

Macroeconomics

CHAPTER 6

Macroeconomics: The Big Picture

What you will learn in this chapter:

- ④ An overview of macroeconomics, the study of the economy as a whole, and how it differs from microeconomics
- ④ The importance of the **business cycle** and why policy-makers seek to diminish the severity of business cycles
- ④ What **long-run growth** is and how it determines a country's standard of living
- ④ The meaning of **inflation** and **deflation** and why **price stability** is preferred
- ④ What is special about the macroeconomics of an **open economy**, an economy that trades goods, services and assets with other countries

Macroeconomics vs. Microeconomics

To understand the scope and sweep of macroeconomics, let's begin by looking more carefully at the difference between microeconomic and macroeconomic questions.

MICROECONOMIC QUESTION	MACROECONOMIC QUESTION
Go to business school or take a job?	How many people are employed in the economy as a whole?
What determines the salary offered by Citibank to Cherie Camajo, a new Columbia MBA?	What determines the overall salary levels paid to workers in a given year?

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Macroeconomics vs. Microeconomics

MICROECONOMIC QUESTION	MACROECONOMIC QUESTION
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 full 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 US and the rest of the world?

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Macroeconomics vs. Microeconomics

➤ **Microeconomics** focuses on how decisions are made by individuals and firms and the consequences of those decisions.

➤ Ex.: 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 or not to offer the course by weighing the costs and benefits.

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Macroeconomics vs. Microeconomics

➤ **Macroeconomics** examines the *aggregate* behavior of the economy (i.e. how the actions of all the individuals and firms in the economy interact to produce a particular level of economic performance as a whole).

➤ Ex.: 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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Four Principal Ways that Macroeconomics Differs from Microeconomics:

1. In macroeconomics, the behavior of the whole macroeconomy is, indeed, **greater than the sum** of individual actions and market outcomes.
2. Macroeconomics is widely viewed as providing a rationale for continual **government intervention** to manage short-term fluctuations and adverse events in the economy.
 - *monetary policy*
 - *fiscal policy*

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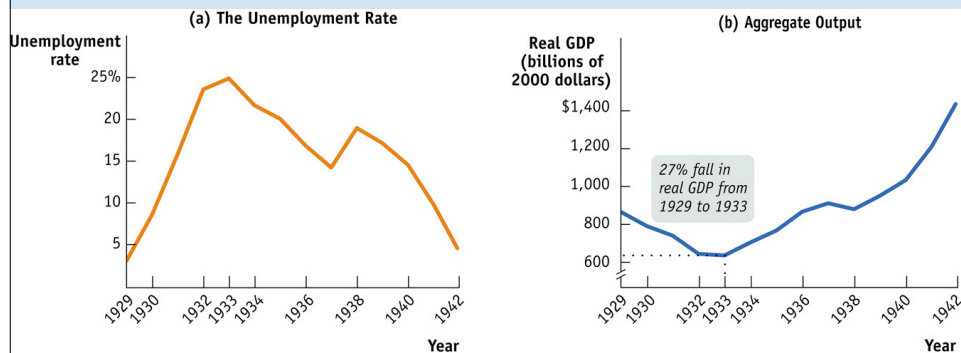
Four Principal Ways that Macroeconomics Differs from Microeconomics (*cont.*):

3. Macroeconomics is the study of **long-run growth**: What factors lead to a higher long-run growth rate? And are there government policies capable of increasing the long-run growth rate?
4. The theory and policy implementation focus on **economic aggregates** -- economic measures that summarize data across many different markets for goods, services, workers, and assets.

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The Great Depression

The Great Depression precipitated a thorough rethinking of macroeconomics which gave rise to modern macroeconomics.



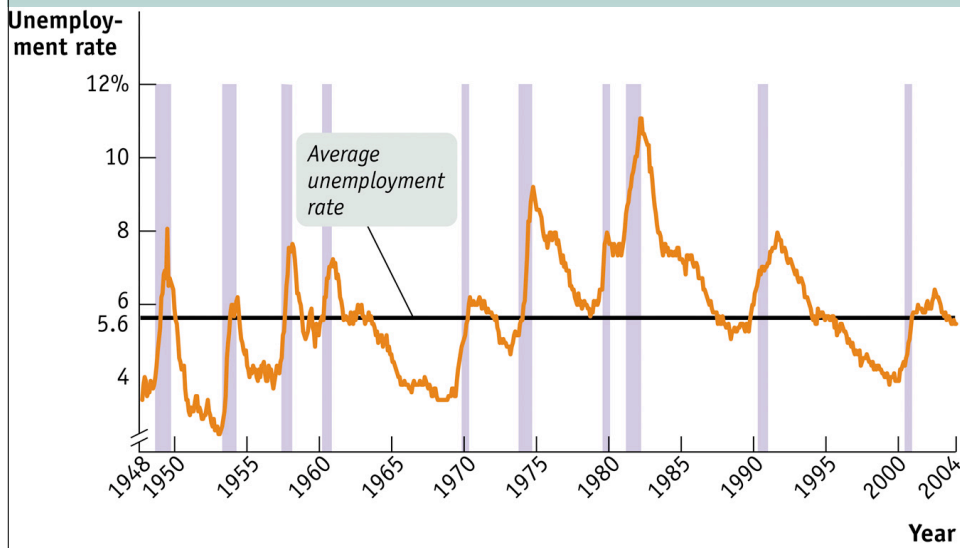
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The Business Cycle

- 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.

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The Unemployment Rate and Recessions Since 1948



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FOR INQUIRING MINDS: Defining Recessions and Expansions

➤ In many countries, economists adopt the rule that a recession is a period of at least 6 months, or two quarters, during which aggregate output falls.

→ sometimes too strict

➤ In the United States, the task of determining when a recession begins and ends is assigned to an independent panel of experts at the National Bureau of Economic Research (NBER). This panel looks at a number of economic indicators, with the main focus on employment and production, but ultimately the panel makes a judgment call.

→ sometimes controversial

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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; and
- the possible role of government policy.

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Employment and Unemployment

- **Employment** is the number of people working in the economy.
- **Unemployment** is the number of people who are actively looking for work but aren't currently employed.
- The **labor force** is equal to the sum of employment and unemployment.

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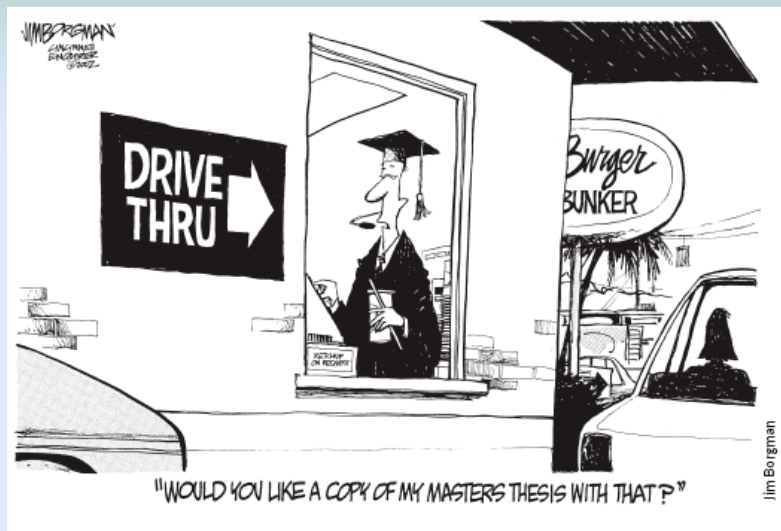
Employment and Unemployment

- **Discouraged workers** are non-working people who are capable of working but are not actively looking for a job.
- **Underemployment** is the number of people who work during a recession but receive lower wages than they would during an expansion due to smaller number of hours worked, lower-paying jobs, or both.
- The **unemployment rate** is the ratio of the number of people unemployed to the total number of people in the labor force, either currently working or looking for jobs.

$$\text{Unemployment rate} = \frac{\text{Number of unemployed workers}}{\text{Number of unemployed workers} + \text{Number of employed workers}} \times 100$$

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Underemployment



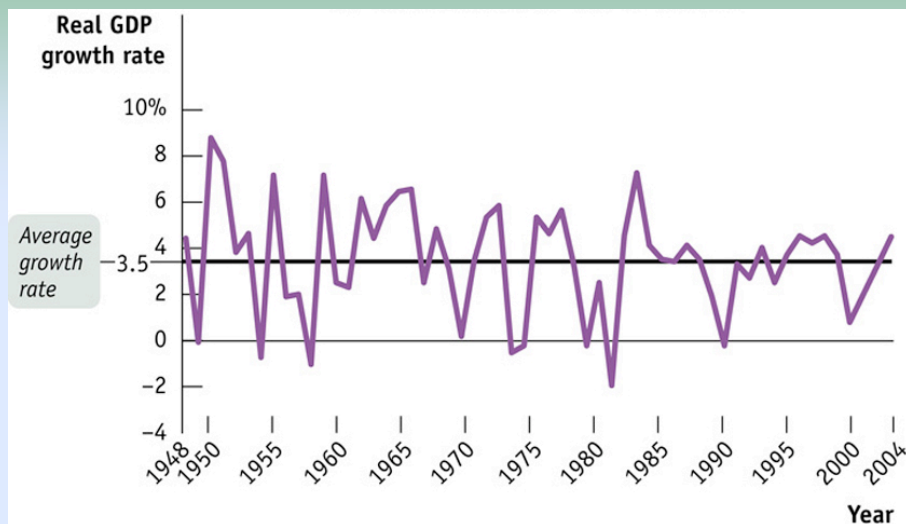
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The Effects of Recessions and Expansions on Unemployment and Aggregate Output:

In general, the **unemployment rate** rises during recessions and falls during expansions. It moves in the direction opposite to **aggregate output**, which falls during recessions and rises during expansions.

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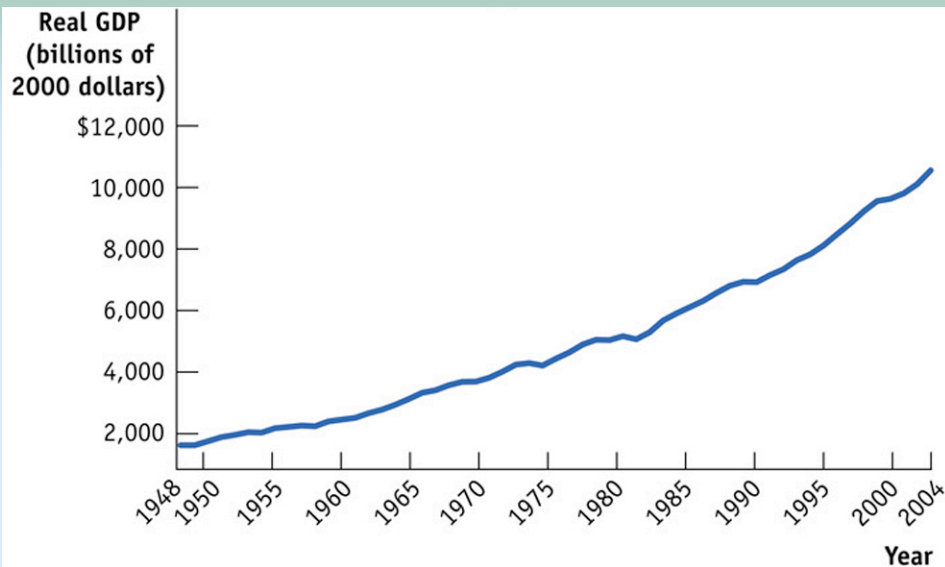
Growth in Aggregate Output, 1948–2004



Real GDP is a measure of aggregate output, the output of the economy as a whole.

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Growth in Aggregate Output, 1948–2004



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Taming the Business Cycle

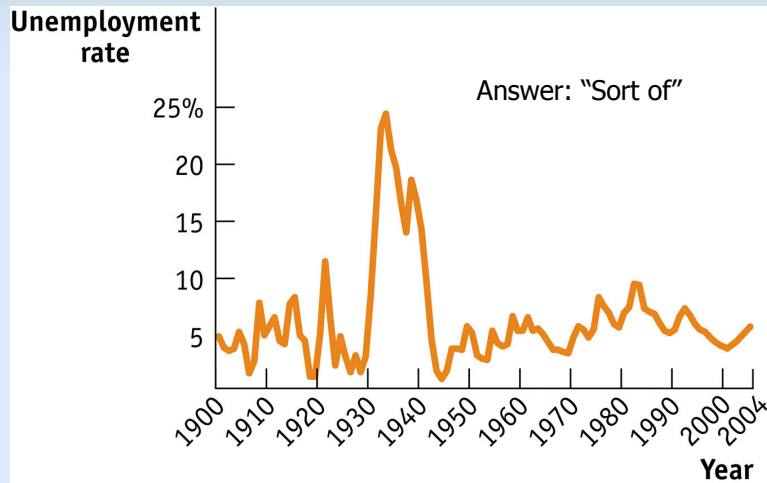
Policy efforts undertaken to reduce the severity of recessions are called **stabilization policy**.

- 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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ECONOMICS IN ACTION: Has the Business Cycle Been Tamed?

Has progress in macroeconomics made the economy more stable?



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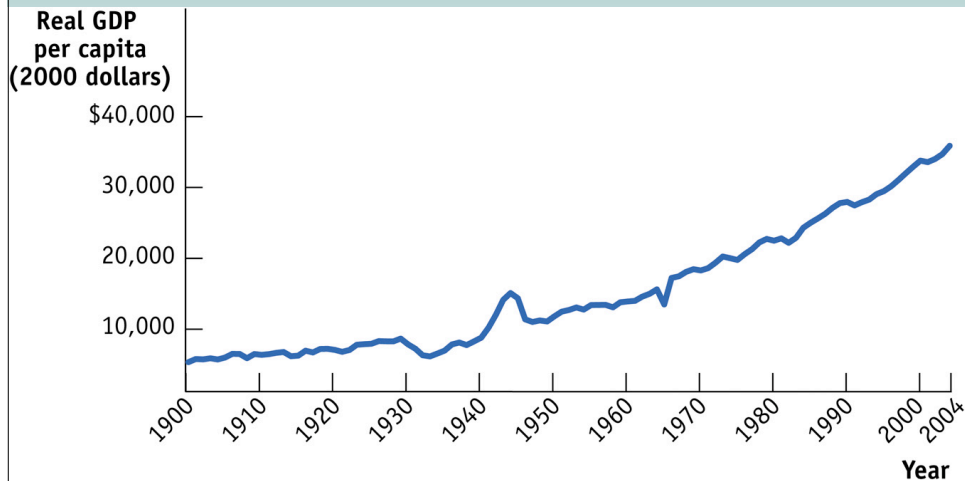
Long-Run Economic Growth

Secular long-run growth, or **long-run growth**, is the sustained upward trend in aggregate output per person over several decades.

A country can achieve a permanent increase in the standard of living of its citizens only through long-run growth. So a central concern of macroeconomics is what determines long-run growth.

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U.S. real gross domestic product per person from 1900 to 2004



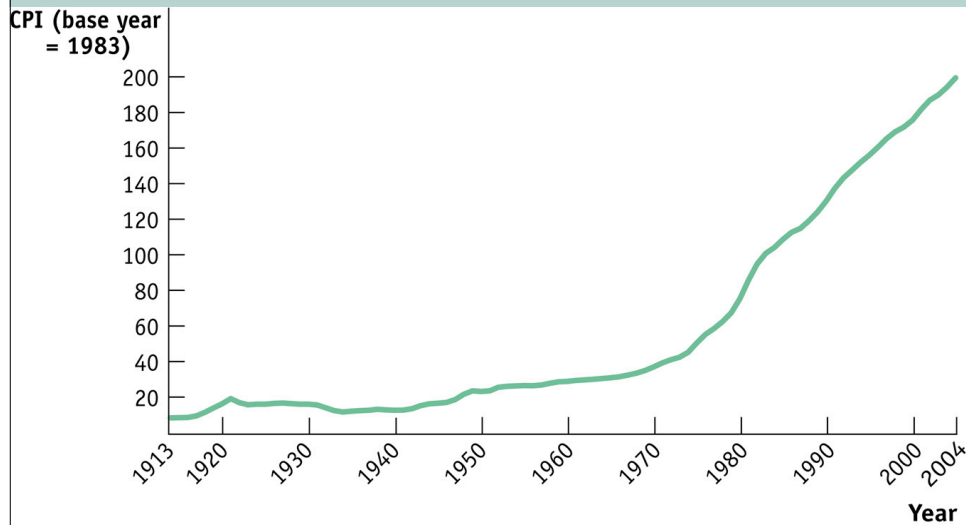
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Aggregate Price Level

- A **nominal** measure is a measure that has not been adjusted for changes in prices over time.
- A **real** measure is a measure that has been adjusted for changes in prices over time.
- The **aggregate price level** is the overall level of prices in the economy.

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Consumer price index from 1913 to 2004



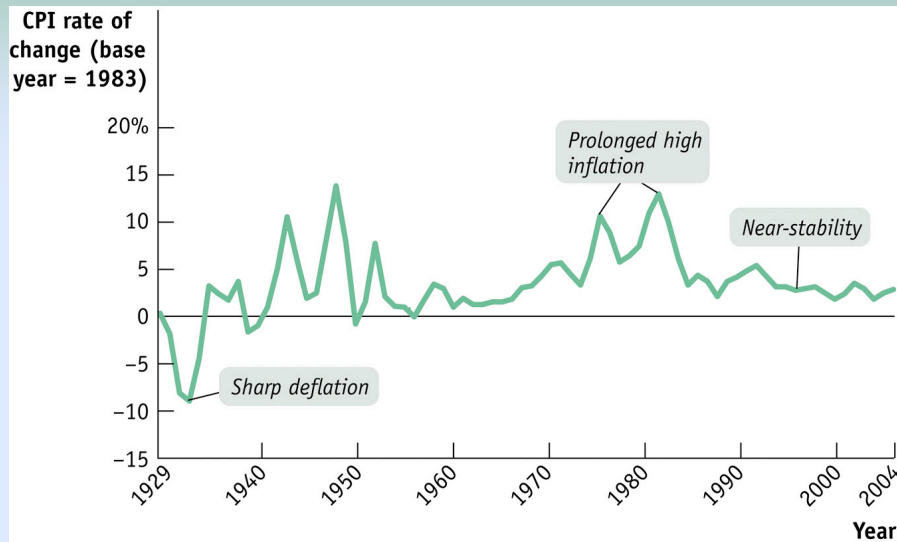
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Inflation and Deflation

- 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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Inflation and deflation since 1929



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ECONOMICS IN ACTION: A Fast (Food) Measure of Inflation

McDonald's opened in 1954: Hamburgers cost only 0.15 cents-25 cents with fries.

Today a hamburger at a typical McDonald's costs five times as much-between \$0.70 and \$0.80.

Too expensive?

No-in fact, a burger is, compared with other consumer goods, a better bargain than it was in 1954. Burger prices have risen about 400%, from \$0.15 to about \$0.75, over the last half century. But the overall consumer price index has increased more than 600%.

If McDonald's had matched the overall price level increase, a hamburger would now cost between 90 cents and \$1.00.

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The Open Economy

- A **closed economy** is an economy that does not trade goods, services, and assets.
- **Open-economy macroeconomics** is the study of those aspects of macroeconomics that are affected by movements of goods, services, and assets across national boundaries.

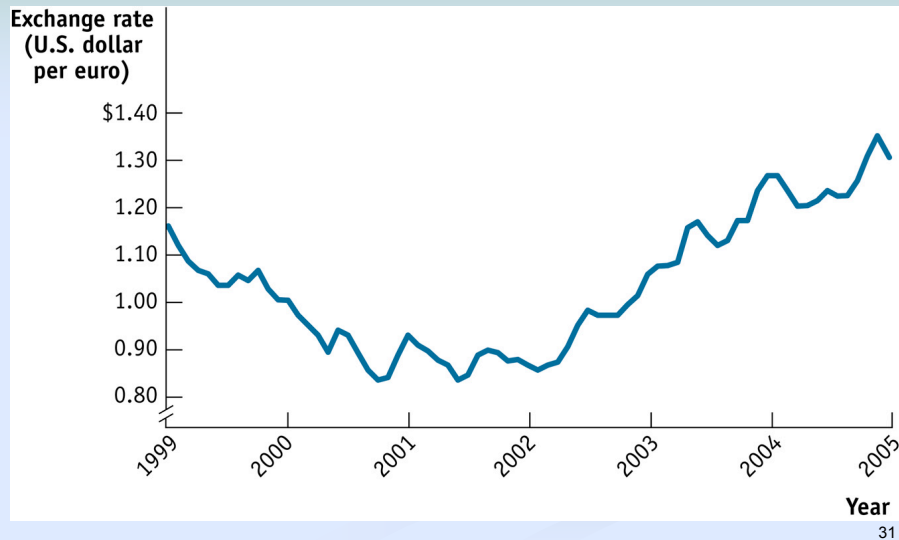
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The Open Economy

- One of the main concerns introduced by open-economy macroeconomics is the **exchange rate**, the price of one currency in terms of another.
 - Exchange rates can affect the aggregate price level.
 - They can also affect aggregate output through their effect on the **trade balance**, the difference between the value of the goods and services a country sells to other countries and the value of the goods and services it buys in return.
- Economists are also concerned about **capital flows**, movements of financial assets across borders.

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Movements of the exchange rate between the U.S. dollar and the euro



The End of Chapter 6

coming attraction:
Chapter 7:
Tracking the Macroeconomy