The Macroeconomic Environment

What is meant by the word ‘environment’ in this context?

Who are the decision-making entities/actors in the macroeconomy.

What actions do they take?

How do they interact with each other?

A. Who are the major actors or participants in any economy?
   1. Households
   2. Firms
   3. Government
   4. Rest of the World: We trade with rest of the world. We drink French wine & they buy our computers. We buy Japanese cars and station troops in Japan to guard it against external aggression. So our products are bought by & sold to other countries, and in turn we buy their products & they sell to us. So, these other countries in the world also appear as actors in our economy. All these countries are included under ‘Rest of the World’.

B. What does each of these actors do?

Each of these actors has a role as both a buyer and seller in the economy (in the goods, services, and labor market. These are the markets where the involved agents indulge in expenditure as buyers to acquire things from sellers).

They also borrow or lend to the other economic players (in the money/loans market).

Over and above that the Government has some special powers: it can tax people, without having to provide anything to them in return.

On the other hand the government has some social responsibilities, so it has to provide some things to everyone, even if the particular individual is unable to provide payment for that service him/herself (e.g., police services).

(For the last two kinds of activities there is no buying or selling involved---let us call this sort of economic activity as NON-MARKET ACTIVITY).
• The list of the things a household does in the economy:

1. It is a buyer in the goods market & services. It buys food, clothes, SUVs, insurance, medical services, vacations, movie tickets, etc., by paying a market price for everything it buys.

2. It is a seller in the labor market. Example: It sells its labor to other households (as a waiter at a restaurant does), or firms (if one works for Procter & Gamble, say), and gets a wage in return.

3. It pays taxes to the government. Like income tax, or sales taxes that one pays when one buys things at the store.

4. It receives handouts (transfers) from the government in the form of social security checks, etc., for which it does not have to anything for the government in return.

5. Lends money to other households, firms, the government, or the rest of the world.

6. Gets repayments on past net loans (net lending) to other households, firms, the government, or the rest of the world.

7. Borrows from other households, firms, the government, or the rest of the world.

SAY WHICH OF THESE IS AN ACTIVITY IN WHICH OF THE MARKETS OR A NON-MARKET ACTIVITY. (Note: sales taxes do get generated during the process of buying & selling, but these taxes are handed over to the govt. without the it having the obligation to provide any good or service in return).

• The list of the things a firm does in the economy:

1. It is a buyer in the labor market & goods market. Example: It hires laborers by paying them wages, and machines from other firms by paying a market price for those machines.

2. It is a seller in the goods market. Example: It sells its goods to households & other firms and receives a price for what it sells.

3. It pays taxes to the government. Like profits tax.

4. Lends money to households, other firms, the government, or the rest of the world, example: Banks

5. Gets repayments on past net loans to households, firms, the government, or the rest of the world.
6. Borrows from households, other firms, the government, or the rest of the world.

SAY WHICH OF THESE IS AN ACTIVITY IN WHICH OF THE MARKETS OR A NON-MARKET ACTIVITY.

- The list of the things the government does in the economy:
  1. It is a buyer in the labor market & goods market. It hires government officials by paying them wages, and goods from firms by paying a market price.
  2. It receives taxes from the households & firms.
  3. It gives transfers to households and provides goods & services in the economy like roads, national defense, etc.
  4. It borrows money from households and/or firms, and/or the rest of the world.
  5. It repays past borrowings (net) from households and/or firms, and/or the rest of the world.
  6. Makes loans to households (like student loans), and/or firms, and/or the rest of the world.

SAY WHICH OF THESE IS AN ACTIVITY IN WHICH OF THE MARKETS OR A NON-MARKET ACTIVITY.

- The list of things the rest of the world does in the economy:
  1. Buys goods & services from our country (our exports to the rest of the world). Example: Goods & services from our households & firms.
  2. Sells goods & services to our households, firms, and government (our imports from the rest of the world).
  3. It borrows money from households and/or firms, and/or the government of our country.
  4. It repays past net borrowings from households and/or firms, and/or the government of our country.
  5. Gives loans to households and/or firms, and/or the government of our country.

SAY WHICH OF THESE IS AN ACTIVITY IN WHICH OF THE MARKETS OR A NON-MARKET ACTIVITY.
The thing to note is that what is spent by one economic agent (expenditure) accrues as income to another:

Examples.
1. The price paid for a good by a household accrues as income to a firm.
2. Wages paid by a firm accrues as income to households.
3. Prices & wages paid by the government buying things & employing people accrue as income to firms & households.
4. Taxes paid by households and firms accrue as income to the government.

Parkin, Ch. 4: Measuring GDP & Economic Growth
In the first lecture we talked about what the three big issues in macroeconomics are, and how a macroeconomist’s job entails measuring, analyzing, and suggesting policies with respect to the living standard of the economy, cost of living, and fluctuations of the economy. Today we shall talk about the measurement of perhaps the single most macroeconomic variable: the Gross Domestic Product (GDP).

**GDP (Definition):** It is the MARKET VALUE of all the FINAL GOODS & SERVICES produced WITHIN A COUNTRY in a GIVEN TIME PERIOD.

All components of the definition are important.

5. Q. Why do we need to take MARKET VALUE?
Ans. An economy produces many different things: airplanes, cars, wheat, soybean, clothes, computers, ice-cream, burgers, movies, mail service. You just cannot add all these things together item by item and measure the total produce of the economy: for example, which is greater 10 cars & 15 computers, or 12 cars & 10 computers? A smart way to account for everything is to take the market values, i.e. market prices of the commodities and arrive at a figure for the total value of the goods & services produced in the economy.

Example: If 10 cars & 50 computers are produced in the economy, and each car has market price of $ 10000 & each computer $ 1000, then the value of production is:

\[ 10 \times 10000 + 50 \times 1000 = 100000 + 50000 = \$ 150000 \]
6. Q. Why FINAL GOODS & SERVICES?

Ans. Consider how a car is produced: the car factory buys steel from steel mills, glass, leather, foam, paint, etc., and uses them to make the car’s body, engines, tires, accessories, etc., puts these together to make a car. Now each of these things has a price (the steel, glass, etc.). When figuring out how much to sell the car for, the car company adds together these costs, adds remuneration for itself, and decides the price of the car. Notice, the price of the glass, steel, etc., has already been included in the price of the car. When we are trying to figure out the value of the goods produced in the economy, and add both the values of the steel, glass & leather that went into the making of the car, as well as the value of the car itself, we will be doing what is called ‘double counting’: adding the value of the same thing twice in our calculations. This will inflate the true value of the GDP beyond what it really is. To avoid this we include only final goods (end products) in our calculation, and not the value of intermediate goods i.e., inputs.

Example.

Say a car uses steel worth $5000, glass worth $2000, labor services and other materials worth $1000. When deciding on the price of the car, the car-maker adds her cost \(5000+2000+1000=8000\), adds 2000$ profits for herself, and sells it for $10000.

What is the value of this car and all the materials & services (steel, labor, etc.) that went into its building (which was produced by the economy, by the way), that should be included in the calculation of domestic product?

If we say $10000, we are correct.

If we say $10000+$5000 (price of steel)+ $2000(glass)+ $2000 (Labor & other inputs) we are incorrect. The other things are already included in the first 10000$. 