Introduction to Macroeconomics (Ch1)

1. **What Macroeconomics Is About**
1. **What Macroeconomists Do**
2. **Why Macroeconomists Disagree**

1. What Macroeconomics Is About

Macroeconomics: the study of structure and performance of national economies and government policies that affect economic performance

What Are Society's Major Economic Problems Today?

Issues addressed by macroeconomists:

a. Long-run economic growth
b. Business cycles
c. Unemployment
d. Inflation
e. The international economy
f. Macroeconomic policy
g. Aggregation: from microeconomics to macroeconomics

a. **Long-run economic growth**
Figure 1.1: Output of United States since 1869
Note decline in output in recessions; increase in output in some wars
Two main sources of growth
i. Population growth
ii. Increases in average labor productivity

Average labor productivity : output produced per unit of labor input
Figure 1.2 shows average labor productivity for United States since 1900

Growth Rate ?

Average labor productivity growth:
About 2.5% per year from 1949 to 1973
1.1% per year from 1973 to 1995
2.0% per year from 1995 to 2005

b. **Business cycles : Short-run contractions and expansions in economic activity**
Downward phase is called a recession.

Draw graph: peak, through, expansion, recession

c. **Unemployment**: the number of people who are available for work and actively seeking work but cannot find jobs
U.S. experience shown in Fig. 1.3

Recessions cause unemployment rate to rise

d. **Inflation**
U.S. experience shown in Fig. 1.4

Deflation: when prices of most goods and services decline

Hyperinflation: an extremely high rate of inflation

Inflation rate: the percentage increase in the level of prices

e. **The international economy**
Open vs. closed economies

i. Open economy: an economy that has extensive trading and financial relationships with other national economies
ii. Closed economy: an economy that does not interact economically with the rest of the world
Trade imbalances
U.S. experience shown in Fig. 1.5
Trade surplus: exports exceed imports
Trade deficit: imports exceed exports

f. **Macroeconomic Policy**
Fiscal policy: government spending and taxation

i. Effects of changes in federal budget
ii. U.S. experience in Fig. 1.6
iii. Relation to trade deficit?

Monetary policy: growth of money supply; determined by central bank; the Fed in U.S.

g. **Aggregation**: summing individual economic variables to obtain economywide totals
Distinguishes microeconomics (disaggregated) from macroeconomics (aggregated)

2. What Macroeconomists Do

Let's Forecast!

Here's an exercise that will surprise both you and your students. On the first day of class, before they even know much about the macroeconomic variables that will be studied in the course, ask them to forecast such things as inflation, unemployment, the growth rate of output, and interest rates. You can give them a handout of the current values of key variables. (By the way, it's easy to pull down such things off the Internet from a number of sites; the easiest is the Federal Reserve Bank of St. Louis FRED database at research.stlouisfed.org/fred.)

Macroeconomic forecasting
Relatively few economists make forecasts
Forecasting is very difficult

Macroeconomic analysis
Private and public sector economists—analyze current conditions
Does having many economists ensure good macroeconomic policies? No, since politicians, not economists, make major decisions

Macroeconomic research
Goal: to make general statements about how the economy works

Theoretical and empirical research are necessary for forecasting and economic analysis
Economic theory: a set of ideas about the economy, organized in a logical framework
Economic model: a simplified description of some aspect of the economy
Usefulness of economic theory or models depends on reasonableness of assumptions, possibility of being applied to real problems, empirically testable implications, theoretical results consistent with real-world data

Box 1.1: Developing and Testing an Economic Theory

Step 1: State the research question
Step 2: Make provisional assumptions
Step 3: Work out the implications of the theory
Step 4: Conduct an empirical analysis to compare the implications of the theory with the data
Step 5: Evaluate the results of your comparisons

Data development—very important for making data more useful

1. **Why Macroeconomists Disagree**

Positive vs. normative analysis

a. Positive analysis: examines the economic consequences of a policy
b. Normative analysis: determines whether a policy should be used

Classicals vs. Keynesians

The classical approach

i. The economy works well on its own
ii. 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
iii. Wages and prices adjust rapidly to get to equilibrium
    1. Equilibrium: a situation in which the quantities demanded and supplied are equal
    2. Changes in wages and prices are signals that coordinate people's actions
iv. Result: Government should have only a limited role in the economy

The Keynesian approach

v. The Great Depression: Classical theory failed because high unemployment was persistent
vi. Keynes: Persistent unemployment occurs because wages and prices adjust slowly, so markets remain out of equilibrium for long periods
vii. Conclusion: Government should intervene to restore full employment

The evolution of the classical-Keynesian debate

viii. Keynesians dominated from WWII to 1970
ix. Stagflation led to a classical comeback in the 1970s
x. Last 30 years: excellent research with both approaches

A unified approach to macroeconomics

c. Textbook uses a single model to present both classical and Keynesian ideas
d. Three markets: goods, assets, labor

e. Model starts with microfoundations: individual behavior
f. Long run: wages and prices are perfectly flexible
g. Short run: Classical case—flexible wages and prices; Keynesian case—wages and prices are slow to adjust