Chapter 4

What Macroeconomics Tries to Explain

Economic Growth

- Increase in production of goods and services that occurs over long periods of time
  - Most developed countries: Annual output of goods and services has risen over time, risen faster than population
  - Economists monitor economic growth by keeping track of real GDP
  - Real GDP: Total quantity of goods and services produced in a country over a year. Real GDP rises faster than the population, output per person rises, so does average standard of living.
  - Real GDP of U.S. (1929-2006)
    - Increased dramatically
    - Population increase?
    - Increased faster than population

Macroeconomic Goals

- Microeconomics
  - Behavior of individual decision makers and individual markets

- Macroeconomics
  - Broad outlines of the economy
  1. Economic growth
  2. Full employment
  3. Stable prices

Economic Growth

Figure 1 U.S. Real Gross Domestic Product, 1929–2006
Economic Growth

- Although output has grown, the rate of growth has varied over the decades
  - Over long periods of time, small differences in growth rates can cause huge differences in living standards
- Growth increases the size of the economic pie (does every citizen have a larger slice?)
  - Growth doesn't benefit everyone (why?)
  - Some people believe that in the long run everyone will benefit from growth
  - Others see a role for the government (how?)
- Macroeconomics helps us understand a number of issues surrounding economic growth.
  - Why does real GDP grow? Why do some countries experience rapid growth while others don't? Can government policy change the growth rate?

High Employment/Low Unemployment

- Unemployment affects distribution of economic well being among our citizens
  - People who cannot find jobs suffer a loss of income
- Joblessness affects all of us—even those who have jobs
  - A high unemployment rate means economy is not achieving its full economic potential
- Average standard of living falls
- Unemployment rate (one measure economists use to keep track of employment)
  - Percentage of the workforce that is searching for a job but hasn't found one

U.S. Unemployment Rate, 1920–2006

- The nation's commitment to high employment has twice been written to law
  - Employment Act of 1946
    - Required Federal Gov. to “promote max. employment, production, purchasing power”
  - Full Employment and Balanced Growth Act of 1978
  - Unemployment Rate of 4%
- The target of 4% was reached in December 1999
- Why does average unemployment rate fluctuate from year to year? Why a target of 4% unemployment rate was not maintained for some periods?
Employment and the Business Cycle

- Firms produce more
  - Hire more workers
- Firms produce less
  - Lay off workers
- Real GDP and Unemployment are closely related
  - Consistently high employment requires a high stable level of output
  - Output is not stable, real GDP has climbed upward, but it has been a bumpy ride
- Business cycles
  - Fluctuations in real GDP around its long-term growth trend
- Expansion
  - A period of increasing real GDP
- Contraction
  - A period of declining real GDP

Real GDP and Unemployment are closely related. Consistently high employment requires a high stable level of output. Output is not stable, real GDP has climbed upward, but it has been a bumpy ride. Business cycles fluctuate around a long-term trend. Expansion involves a period of increasing real GDP. Contraction involves a period of declining real GDP.

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Recession
- A contraction of significant depth, breadth and duration

Depression
- An unusually severe recession

In the twentieth century, the United States experienced one decline in output serious enough to be considered a depression—the worldwide Great Depression of the 1930s
- From 1929 to 1933, the first four years of Great Depression, U.S. output dropped by more than 25%
Stable Prices

- With very few exceptions, inflation rate has been positive
- During 1990s, inflation rate averaged less than 3% per year
- During the 2000s (through mid-2006) inflation rate averaged about 2.8%
- Other countries have not been so lucky
  - An extreme case was the new nation of Serbia—prices rose by 1,880% in August 1993. Also Zimbabwe’s annual inflation reached 1,000% in mid-2006.
- Why are stable prices—a low inflation rate—an important macroeconomic goal?
  - Because inflation is costly to society
  - With annual inflation rates in the thousands of percent, the costs are easy to see
    - Purchasing power of currency declines so rapidly that people are no longer willing to hold it

Stable Prices

- Economists regard some inflation as good
- Price stabilization requires not only preventing inflation rate from rising too high
  - But also preventing it from falling too low, where it would be dangerously close to turning negative—deflation—a period of decreasing prices

Macroeconomic Approach

- In macroeconomics, we want to understand how the entire economy behaves
  - Thus, we apply the steps to all markets simultaneously
- How can we possibly hope to deal with all these markets at the same time?
- The answer is aggregation—process of combining different things into a single category and treating them as a whole

Macroeconomic Controversies

- John Maynard Keynes
  - Father of modern macroeconomics
  - Keynes took on the conventional wisdom of his time, ‘classical economics’ which held that:
    - The macroeconomy worked very well on its own
    - Best policy for the government to follow was laissez faire—‘leave it alone’.
- Keynesians
  - The economy does not do well on its own and requires continual guidance from an activist and well-intentioned government
Macroeconomic Controversies

- Some early controversies resolved, others have risen.
- Still there are disagreements:
  - Controversy over the Bush administration’s $350 billion 10-year tax cut.
  - Distinction between positive (what is?) and normative (what should be?)
- Economics profession has come to a consensus on many basic principles, we will stress these as we go.

Example

- In 1973, real GDP (at 2000 prices) was $4,342 billion. In 2000 it was, $9,817 billion. During the same period, U.S. population rose from 212 million to 281 million.
  - What was the total percentage increase in real GDP?
  - What was the total percentage increase in the U.S. population during this period?
  - Calculate Real GDP per person in 1973 and in 2000. By what percentage did output per person grow over this period?