

Topic 1: Introduction to the Global Economy

What is macroeconomics?

- Macroeconomics is the study of aggregates or whole systems (the economy), as opposed to individual markets
- A central concern of macroeconomics is how the economy as a whole grows and changes over time

Key Measurements

To determine how the economy is doing, it is important to have some measurements (diagnostic tests).

Macroeconomic aggregates:

- **Gross domestic product (GDP):** total output of goods and services produced in a country over a given period of time, normally a year
- **General price level:** measure of the average price of all the goods and services in an economy
- **Interest rates, unemployment and exchange rates**

Why study macroeconomics?

- Changes in these key indices not only impact private banks and governments policies but can also change household decisions
- **Examples:** Personal decisions such as the decision to buy a house, borrow from the bank to buy a car, go on to further study or join the labour market
- Knowing macroeconomics will help you to make smarter decisions to either protect yourself from adverse economic changes or take advantage of positive changes
- Macroeconomics is essential to determining good policy and building economic systems that are prosperous and environmentally sustainable

Macroeconomics vs Microeconomics

- **Microeconomics:** the branch of economics that examines individual decision making by firms and households, and the way in which they interact in specific industries and markets
- **Macroeconomics:** the branch of economics that examines the workings and problems of the economy as a whole

The macroeconomy behaves differently than if each individual component were considered by itself.

Economic models

- A macroeconomic model is an explanation of how the economy or a large part of the economy works
- These are abstractions, or simplifications, of the real world that can be described with words, numerical tables, graphs and algebra
- Using these frameworks, we can then ask numerous questions that are relevant for households and firms

Example: If the government reforms superannuation, what is likely to happen to the Australian financial market?

Economic models cont.

- To make the analysis manageable, we usually hold these other factors constant, so we can think through the effects of interest rates on the housing market
- Economic models use a **ceteris paribus** assumption, which means that our models hold 'other things equal'
- In reality many factors change at the same time
- It is then key to identify which factors are the most important and likely to change

Macroeconomics in practice

- The Reserve Bank has kept the official cash rate at its historic low of 1.5% for the 26th consecutive month

Positive vs normative statements

- Positive economics is about what is observed as 'facts', open to testing, verifiable or can be proved or disproved
- Normative economics is about values, emotions, beliefs, involves 'value judgements'

Macroeconomists generally do not view making normative policy decisions as their main tasks.
Politicians have the job of deciding what the community thinks is right or wrong.

Positive economics

Positive economics is about how the economy in fact works.
It can help us inform whether an economic policy is likely to be effective.

Examples:

- What would happen in response to an interest rate cut?
- Observing or deducing that there is an inverse relation between the unemployment rate and inflation rate of one country

Normative economics

Normative economics recommends particular policies that encourage a desired amount (or type) of growth.

Example:

- The unemployment rate is too high, and the government should act in order to reduce the unemployment rate

Conflicting policy goals

- Societies cannot necessarily achieve all their policy goals simultaneously
- Some goals are quite compatible, but others tend to conflict
- Ideally decision makers are looking for the best **trade-off** – minimising what you have to give up to achieve a policy goal

Broad government intervention or free market

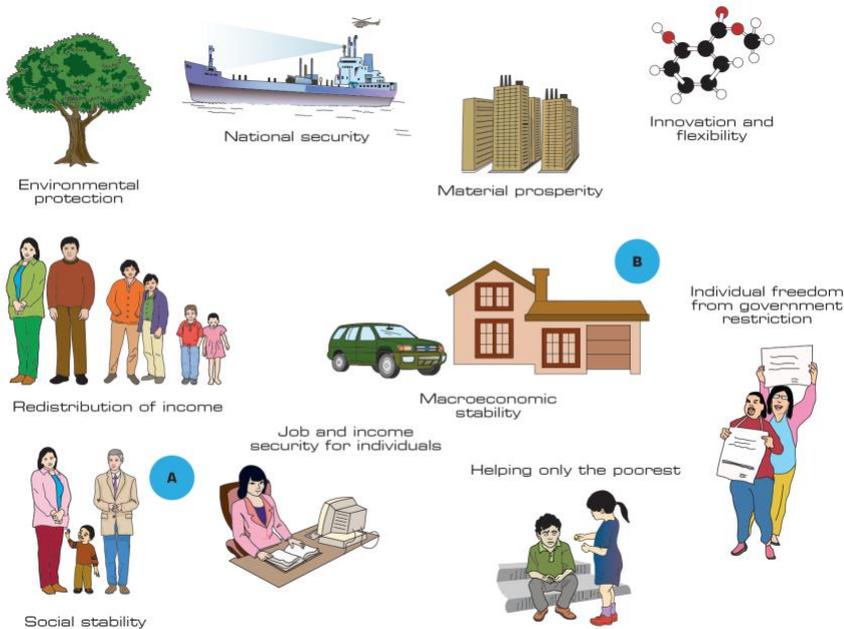


Figure 1: Free Market elements

Trade-off

Managers making choices at BMW

BMW's management face many decisions involving trade-offs. For example, whether to concentrate production in Germany, or to build factories in overseas markets.

Production Possibility Frontier: BMW

BMW faces a production trade-off between Roadsters and Convertibles

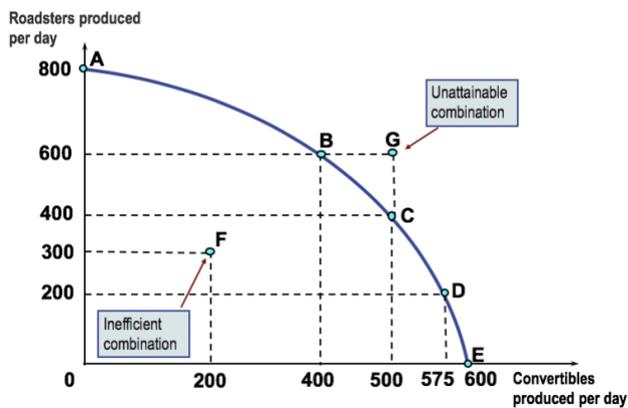


Figure 2: BMW's Production Choices per day

Production possibility frontiers and real-world trade-offs

Increasing marginal opportunity costs

- The bowed-out shape of the production possibility frontier illustrates the concept of increasing marginal opportunity cost
- Increasing marginal opportunity costs demonstrate an important economic concept:

Law of Increasing Opportunity Cost: When all resources are being used, an increase in the production of one good will lead to greater forgone production of another good.

The more resources already devoted to an activity, the smaller the payoff to devoting additional resources to that activity.

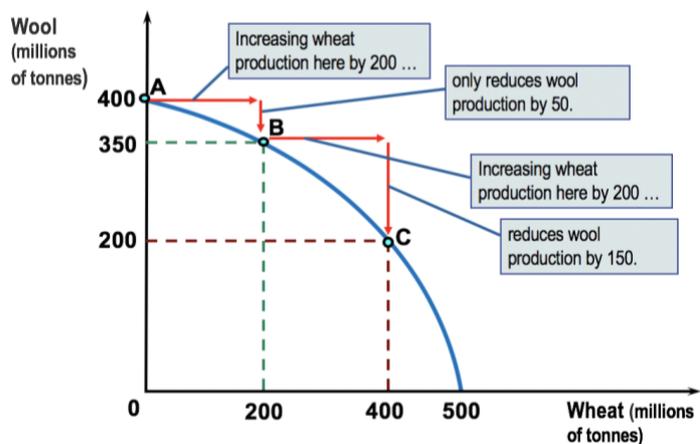
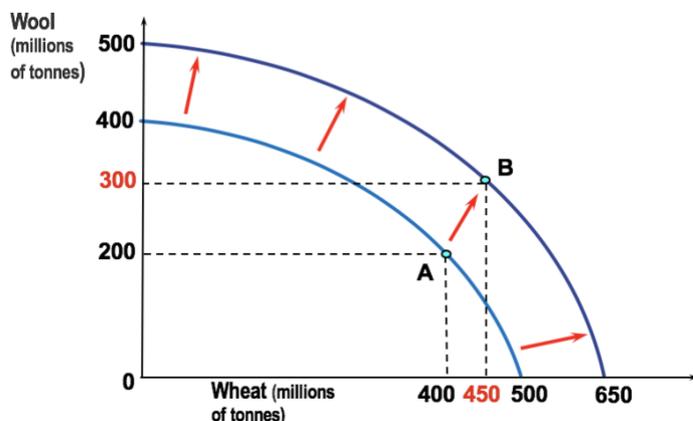


Figure 3: Increasing Marginal Opportunity Cost

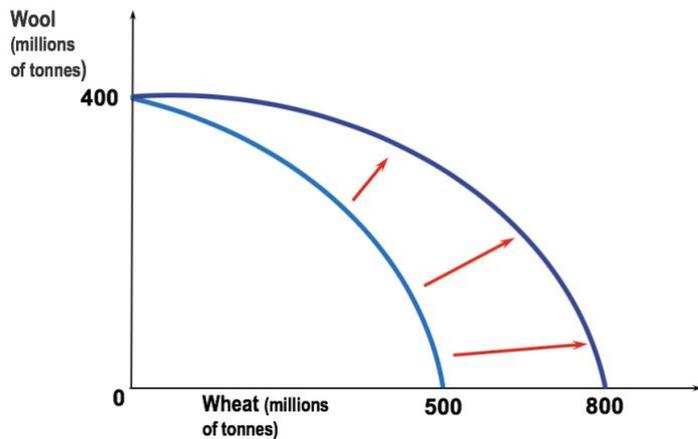
Economic growth

- **Economic growth:** The expansion of societies production potential
- Economic growth can be illustrated using the production possibility frontier



Shows that as **more economic resources become available** and technological change occurs, the economy can move from point A to point B, producing more wool and more wheat.

Figure 4: Shifting out the production possibility frontier



Shows the results of **technological advance** in the wheat industry that increases the quantity of wheat that workers can produce per year, while leaving the maximum quantity of wool that can be produced unchanged. Shifts in the production possibility frontier represent economic growth

Figure 5: Technological change in the wheat industry

Comparative advantage and trade

- We use the production possibility frontier and the concept of opportunity cost to explain the economic gains from specialisation and trade
- **Trade:** The act of buying or selling a good or service in a market

Specialisation and gains from trade

- We use a simple example of two people – you and your neighbour
- And two goods, apples and cherries, measured in kilograms (kgs)

	You		Your neighbour	
	Apples	Cherries	Apples	Cherries
All time picking apples	20 kg	0 kg	30 kg	0 kg
All time picking cherries	0 kg	20 kg	0 kg	60 kg

Table 1: Fruit picked each month without trade

Shows how many kilograms of apples and how many kilograms of cherries you and your neighbour can each pick in one month.

	You		Your Neighbour	
	Apples (kg)	Cherries (kg)	Apples (kg)	Cherries (kg)
Production and consumption without trade	8	12	9	42
Production with trade	20	0	0	60
Consumption with trade	10	15	10	45
Gains from trade	2	3	1	3

Summarises the change in production and consumption that result from your trade with your neighbour.

Table 2: Summary of gains from trade

Absolute advantage versus comparative advantage

Absolute advantage: The ability of an individual, firm or country to produce more of a good or service than competitors using the same amount of resources

Comparative advantage: The ability of an individual, firm or country to produce a good or service at a lower opportunity cost than other producers.

	1 kg of apples	1 kg of cherries
You	1 kg of cherries	1 kg of apples
Your neighbour	2 kg of cherries	0.5 kg of apples

Table 3: Opportunity cost of picking fruit

Summarises the opportunity costs for you and your neighbor of picking apples and cherries.

Comparative advantage and the gains from trade

- The basis for trade is comparative advantage, not absolute advantage
- Individuals, firms or countries are better off if they specialize in producing goods and services for which they have a comparative advantage and obtain other desirable goods and services by trading