INTRODUCTION TO MACROECONOMICS

Chapter 17
Chapter Outline

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

**aggregate behavior** The behavior of all households and firms together

**sticky prices** Prices that do not always adjust rapidly to maintain equality between quantity supplied and quantity demanded
THE ROOTS OF MACROECONOMICS

The 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
The 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
- Governments could intervene in the economy and affect the level of output and employment
RECENT MACROECONOMIC HISTORY

Fine-Tuning in the 1960s

fine-tuning The phrase used by Walter Heller to refer to the government’s role in regulating inflation and unemployment

1970s and Early 1980s

stagflation Occurs when the overall price level rises rapidly (inflation) during periods of recession or high and persistent unemployment (stagnation)
MACROECONOMIC CONCERNS

Three of the major concerns of macroeconomics are:

• Inflation
• Output growth
• Unemployment
INFLATION AND DEFLATION

**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
OUTPUT GROWTH: SHORT RUN AND LONG RUN

**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
UNEMPLOYMENT

unemployment rate  The percentage of the labor force that is unemployed
GOVERNMENT IN THE MACROECONOMY

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

1. Fiscal policy
2. Monetary policy
3. Growth or supply-side policies
FISCAL POLICY

fiscal policy  Government policies concerning taxes and expenditures (spending)

• Expansionary
• Contractionary
MONETARY POLICY

monetary policy  The tools used by the Federal Reserve (Central Bank) to control the quantity of money in the economy
GROWTH POLICIES

supply-side policies  Government policies that focus on stimulating aggregate supply instead of aggregate demand
THE COMPONENTS OF THE MACROECONOMY

Macroeconomics focuses on four groups:

- Households
- Firms
  (which together compose the private sector)
- The government (the public sector)
- The rest of the world (the international sector)
THE CIRCULAR FLOW DIAGRAM

circular flow  A diagram showing the income received and payments made by each sector of the economy
THE COMPONENTS OF THE MACROECONOMY

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
  • Social Security benefits, veterans’ benefits, and welfare payments

• Everyone’s expenditures go somewhere
  • It is impossible to sell something without there being a buyer, and it is impossible to make a payment without there being a recipient
  • Every transaction must have two sides
THE THREE MARKET ARENAS

1. Goods-and-services market
2. Labor market
3. Money (financial) market
Goods-and-Services Market
- Firms supply to the goods-and-services market
- Households, the government, and firms demand from this market

Labor Market
- Households supply labor
- Firms and the government demand labor

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
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 AND AGGREGATE SUPPLY

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

aggregate supply  The total supply of goods and services in an economy
THE METHODOLOGY OF MACROECONOMICS

FIGURE 5.2 The Aggregate Demand and Aggregate Supply Curves