Introduction

Chapter 1

Outline

- Macroeconomics and Its Uses
- Recent Macroeconomic Performance
- Explaining Economic Growth and Fluctuations

1.1 MACROECONOMICS AND ITS USES

- **Macroeconomics** – explains why the economy grows and fluctuates over time
- Moving forces – increasing population, more factories and machines, and better technology
- Not smooth – cycles of expansions, recessions, and recoveries

1.1. MACROECONOMICS AND ITS USES

- **Microeconomics** – study of behavior of individual consumers, firms, and markets
- More concerned with individual markets than the economy as a whole
- It considers as given such variables as national income, price, and interest rates, which are explained by macroeconomics

MACROECONOMICS AND ITS USES

It is essential for a good economic policy, and it has great potential to improve economic welfare

Macroeconomics helps policy makers:

- avert recessions or ensure that they are short
- choose among various government spending and tax proposals in order to increase long-run economic growth
- keep inflation low and stable without making the economy unstable in the short run
- assess how their policy changes affect the types of goods produced in the economy

1.2 Recent Macroeconomic Performance

- **Definition of Real GDP**
- The measure of the physical production of cars, trucks, medical treatments, and all other goods and services that people in the US produce for trade with one another or the rest of the world
- The sum of the dollar value of production adjusted for any price changes that have occurred from year to year
- The total output of goods in the economy (real output)

1.2 Recent Macroeconomic Performance

Real GDP

- Average growth rate is **3.2%**
- Total growth: growth in labor, capital, and technological improvements
- US has experienced **Six recessions** since 1968
- The fluctuations do not occur at regular intervals; they cannot be anticipated
- The most noticeable recession was the Great Depression in the 1930s
- Fluctuations in the US have diminished in magnitude

Employment

- Correlation between Real GDP and employment fluctuations
- Employment fell through the six recessions (layoffs and fewer hires)
- Employment grew with each recovery (new hires)
- Close association between production and employment (recession = large-scale job loss)
- Fluctuations in ***employment*** mirror fluctuations in ***unemployment:*** 1982 – unemployment rose to 10%, 1989 fell to 5%, 1992 rose to 8%, etc

■ Inflation

- Correlation between economic fluctuations and inflation rates
- Prices grow faster when the economy is near its ***peak*** and slower when the economy is near a ***trough*** *(the end of a recession)* – both lag behind the fluctuations in GDP
- Inflation was much higher and volatile in the 1970s than 1980s and 1990s

■ Interest rates

- Procyclical – they move together with output, rising during expansions and falling during recessions
- Usually rise with inflation
- The Federal Funds Rate measures how much banks pay to borrow funds from each other overnight
- Key measure of the effect of the Federal Reserve Board

- **Real Interest Rate**

- Real interest rate is the interest rate minus the expected rate of inflation
- It is the *key* variable in macroeconomics because it strongly influences real GDP
- The real interest rate is lower than the interest rate for the United States because inflation has been positive

Money supply

- Currency and deposits people have at banks and other institutions; closely related to the interest rate
- Controlled by the Federal Reserve Board
- Real money = money/price level
- Relation between money, expansions and recessions – changes in money supply might cause fluctuations in the economy