20

Introduction to Macroeconomics

CHAPTER OUTLINE

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

Which of the following statements is correct?

a. Macroeconomics examines the behavior of individual industries.

b. Both macroeconomics and microeconomics are concerned with the decisions of households and firms.

c. Microeconomists look for macroeconomic foundations to explain why most markets arrive at equilibrium.

d. All of the above.

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d. All of the above.

Macroeconomic Concerns

Three of the major concerns of macroeconomics are

- Output growth
- Unemployment
- Inflation and deflation

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a. Aggregate output.

b. Aggregate employment.

c. The aggregate price level.

d. The growth rate of the population.

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Macroeconomic Concerns

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.

Macroeconomic Concerns

Output Growth

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

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

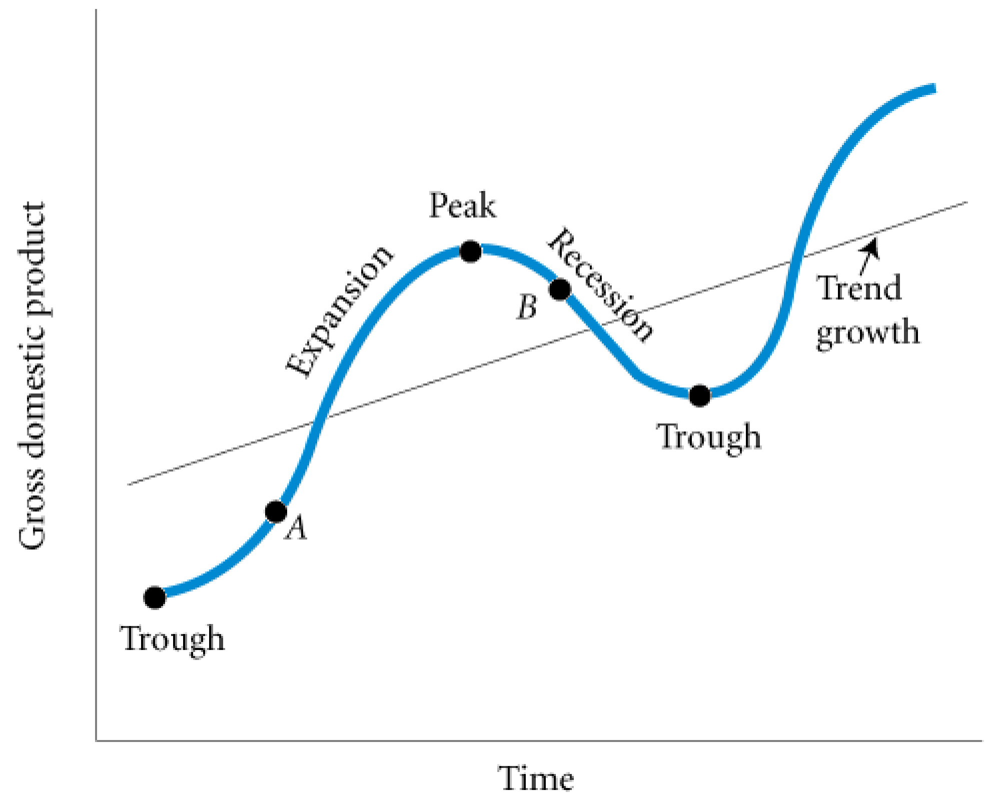
Macroeconomic Concerns

Output Growth

▶ **FIGURE 20.1 A Typical Business Cycle**

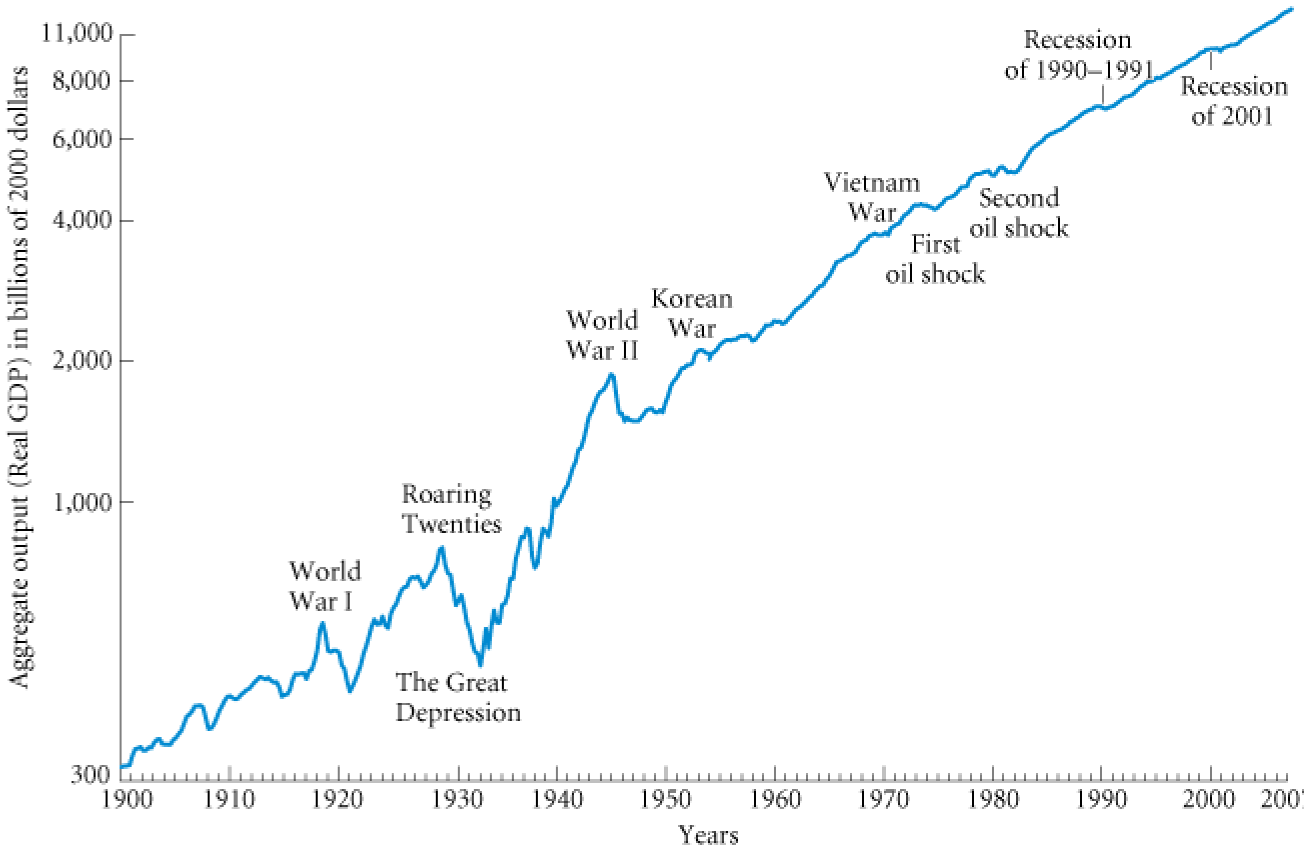
In this business cycle, the economy is expanding as it moves through point *A* from the trough to the peak.

When the economy moves from a peak down to a trough, through point *B*, the economy is in recession.



Macroeconomic Concerns

Output Growth



▲ **FIGURE 20.2 U.S. Aggregate Output (Real GDP), 1900–2007**

The periods of the Great Depression and World Wars I and II show the largest fluctuations in aggregate output.

Macroeconomic Concerns

Unemployment

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

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.

In microeconomic theory, which of the following happens as the labor market eliminates unemployment and restores its equilibrium?

a. The equilibrium wage rises above the wage that prevailed when there was unemployment.

b. As it moves toward equilibrium, the market experiences an increase in the quantity of labor demanded and a decrease in the quantity supplied.

c. The market will turn a shortage into a surplus.

d. Supply and demand will shift, but equilibrium price remain the same in the end.

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The Components of the Macroeconomy

Macroeconomics focuses on four groups. To see the big picture, it is helpful to divide the participants in the economy into four broad groups:

(1) *households*,

(2) *firms*,

(3) the *government*, and

(4) the *rest of the world*.

The Components of the Macroeconomy

The Circular Flow Diagram

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

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.

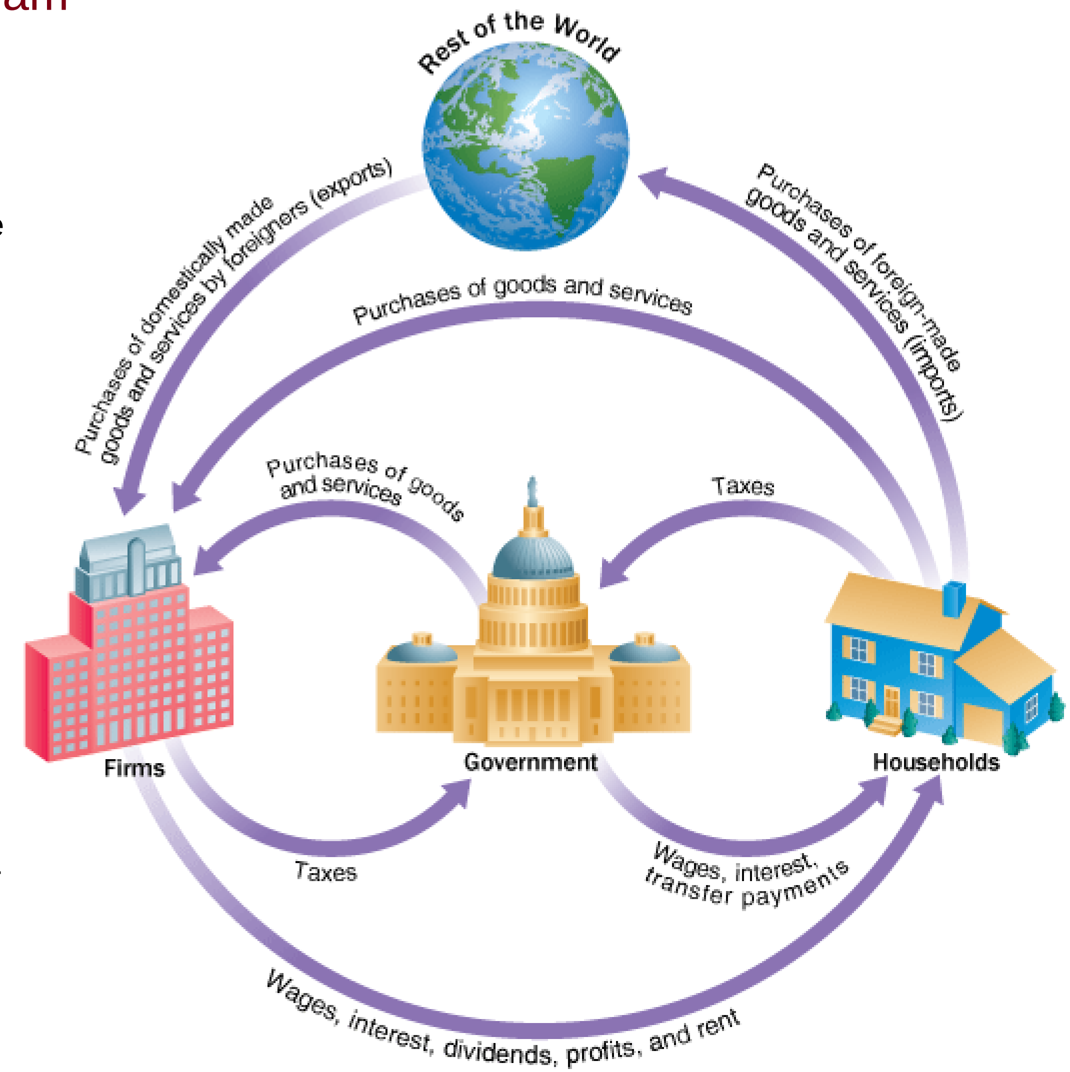
The Components of the Macroeconomy

The Circular Flow Diagram

▶ **FIGURE 20.3 The Circular Flow of Payments**

Households receive income from firms and the government, purchase goods and services from firms, and pay taxes to the government. They also purchase foreign-made goods and services (imports). Firms receive payments from households and the government for goods and services; they pay wages, dividends, interest, and rents to households and taxes to the government. The government receives taxes from firms and households, pays firms and households for goods and services—including wages to government workers—and pays interest and transfers to households. Finally, people in other countries purchase goods and services produced domestically (exports).

Note: Although not shown in this diagram, firms and governments also purchase imports.



The Components of the Macroeconomy

The 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.

We divide the markets into three broad arenas:

(1) the goods-and-services market,

(2) the labor market, and

(3) the money (financial) market.

The Components of the Macroeconomy

The Three Market Arenas

Goods-and-Services Market

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

Labor Market

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

The Components of the Macroeconomy

The Three Market Arenas

Money Market

Households *supply* funds to this market in the expectation of earning income in the form of dividends on stocks and interest on bonds.

Firms, the government, and the rest of the world also engage in borrowing and lending which is coordinated by financial institutions.

The Components of the Macroeconomy

The Three Market Arenas

Money Market

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

corporate bonds Promissory notes issued by firms 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 firm's profits that the firm pays out each period to its shareholders.

All of the following are debt instruments, or promissory notes issued by a borrower, except one. Which one?

a. Treasury bonds.

b. Treasury notes.

c. Treasury bills.

d. Corporate Stocks.

e. Corporate bonds.

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The Components of the Macroeconomy

The Role of the Government in the Macroeconomy

fiscal policy Government policies concerning taxes and spending.

monetary policy The tools used by the Federal Reserve to control the quantity of money, which in turn affects interest rates.

A Brief History of Macroeconomics

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

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

stagflation A situation of both high inflation and high unemployment.

Which of the following ideas was central in Keynesian theory?

a. The invisible hand. The forces of supply and demand ensure that a market will quickly adjust to deviations from equilibrium.

b. Self-correcting prices and wages determine the level of output and employment in the economy.

c. Government intervention can be used to affect the level of output and employment in the economy.

d. Monetary policy can bring the economy out of a recession, or a depression.

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ECONOMICS IN PRACTICE

Macroeconomics in Literature

The underlying phenomena that economists study are the stuff of novels as well as graphs and equations.

The Great Gatsby

The Grapes of Wrath

The U.S Economy Since 1970

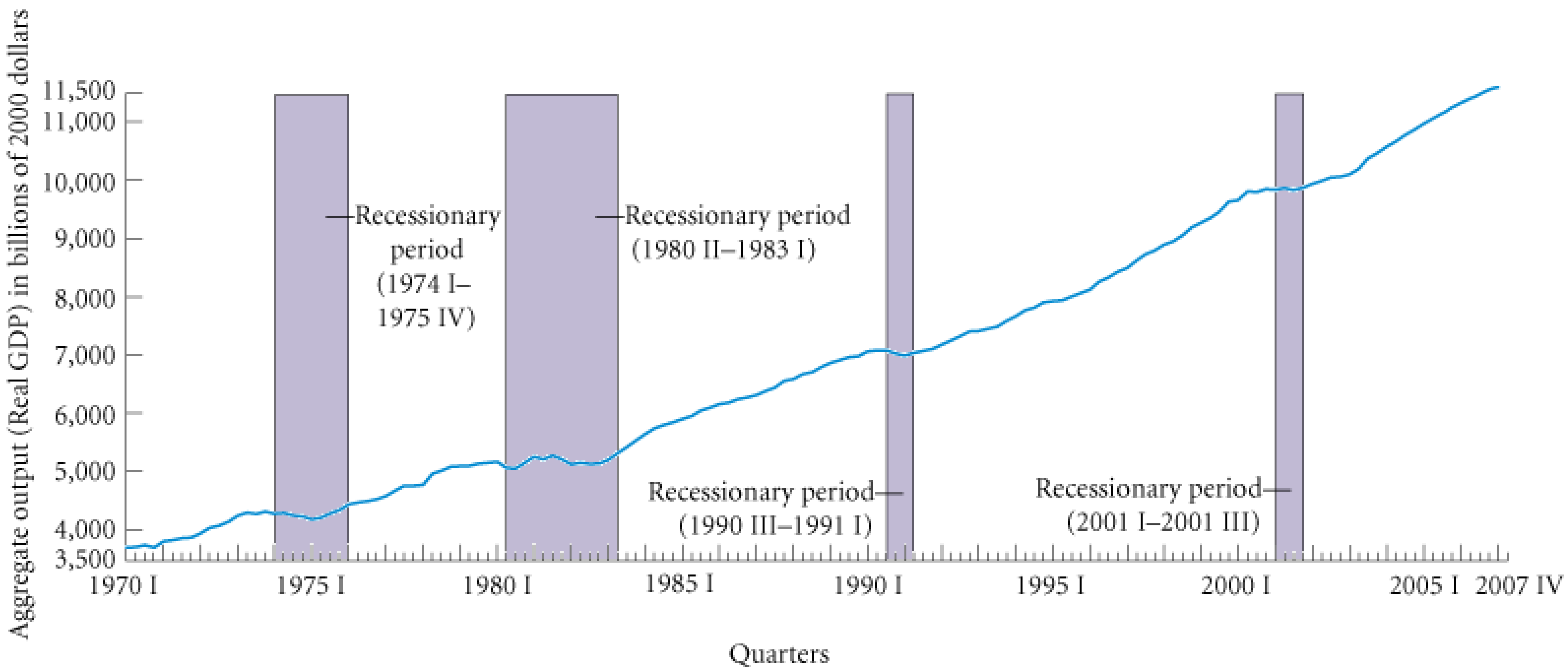
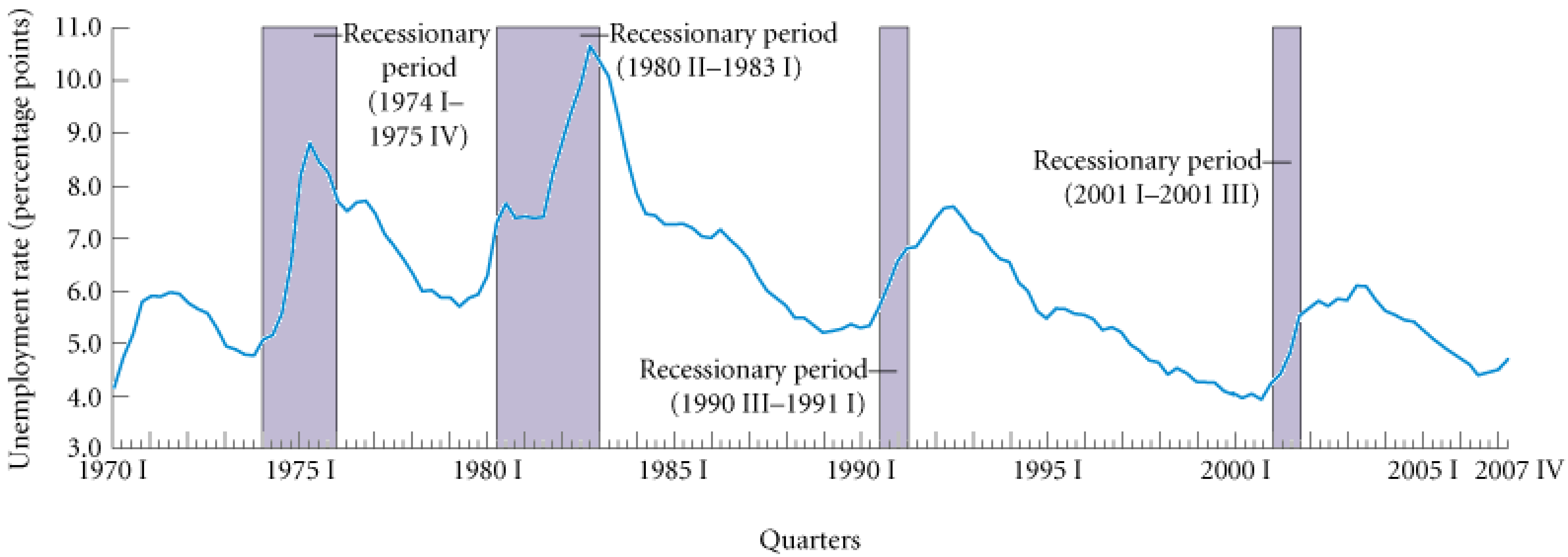


FIGURE 20.4 Aggregate Output (Real GDP), 1970 I–2007 IV

Aggregate output in the United States since 1970 has risen overall, but there have been four recessionary periods: 1974 I–1975 IV, 1980 II–1983 I, 1990 III–1991 I, and 2001 I–2001 III.

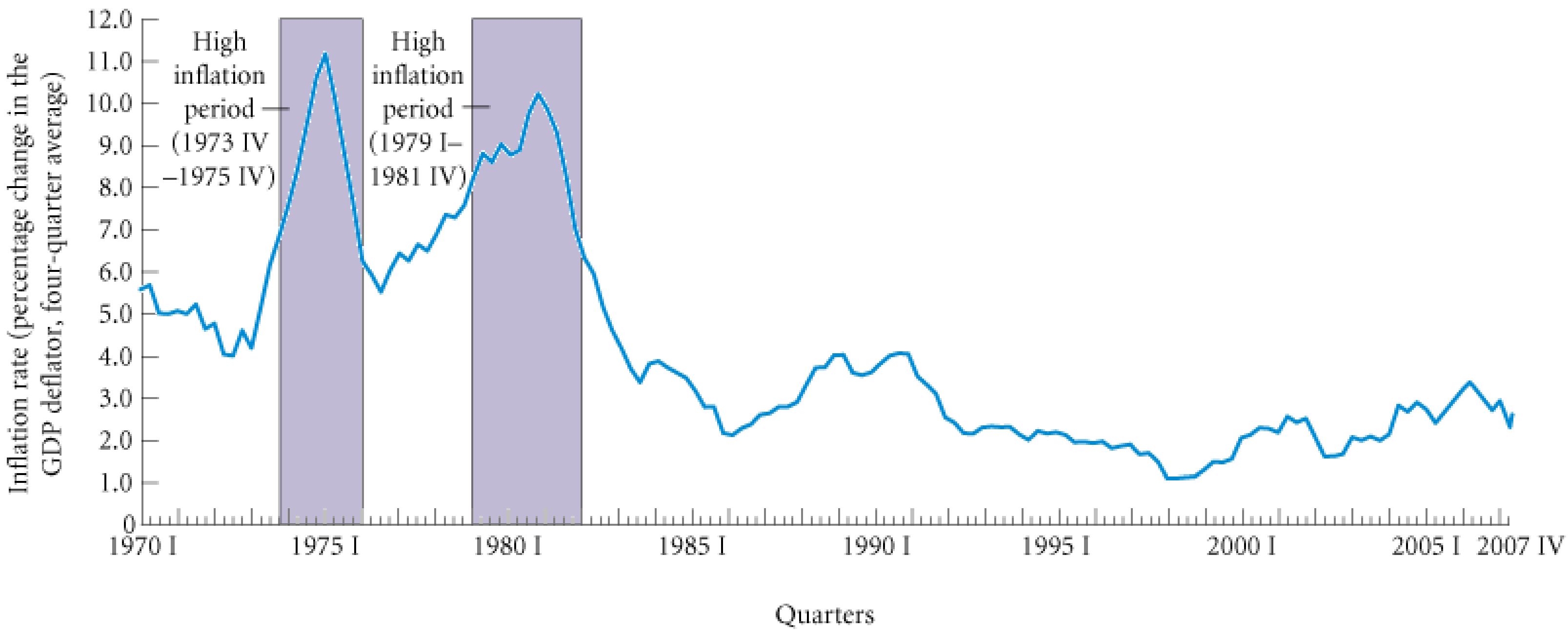
The U.S Economy Since 1970



▲ **FIGURE 20.5 Unemployment Rate, 1970 I–2007 IV**

The U.S. unemployment rate since 1970 shows wide variations. The four recessionary reference periods show increases in the unemployment rate.

The U.S Economy Since 1970



▲ **FIGURE 20.6 Inflation Rate (Percentage Change in the GDP Deflator, Four-Quarter Average), 1970 I–2007 IV**

Since 1970, inflation has been high in two periods: 1973 IV–1975 IV and 1979 I–1981 IV. Inflation between 1983 and 1992 was moderate. Since 1992, it has been fairly low.

Since 1983, which of the following rates has been low relative to the standards of the 1970s?

a. The unemployment rate.

b. The inflation rate.

c. The rate of interest.

d. The exchange rate.

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ECONOMICS IN PRACTICE

John Maynard Keynes

Much of the framework of modern macroeconomics comes from the works of John Maynard Keynes, whose *General Theory of Employment, Interest and Money* was published in 1936.

aggregate behavior

aggregate output

business cycle

circular flow

contraction, recession, *or* slump

corporate bonds

deflation

depression

dividends

expansion *or* boom

fine-tuning

fiscal policy

Great Depression

hyperinflation

inflation

macroeconomics

microeconomics

monetary policy

recession

shares of stock

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Treasury bonds, notes, *and* bills

unemployment rate