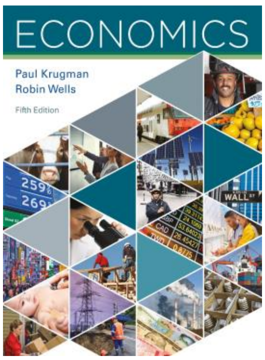
CHAPTER 6 LECTURE - MACROECONOMICS: THE BIG PICTURE

macmillan learning



6(21)

MACROECONOMICS: THE BIG PICTURE

- Revised by Solina Lindahl

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

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

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.
- **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

CHAPTER 6 LECTURE - MACROECONOMICS: THE BIG PICTURE

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.

5

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.

6

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

7

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**.

8

Growth, Interrupted, 1985–2017

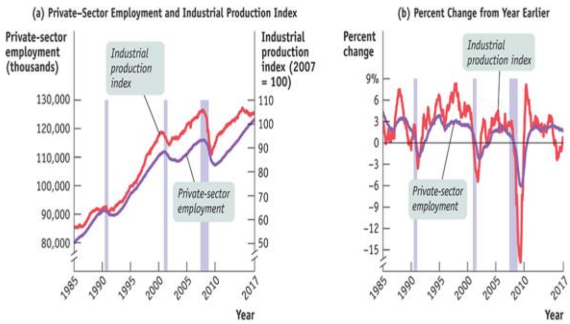
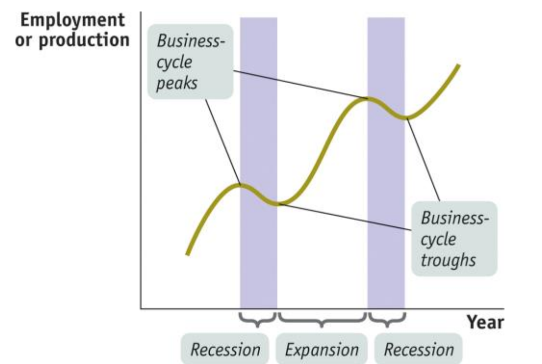


FIGURE 6-2 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers
Data from: Federal Reserve Bank of St. Louis.

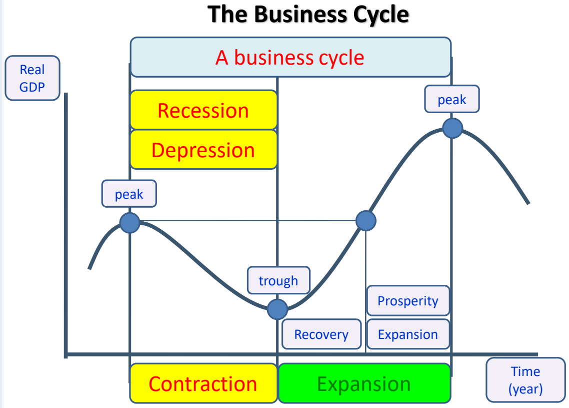
9

The Business Cycle



10

The Business Cycle



11

The Business Cycle

TABLE 21-2 The History of the Business Cycle

Business-Cycle Peak	Business-Cycle Trough
no prior data available	December 1854
June 1857	December 1858
October 1860	June 1861
April 1865	December 1867
June 1869	December 1870
October 1873	March 1879
March 1882	May 1885
March 1887	April 1888
July 1890	May 1891
January 1893	June 1894
December 1895	June 1897
June 1899	December 1900
September 1902	August 1904
May 1907	June 1908
January 1910	January 1912
January 1913	December 1914
August 1918	March 1919
January 1920	July 1921
May 1923	July 1924
October 1926	November 1927
August 1929	March 1933
May 1937	June 1938
February 1945	October 1945
November 1948	October 1949
July 1953	May 1954
August 1957	April 1958
April 1960	February 1961
December 1969	November 1970
November 1973	March 1975
January 1980	July 1980
July 1981	November 1982
July 1990	March 1991
March 2001	November 2001
December 2007	June 2009

Source: National Bureau of Economic Research.

12

CHAPTER 6 LECTURE - MACROECONOMICS: THE BIG PICTURE

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

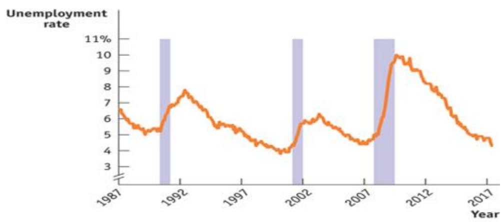


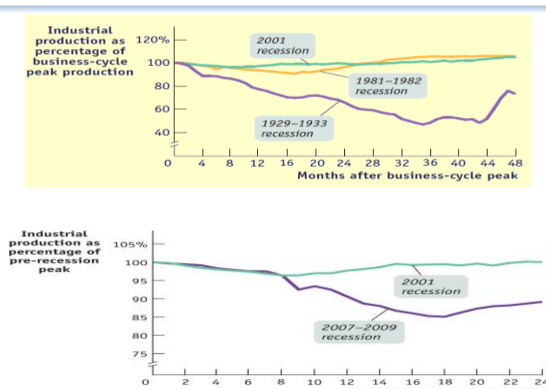
FIGURE 6-4 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers
Data from: Bureau of Labor Statistics.

13

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.

14



15

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.

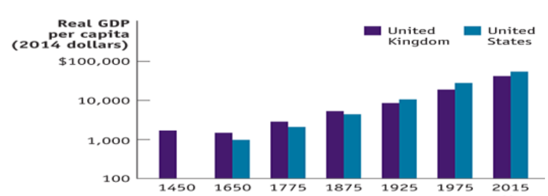
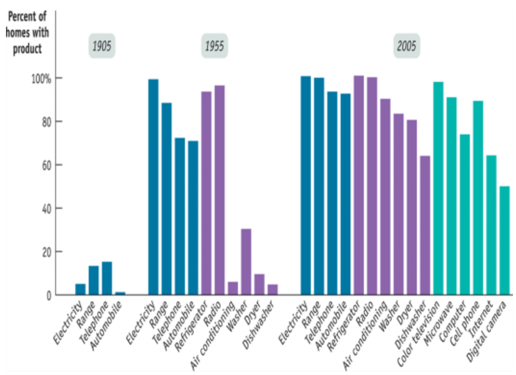


FIGURE 6-7 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers
Data from: Maddison Data Project,
The Conference Board Total Economy Database™, January 2016.

16

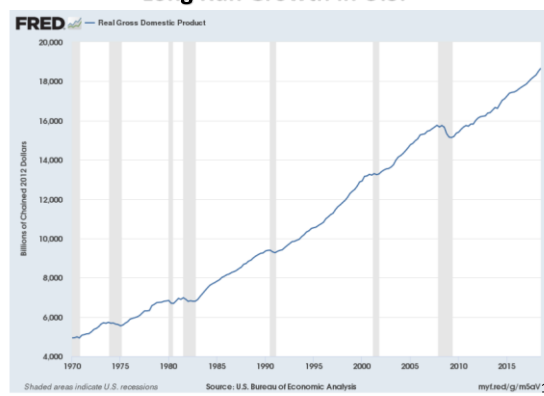
CHAPTER 6 LECTURE - MACROECONOMICS: THE BIG PICTURE

Percent of Houses with Product (US)



17

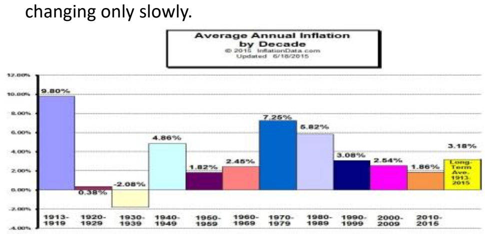
Long Run Growth in U.S.



18

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.



19

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.

20

CHAPTER 6 LECTURE - MACROECONOMICS: THE BIG PICTURE

International Imbalances

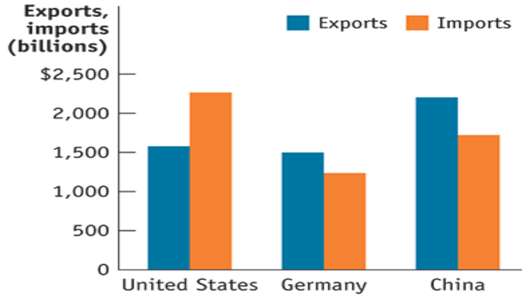


FIGURE 6-9 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers
Data from: International Monetary Fund, International Financial Statistics.

21

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

22

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

23

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?

24