CHAPTER 6 LECTURE - MACROECONOMICS: THE BIG PICTURE

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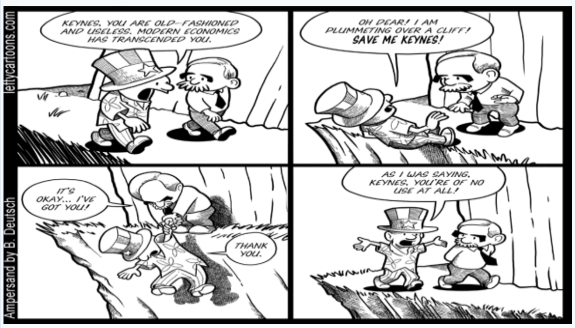

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WHAT YOU WILL LEARN IN THIS CHAPTER

- What makes macroeconomics different from microeconomics
- What a business cycle is and why policy makers seek to diminish the severity of business cycles
- How long-run economic growth determines a country's standard of living
- The meaning of inflation and deflation and why price stability is preferred
- The importance of open economy macroeconomics and how economies interact through trade deficits and trade surpluses

2

2

Macroeconomics versus Microeconomics

Microeconomic Questions	Macroeconomic Questions
Should I go to business school or take a job right now?	How many people are employed in the economy as a whole this year?
What determines the salary Google offers to Cherie Camajo, a new MBA?	What determines the overall salary levels paid to workers in a given year?
What determines the cost to a university or college of offering a new course?	What determines the overall level of prices in the economy as a whole?
What government policies should be adopted to make it easier for low-income students to attend college?	What government policies should be adopted to promote employment and growth in the economy as a whole?
What determines whether Citibank opens a new office in Shanghai?	What determines the overall trade in goods, services, and financial assets between the United States and the rest of the world?

3

3

Macroeconomics versus Microeconomics

- **Macroeconomics** examines the *aggregate* behavior of the economy (that is, how the actions of all the individuals and firms in the economy interact to produce a particular level of economic performance as a whole).
  - Example: Overall level of prices in the economy (how high or how low they are relative to prices last year) rather than the price of a particular good or service.

4

4

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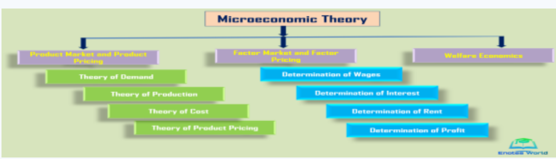
Macroeconomics versus Microeconomics

- **Microeconomics** focuses on how decisions are made by individuals and firms and the consequences of those decisions.
  - Example: How much it would cost for a university or college to offer a new course – the cost of the instructor's salary, the classroom facilities, the class materials, and so on.
  - Having determined the cost, the school can then decide whether to offer the course by weighing the costs and benefits.



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Macroeconomics versus Microeconomics

- In macroeconomics, the behavior of the whole macroeconomy is, indeed, *greater than the sum* of individual actions and market outcomes.
  - Example: ***Paradox of thrift****:* when families and businesses are worried about the possibility of economic hard times, they prepare by cutting their spending.
  - This reduction in spending depresses the economy as consumers spend less and businesses react by laying off workers.
  - As a result, families and businesses may end up worse off than if they hadn't tried to act responsibly by cutting their spending.

6

6

Macroeconomics: Theory and Policy

- In a **self-regulating economy,** problems such as unemployment are resolved without government intervention, through the working of the invisible hand.
- According to **Keynesian economics,** economic slumps are caused by inadequate spending and they can be mitigated by government intervention.
- **Monetary policy** uses changes in the quantity of money to alter interest rates and affect overall spending.
- **Fiscal policy** uses changes in government spending and taxes to affect overall spending.

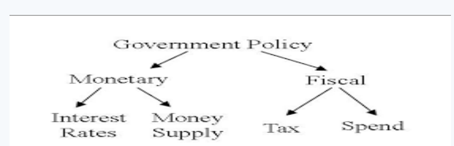
7

7

What Macroeconomics Is About

Macroeconomic Policy

- Fiscal policy: government spending and taxation
  - Effects of changes in federal budget
  - U.S. experience in Fig. 1.6
  - Relation to trade deficit?
- Monetary policy: growth of money supply; determined by central bank; the Fed in U.S.



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MACROECONOMICS

- "The long run is a misleading guide to current affairs. **In the long run we are all dead**. Economists set themselves too easy, too useless a task if in tempestuous seasons they can only tell us that when the storm is past the ocean is flat again."
- -John Maynard Keynes, *A Tract on Monetary Reform* (1923) Ch. 3

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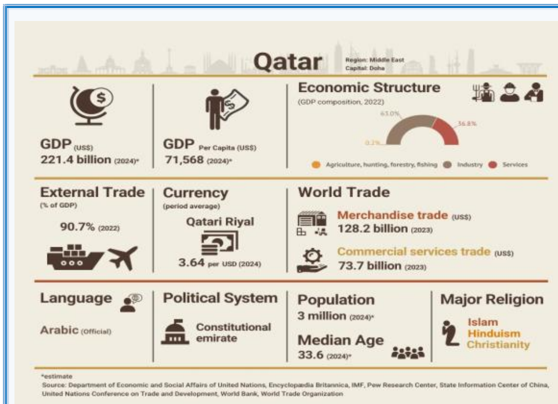

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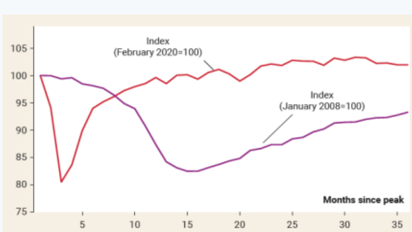
COMPARING TWO SEVERE ECONOMIC SLUMPS



- 2008 Financial Crisis: policy makers criticized for inadequate policy response.
- 2020 Coronavirus Pandemic: policy response was huge with the U.S. government aiding families and businesses.

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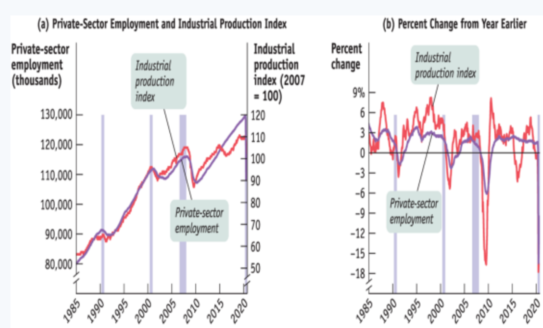
Growth, Interrupted, 1985–2020



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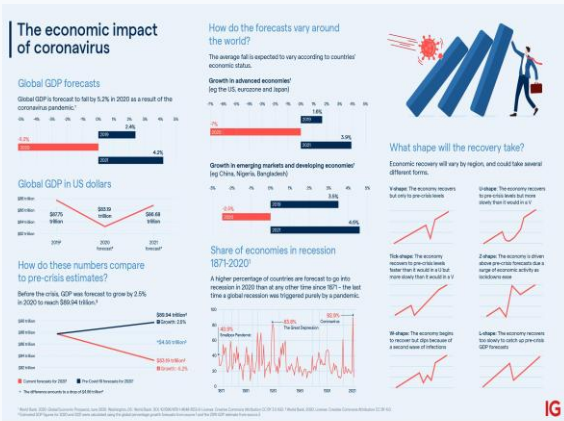
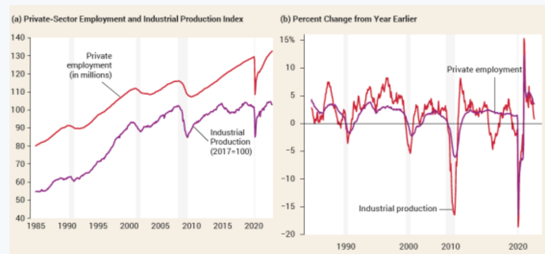


13

THE BUSINESS CYCLE



- Major economic indicators show a strong upward trend.
- But they didn't rise steadily. There were downturns in the early 1990s, the early 2000s, 2007, and 2020.

14

14

The Business Cycle

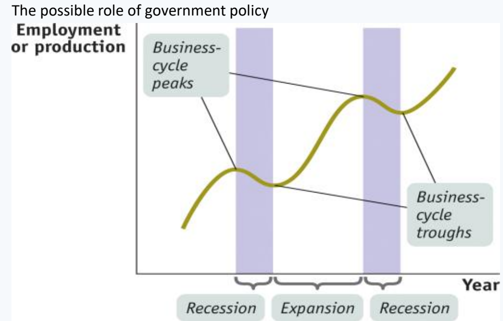
- The **business cycle** is the short-run alternation between economic downturns and economic upturns.
- A **depression** is a very deep and prolonged downturn.
- **Recessions** are periods of economic downturns when output and employment are falling.
- **Expansions**, sometimes called *recoveries*, are periods of economic upturns when output and employment are rising.
- The point at which the economy turns from expansion to recession is a **business-cycle peak**.
- The point at which the economy turns from recession to expansion is a **business-cycle trough**.

15

15

The Business Cycle

- What happens during a business cycle, and what can be done about it?
- The effects of recessions and expansions on unemployment
- The effects on aggregate output
- The possible role of government policy



16

16

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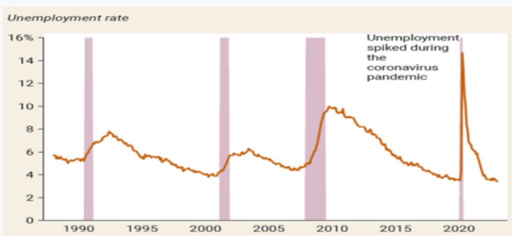
The Business Cycle

- What happens during a business cycle, and what can be done about it?
  - The effects of recessions and expansions on unemployment
  - The effects on aggregate output
  - The possible role of government policy



17

17

Taming the Business Cycle

- The business cycle is a main concern of modern policy makers: they try to smooth out the business cycle. They haven't been completely successful.
- Policy efforts undertaken to reduce the severity of recessions are called **stabilization policies**.
- One type of stabilization policy is **monetary policy**: changes in the quantity of money or the interest rate.
- The second type of stabilization policy is **fiscal policy**: changes in tax policy or government spending, or both.

18

18

LEARN BY DOING: PRACTICE QUESTION 1

- The use of taxes and government spending to change the overall level of spending in an economy is called:
  a) monetary policy.
  b) fiscal policy.
  c) either monetary or fiscal policy, depending on what is happening to the interest rate.

19

19

LEARN BY DOING: PRACTICE QUESTION 1 (Answer)

- The use of taxes and government spending to change the overall level of spending in an economy is called:
  a) monetary policy.
  b) fiscal policy. (correct answer)
  c) either monetary or fiscal policy, depending on what is happening to the interest rate.

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20

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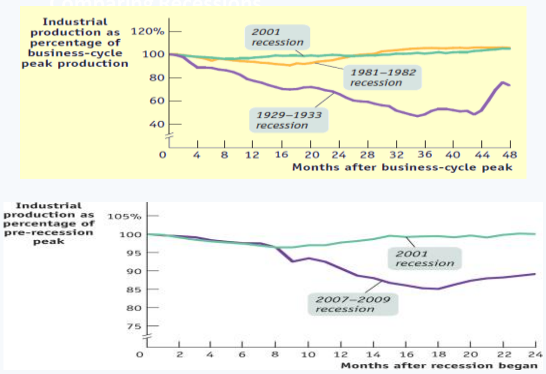
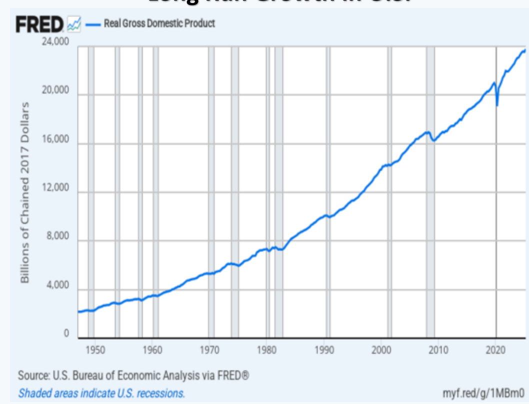
Comparing Recessions



21

21

Long Run Growth in U.S.



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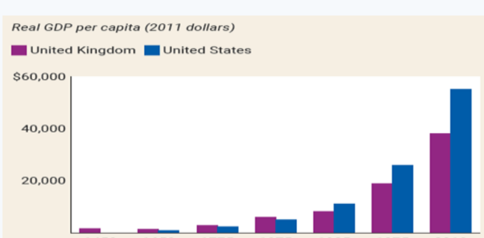
22

Long-Run Economic Growth

- **Long-run economic growth** is the sustained upward trend in the economy's output over time.
  A country can achieve a permanent increase in the standard of living of its citizens only through long-run growth.
  A central concern of macroeconomics is what determines long-run economic growth.



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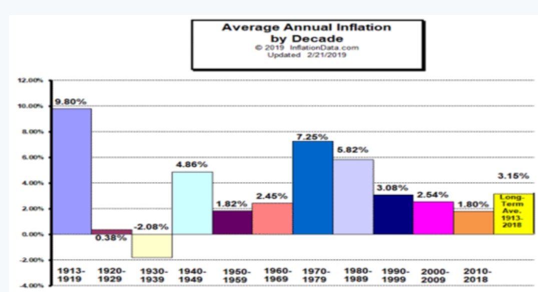
23

Inflation and Deflation

- A rising aggregate price level is **inflation**.
- A falling aggregate price level is **deflation**.
- The **inflation rate** is the annual percent change in the aggregate price level.
- The economy has **price stability** when the aggregate price level is changing only slowly.



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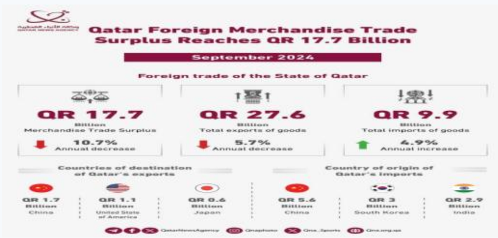
24

International Imbalances

- An **open economy** is an economy that trades goods and services with other countries.
- A country runs a **trade deficit** when the value of goods and services bought from foreigners is more than the value of goods and services it sells to them.
- It runs a **trade surplus** when the value of goods and services bought from foreigners is less than the value of the goods and services it sells to them.



25

25

LEARN BY DOING: PRACTICE QUESTION 2

- This year the value of a country's imports is equal to $1.2 billion, and the value of its exports is equal to $1.3 billion. This country is running a:
  a) trade surplus.
  b) trade deficit.

26

26

LEARN BY DOING: PRACTICE QUESTION 2 (Answer)

- This year the value of a country's imports is equal to $1.2 billion, and the value of its exports is equal to $1.3 billion. This country is running a:
  a) trade surplus. (correct answer)
  b) trade deficit.

27

27

Why Macroeconomists Disagree

- Classicals vs. Keynesians
  - The classical approach
    - ✓The economy works well on its own
    - ✓The "invisible hand": the idea that if there are free markets and individuals conduct their economic affairs in their own best interests, the overall economy will work well
    - ✓Wages and prices adjust rapidly to get to equilibrium
      - – Equilibrium: a situation in which the quantities demanded and supplied are equal
      - – Changes in wages and prices are signals that coordinate people's actions
    - ✓Result: Government should have only a limited role in the economy

28

28

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Why Macroeconomists Disagree

- Classicals vs. Keynesians
  - The Keynesian approach
    - ✓The Great Depression: Classical theory failed because high unemployment was persistent
    - ✓Keynes: Persistent unemployment occurs because wages and prices adjust slowly, so markets remain out of equilibrium for long periods
    - ✓Conclusion: Government should intervene to restore full employment
  - The evolution of the classical-Keynesian debate
    - ✓Keynesians dominated from WWII to 1970
    - ✓Stagflation led to a classical comeback in the 1970s
    - ✓Last 30 years: excellent research with both approaches

29

29

	Keynesian view	Monetarist view
Fiscal policy	In recession, expansionary fiscal policy can stimulate economic activity	Fiscal policy causes no long-term increase in real output
Wage rigidity	Wages can be sticky downwards causing unemployment	In absence of min wages/ trade unions wages flexible.
Unemployment	Demand-deficient unemployment big causes	Tend to emphasis supply-side unemployment (natural rate)
Phillips Curve	There is a trade off between unemployment and inflation	Only a trade-off in the short-term.
Government borrowing	In recession, governments should borrow more to offset fall in private spending	Government should seek to run balanced budget
Crowding out	No crowding out in recession	Government borrowing causes more crowding out

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30

30

Major Economic Problems

Rank the **importance** to them of the following economic issues:
(1) Unemployment
(2) inflation
(3) economic growth
(4) stagnant incomes
(5) the trade deficit
(6) Social Security
(7) the government budget
(8) income inequality.

What are some other issues?

31

31

"Snap out of it, Hornblatt. You knew economics was a dismal science when you took this job!"

32

32