



Introduction to Macroeconomics I

Financial Programming and Policies
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TAOLAM

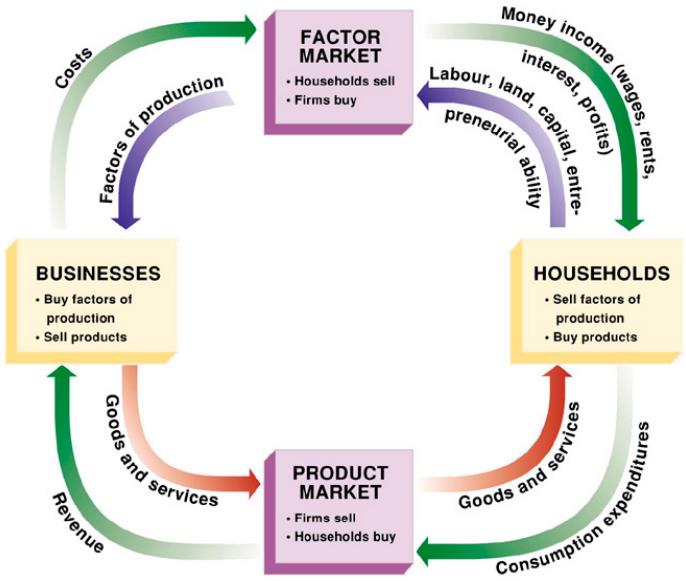
Outline

- I. Defining Macroeconomics**
- II. Long-Run Economic Growth**
- III. Economic Fluctuations**
- IV. Principles of Macroeconomics**

Defining Macroeconomics

Macroeconomics takes a top-down view:

- Macroeconomics is about the whole economy or economy-wide aggregates such as GDP, CPI, or the current account;
- Microeconomics, in contrast, looks at the behavior of individuals and small players whose actions do not affect the economy at large but set prices and quantities in their individual markets;
- It's all fairly abstract but it does matter for the well-being of many people ...



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Defining Macroeconomics

Practical applications:

- Macroeconomic management:
 - ✓ Avoid crisis!
 - ✓ Support economic growth
 - ✓ Keep inflation moderately low
- Economic forecasting:
 - ✓ Macroeconomic forecasts are an input into macroeconomic management
 - ✓ But they are also of interest to businesses, financial markets etc.

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Defining Macroeconomics

Two main issues:

- Determinants of long-run economic growth
 - ✓ Enormously important for economic well being
 - ✓ Last 200 years were very successful
 - ✓ We don't really understand sources of growth very well ...
- Sources of economic fluctuations:
 - ✓ Business cycles
 - ✓ Economic crises

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Long-Run Economic Growth

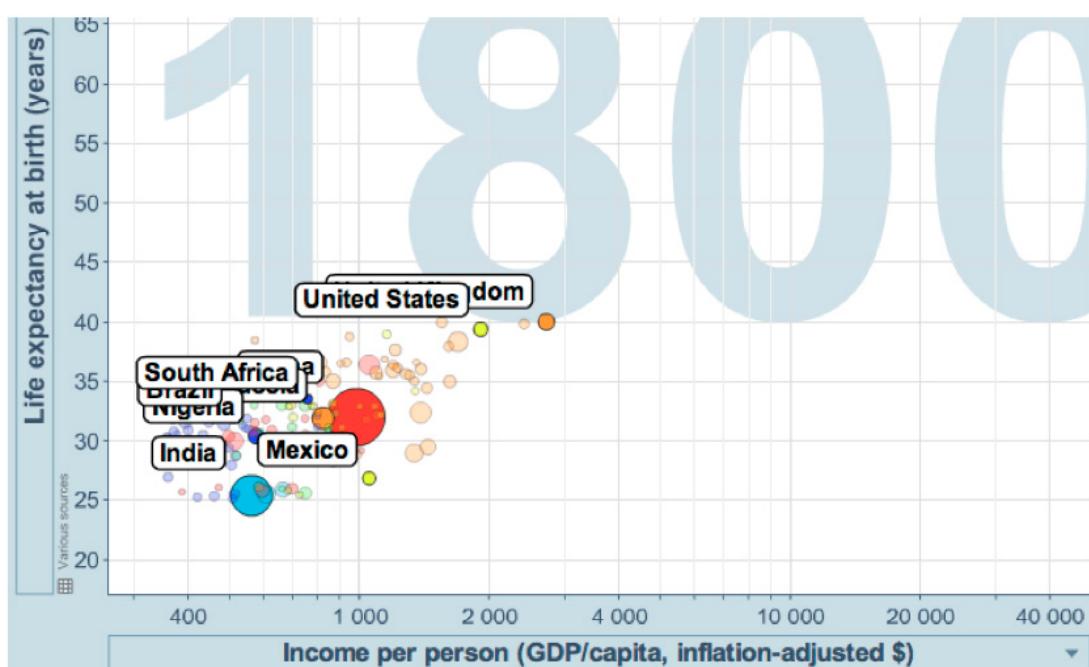
Even small growth rates can have enormous output impact if maintained over long time:

- A quantity growing at 1%/year doubles in 72 years...
- A quantity growing at 2%/year doubles in 36 years...
- A quantity growing at 3%/year doubles in 24 years...
- A quantity growing at 0.1%/year doubles in 720 years...
- A quantity growing at 0.01%/year doubles in 7200 years...

Source: Brad DeLong: Econ 2, Spring 2014, Long-run economic growth

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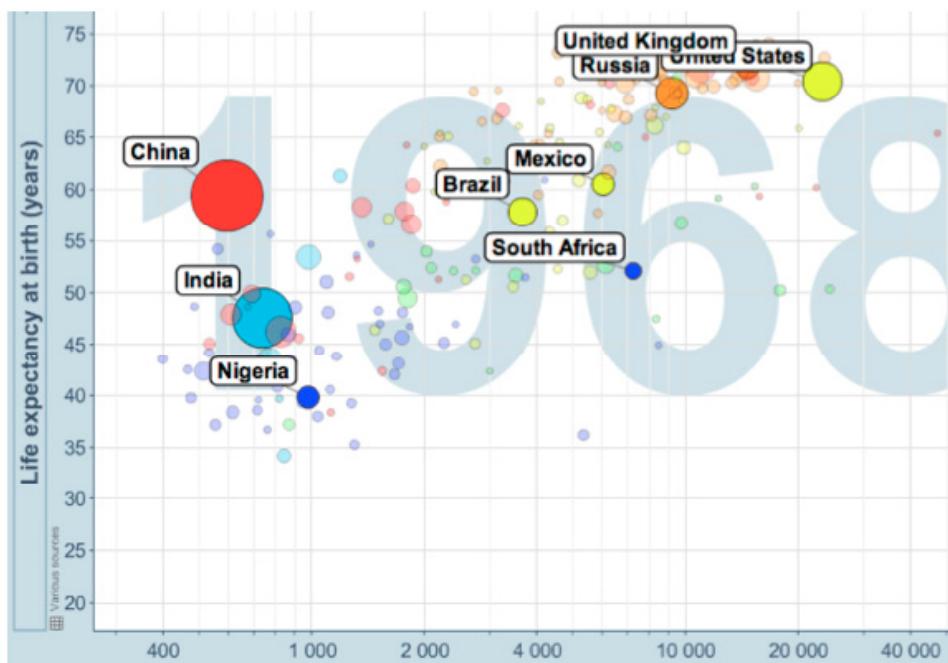
Long-Run Economic Growth: The World in 1800



Source: Brad DeLong: Econ 2, Spring 2014, Long-run economic growth

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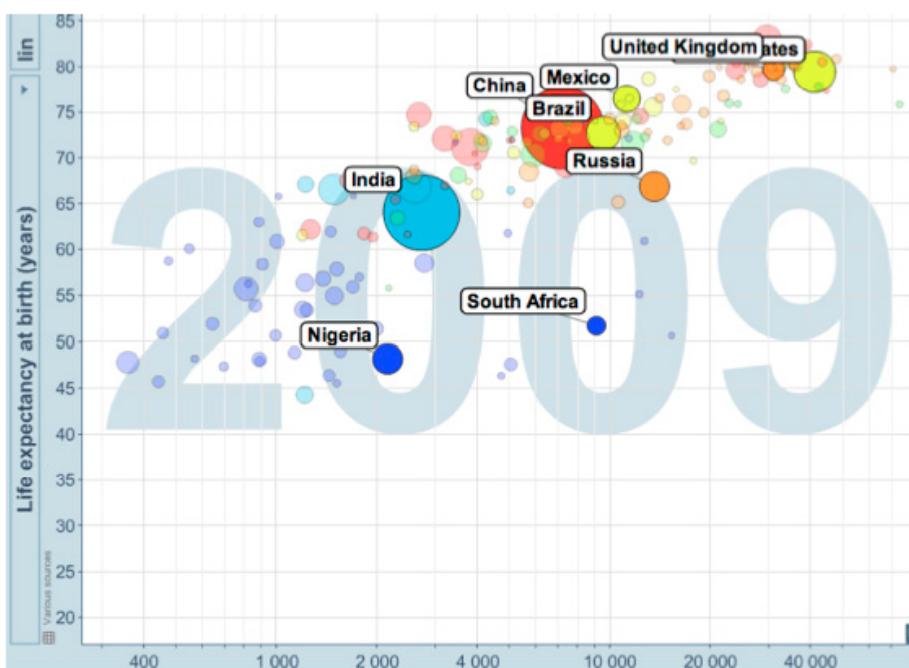
Long-Run Economic Growth: The Great Divergence to 1968



Source: Brad DeLong: Econ 2, Spring 2014, Long-run economic growth

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Long-Run Economic Growth: Convergence Post-1968?



Source: Brad DeLong: Econ 2, Spring 2014, Long-run economic growth

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Long-Run Economic Growth

What happened since 1800?

Remember:

- We are not (really) smarter than our ancestors
- It is doubtful that we progressed much in cultural terms
- The only areas where we distinguished ourselves from our ancestors 200 years ago is
 - ✓ We have a lot more 'stuff'
 - ✓ We are healthier and live longer



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Long-Run Economic Growth

What happened since 1800?

- The industrial revolution happened—clearly a large part of economic progress is due to technical progress;
- But rise of modern market economy over large parts of the globe played a key role too:
 - ✓ Underpinned technological progress (funds, incentives, stability)
 - ✓ Enabled deep specialization (global trade)
 - ✓ Helped to spread wealth (a bit) more widely



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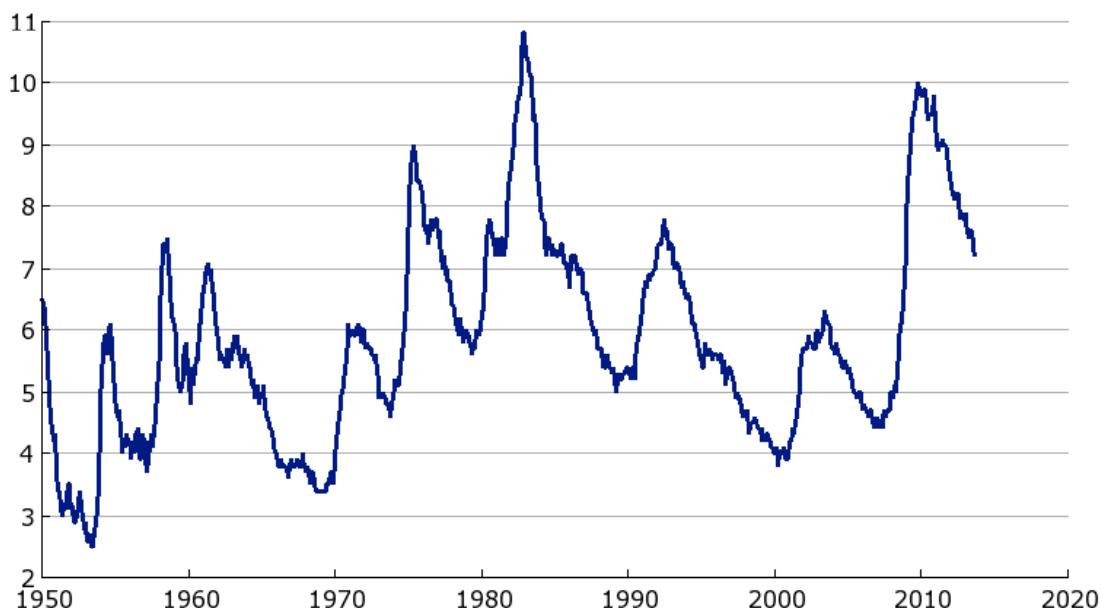
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Economic Fluctuations: Business Cycles

Unemployment in the United States



Economic Fluctuations: Business Cycles

Unemployment in the United States

- Very high unemployment: economic recession
- Falling unemployment: recovery
- Very low unemployment: boom times
- Increasing unemployment: slowdown

- Note that peaks and troughs in unemployment are fairly regular—this is why it's called a 'business cycle'
- But it's not exactly a cycle: unemployment tends to rise rapidly—a recession is more akin to a crash than a gradual, regular decline in economic activity

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Economic Fluctuations: Business Cycles

What is the source of economic fluctuations?

- Mostly fluctuations in aggregate demand (as opposed to aggregate supply)
- Aggregate demand refers to spending of domestic households, government, businesses as well as foreigners (exports)—system of National Income and Product Accounts was designed to capture these demand components
- Aggregate demand is also seen as driving force behind inflation
- Key objective for macroeconomic policy is to keep aggregate demand stable and inflation moderately low



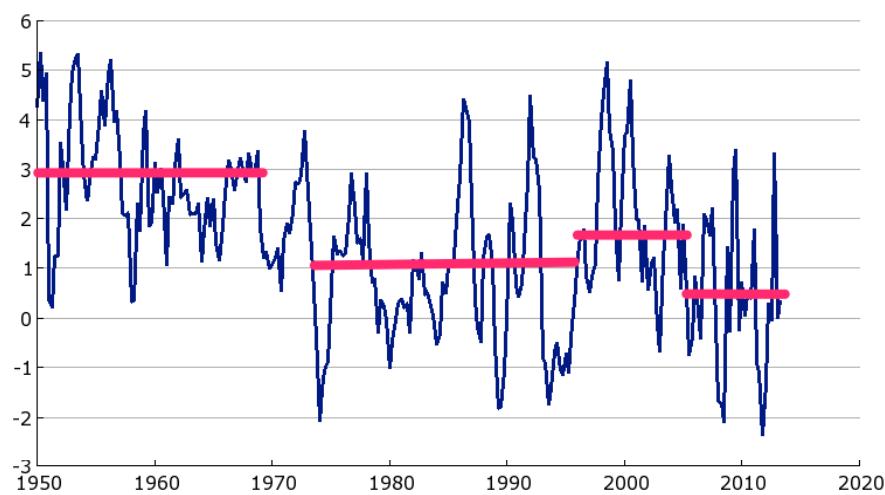
Source: Brad DeLong: Econ 2, Spring 2014, Budgeting & Macro Policy

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Economic Fluctuations: Business Cycles

Fluctuations versus Average Growth Levels

- Business cycles are about economic fluctuations, visible in the peak and troughs in unemployment and economic growth
 - Average growth levels vary between cycles
 - Difference in average growth rates is a long-run growth issue and not part of business-cycle theory



Source: Brad DeLong: Econ 2, Spring 2014, Budgeting & Macro Policy

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Economic Fluctuations: Business Cycles

Fluctuations versus Average Growth Levels

- From a long-run perspective, it is the average growth rate that matters for the standard of living
 - Underlying growth rate is also called potential GDP, referring to the supply potential of the economy



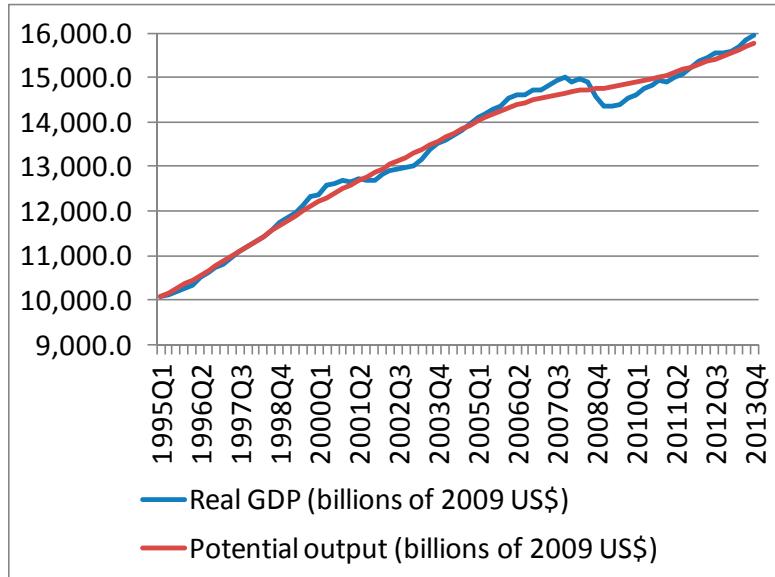
Source: Brad DeLong: Econ 2, Spring 2014, Introduction to Macroeconomics

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Economic Fluctuations: Business Cycles

Fluctuations versus Average Growth Levels: Potential GDP

- There is no unique estimation procedure for potential GDP (which implies considerable uncertainty!)
- Estimate shown here is based on HP filter, which generates results similar to a moving average

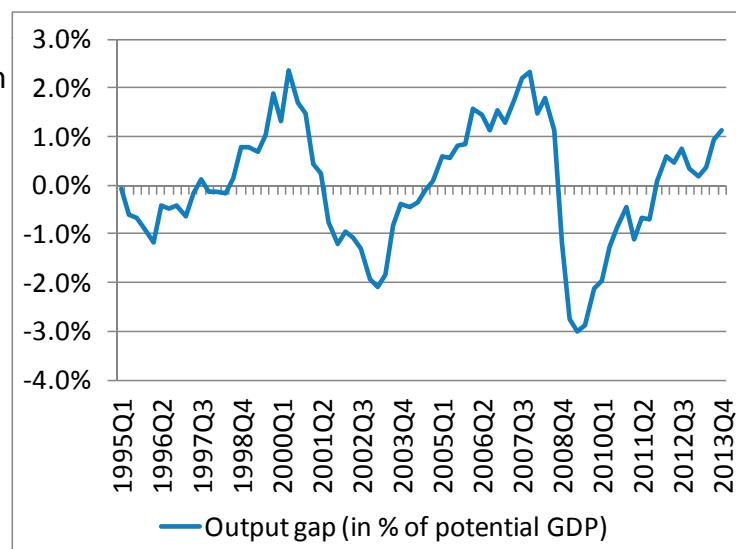


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Economic Fluctuations: Business Cycles

Fluctuations versus Average Growth Levels: Output Gap

- Business cycle fluctuations are captured in the output gap
- Alternative measure to fluctuations in the unemployment rate
- Most popular measure for aggregate demand conditions
- Macroeconomic policy is about keeping the output gap small
- Again, considerable uncertainty on size of gap!



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Economic Fluctuations: Economic Crises

Economic crises have a major economic impact

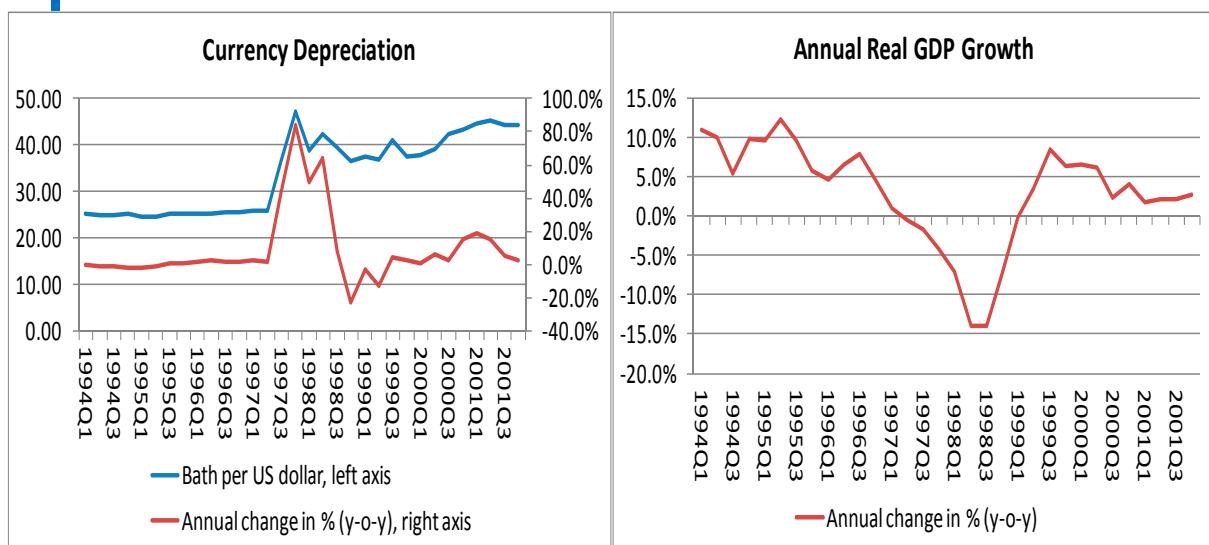
Even though underlying growth performance is key determinant of long-run economic well being, economic crises occur relatively frequently and typically have a major negative impact on:

- Output level (large drop in output/deep recession)
- Value of currency (currency crisis → depends on type of crisis)
- Inflation (often in the wake of a currency crisis → depends on type of crisis)
- Financial sector (not always but often → depends on type of crisis)
- Asset prices (not always → depends on crisis)

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Economic Fluctuations: Economic Crises

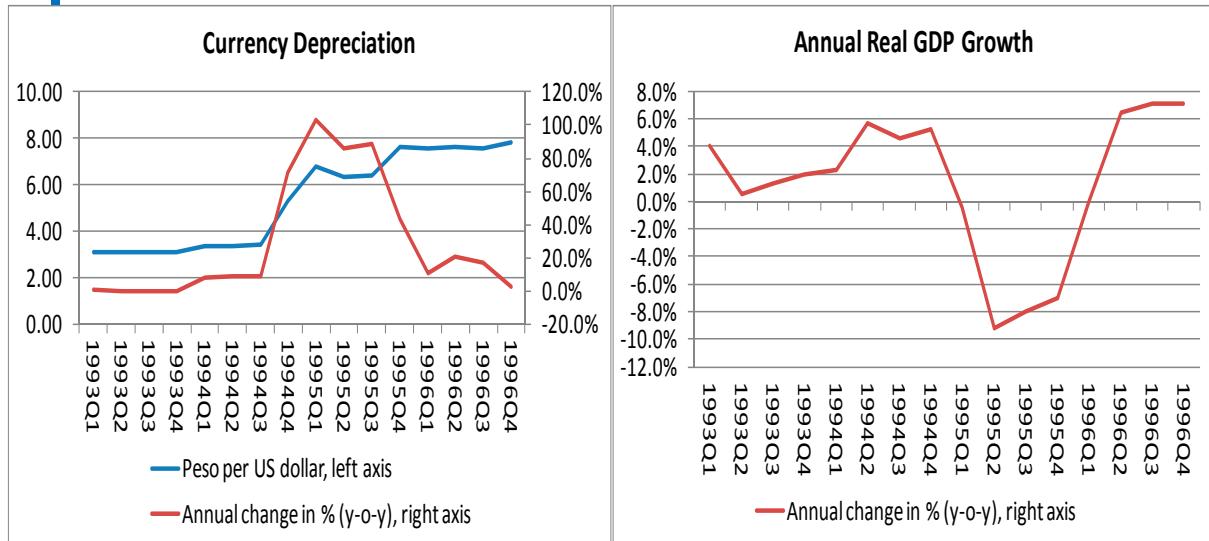
Selected examples: Thailand (Asian Crisis, 1997-98)



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Economic Fluctuations: Economic Crises

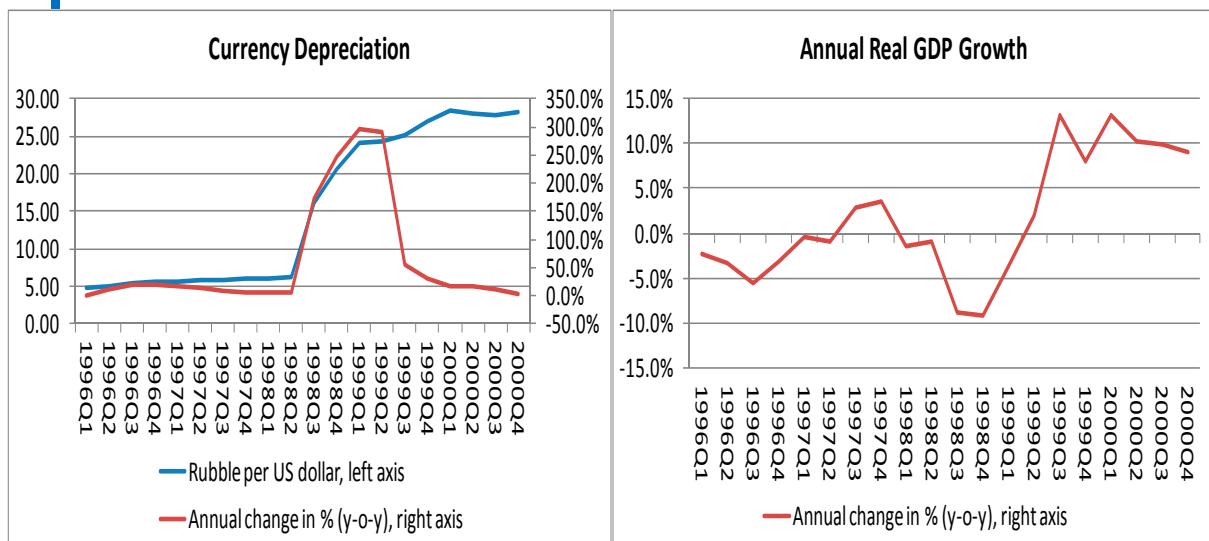
Selected examples: Mexico (1994-95)



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Economic Fluctuations: Economic Crises

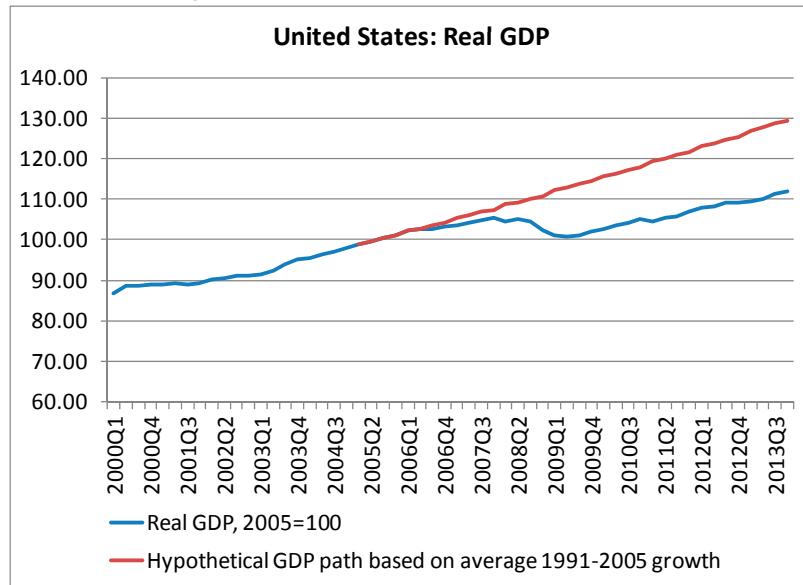
Selected examples: Russia (1998-99)



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Economic Fluctuations: Economic Crises

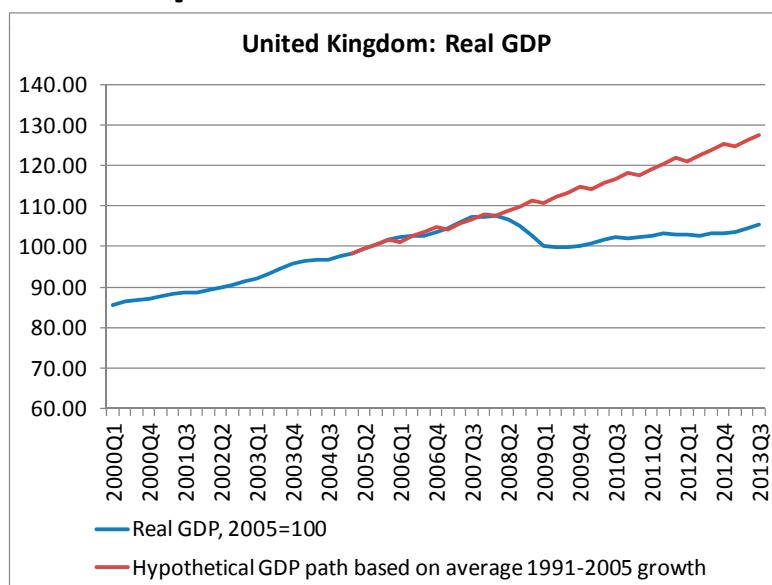
Selected examples: Global Financial Crisis—U.S.A.



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Economic Fluctuations: Economic Crises

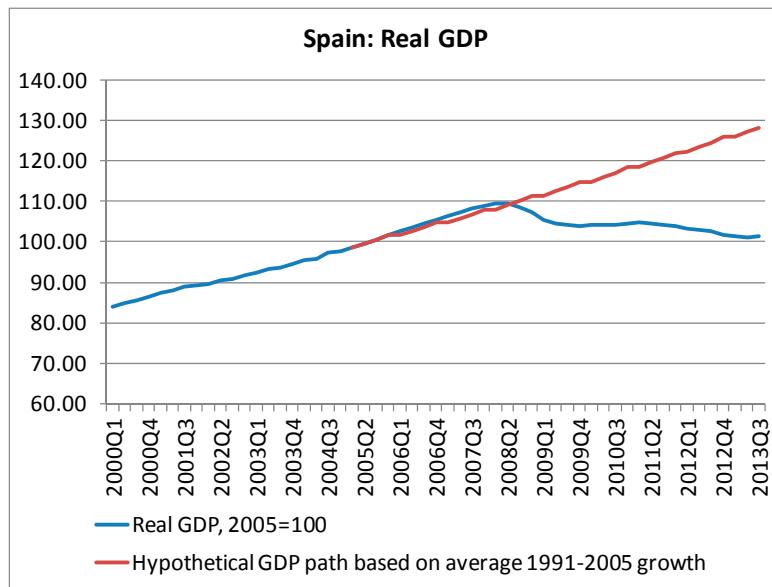
Selected examples: Global Financial Crisis—UK



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Economic Fluctuations: Economic Crises

Selected examples: Global Financial Crisis—Spain



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Principles of Macroeconomics

Managing macroeconomic fluctuations

Brad DeLong:

- Principles of macroeconomics:
 - One person's spending is another person's income
 - Overall spending sometimes gets out of line with the economy's productive capacity
 - Government policies can change spending

Source: Brad DeLong: Econ 2, Spring 2014, Guiding Principles

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Principles of Macroeconomics

Role of Markets

What the Market System Gets Us

- People can "specialize" in what they are most productive doing
- People can become more productive
- People can trade via this institution called "market"
- Market exchange is win-win
 - Relative to baseline
- Market exchange maximizes wealth
 - As long as commodities are excludable, rival, known, and internal
- Distribution?



Source: Brad DeLong: Econ 2, Spring 2014, Guiding Principles

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Principles of Macroeconomics

Role of Markets

Central role of markets for economy implies that macroeconomic policies typically prefer to act by influencing prices, especially

- Real interest rates (monetary policy; impact aggregate demand)
- Real exchange rates (monetary policy; impact aggregate demand & external competitiveness)

Fiscal policy affects aggregate demand directly through government spending and taxation → powerful tool but primary role for macroeconomic demand management typically falls to monetary policy

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Principles of Macroeconomics

Role of Government—The Good

Governments Create Markets

- Money and trust
 - “Thick-tie” exchanges
 - “Thin-tie” exchanges
 - Weights and measures
- Property rights
- Contract enforcement
- Threats to property, contract, and (arms-length) exchange:
 - Positive and negative affective ties
 - Roving bandits
 - Local notables
 - Government’s own functionaries

Principles of Macroeconomics

Role of Government—The Bad

Governments Distort Markets

- Markets do very important jobs
 - How much should be traded
 - Who should buy
 - Who should sell
- Governments follow alternative logics
 - Logic of politics
 - Logic of bureaucracy
 - Logic of favoritism
 - Logic of corruption
 - Logic of logrolling
 - Logic of insurance
 - Logic of redistribution

Source: Brad DeLong, Econ 2, Spring 2014; Principles of Economics – Moral Philosophy – Essential Principles

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Outlook

Next up:

- We will illustrate the circularity of income/spending flows, which is central for understanding how deep recessions can arise (this is also what makes macro special!)
- We will take a closer look at
 - ✓ aggregate demand (income-expenditure framework)
 - ✓ role of interest rates
 - ✓ aggregate supply
 - ✓ the link between aggregate demand, supply and inflation

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