

Transition from Micro to Macroeconomics

Micro: focus on firms and individuals, at most, the industry for a *single* good X

- not many problems with measurement

From Supply and Demand:

P_x - price of well-defined good

Q_x - amount bought/sold of good X

Macroeconomics:

Perspective: the overall economy (aggregate economic activity) - and its behavior

- measurement AND behavior

MICRO	MACRO
Firms Individuals	Business Sector Household Sector Add: Government Foreign Trade
P_x Q_x	Average Price Level Output - Entire Economy

MEASUREMENT:

To Measure Price Level

How do we measure the average level of all prices?

Problem: Every good should *not* be given equal "weight" since some goods more important than others

Solution: Use Q's as weights, BUT:

- whose spending patterns do we use?

- which time period do we use? Need a time period as basis for comparison (BASE PERIOD (YEAR))

If BASE PERIOD very distant, spending patterns assumed are very unrealistic

- this is the problem with the CPI

Can't really account for quality improvements

To Measure Output of Entire Economy

Problem: If X = computers and Y = autos

- CAN'T ADD Q_x and Q_y (what is 10,000 autos + 25,000 computers??)

Solution: use *dollar values* of X and Y

=> Nominal Gross Domestic Product (GDP)

BUT - this can be distorted by inflation

Because of this: use *REAL* GDP

- Economic growth defined as increase in real GDP
- Recessions/Recoveries defined based on real GDP

BEHAVIOR OF THE MACRO ECONOMY:

Through time, economy exhibits:

Long-Term Upward (Secular) Trend

- result of increases in labor/capital/technology

Cyclical Behavior (fluctuations around long-term trend): THE BUSINESS CYCLE

BUSINESS CYCLE - has stages

Recovery (upturn): real GDP is rising

- employment and income *rise*
- unemployment rate falls
- tax revenue *automatically* rises (smaller deficits)

Recession (downturn): real GDP falls for at least six consecutive months

- employment and real income *fall*
- unemployment rate rises
- tax revenue *automatically* falls (larger deficits)

Depression: not really defined - "long and deep recession"

- you'll know it when you see it
- haven't had one since the 1930s - due to existence of "automatic stabilizers"

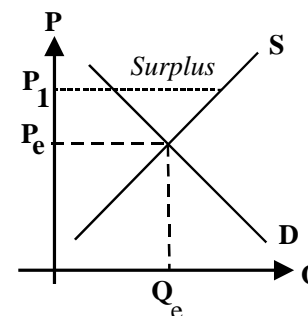
Recoveries - average duration has increased

Recessions - shorter duration, less frequent, smaller decline in real GDP than pre-World War II

- since 1950s - have not exceeded 18 months

Microeconomic Basis of Macro Problems

Assume current price (P_1) exceeds equilibrium



- Price Adjustment Mechanism: competition among sellers forces $P \downarrow$ until return to P_e
=> *Markets Stable and Self Correcting - perfect price flexibility exists*

=> *No need for government intervention, so Laissez-Faire is appropriate*

- At macro level, economy is always at or moving toward full employment (onto PPC)
- No role for monetary or fiscal policy

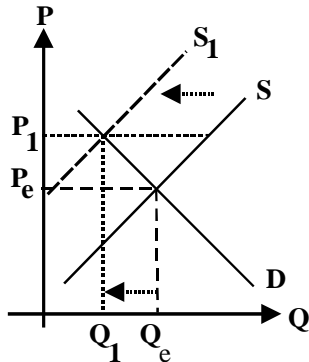
CLASSICAL ECONOMICS

- Could not explain depression in 1929

A new "paradigm" that could explain depression emerged: **KEYNESIAN ECONOMICS**

- Agreed with Classical Economics (about price flexibility) in long-run
- Provided a short-run model: "*Demand-Side Economics* that gave a rationale to federal deficits

If $P > P_e$ (such as P_1) - short-run: prices do *not* fall - *Quantity Adjustment Mechanism* -



at P_1 : $Q^S > Q^D$ - firms have too much inventory
 - decrease production, attempt to sell off excess
 => $\downarrow S \Rightarrow \downarrow Q_e$

As production falls:

Less employment/income, more unemployment -
 AND - *this is an equilibrium*

- As income falls - demand falls too

EFFECTIVE DEMAND FAILURE

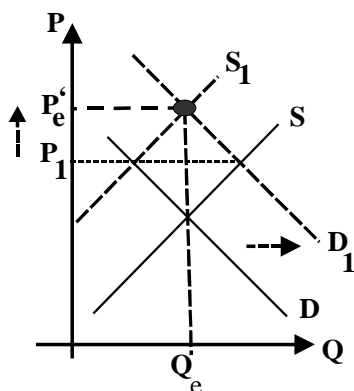
- Firms want people to spend more so can $\uparrow Q$ and hire workers back, BUT
- Consumers don't have enough \$ - if firms first hire us back - as income \uparrow , then we spend more
 => Role for Government: "Pump Priming"

Classical Economics: leave the economy alone, it will correct itself

- True in long-run, but in short-term, are political *and* social costs of higher unemployment
- Society often finds these unacceptable

Keynes: in short-run have *government* stimulate demand through FISCAL POLICY

- this is not laissez faire
- government deficit (macro) raises demand (micro)



With higher D, restores old Q_e - eliminates the unemployment

Rationale for Deficits: stimulate demand, can boost the economy/rate of economic growth

Problem: easier to raise deficit than to lower it

In Depression: this was done thru Public Works

- unemployed build roads/bridges - *infrastructure*

ex: WPA - look on sidewalks on Upper College Rd

Clinton tried this in early 1990s (jobless recovery)

- Skill levels - much higher today than 1930s
- Many of unemployed - white collar (they not do roads/bridges)