chapter 6 (22)

Macroeconomics: The Big Picture

Chapter Objectives

Students will learn in this chapter:

- The definition of macroeconomics and get an overview of the economy as a whole.
- How macroeconomics differs from microeconomics and that what is good for the part is not necessarily good for the whole.
- The importance of the business cycle and why policy makers seek to diminish the severity of business cycles.
- The meaning of long-term growth and how it affects a country's standard of living.
- The definitions of inflation and deflation.
- Why policy makers and economists prefer price stability in the macroeconomy.
- The meaning of the balance of payments and why.

Chapter Outline

Opening Example: "Hoovervilles" was the name for shantytowns that sprang up across the United States as a result of homelessness created in the Great Depression. They were named after Herbert Hoover, president at the time, because he was blamed for the Depression. However, the study of macroeconomics was in its infancy, only beginning to develop during the Depression. So President Hoover was far from the only one who didn't fully understand the macroeconomy at the time.

I. The Nature of Macroeconomics

A. Macroeconomics is the area of economics that focuses on the behavior of the economy as a whole.

B. Macroeconomic versus microeconomic questions

C. Macroeconomics is more than the sum of its parts

1. Paradox of Thrift

D. Macroeconomics: Theory and Policy

1. *Definition:* **A self-regulating** economy will correct itself through the workings of the invisible hand.
2. *Definition:* **Keynesian economics** says that when an economy is depressed, it is because of inadequate spending.
3. *Definition:* **Monetary policy** refers to changes in interest rates to help a depressed economy.

4. *Definition:* **Fiscal policy** refers to changes in taxes and government spending to help a depressed economy.

II. The Business Cycle

A. *Definition*: The **business cycle** is the short-run alternation between economic downturns, known as recessions, and economic upturns, known as expansions.

B. Charting the Business Cycle.

   1. *Definition*: **Recessions** are periods of economic downturns when output and employment are falling.
   2. *Definition*: **Expansions**, or recoveries, are periods of economic upturns when output and employment are rising.
   3. *Definition:* The **business cycle peak** is the point in time at which the economy shifts from expansion to recession.
   4. *Definition:* The **business cycle trough** is the point in time at which the economy shifts from recession to expansion.

C. The Pain of Recession

   1. The Pain of Recession is felt by workers who are unable to find or hold jobs.

D. Taming the business cycle

   1. Policy efforts are undertaken to reduce the severity of recessions and rein in excessively strong expansions; that is, they are meant to "smooth out" the business cycle.

III. Long-Run Economic Growth

A. *Definition:* **Long-run economic growth** is the sustained upward trend in aggregate output over several decades.

B. Long-run economic growth is fundamental to many of the most pressing economic questions of the day.

C. Macroeconomists do not use the same models to think about long-run growth that they use to think about the business cycle.

IV. Inflation and Deflation

A. *Definition:* **Inflation** is a rising aggregate price level.

B. *Definition:* **Deflation** is a falling aggregate price level.

C. The causes of inflation and deflation

   1. In the long run, the overall level of prices is mainly determined by changes in the money supply.

D. The pain of inflation and deflation

   1. *Definition:* **Price stability** is a situation in which the overall cost of living is changing if at all, only slowly.
   2. In general, economists regard **price stability** as a desirable goal.

V. International Imbalances

A. *Definition*: An **open economy** is an economy that trades goods, services, and assets with other countries.

B. *Definition:* A **trade deficit** occurs when the value of the goods and services a country buys from the rest of the world is larger than the value of the goods and services the country sells to the rest of the world.

C. *Definition:* A **trade surplus** occurs when the value of the goods and services the country buys from the rest of the world is smaller than the value of the goods and services the country sells to the rest of the world.

Teaching Tips

The Nature of Macroeconomics

Creating Student Interest

Explain your institution's policy regarding the sequencing of introductory micro- and macroeconomics courses. Are students required (or encouraged) to take one course before the other? Or can students take either course first? Explain that the policy is not the same at every school. Use your institution's policy to emphasize that macroeconomics is more than the summation of microeconomics. Note that the first part of introductory microeconomics and macroeconomics courses covers some of the same material.

If some (or all) of your students have already taken a course in microeconomics, ask them what they studied in that course. Then ask them what different topics they think they will study in that course. If all of your students are in their first economics course, ask them what they think they would study in microeconomics and what they think they will study in this class. List the micro and macro topics on the board. If necessary, help them to identify any important topics they have overlooked.

Presenting the Material

Direct students' attention to the Microeconomic Versus Macroeconomic Questions listed in Table 6-1 (Table 22-1) in the text. Have them compare their earlier responses regarding the differences between microeconomics and macroeconomics with the specific questions listed in this table.

Microeconomic Versus Macroeconomic Questions

Microeconomic Questions	Macroeconomic Questions
Should I go to business school or take a job right now?	How many people are employed in the economy as a whole this year?
What determines the salary offered by Citibank to Cherie Camajo, a new Columbia MBA?	What determines the overall salary levels paid to workers in a given year?
What determines the cost to a university or college of offering a new course?	What determines the overall level of prices in the economy as a whole?
What government policies should be adopted to make it easier for low-income students to attend college?	What government policies should be adopted to promote employment and growth in the economy as a whole?
What determines whether Citibank opens a new office in Shanghai?	What determines the overall trade in goods, services, and financial assets between the United States and the rest of the world?

The Business Cycle

Creating Student Interest

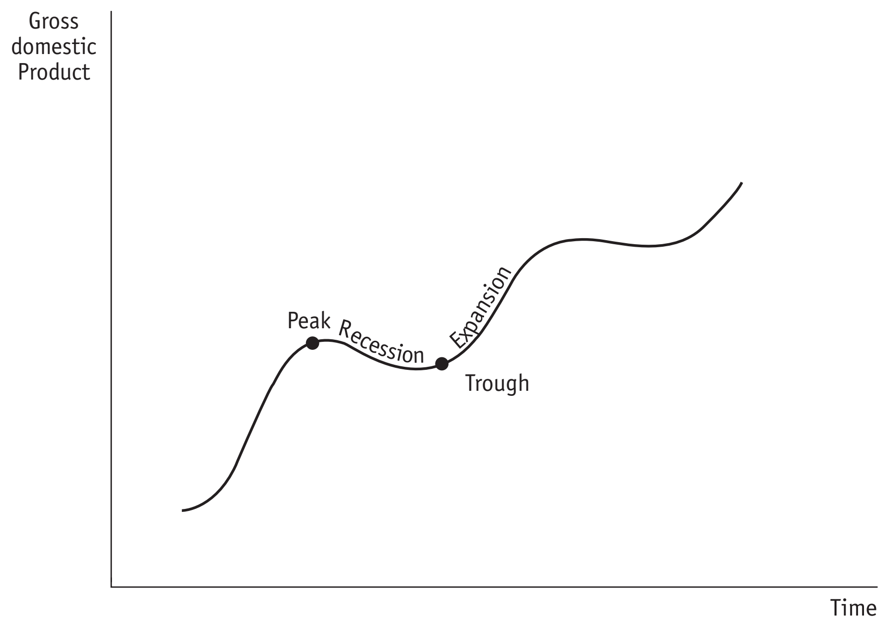
Conduct a brief poll of your students to identify how they think the economy is doing. Have them each identify (by a show of hands, a voice vote, or on a slip of paper) whether they think the state of the economy is “excellent”, “good”, “fair”, or “poor.” Present the results of the poll to the class.

Now ask your students to tell you on what they based their decision. What made them choose *excellent, good, fair,* or *poor?* Note that economists often disagree on this question. Keep a list of their responses. Ask them how their response would have been different a year ago and five years ago. Use their sense of how things are going and how the state of the economy can change over time to lead into discussion of the business cycle.

Presenting the Material

Begin teaching this section using the following hypothetical figure of the business cycle. By your starting the discussion with this relatively simple graph, students will be more inclined to absorb all of the associated definitions, i.e., recession/depression, trough, expansion, and peak.

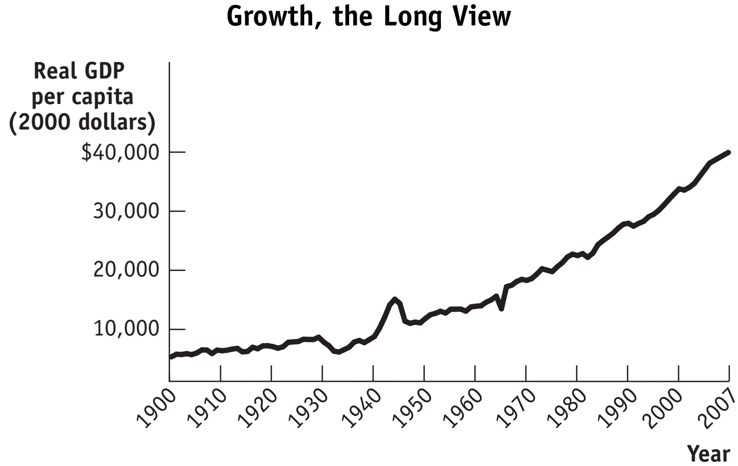
Hypothetical Business Cycle



Long-Run Economic Growth

Creating Student Interest

Ask students at what percentage rate they think the U.S. economy grows per year. List their responses on the board. Then compare their responses with the data contained in Figure 6-6 (Figure 22-6) in the text. You may also use the data available on the websites listed under Web Resources to provide students with GDP growth data



Presenting the Material

Begin this section by reviewing with students the necessary definitions for understanding long-run economic growth. Specifically, review the meaning of the following terms:

- Long-run growth (or long-run secular growth)
- Real GDP
- Real GDP per capita

Afterward, stress the connection between long-run economic growth and a country's standard of living.

Inflation and Deflation

Creating Student Interest

Ask students how much a can of Coca-Cola costs. Have they ever heard anyone bring up the cost of a soda starting with "Well, back in MY day, a soda cost . . ."? Present the class with the following data: Coke was first sold in cans in the 1950s for 5 cents a can. By the end of the 1950s, the same can of coke cost 10 cents. In 1960, the average price was about 13 cents, and by 1970 about 85 cents. Have the students consider and speculate as to why the same can of soda costs so much more today than in the 1950s.

Presenting the Material

First define the terms *inflation* and *deflation* and the negative impacts each can have on an economy. Also stress that these are measures of changes in the aggregate level of prices in the economy, and not necessarily reflective of the changes in the price of any one specific good, e.g., a can of Coke. Afterward, discuss the importance of price stability in an economy for achieving long-run economic growth.

International Imbalances

Creating Student Interest

Ask students what products they have purchased that were produced in another country. Create a list of these items. Then ask students to name some products the United States has produced and sold to other countries. Create a list of these items. It will likely be easier for students to name imports they have purchased than exports the United States has sold.

Poll the class, asking if we buy more from other countries than they sell to us or if we sell more to other countries than we buy from them. Explain that we buy more from other countries (see the data available from the web site listed under “web resources”) then we sell to them – define trade surplus and trade deficit.

Presenting the Material

Begin by introducing the terminology necessary to discuss the topic of international trade, specifically:

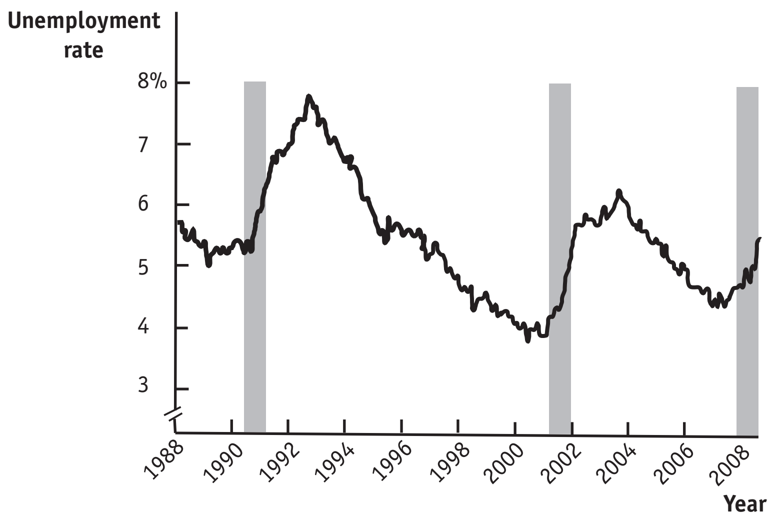
- Closed economy
- Open economy
- Trade deficit
- Trade surplus
- Trade balance

Emphasize the importance of transportation costs and trade barriers such as tariffs and quotas in determining trading partners. In particular, point out that Canada’s largest trading partner is the United States, due partly to the relatively low transportation costs and free trade agreements between these countries. Present current trade data (see Web Resources).

Common Student Pitfalls

- **The relationship between micro- and macroeconomics.** Students may feel that a course in microeconomics is a prerequisite for the study of macroeconomics. Emphasize that, especially in the short run, the combined effect of individual (microeconomic) decisions can have effects on the macroeconomy that are very different from what any one individual intended. Thus, macroeconomics is more than simply the aggregate outcome of all microeconomic choices, and one’s understanding of macroeconomics does not rely on a prior understanding of microeconomics.
- **All business cycles are not alike.** Students may think that all recessions (or expansions) are the same in terms of duration and severity. This misconception can be displaced by referring to Figure 6-3 (Figure 22-3) in the text which shows different-sized shaded bands for periods during which the U.S. economy was in a recession and, hence, the unemployment rate was rising.

The U.S. Unemployment Rate, 1988–2008



Case Studies in the Text

Economics in Action

Why George W. Bush Wasn't Herbert Hoover—This EIA compares George W. Bush's response to the 2001 economic slump to Herbert Hoover's response to the Great Depression. While both presidents were pro-business and pro-free markets, President Bush did not choose to let the slump "run its course," as President Hoover did.

Ask students the following questions:

1. What did the conventional economic wisdom lead President Hoover to do about the Great Depression and why? (Answer: Nothing—he decided to let it "run its course")
2. What did conventional economic wisdom lead President Bush to do about the economic downturn in 2001? (Answer: Fiscal and monetary policy) What changed between the 1930s and 2001? (Answer: The rise of macroeconomics as a discipline)

Comparing Recessions—This EIA compares the depth and duration of three recessions in the United States.

Ask students the following questions:

1. Which recession was the worst in terms of duration? (Answer: The Great Depression—43 months)
2. Which recession was worst in terms of depth? (Answer: The Great Depression—industrial production fell to less than 50% of what it had been)

A Tale of Two Colonies—This EIA compares Canada and Argentina, two countries that looked rather similar and were in a good position at the beginning of the twentieth century.

Ask students the following questions:

1. What factors were similar between Argentina and Canada at the beginning of the twentieth century? (Answer: Major exporters of agricultural products, large numbers of European immigrants, large amounts of European investment, railroads)
2. What differences contributed to the two countries' different position today? (Answer: Political stability, macroeconomic policies)

A Fast (Food) Measure of Inflation—this EIA uses the price of a hamburger to show that, after adjusting for inflation, the price of a hamburger has decreased since 1954.

Ask students the following question:

1. Ask students why McDonald's chose to cut the price of their hamburgers in 1997. (Answer: This was in response to decreases in the rate of inflation, which undoubtedly led to lower costs for McDonald's, thus justifying the choice to lower the price of their hamburgers.)

Estonia's Miraculous Deficit—Since it broke away from the Soviet Union in 1991, Estonia has thrived. It has also run relatively high trade deficits.

Ask students the following questions:

1. How large is Estonia's trade deficit? (Answer: Small in dollar terms, but large relative to the size of its economy—three times that of the United States)
2. Why has Estonia run such a relatively large trade deficit? (Answer: Because it has been successful in attracting investment)

For Inquiring Minds

Defining Recessions and Expansions—This FIM explains how recessions are defined (and that there is no exact definition!).

When Did Long-run Growth Start?—This FIM traces economic growth and determines that long-run economic growth in the United States began in 1800s.

Global Comparison

International Business Cycles—Shows the annual rate of growth in employment for the United States and the "Eurozone" for 1988–2007.

Activities

Thinking Like an Economist (10 minutes)

Explain to students that three important topics of interest to economists are:

- employment
- prices
- output

Pair students and ask them to develop one microeconomic statement and one macroeconomic statement dealing with each of the three topics just listed. Possible answers may include:

- Microeconomic Employment Statement: Steve worked at the local General Motors plant for 20 years, but he was recently laid off from his job.
- Macroeconomic Employment Statement: The unemployment rate in the United States rose to 24.9% during the Great Depression.
- Microeconomic Price Statement: When the price of a gallon of gasoline reached $3.00, Randy started to carpool to school with his friend.
- Macroeconomic Price Statement: The rate of inflation in the United States rose to 3.9% in September 2005 due to higher energy prices.
- Microeconomic Output Statement: An Iowa soybean farmer saw his output drop due to a severe drought.
- Macroeconomic Output Statement: Following the Great Depression, total output did not rise above its 1929 level until 1937.

In the Year You Were Born (5–10 minutes)

Ask students to estimate the rate of economic growth at the year of their birth using the data in Figure 6-6 (Figure 22-6) of the text. Has the economy grown at a faster rate in the previous year than in their birth year? If so, what could be this reason for this?

Differences in Price Changes (10–15 minutes)

Pair students and ask if the nominal prices of the following goods or services have increased or decreased over the past 10 years.

Personal Computer	(Answer: decreased)
First Class Postage Stamp	(Answer: increased)
Internet Service	(Answer: decreased)
College Tuition	(Answer: increased)
T.V. Guide Magazine	(Answer: increased)

Web Resources

The following websites provide information on U.S. business cycles, economic growth, and international trade:

National Bureau of Economic Research "Business Cycles" web page:
http://www.nber.org/cycles.html.

Bureau of Economic Analysis, GDP data: http://bea.gov/national/index.htm#gdp.

Bureau of Economic Analysis, trade data:
http://bea.gov/international/index.htm#trade.