CHAPTER 6 LECTURE - MACROECONOMICS: THE BIG PICTURE

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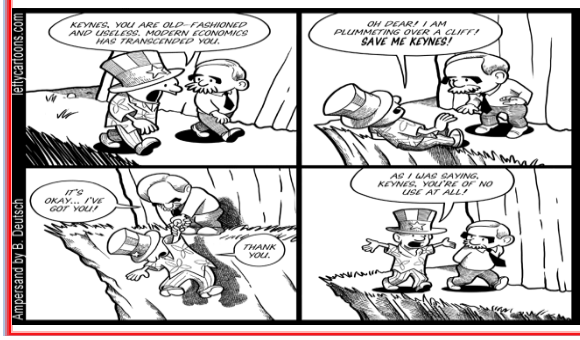

WHAT YOU WILL LEARN IN THIS CHAPTER

- 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

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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?

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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.
- **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.

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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.

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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.

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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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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**.

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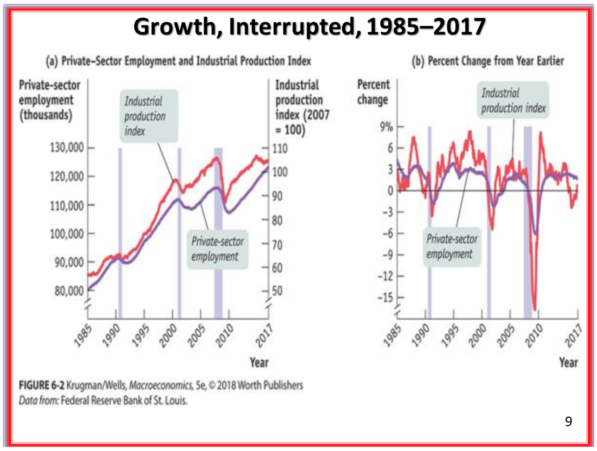

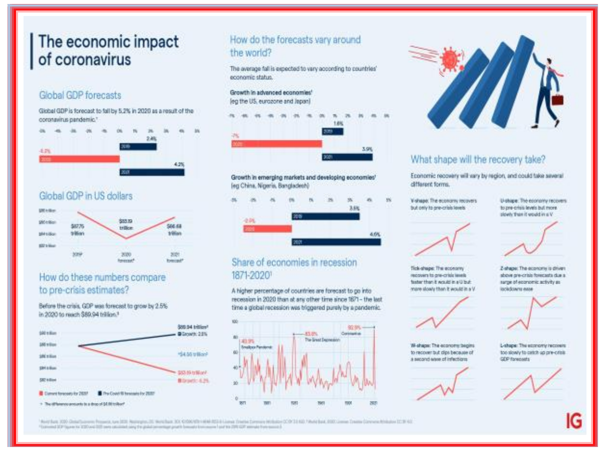

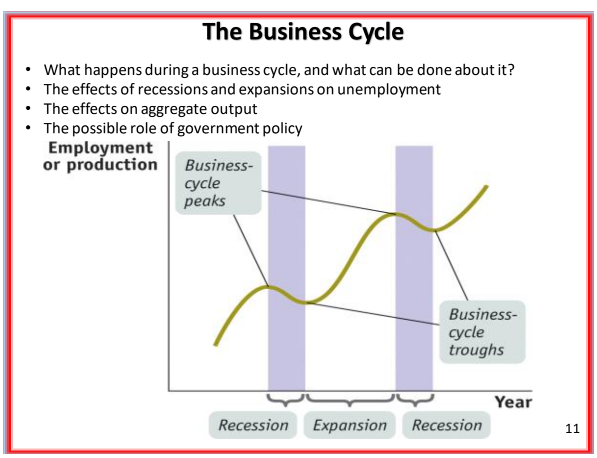

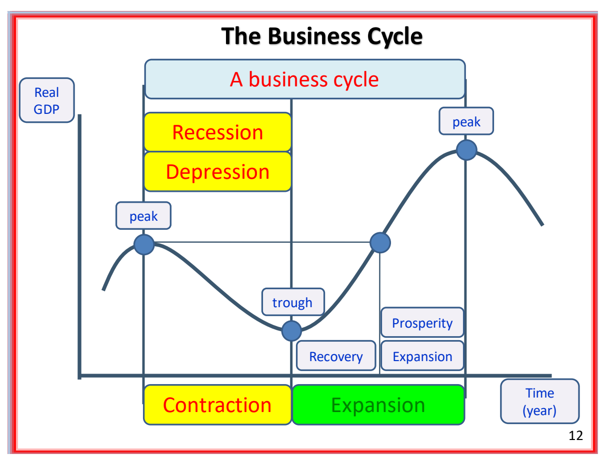

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The Business Cycle

- 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

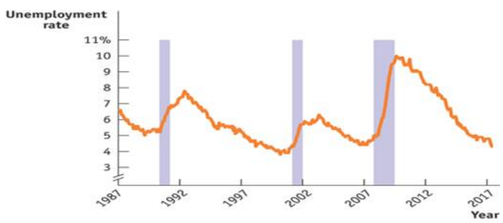

FIGURE 6-4 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers
Data from: Bureau of Labor Statistics.

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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.

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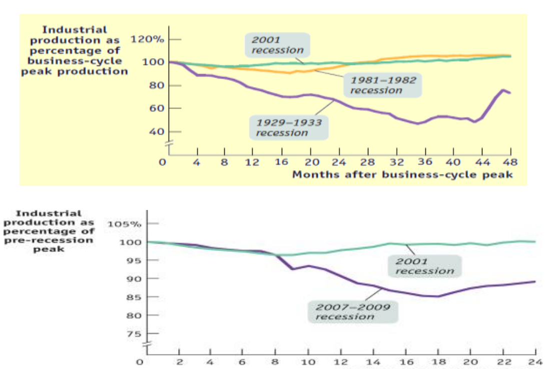

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Long-Run Economic Growth

- **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.

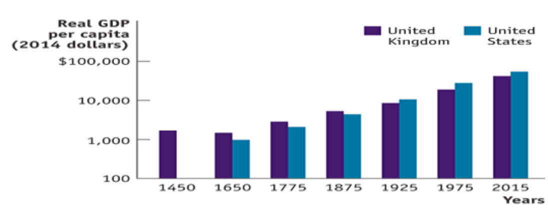

FIGURE 6-7 Krugman/Wells, *Macroeconomics*, 5e, © 2018 Worth Publishers
Data from: Maddison Data Project,
The Conference Board Total Economy Database™, January 2016.

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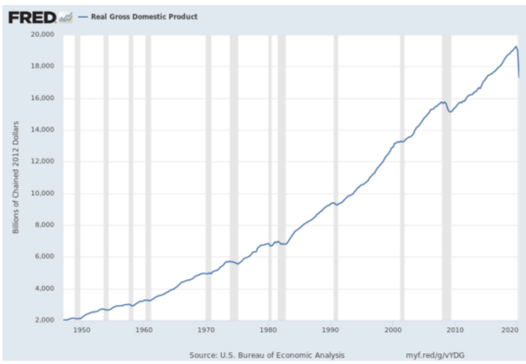
Long Run Growth in U.S.



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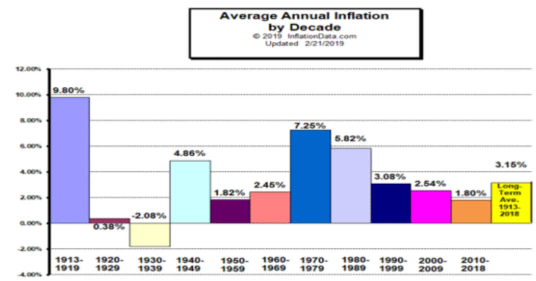
Inflation and Deflation

- 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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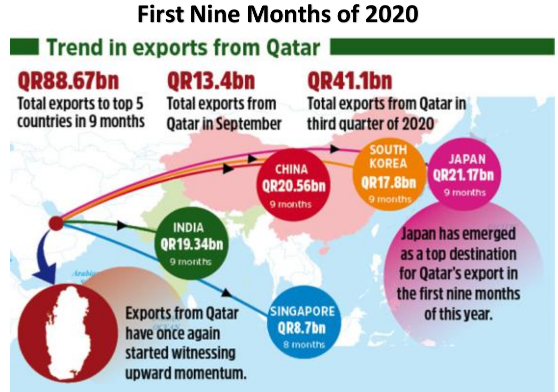
International Imbalances

- 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.

First Nine Months of 2020



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International Imbalances

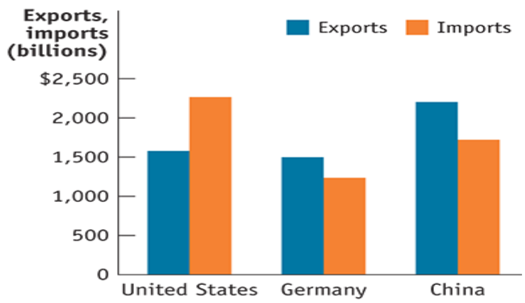

FIGURE 6-9 Krugman/Wells, *Macroeconomics*, 5e,
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Data from: International Monetary Fund, International Financial Statistics.

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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

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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

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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?

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