Economics 212
Principles of Macroeconomics
Notes

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INTRODUCTION

I  What is Macroeconomics

A  Definition

Definition 1  Macroeconomics is the study of how the economy as a whole grows and changes over time.

B  Concerns of Macroeconomics

1. Measuring how well the economy is performing.

2. Seeking to understand how the economy works.

3. Improving the performance of the economy.

C  Why study macroeconomics?

Why should we study this field? Why is this relevant?

1. Improvements in the economy translate directly into increases in the wealth and welfare of society. For example, macroeconomics seeks to find ways to:
   - Reduce unemployment.
   - Increase wealth in less developed countries.

   In the long run, the difference between a well-run economy and a poorly run economy can be the difference between Ethiopia and Germany. Money cannot buy happiness, but comes close: wealthier societies have more goods, better health care (longer life expectancy), more leisure time, and less pollution.

2. But, of what use is macroeconomics to the lay people, the non-experts? A good working knowledge of the tools of macroeconomics allows one to make a reasonable estimate of the current and future performance of the economy. With this knowledge, one can determine:
   - when to buy a house.
   - when to buy small stocks or large stocks (small stocks do worse than large stocks when the economy is doing poorly).
• whether or not this job offer a competitive one.

For example, you might be interested in starting a new business. During bad economic times, few people start new businesses because households do not have extra income to spend on a new product.

II The modeling approach to economics: microfoundations

To get an idea of the difficulty of the problem we are undertaking, remember that we are attempting to make sense out of an economy in which 13 trillion dollars worth of goods are sold each year by and to 300 million people, no two of which is alike. We are trying to look simultaneously at multimillion dollar mergers and Idaho russet potato farmers.

A Economic Principles

So instead of studying the actual economy, macroeconomics studies a model of the economy. Economic models attempt to simplify the economy while at the same time preserve the essential relationships between different groups in the economy. How do economists model the economy?

We start by modelling each individual behavior, and then aggregate across individuals up to get economy-wide statistics. Because this is often very complicated, we often assume that people are similar, which means we need only compute the actions of one person or a few types of people.

B Macroeconomic Markets

Recall from micro that it was often easy to characterize a market, in which buyers and sellers negotiated upon a mutually satisfactory price at which an equilibrium quantity of the goods or service were sold. Macro studies 4 special categories of markets. These characterize much of what happens in the overall economy.

1. OUTPUT MARKET. Here are all finished goods and services produced in the economy (marshmallows, Ipads, etc). Firms are the supplies, while consumers, firms, and consumers in other countries demand.

2. INPUT MARKETS. Here all raw materials used to produce the finished goods are bought and sold.
• LABOR is an especially important input. Firms demand and households supply.
• CAPITAL (hammers, plants, and equipment) is the other input, which is generally purchased on credit. All stocks, bonds, bank loans, etc. are lumped together. Households supply the savings for which firms (and households) demand in order to purchase capital equipment from other firms.

3. MONEY/FOREIGN EXCHANGE MARKETS.

• MONEY MARKET. To study things like interest rates, we need money in the economy. Households demand (hold) money while the government supplies money.
• FOREIGN EXCHANGE MARKET. US households demand foreign currency to purchase imports, foreigners supply foreign currency to get US currency to purchase our exports.

III Some questions we will answer

1. Economic Growth: why are their differences across countries?
2. Unemployment: what explains the changes in unemployment across the business cycle, across countries, and over time in the US?
3. Inflation: what explains periods of extremely high inflation in developing countries?

IV Current economic conditions

A GDP/unemployment

We can see from the graphs available on the website, that for the US:

• The total amount of goods and services produced (GDP) is an indicator of the health of the economy.
• GDP has grown substantially since 1950.
• Recessions are periods when GDP falls. The most recent recessions are 1991, 2001, and 2008-9.
• The unemployment rate is the number of people looking and unable to find work as a percentage of the total number of people working and looking.
• Unemployment rises during recessions. Unemployment was above 10% in 1981 and 2009-10.

• Some unemployment always exists.

Worldwide:

• China, Thailand, and Chile are among the fastest growing economies during the period 1980-2006. Nicaragua and Venezuela are among the slowest growing countries.

• The US economy grows at about 3% per year. At this rate, incomes double every 35 years. China grows at 9.5% per year. At this rate, incomes in China double every 8 years. Venezuela grows at about 1% per year. At this rate, incomes double every 70 years.

• Korea, Peru, Panama, Chile, and Columbia had nearly identical incomes per person in 1980. Korea’s income is now 5 times higher than Peru’s. Chile’s per capita income is now nearly 2.5 times higher than Peru’s.

• Argentina, Spain, and Ireland had nearly identical incomes in 1980. Ireland’s is now more than 3 times higher than Argentina and almost twice as high as Spain’s.

• Spain has the highest average unemployment among developed countries, more than 17%! The US averages a little over 6%, and has not exceeded 11%. Japan, Singapore, and Switzerland average less than 4%. Why?

B Recessions

• In the recession of 2008-9, GDP fell more than other recent recessions, more than 4%.

• The recession of 2008-9 has also been very long lasting. GDP has still not recovered to pre-recession levels.

• Unemployment rose much more than in previous recessions, and has still not recovered.

• Most recessions result not from a fall in consumer spending, but a fall in investment spending: purchase of goods and services by firms and new housing. Investment spending fell by more than 20% and has still not recovered.

• Of particular concern is housing and construction. New housing fell almost 30% and appears to be still declining.
C Prices and Inflation

- Something that cost $1 in 1776 cost $1.01 in 1945.

- Something that costs $1 in 1945 costs more than $9 today.

- Prices have increased more slowly since the early 1980s. Price changes are also less volatile.

- Prices increased quickly during the oil crises of the 1970s: as much as 11% per year during the oil crises of 1979. More recent oil crises have not had similar effects, however.

- The supply of money experienced little growth until WWII. Since WWII, the supply of money has grown more rapidly, especially during the current recession.

D Interest Rates

- Overnight lending rates are at historic lows.

- Interest rates fall in recessions and rise during periods of high inflation.

- During 2001-2006, the Federal Reserve has kept interest rates far below levels dictated by current economic conditions. Most bubbles are preceded by periods of very low interest rates. Could the FED have contributed to the housing bubble?