Chapter 6

Macroeconomics: The Big Picture

WHAT YOU WILL LEARN IN THIS CHAPTER

- What is the difference between macroeconomics and microeconomics?
- What are business cycles and why do policy makers try to diminish their severity?
- How does long-run economic growth determine a country’s standard of living?
- What are inflation and deflation, and why is price stability preferred?
- Why does international macroeconomics matter, and how do economies interact through trade deficits and trade surpluses?

LEARN BY DOING: DISCUSSION QUESTION 1

- With a partner (and without technology), discuss if the U.S. economy is currently experiencing an economic boom or a recession.

  http://www.bls.gov

THE NATURE OF MACROECONOMICS (1/2)

- Macroeconomics differs from microeconomics by focusing on the behavior of the economy as a whole.
- Microeconomics focuses on decisions made by individuals and firms.
- Macroeconomics examines the actions of all the individuals and all the firms in the economy.

THE NATURE OF MACROECONOMICS (2/2)

TABLE 6(21)-1 Microeconomic versus Macroeconomic Questions

Microeconomic Questions	Macroeconomic Questions
Should I go to business school or take a job right now?	How many people are employed in the economy as a whole this year?
What determines the salary Google offers to Cherie Camajo, a new MBA?	What determines the overall salary levels paid to workers in a given year?
What determines the cost to a university or college of offering a new course?	What determines the overall level of prices in the economy as a whole?
What government policies should be adopted to make it easier for low-income students to attend college?	What government policies should be adopted to promote employment and growth in the economy as a whole?
What determines whether Citibank opens a new office in Shanghai?	What determines the overall trade in goods, services, and financial assets between the United States and the rest of the world?
Why was there a shortage of toilet paper during the coronavirus pandemic?	How did a fall in consumer spending during the pandemic affect overall employment?

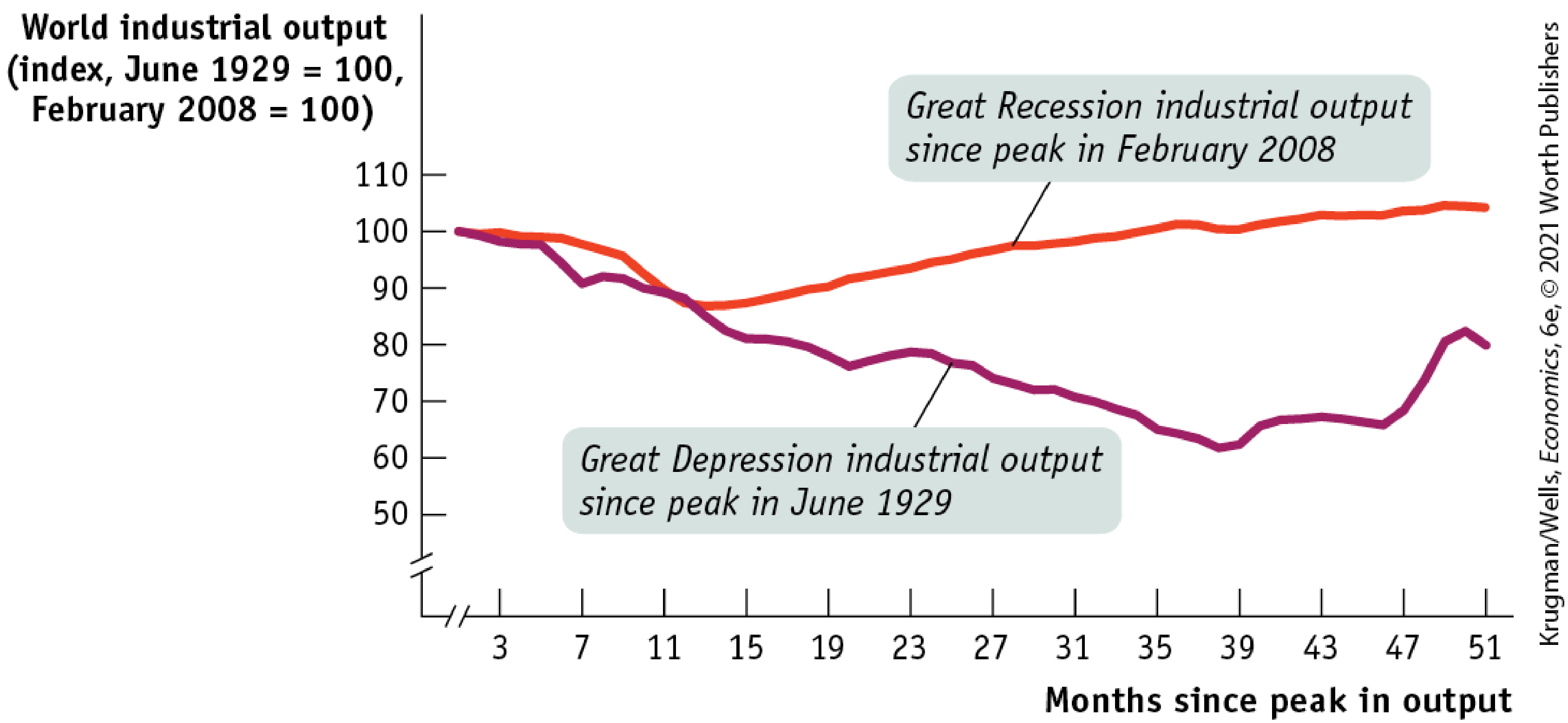
MACROECONOMICS: THE WHOLE IS GREATER THAN THE SUM OF ITS PARTS

- Macroeconomic questions can’t be answered simply by adding up microeconomic answers.
- Consider, for example, the **paradox of thrift**: When people are worried about economic hard times, they prepare by cutting their spending. This reduction in spending depresses the economy and businesses react by laying off workers.
- As a result, people end up worse off than if they hadn’t cut their spending. Seemingly virtuous behavior—saving more—harms everyone.
- The combined effect of individual decisions can have results that are different from what any one individual intended. The behavior of the macroeconomy is greater than the sum of individual actions and market outcomes.

MACROECONOMICS: THEORY AND POLICY

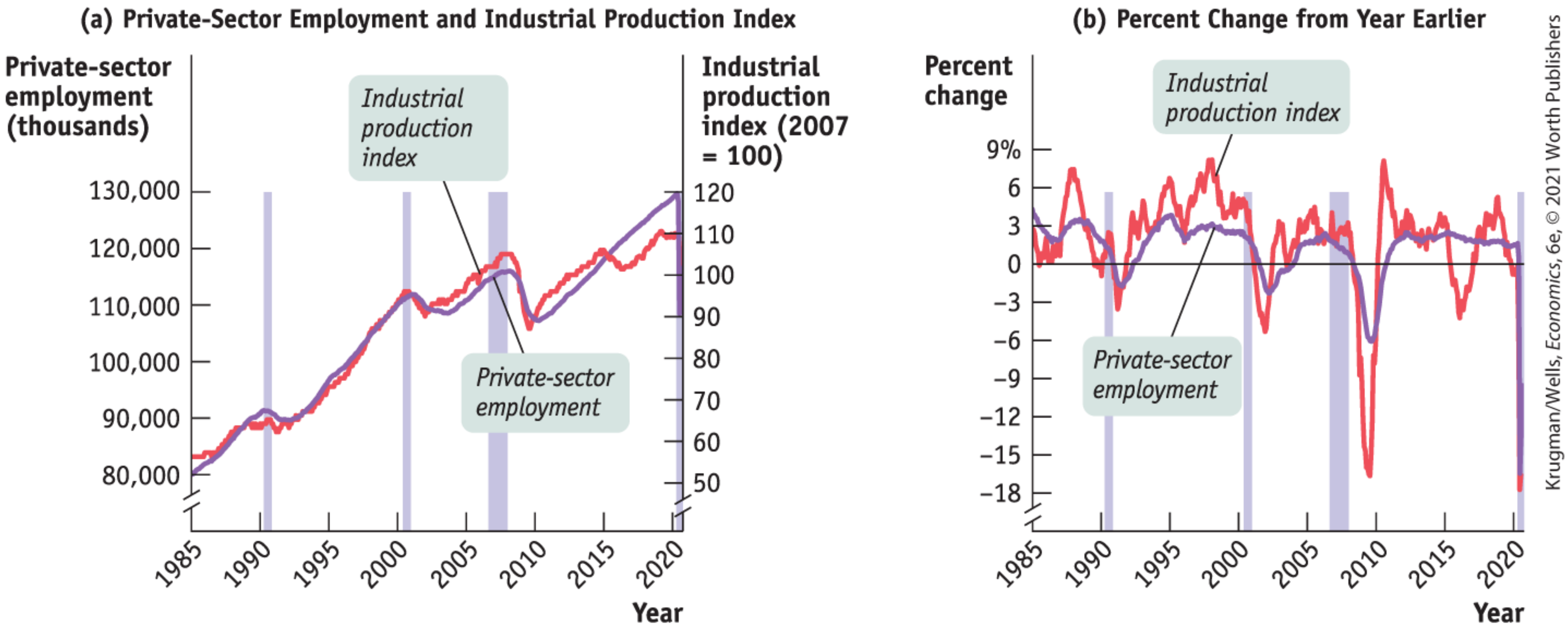
- **Pre-1930s economics:** the economy is **self-regulating**. Problems such as unemployment would be corrected through the working of the "invisible hand" and that government interventions would probably make things worse.
- **Post-1930s Keynesian economics:** a depressed economy is the result of inadequate spending. *Government intervention can help* a depressed economy through monetary policy and fiscal policy.
- **Monetary policy** uses changes in the quantity of money to alter interest rates, which in turn affect the level of overall spending.
- **Fiscal policy** uses changes in taxes and government spending to affect overall spending.
- John Maynard Keynes established the idea that managing the economy is a government responsibility.

COMPARING THE GREAT RECESSION TO THE GREAT DEPRESSION



- The Great Depression: policy makers let the slump run its course.
- The Great Recession: policy makers slashed interest rates, increased spending and cut taxes—governments helped avoid a global economic catastrophe.

THE BUSINESS CYCLE



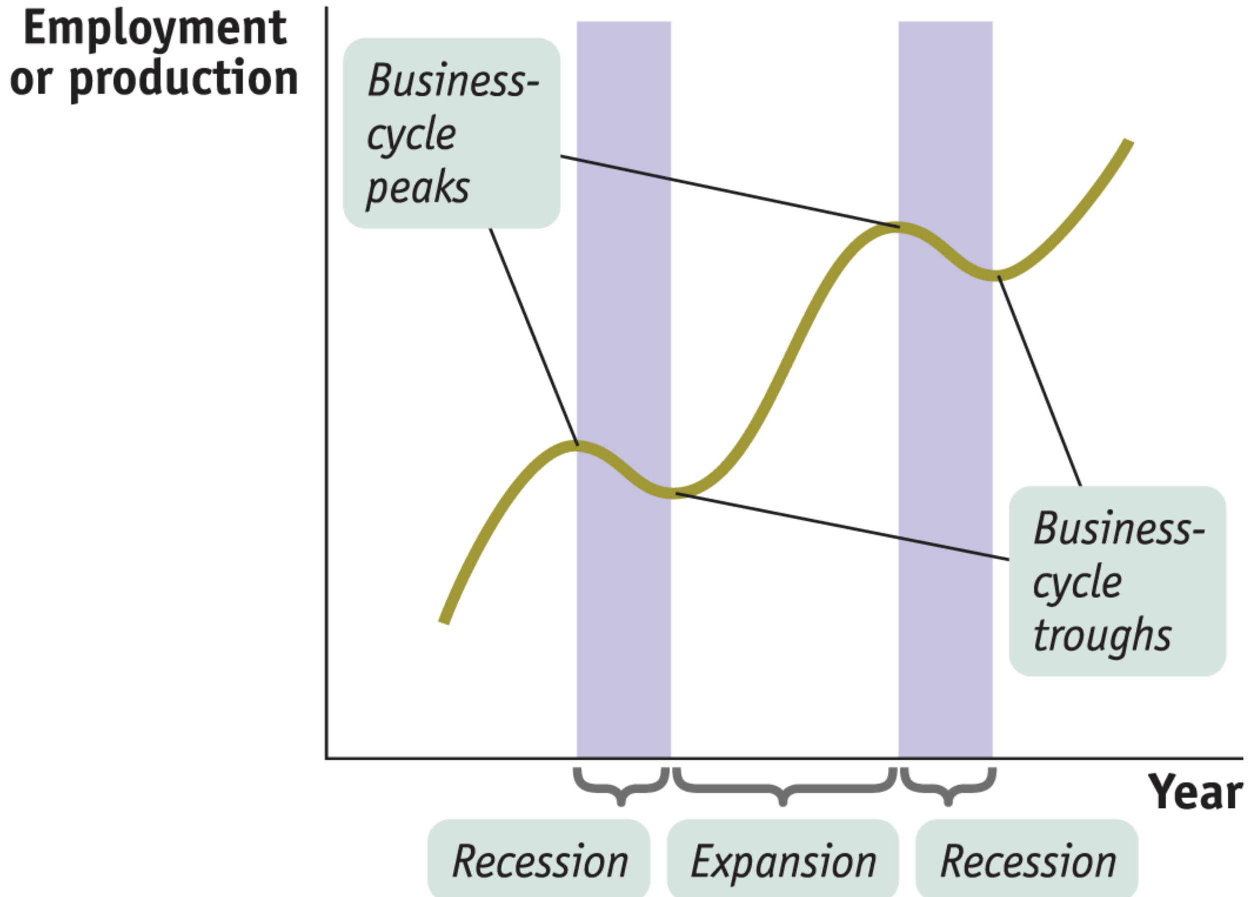
- Major economic indicators show a strong upward trend.
- But they didn’t rise steadily. There were downturns in the early 1990s, the early 2000s, 2007, and 2020.

CHARTING THE BUSINESS CYCLE (1 of 2)

- **Recessions (contractions):** periods of economic downturn when output and employment are falling
- **Expansions (recoveries):** periods of economic upturn when output and employment are rising
- **Business cycle:** the short-run alternation between recessions and expansions

CHARTING THE BUSINESS CYCLE (2 of 2)

- The point at which the economy turns from expansion to recession is a **business-cycle peak**.
- The point at which the economy turns from recession to expansion is a **business-cycle trough**.

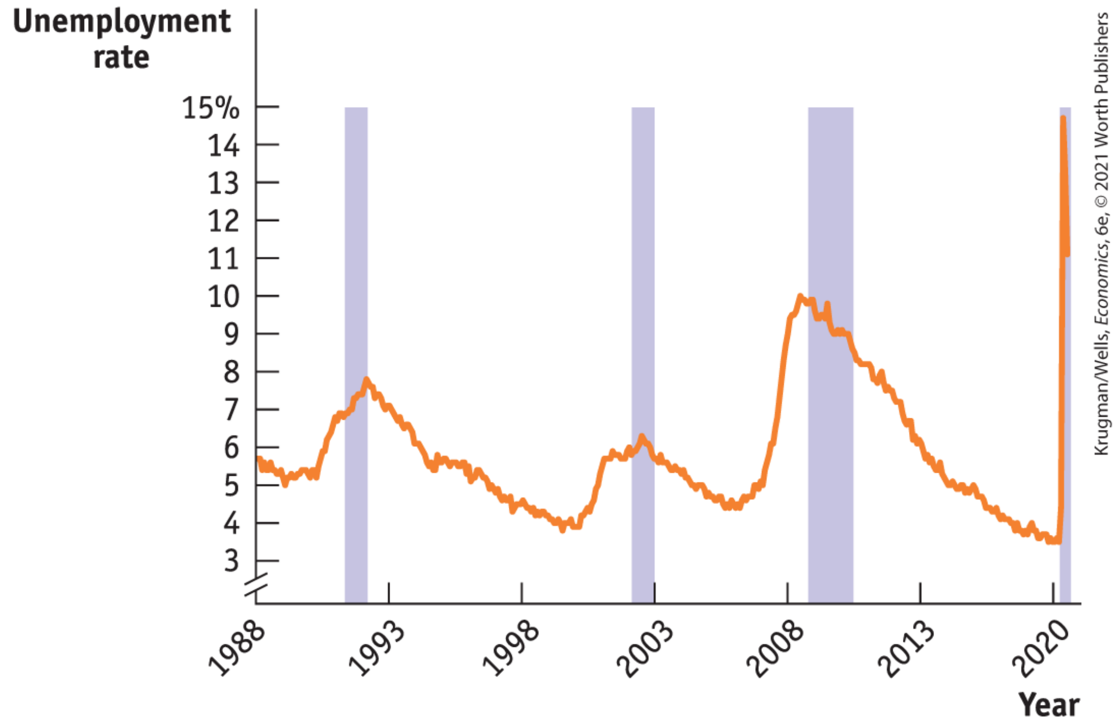


THE PAIN OF RECESSION

- Recessions cause many people to lose their jobs and make it hard to find new ones.
- Recessions reduce the standard of living, increase poverty, cut corporate profits, and result in bankruptcies of many small businesses.
- Can anything be done to reduce the frequency and severity of recessions?

TAMING THE BUSINESS CYCLE

- Modern macroeconomics largely came into being as a response to the recession of 1929–1933.
- According to John Maynard Keynes and Milton Friedman, policy makers should try to "smooth out" the business cycle. They haven't been completely successful but helped make the economy more stable.



LEARN BY DOING: PRACTICE QUESTION 1

- The use of taxes and government spending to change the overall level of spending in an economy is called:

  a) monetary policy.

  b) fiscal policy.

  c) either monetary or fiscal policy, depending on what is happening to the interest rate.

LEARN BY DOING: PRACTICE QUESTION 1 (Answer)

- The use of taxes and government spending to change the overall level of spending in an economy is called:

  a) monetary policy.

  b) fiscal policy. (correct answer)

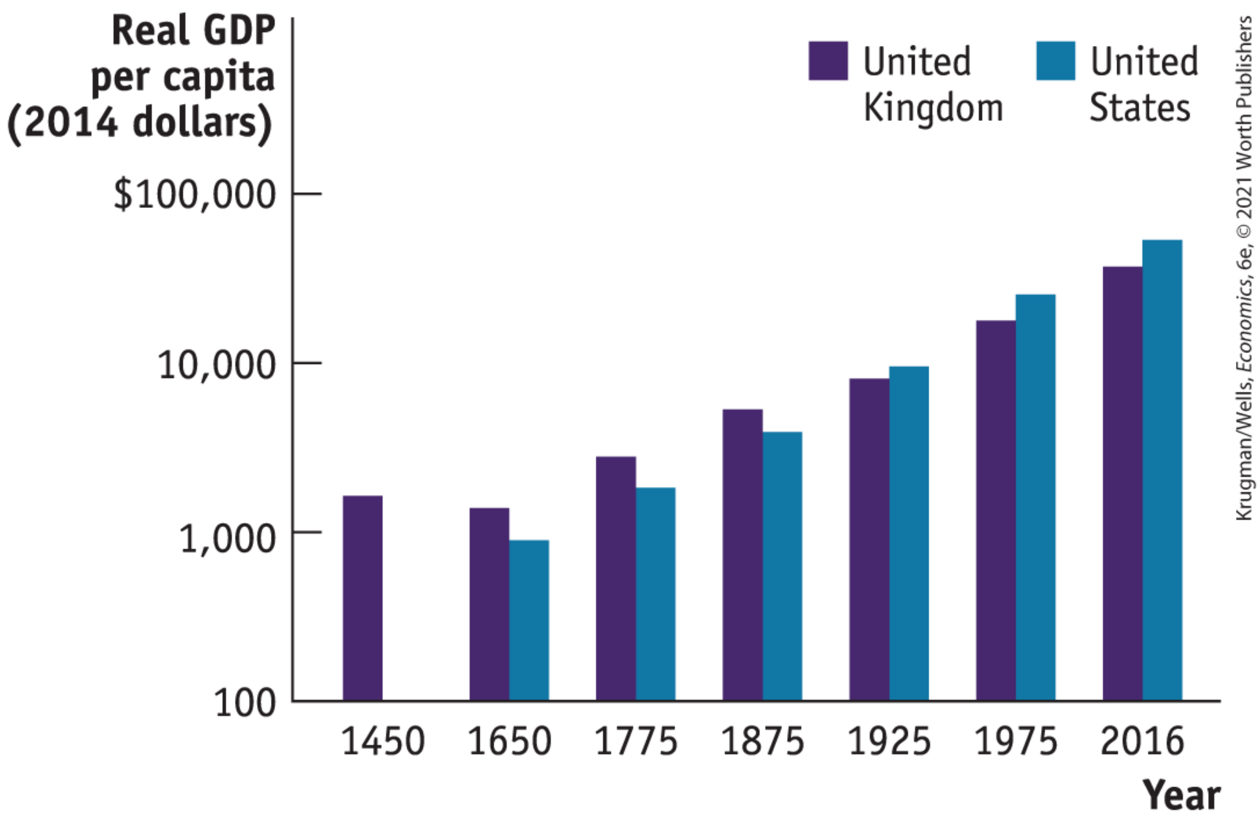
  c) either monetary or fiscal policy, depending on what is happening to the interest rate.

LEARN BY DOING: DISCUSSION QUESTION 2

- With a partner, discuss if the government should launch massive spending when recession strikes.
- What are the pros and cons of government interventions into the economy?

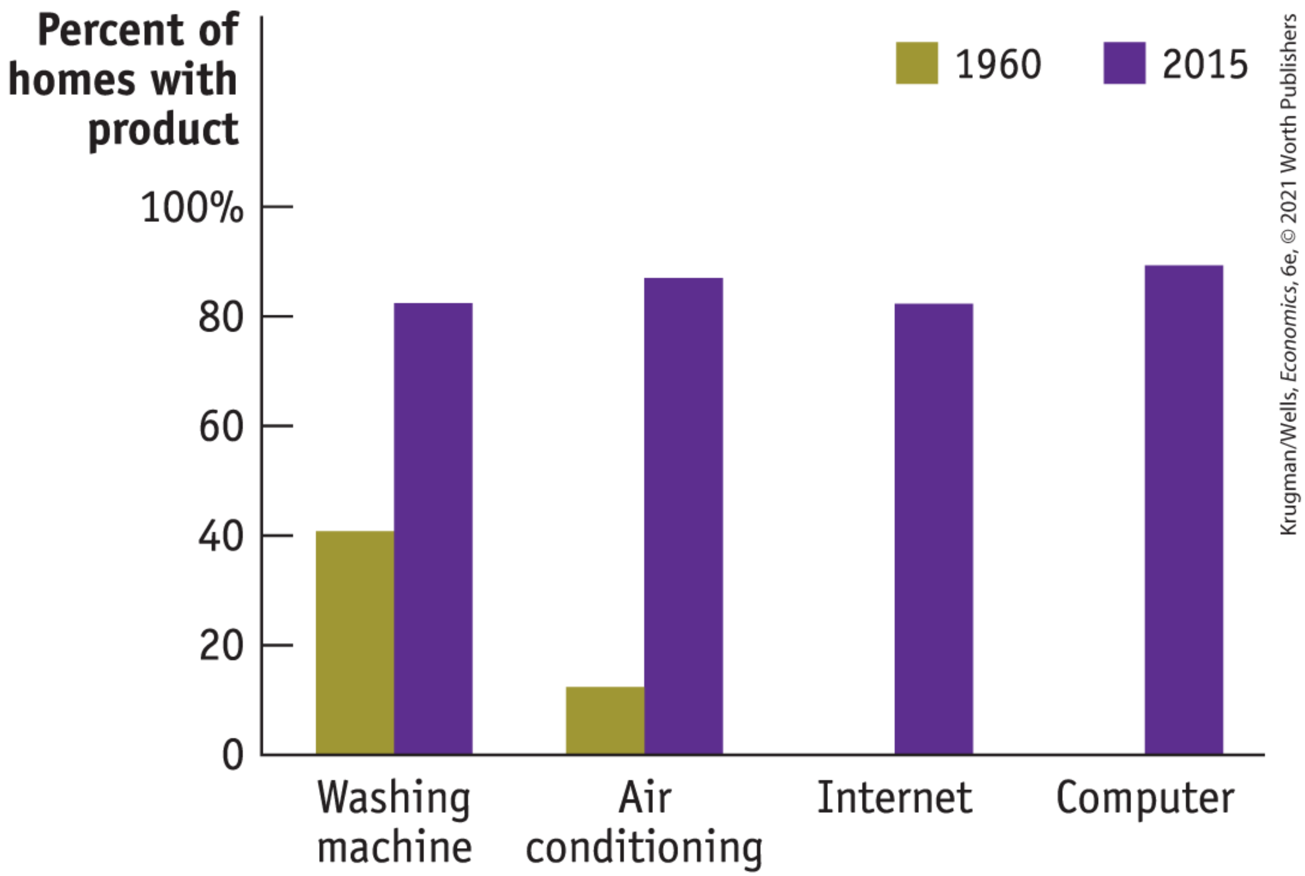
LONG-RUN ECONOMIC GROWTH (1 of 3)

- Long-run economic growth is the sustained upward trend in the economy’s output over time.
- It reflects one of our basic principles of economics: Increases in the economy’s potential lead to economic growth over time.



LONG-RUN ECONOMIC GROWTH (2 of 3)

- Americans have become able to afford many more material goods over time thanks to long-run economic growth.

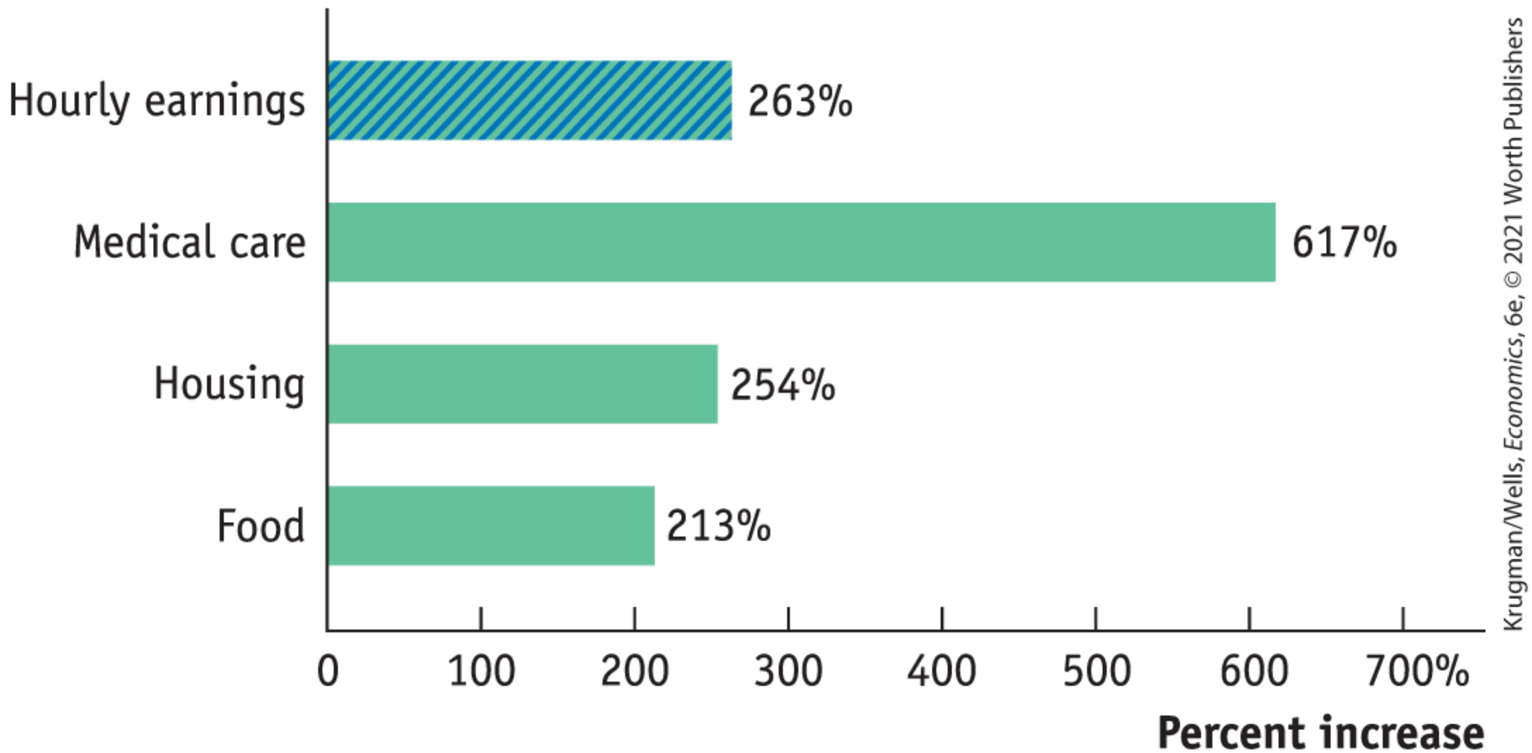


LONG-RUN ECONOMIC GROWTH (3 of 3)

- Long-run economic growth is a modern invention: Britain, for example, wasn't any richer in 1650 than it was two centuries earlier.
- Countries don't necessarily grow at the same rate. Britain was once substantially richer than the United States, but it was overtaken by the United States after 1875.

INFLATION AND DEFLATION

- A rise in the overall level of prices is **inflation**.
- A fall in the overall level of prices is **deflation**.



Growth between 1980 and 2020

THE CAUSES OF INFLATION AND DEFLATION

- Can’t we just add up supplies and demands in all the markets to find out what happens to the overall level of prices?
- No, because supply and demand can only explain why a good or service becomes more expensive **relative to other goods and services**.
- In the **short run,** movements in **inflation** are **closely related to the business cycle**.
  - **When the economy is depressed and jobs are hard to find, inflation tends to fall**
  - **When the economy is booming, inflation tends to rise.**
- In the **long run**, the overall level of prices is mainly determined by changes in the money supply.

THE PAIN OF INFLATION AND DEFLATION

- Both inflation and deflation are problematic.
  - **Inflation** discourages people from holding onto cash (because cash loses value if prices are rising). In extreme cases, people stop using cash altogether.
  - **Deflation** can cause the reverse problem. Since cash gains value if the price level is falling, holding on to it is more attractive than investing in new factories and other productive assets. This can deepen a recession.

- The economy has **price stability** when the overall level of prices changes slowly.
- Economists view price stability as a desirable goal. From the 1990s to the present, it has been achieved.

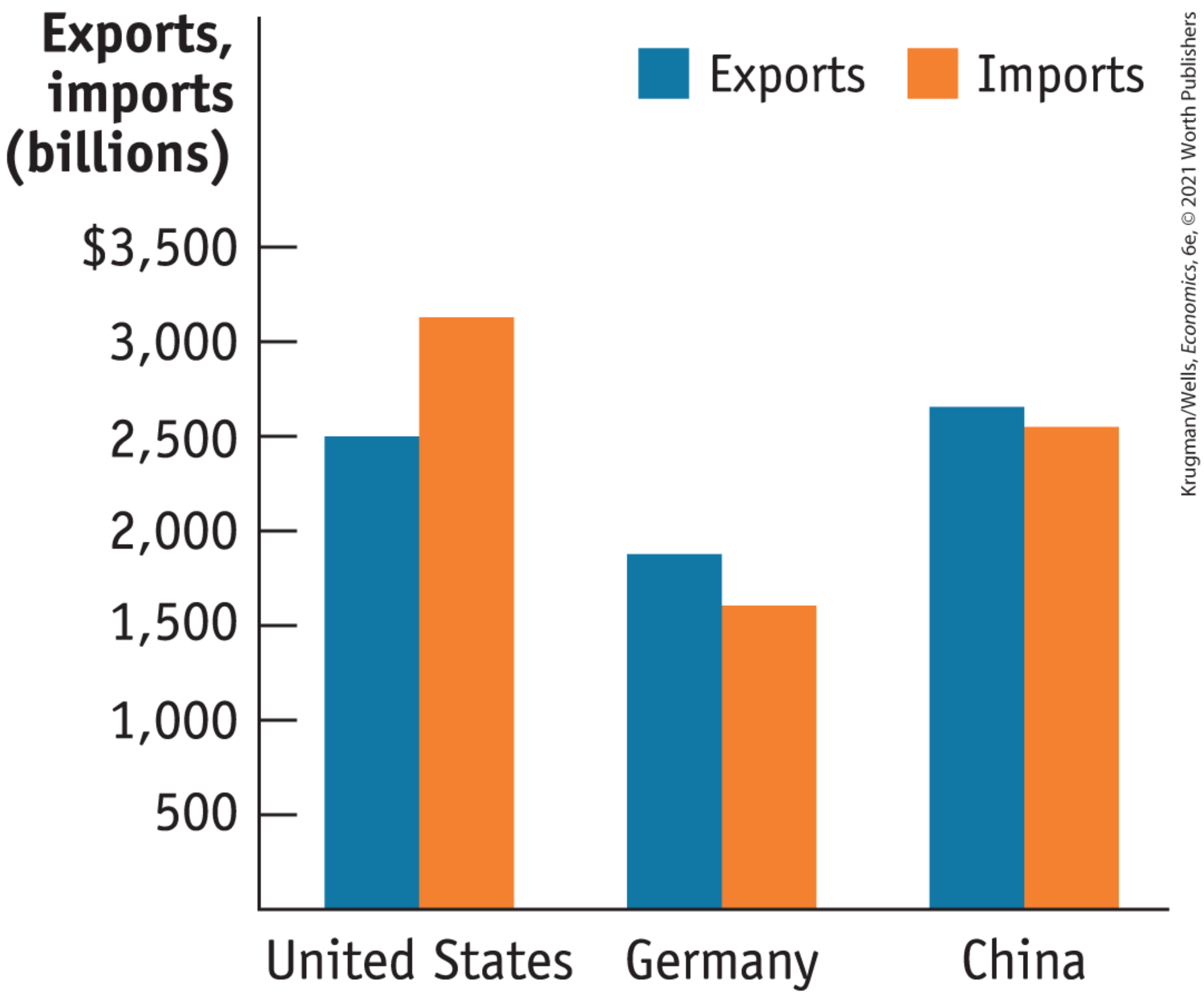
INTERNATIONAL IMBALANCES (1 of 3)

- The United States is an **open economy:** it trades goods and services with other countries.
- Since the 1990s, the United States runs big trade deficits when the country imported more than it exported.
- **Trade deficit:** the value of goods and services bought from foreigners is more than the value of goods and services sold to them
- **Trade surplus:** the value of goods and services bought from foreigners is less than the value of the goods and services sold to them
- Are the U.S. trade deficits a sign that something is wrong with the economy?

INTERNATIONAL IMBALANCES (2 of 3)

- In a later chapter we'll learn the surprising answer: the determinants of the overall balance between exports and imports lie in decisions about **savings and investment spending**.
- Countries with high investment spending relative to savings run **trade deficits**; countries with low investment spending relative to savings run trade surpluses.

INTERNATIONAL IMBALANCES (3 of 3)



LEARN BY DOING: PRACTICE QUESTION 2

- This year the value of a country's imports is equal to $1.2 billion, and the value of its exports is equal to $1.3 billion. This country is running a:
  a) trade surplus.
  b) trade deficit.

LEARN BY DOING: PRACTICE QUESTION 2 (Answer)

- This year the value of a country's imports is equal to $1.2 billion, and the value of its exports is equal to $1.3 billion. This country is running a:

  a) trade surplus. (correct answer)

  b) trade deficit.

Data Exercises

- Go to the Federal Reserve Bank of St. Louis (FRED) website (https://fred.stlouisfed.org/) and create graphs of the following four data series
  a) Real Gross Domestic Product (GDP)
  b) Unemployment rate
  c) Inflation rate (Inflation, consumer prices for the United States)
  d) U.S. trade balance (Trade Balance: Goods and Services, Balance of Payments Basis)

  – Explain briefly the behavior of the first three series during recessions and expansions. Why do they behave that way?
  – Why is the U.S. trade balance negative? What does it mean?