

Introduction to Macroeconomics

Macroeconomics is the branch of economics that examines the economy as a whole and tries to determine the forces that cause both good and bad economic performance. Policymakers can use the information gleaned from macroeconomics to better decide what actions, if any, that they should take to correct the course of the economy.

Some Americans—especially younger Americans—may question the need for any serious examination of the workings of the economy, since the U.S. economy has performed quite well for the past decade or so. Those who are older know that the U.S. economy has sometimes had a turbulent past. As recently as 1982, the unemployment rate was as high as 11.2 percent, and as recently as 1980 the inflation rate approached 20 percent. In addition, despite recent gains in the 1990s there has been a slowdown in the rate of growth of the purchasing power of the average American; during the period from 1945-1972 the average American's purchasing power doubled, while from 1973-2000 the average American's purchasing power grew only 11%.

Macroeconomics is a fairly young branch of economics, having only been thoroughly developed after World War II. Many believe that our improved understanding of the economy has helped us avoid the serious economic upheavals, such as the Great Depression, that plagued the U.S. economy prior to the 1940s.

The principal tool of macroeconomics is the *scientific method*; Macroeconomists formulate theories about how the economy works, they use these theories to develop models of the economy (using mathematics), then they test and refine those theories and models. In addition, macroeconomists, in conjunction with statisticians and data analysts, have developed ways to measure how well the economy is performing.

The purpose of this class is, of course, to gain a working understanding of the science of macroeconomics. We will:

- Examine how the performance of the economy is measured.
- Look at how the various parts of the modern economy, how each part is modeled, and how these parts are combined into an overall model of the economy.

Some questions that we'll try to answer:

- What causes inflation, and what actions (if any) should government take to keep inflation low?
- What causes unemployment, and what actions (if any) should government take to keep it low?
- What causes standards of living to rise over time, and what actions (if any) should government take to keep living standards rising?
- Should government pay down its huge debt?
- What causes an international trade deficit, and should this be a concern?

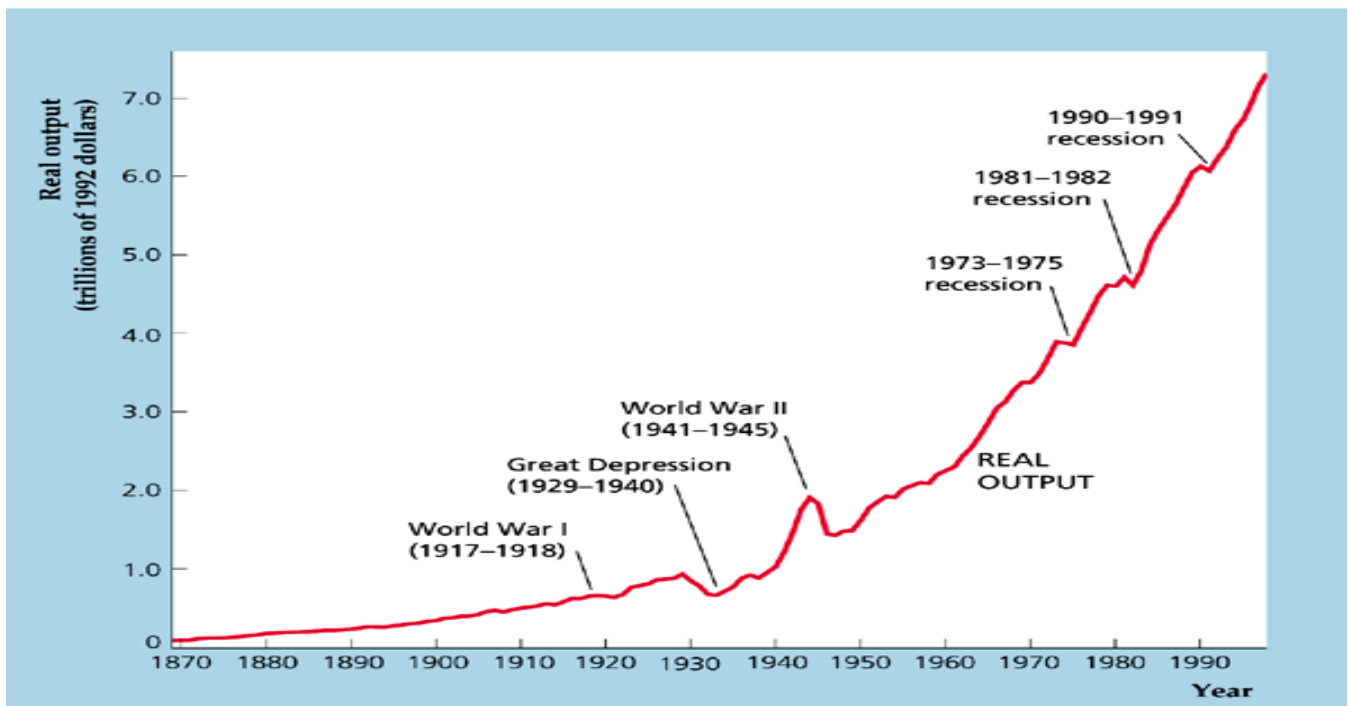
On our journey, we'll often confront the fundamental truth gained from all economics research: **TANSTAAFL**—There Ain't No Such Thing As A Free Lunch. Improvements in one area often lead to bad things in other areas. In particular, we'll see that:

- Events which keep inflation low often cause unemployment to rise.
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- Events which increase the standard of living of the present generation often reduce the living standards of subsequent generations.
- Events which increase the standards of living of future generations often reduce the living standards of the present generation.

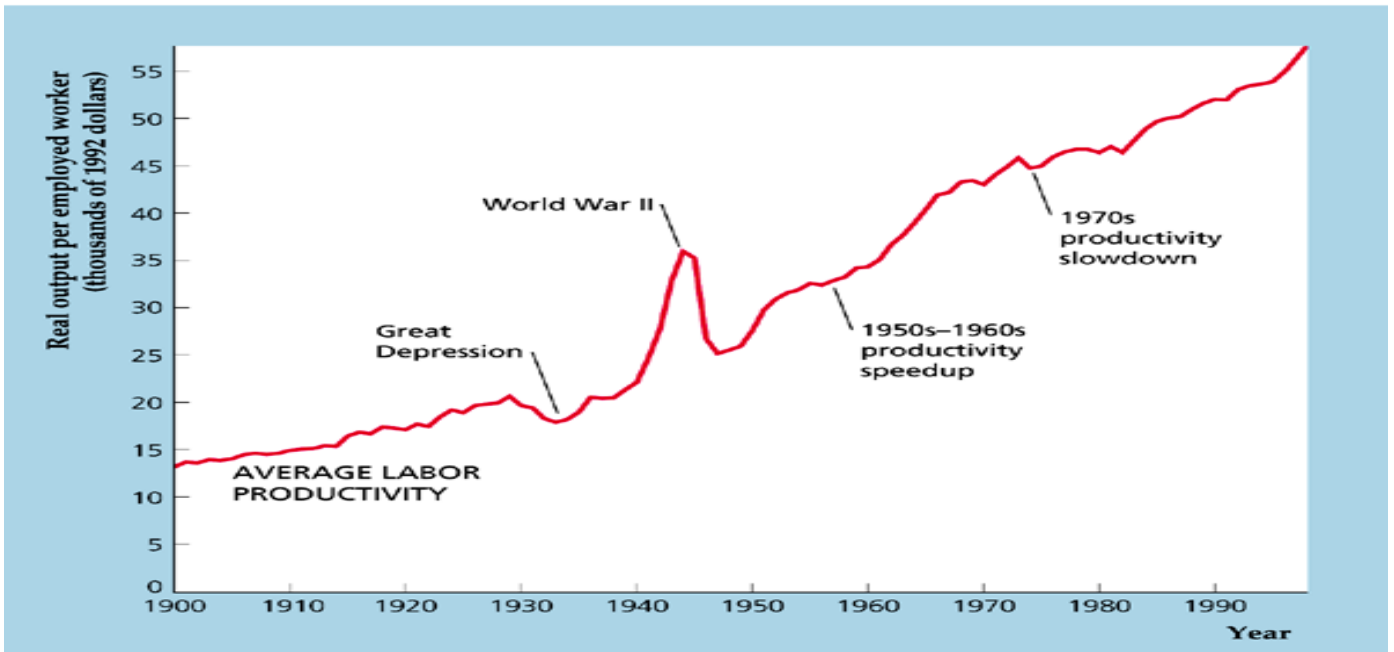
When we're finished, we will understand macroeconomics (though not well enough to become practicing economists—most economists have Ph.D.s). As citizens knowledgeable about the economy, we will be able to participate in deciding the future course of our economy.

A Few Graphs Depicting the Performance of the U.S. Economy

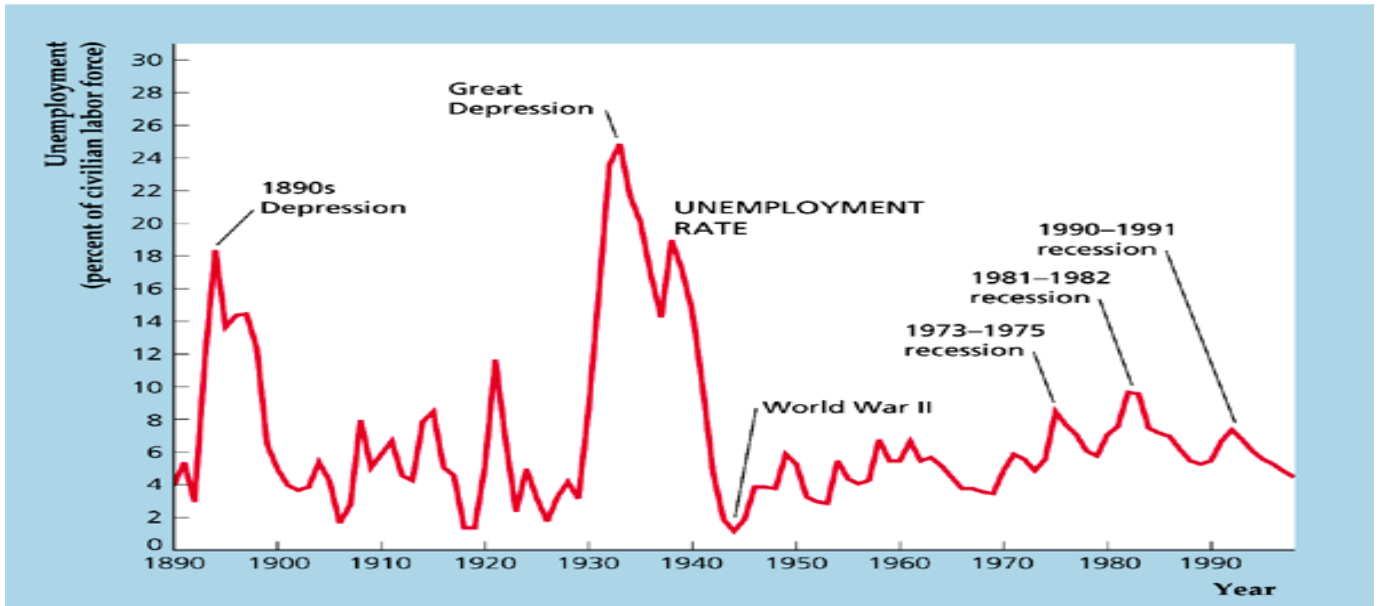
An MBA will be expected to have a general idea of how the U.S. economy has performed in the past, how it is performing now, and how it is expected to perform in the future. Here are some graphs (taken from Macroeconomics, 4th edition, by Abel and Bernanke):



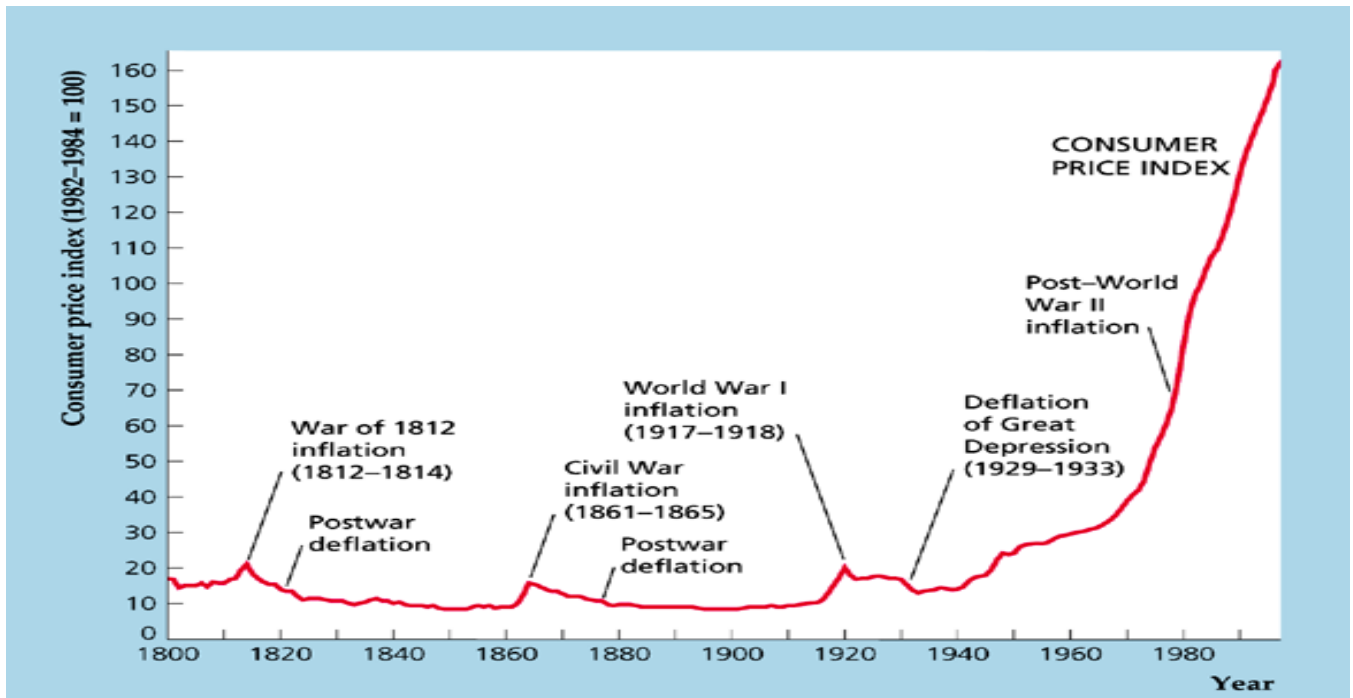
Notice that output has generally risen, though not at a constant rate; we have had recessions (during which output has declined).



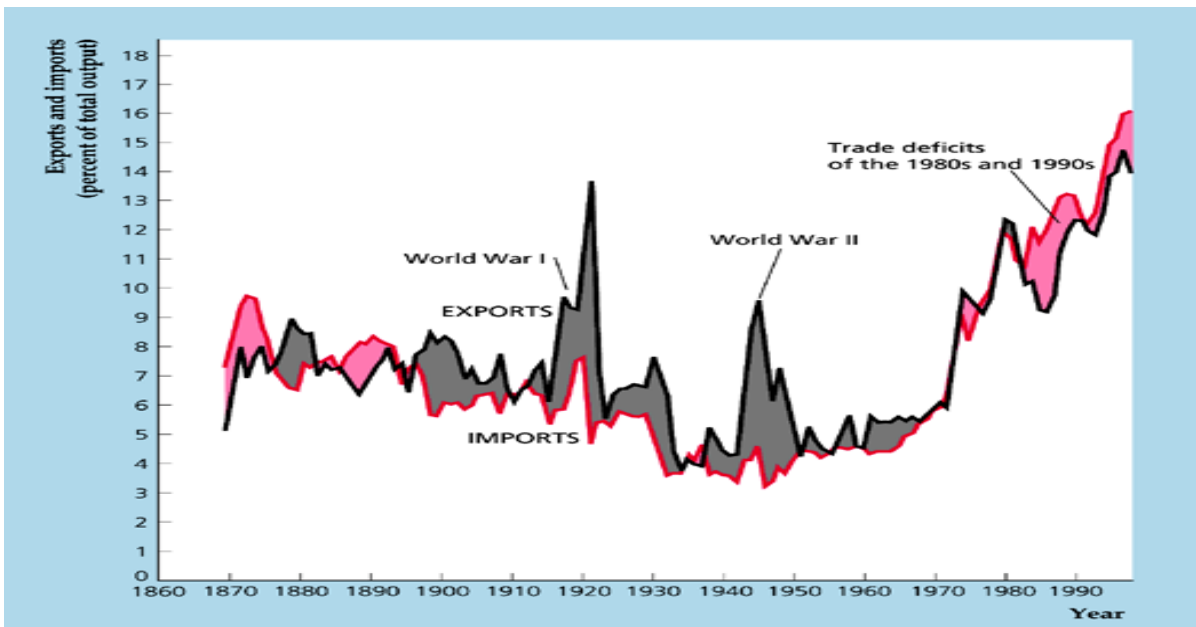
Notice that workers have become more productive – i.e. that average modern worker produces more output per hour than her predecessors from years ago.



Notice the large fluctuations in unemployment, and the fact that unemployment is never 0%.



Notice that prices were fairly stable until after WWII, when we have had inflation (though not at a constant rate) every year.



Notice that in the past 20 years or so the U.S. has had trade deficits (meaning that imports of goods and services have exceeded exports).



Notice that the Federal government has had lots of budget deficits (meaning that government spending during the year exceeded revenue from taxes and fees), though recently the Federal government has had budget surpluses (meaning that tax and fee revenue during the year exceeded government spending).