** Increases **cash value**, discourages spending/investment, and can **deepen recessions**.
- **Price Stability** is preferred to avoid these extremes.

International Macroeconomics and Trade Balances

- The U.S. is an **open economy**, meaning it **trades goods and services** with other nations.
- **Trade Deficit: Imports exceed exports**.
- **Trade Surplus: Exports exceed imports**.

Determinants of Trade Balances

- **Countries with high investment spending relative to savings** run **trade deficits**.
- **Countries with low investment spending relative to savings** run **trade surpluses**.

Practice Questions

1. **If a country's imports are $1.2 billion and exports are $1.3 billion, what is it running?**
   Answer: Trade surplus.
2. **What policy uses taxes and government spending to influence the economy?**
   Answer: Fiscal policy.
3. **If the economy is booming, what happens to inflation?**
   Answer: It rises.