ECON205 – Macroeconomic Theory and Policy

LECTURE 1: An Introduction to Macroeconomics & National Income Accounting and Prices

Readings: Dornbusch et al. chapters 1 & 2

Introduction

Macroeconomics: deals with the behaviour of the economy as a whole and the major economic issues of the day. It examines the behaviour of:

- Output
- Employment
- The aggregate price level
- The balance of payments
- The exchange rate

Macroeconomics focuses on policies that affect consumption, investment, interest rates, trade balance, determinants of wages and prices, the federal budget, and national debt.

Macroeconomics in the short run: focuses on analysis of business cycles (alternating periods of economic expansion and economic recession).

Expansions: periods of positive GDP growth.
Recessions: periods of negative GDP growth.

The short-run goal of policy makers is to use fiscal and monetary policy to smooth out cyclical movements in the economy to avoid episodes of high unemployment or inflation.

Note: In the short run, the price level is fixed, and output is determined by the level of aggregate demand.

Macroeconomics in the long run: focuses on long-run economic growth (the process by which increasing productivity raises the average standard of living).

The long-run goal of policy makers is to promote high and stable economic growth to improve the standard of living.

$$\text{GDP Growth} = \frac{\mathrm{Y_t} - \mathrm{Y_{t-1}}}{\mathrm{Y_{t-1}}}$$

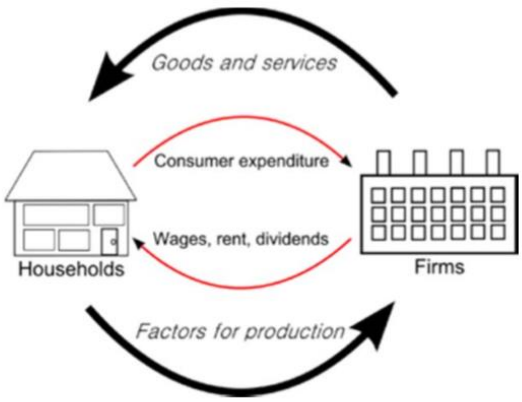
Markets: since the economy is a complex system, we simplify the analysis of the system into more manageable parts, called markets.

1. Goods (Product) Market
2. Money/Assets Market
3. Labour Market
4. External Markets, i.e. the interaction of residents with the rest of the world (ROW)

The circular flow of income: a system describing interactions between households, firms, the government, financial institutions, and the foreign sector.

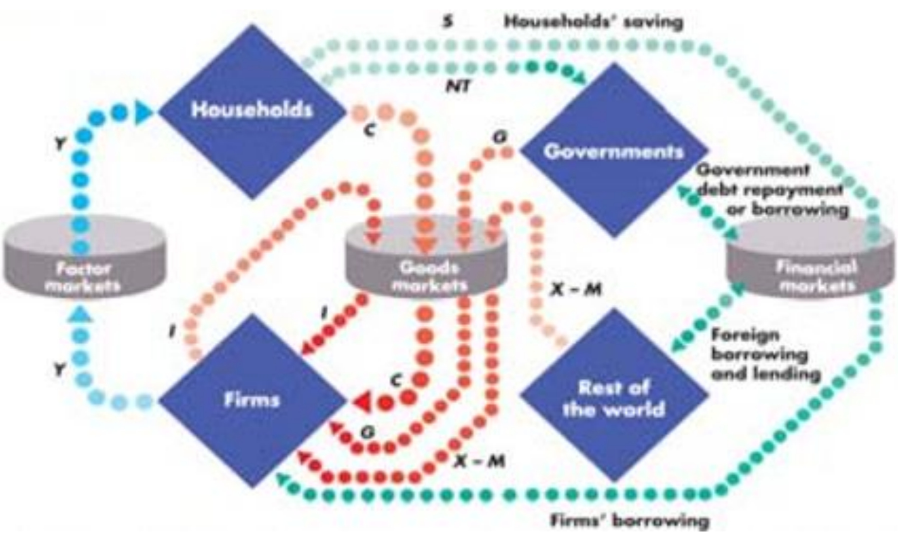
Diagram of a simple economy (households and firms only):

Households are owners of resources (land, labour, capital, & management).
Firms are basic decision-making units (what to produce, how to produce, & for whom to produce.



The complete circular flow diagram of income and expenditure:

- Shows the interaction of the goods and factor markets.
- The value of goods/services = the value of factor incomes = the value of expenditures.
- Non-fulfillment of the above relation results in macroeconomic problems.
- E.g. If the value of goods/services < or > the value of expenditures.



Y = income received by households from firms
C = household consumption
S = household savings
NT = net taxes
I = investment expenditure by firms
G = government purchases of goods/services
(X – M) = net exports = the rest of the world purchases
Firms, governments, and the rest of the world also borrow from financial markets

Note: The relevance of this model is demonstrated in national income accounting where the expenditure, income, and output methods should each produce the same measure of national income/output.

Schools of Thought in Macroeconomics

Macroeconomics is an unsettled body of knowledge; major controversies still exist and there are many schools of thought, including:

1. Classical School
2. Neo-classical School
3. Keynesian School
4. Monetarism
5. New Classical Macroeconomics
6. Neo-Keynesianism
7. Post Keynesianism

Classical economics:

- 1776-1876, Adam Smith's *An Inquiry into the Nature and Causes of Wealth of Nations* (1776), other important figures were Ricardo and Marx.
- The economy is always at or near the natural level of real GDP.
- Say's Law, “Supply creates its own demand” (automatic full employment).
- Prices, wages, and interest rates are flexible.
- Quantitative Theory of Money: general price level is directly proportional to the amount of money in circulation (money supply); therefore, money has no long-term effect.
- Prices are determined by cost of production, not demand.
- Focuses on the long-run.

Neo-classical economics:

- 1870s, includes the works of Carl Menger, William Jevons, and John Clark.
- Optimisation and the rational choice theory.
- Competitive economy and market clearing are assumed.
- Rejects cost-based pricing.
- Automatic full employment is always attained.
- Focuses on short-run behaviour.