Chapter 1

Introduction to Macroeconomics
Chapter Outline

• What Macroeconomics Is About
• What Macroeconomists Do
• Why Macroeconomists Disagree
What Macroeconomics Is About

- Macroeconomics: the study of structure and performance of national economies and government policies that affect economic performance
- Issues addressed by macroeconomists:
  - Long-run economic growth
  - Business cycles
  - Unemployment
  - Inflation
  - The international economy
  - Macroeconomic policy
- Aggregation: from microeconomics to macroeconomics
What Macroeconomics Is About

• Long-run economic growth
  – Figure 1.1: Output of United States since 1869
Figure 1.1 Output of the U.S. economy, 1869-2005
What Macroeconomics Is About

- 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
    - Population growth
    - Increases in average labor productivity
What Macroeconomics Is About

• Average labor productivity
  – Output produced per unit of labor input
  – Figure 1.2 shows average labor productivity for United States since 1900
Figure 1.2  Average labor productivity in the United States, 1900-2005
What Macroeconomics Is About

• 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
What Macroeconomics Is About

• Business cycles
  – Business cycle: Short-run contractions and expansions in economic activity
  – Downward phase is called a recession
What Macroeconomics Is About

• Unemployment
  – 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
Figure 1.3 The U.S. unemployment rate, 1890-2005
What Macroeconomics Is About

• Inflation
  – U.S. experience shown in Fig. 1.4
Figure 1.4 Consumer prices in the United States, 1800-2005
What Macroeconomics Is About

• Inflation
  – Deflation: when prices of most goods and services decline
  – Inflation rate: the percentage increase in the level of prices
  – Hyperinflation: an extremely high rate of inflation
What Macroeconomics Is About

• The international economy
  – Open vs. closed economies
    • Open economy: an economy that has extensive trading and financial relationships with other national economies
    • 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
Figure 1.5 U.S. exports and imports, 1869-2005
What Macroeconomics Is About

• Macroeconomic Policy
  – Fiscal policy: government spending and taxation
    • Effects of changes in federal budget
    • U.S. experience in Fig. 1.6
    • Relation to trade deficit?
  – Monetary policy: growth of money supply; determined by central bank; the Fed in U.S.
Figure 1.6 U.S. Federal government spending and tax collections, 1869-2005
What Macroeconomics Is About

• Aggregation
  – Aggregation: summing individual economic variables to obtain economywide totals
  – Distinguishes microeconomics (disaggregated) from macroeconomics (aggregated)
What Macroeconomists Do

• 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
What Macroeconomists Do

- 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
What Macroeconomists Do

• 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
What Macroeconomists Do

- Data development—very important for making data more useful
Why Macroeconomists Disagree

• Positive vs. normative analysis
  – Positive analysis: examines the economic consequences of a policy
  – Normative analysis: determines whether a policy should be used
Why Macroeconomists Disagree

• Classicals vs. Keynesians
  – The classical approach
    • The economy works well on its own
    • 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
    • Wages and prices adjust rapidly to get to equilibrium
      – Equilibrium: a situation in which the quantities demanded and supplied are equal
      – Changes in wages and prices are signals that coordinate people’s actions
    • Result: Government should have only a limited role in the economy
Why Macroeconomists Disagree

• Classical vs. Keynesians
  – The Keynesian approach
    • The Great Depression: Classical theory failed because high unemployment was persistent
    • Keynes: Persistent unemployment occurs because wages and prices adjust slowly, so markets remain out of equilibrium for long periods
    • Conclusion: Government should intervene to restore full employment
Why Macroeconomists Disagree

• Classical vs. Keynesians
  – The evolution of the classical-Keynesian debate
    • Keynesians dominated from WWII to 1970
    • Stagflation led to a classical comeback in the 1970s
    • Last 30 years: excellent research with both approaches
Why Macroeconomists Disagree

• A unified approach to macroeconomics
  – Textbook uses a single model to present both classical and Keynesian ideas
  – Three markets: goods, assets, labor
  – Model starts with microfoundations: individual behavior
  – Long run: wages and prices are perfectly flexible
  – Short run: Classical case—flexible wages and prices; Keynesian case—wages and prices are slow to adjust