COURSE 1 (Chapter 20)

INTRODUCTION TO MACROECONOMICS

Outline of today's lecture:

1) Roots of Macroeconomics
2) Macroeconomic Concerns
3) Government In the Macroeconomy
4) Components of the Macroeconomy
5) Methodology of Macroeconomics
6) Trends and Cycles

microeconomics Examines the functioning of individual industries and the behavior of individual decision-making units.

- business firms and households.

macroeconomics Deals with the economy as a whole.

- focuses on the determinants of total national income,
- deals with aggregates such as aggregate consumption and investment,
- looks at the overall level of prices instead of individual prices.

1) Roots of Macroeconomics

Great Depression The period of severe economic contraction and high unemployment that began in 1929 and continued throughout the 1930s.

Classical Models

- Classical economists applied microeconomic models, or "market clearing" models, to economy-wide problems.

- Simple classical models failed to explain the prolonged existence of high unemployment during the Great Depression. This provided the impetus for the development of macroeconomics.

Keynesian Revolution

- In 1936, John Maynard Keynes published *The General Theory of Employment, Interest, and Money*.

- Much of macroeconomics has roots in Keynes's work.
    - According to Keynes, it is not prices and wages that determine the level of employment, as classical models had suggested, but instead the level of aggregate demand for goods and services.

Recent Macroeconomic History

1) **Fine-Tuning in the 1960s**
    - **fine-tuning** phrase used by Walter Heller to refer to the government's role in regulating inflation and unemployment.

2) **Disillusionment in the 1970s and Early 1980s**
    - **stagflation** Occurs when the overall price level rises rapidly (inflation) during periods of recession or high and persistent unemployment (stagnation).

3) **Good Times in the 1990s, Pause in 2000–2001, and Recovery in 2002–2005**
    - The strong economy in the 1990s and recovery in 2002–2005 did not lead to a convergence of views of macroeconomists about how the macroeconomy works.
    - Discipline of macroeconomics is still in flux, and many important issues have yet to be resolved.

2) Macroeconomic Concerns

Three of the major concerns of macroeconomics are:

a. Inflation
b. Output growth
c. Unemployment

a. Inflation

inflation An increase in the overall price level.

hyperinflation A period of very rapid increases in the overall price level.

deflation A decrease in the overall price level.

b. Output growth

business cycle The cycle of short-term ups and downs in the economy.

aggregate output The total quantity of goods and services produced in an economy in a given period.

recession A period during which aggregate output declines.

- Conventionally, a period in which aggregate output declines for two consecutive quarters.

depression A prolonged and deep recession.

c. Unemployment

unemployment rate The percentage of the labor force that is unemployed.

3) Government in the Macroeconomy

There are three kinds of policy that the government has used to influence the macroeconomy:

a) Fiscal policy
b) Monetary policy
c) Growth or supply-side policies

a) Fiscal Policy

fiscal policy Government policies concerning taxes and expenditures (spending).

b) Monetary policy

monetary policy The tools used by the Federal Reserve to control the quantity of money in the economy.

c) Growth Policies

supply-side policies Government policies that focus on stimulating aggregate supply instead of aggregate demand.

4) Components of the Macroeconomy

Macroeconomics focuses on four groups:

1. households and
2. firms, which together compose the private sector,
3. the government (the public sector), and
4. the rest of the world (the international sector).

circular flow A diagram showing the income received and payments made by each sector of the economy.

FIGURE 5.1 The Circular Flow of Payments

transfer payments Cash payments made by the government to people who do not supply goods, services, or labor in exchange for these payments.

- They include Social Security benefits, veterans' benefits, and welfare payments.

Three Market Arenas Another way of looking at the ways households, firms, the government, and the rest of the world relate to each other is to consider the markets in which they interact.

- The three market arenas are:
    1) Goods-and-services market
    2) Labor market
    3) Money (financial) market

1) Goods-and-Services Market

- Firms *supply* to the goods-and-services market. Households, the government, and firms *demand* from this market.

2) Labor Market

- In this market, households *supply* labor, and firms and the government *demand* labor.

3) Money Market

- Households *supply* funds to this market in the expectation of earning income, and also *demand* (borrow) funds from this market.
- Firms, government, and the rest of the world also engage in borrowing and lending, coordinated by financial institutions.

Treasury bonds, notes, and **bills** Promissory notes issued by the federal government when it borrows money.

corporate bonds Promissory notes issued by corporations when they borrow money.

shares of stock Financial instruments that give to the holder a share in the firm's ownership and therefore the right to share in the firm's profits.

dividends The portion of a corporation's profits that the firm pays out each period to its shareholders.

5) Methodology of Macroeconomics

- Macroeconomic behavior is the sum of all the microeconomic decisions made by individual households and firms.
- If the movements of macroeconomic aggregates, such as total output or total employment, reflect decisions made by individual firms and households, we cannot understand the former without some knowledge of the factors that influence the latter.

aggregate demand The total demand for goods and services in an economy.

aggregate supply The total supply of goods and services in an economy.

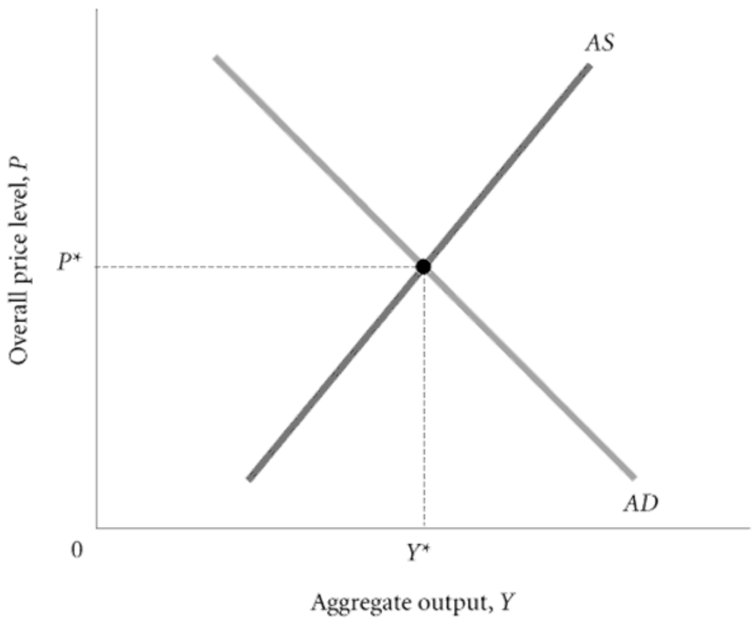

FIGURE 5.2 The Aggregate Demand and Aggregate Supply Curves

6) Trends and Cycles

expansion or **boom** The period in the business cycle from a trough up to a peak, during which output and employment rise.

contraction, recession, or **slump** The period in the business cycle from a peak down to a trough, during which output and employment fall.

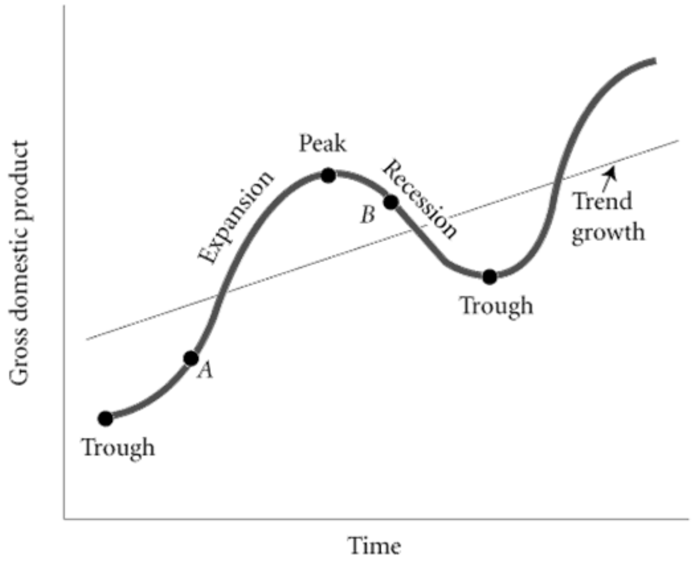

FIGURE 5.3 A Typical Business Cycle

FIGURE 5.4 Real GDP, 1900–2004