Introduction to Economics

Overview of Macroeconomics

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Microeconomics vs. Macroeconomics

- Microeconomics
  - Decisions of individual units
    - No matter how large
    - Example: Large Firm pricing policy
- Macroeconomics
  - Behavior of entire economies
    - No matter how small
    - Example: inflation in Monaco
  - Economic aggregates: aggregate output, inflation, unemployment, …

Two central themes

- The short-term fluctuations in output, employment, financial conditions, and prices that we call the *business cycle*
- The longer-term trends in output and living standards known as *economic growth*.

Roots of Macro economics

- Before the publication of Keynes "General Theory of Employment, Interest and Money", the distinction between Micro & Macro economic issues did not arise at all.
- The need for separate study of macro economics was felt by Keynes while understanding and analyzing the Great Depression of 1929.
- The Great Depression was a period of severe economic contraction and high unemployment that began in 1929 and continued throughout the 1930s.

Roots of Macro economics

- The accepted economic theory of the pre – Keynesian era, believed that the economy usually remains at full employment level(full utilization of resources). If there are any departures from this situation, these are purely temporary and for a short period of time.
- However, these classical models failed to explain the prolonged existence of high unemployment during the Great Depression. This provided the impetus for the development of macroeconomics.

Roots of Macro economics

- In 1936, John Maynard Keynes published The General Theory of Employment, Interest, and Money.
- Keynes believed governments could intervene in the economy and affect the level of output and employment.
- During periods of low private demand, the government can stimulate aggregate demand to lift the economy out of recession.

Importance of Macroeconomics

- ***Why do output and employment sometimes fall, and how can unemployment be reduced?***

- Macroeconomics studies the sources of persistent unemployment and high inflation. Having considered the symptoms, macroeconomists suggest possible remedies, such as using monetary policy to alter interest rates and credit conditions or using fiscal instruments such as taxes and spending.

Importance of Macroeconomics

- ***What are the sources of price inflation, and how can it be kept under control?***

- Macroeconomics can suggest the proper role of monetary and fiscal policies, of exchange rate systems, and of an independent central bank in containing inflation.

Importance of Macroeconomics

- ***How can a nation increase its rate of economic growth?***

- Nations want to know the ingredients in a successful growth recipe. Economic historians have found that the key factors in long-term economic growth include reliance on well-regulated private markets for most economic activity, stable macroeconomic policy, high rates of saving and investment, openness to international trade, and accountable and noncorrupt governing institutions.

Objectives

Output:
High level and rapid growth of output

Employment:
High level of employment with low involuntary unemployment

Stable prices

Instruments

Monetary policy:
Buying and selling bonds, regulating financial institutions

Fiscal policy:
Government expenditures
Taxation

- Output - **GDP** is the measure of the market value of all final goods and services produced in a country during a year.

  Nominal GDP is measured in actual market prices.

  Real GDP is calculated in constant or invariant prices.

- Despite the short-term fluctuations seen in business cycles, advanced economies generally exhibit a steady long-term growth in real GDP and an improvement in living standards; this process is known as ***economic growth*** .
- **Potential GDP** represents the maximum sustainable level of output that the economy can produce.

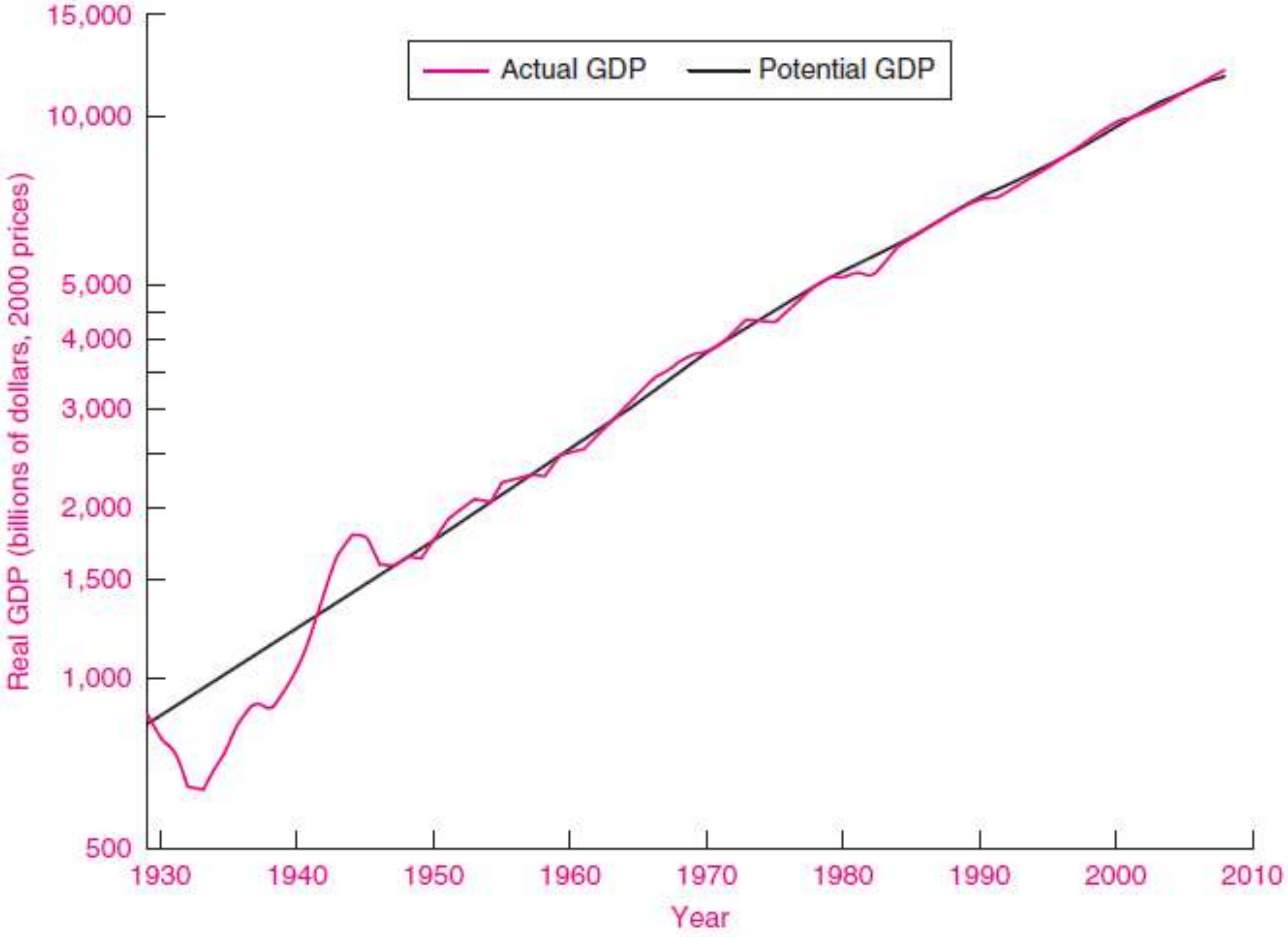

FIGURE 19-2. Actual and Potential GDP in the United States

- ***High Employment, Low Unemployment.*** Of all the macroeconomic indicators, employment and unemployment are most directly felt by individuals.
- In macroeconomic terms, these are the objectives of *high employment*, which is the counterpart of *low unemployment* .
- The labor force includes all employed persons and those unemployed individuals who are seeking jobs. It excludes those without work who are not looking for jobs.

- ***Price Stability.*** The third macroeconomic objective is *price stability*. This is defined as a low and stable inflation rate.
- **Price indexes - consumer price index** (CPI), which measures the trend in the average price of goods and services bought by consumers.
- The **inflation rate** is the percentage change in the overall level of prices from one year to the next.

The Tools of Macroeconomic Policy

- Put yourself in the shoes of the chief economist advising the government.

- *Unemployment is rising and GDP is falling.*
- *Actual situation of your country.*

- Your advice???

Fiscal Policy

- Fiscal policy consists of government expenditure and taxation. Government expenditure influences the relative size of collective spending and private consumption. Taxation subtracts from incomes, reduces private spending, and affects private saving.
- In addition, it affects investment and potential output. Fiscal policy is primarily used to affect long-term economic growth through its impact on national saving and investment; it is also used to stimulate spending in deep or sharp recessions.

Monetary Policy

- Monetary policy, conducted by the central bank, determines short-run interest rates. It thereby affects credit conditions, including asset prices such as stock and bond prices and exchange rates.
- Changes in interest rates, along with other financial conditions, affect spending in sectors such as business investment, housing, and foreign trade.
- Monetary policy has an important effect on both actual GDP and potential GDP.

Aggregate Supply And Demand

- **Aggregate supply** refers to the total quantity of goods and services that the nation's businesses willingly produce and sell in a given period. (AS)
- **Aggregate demand,** which refers to the total amount that different sectors in the economy willingly spend in a given period. Aggregate demand (often written *AD*) equals total spending on goods and services.
- The components of aggregate demand include *consumption*; *investment*; *government purchases*; and *net exports*.
- $AD = C+I+G+NX$
- $NX = Ex - Im$

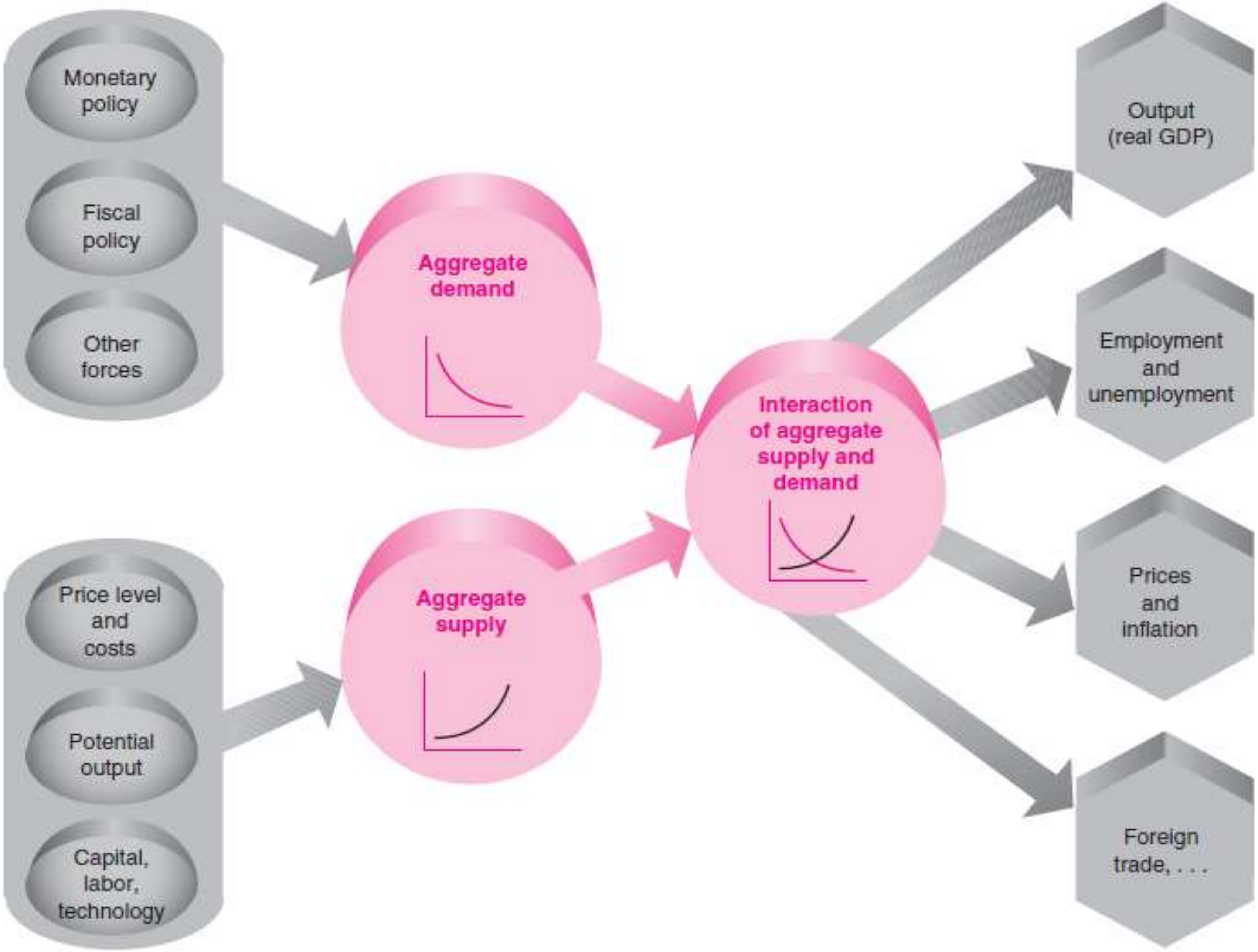

FIGURE 19-5. Aggregate Supply and Demand Determine the Major Macroeconomic Variables

Macroeconomic Equilibrium.

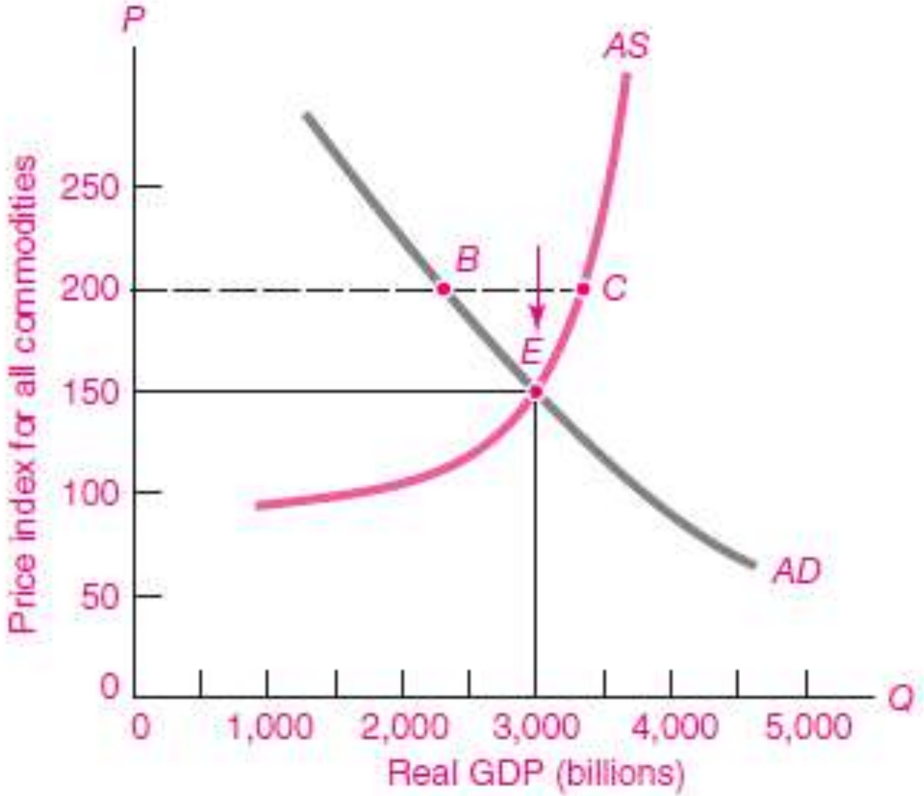

FIGURE 19-6. Aggregate Price and Output Are Determined by the Interaction of Aggregate Supply and Demand

- A **macroeconomic equilibrium** is a combination of overall price and quantity at which all buyers and sellers are satisfied with their overall purchases, sales, and prices.

Exercise

- In 1981–1983, the Reagan administration implemented a fiscal policy that reduced taxes and increased government spending.

a. Explain why this policy would tend to increase aggregate demand. Show the impact on output and prices assuming only an *AD* shift.