

CONCEPT OF MACROECONOMICS

Macroeconomics is the branch of economics that studies economic aggregates (grand totals):e.g. the overall level of prices, output and employment in the economy.

If you want to be able to say more than "the economy is good," or "the economy is not so good," you need to understand and be able to analyze these six variables

These six key indicators are:

- Real Gross Domestic Product
- The unemployment rate
- The inflation rate
- The interest rate
- The level of the stock market
- The exchange rate

CLOSED MODEL OF ECONOMY

The circular flow of income is one of the most useful economic models.

In fig.1, firms use factors of production provided by households. Land, labour, capital and entrepreneurship are used by firms to produce a good or service. The firms pay households a reward for using these factors. Rent for land, wages for labour, interest for capital and profit for entrepreneurship. Collectively these rewards are called income and we use the letter Y to represent them.

Circular flow of income is a simple way of showing how output, income and expenditure circulate and change in an economy over a period of time.

- It shows the flow of money
- It shows the real flow of production and factor

Fig.1. A simple model

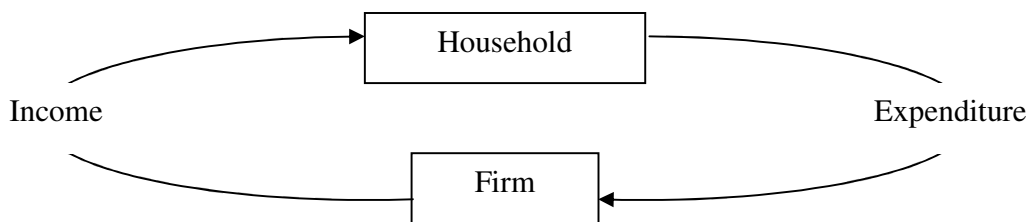


Fig.1

Assumptions:

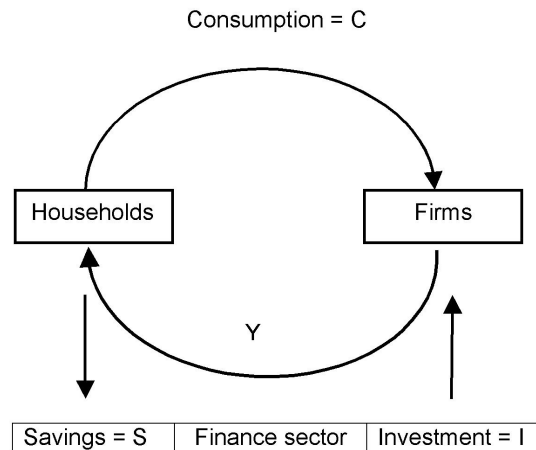
1. Households spend all their income on goods and services produced by a firm while firms spend all their revenues on factors of production owned by households
2. There is no government sector – no government spending and taxes
3. The economy is closed (no foreign sector)

In fig. 2 households save some of their income and deposit it in banks and other financial institutions. Savings in economic is defined as income not spent.

FROM CLOSED MODEL OF ECONOMY TO OPEN MODEL OF ECONOMY

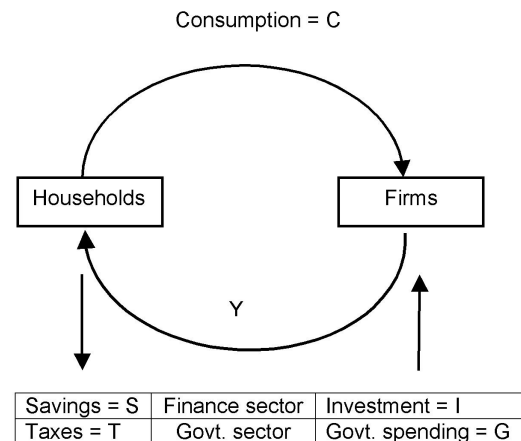
The banks lend money to firms who in turn invest in new machinery, factories, research and development etc.

Fig 2.



Note also that Expenditure is now made up of two items. Households spend money with firms for goods and services and this we now call consumption (C) and firms spend money with other firms (investment). Expenditure is therefore equal to consumption plus investment. $E = C + I$.

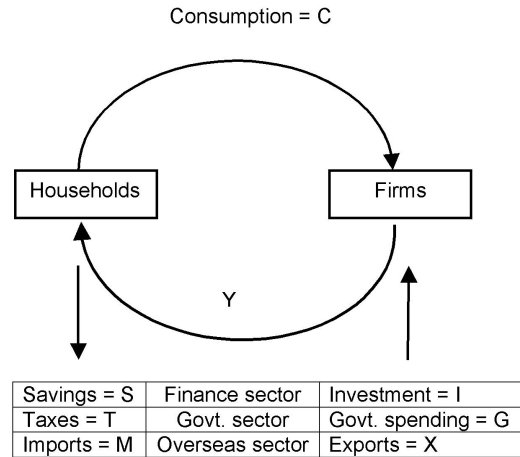
Fig. 3



In fig. 3 we now add the government sector. Households in this model are required to pay taxes. When the government receives these taxes they then spend them (government

spending) on building roads, paying soldiers, teachers and so on. In this model the total amount of expenditure is equal to consumption plus investment plus government spending. $E = C + I + G$.

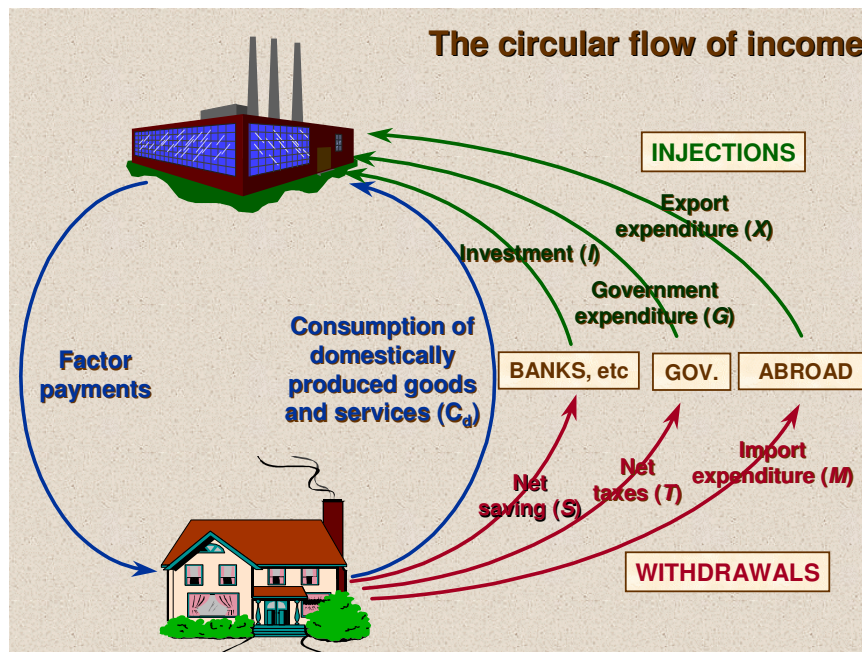
Fig.4



In fig. 4 the overseas sector is added. This model is called an open model. The previous models all assumed that the economy was closed, i.e., no foreign trade occurred.

Notice that those items leaking out of the circular flow on the left of the model (S, T and M) have been labelled withdrawals and those items on the right (I, G and X) injections.

Fig. 5



Finally for this simple open model we can see that expenditure is equal to consumption plus investment plus government spending plus exports. However, because the model is now open to the outside world domestic spending on goods and services which originate outside the economy must be subtracted. Therefore imports (M) have to be subtracted. So, $E = C + I + G + (X - M)$.

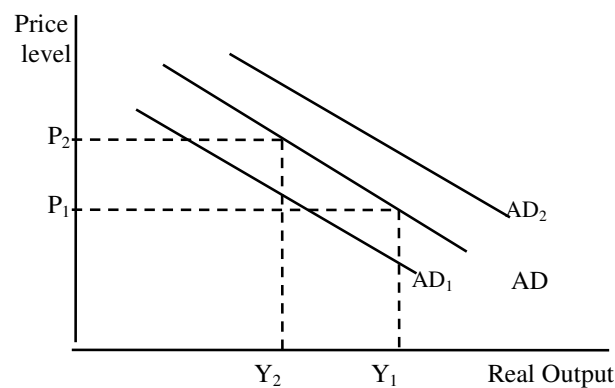
AGGREGATE DEMAND

Aggregated demand consists of the total amount of domestic consumption. AD, as it is abbreviated, is made up of consumption (C), investment (I), government expenditure (G), and money spent by people outside the country on goods and services produced in the country, i.e., exports (X).

The total amount of expenditure in an economy can now be renamed Aggregate Demand AD so that

$$AD = C + I + G + (X - M).$$

The AD curve shows the relationship between the price level and the equilibrium level of real income and output.



SHIFT IN AGGREGATE DEMAND CURVE

A change in the price level results in a movement along the AD curve. High prices lead to falls in Aggregate Demand.

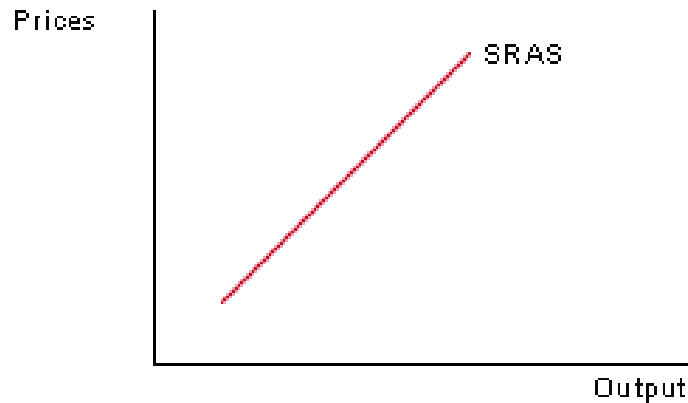
Shifts in the AD curve will occur if there is a change in any other relevant variable apart from the price level.

AGGREGATE SUPPLY

The aggregate supply curve shows the amount that will be supplied by the firms in the economy at each price level.

There is a lot of debate about the exact shape of the curve. Many classical economists and Monetarists argue that the shape differs between the short-run and long run. In the short-run there may some increase in output if demand increases, but in the long run any increases in demand will be inflationary.

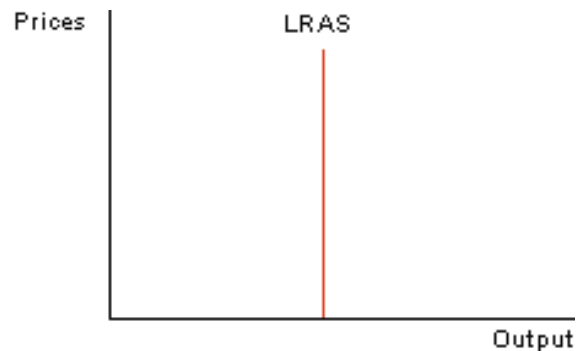
SHORT RUN



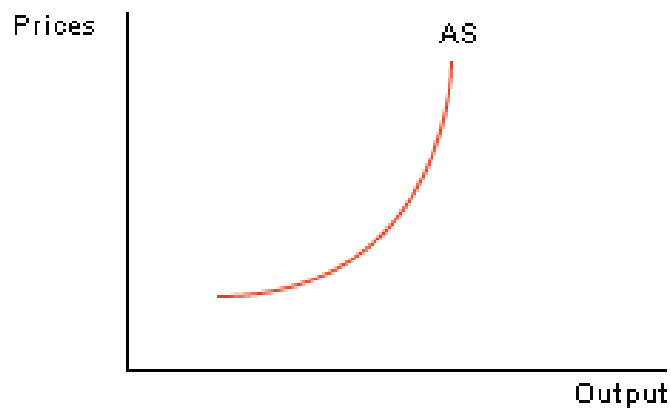
Just as in microeconomics the quantity supplied is measured on the x-axis and price on the y-axis. For aggregate supply however, the price means an average of all prices so we label it price-level rather than just price. Output, you will remember, is the same as expenditure or income when we are looking at the economy as a whole, so we could equally well label the x-axis - national income - if we wanted to.

LONG RUN

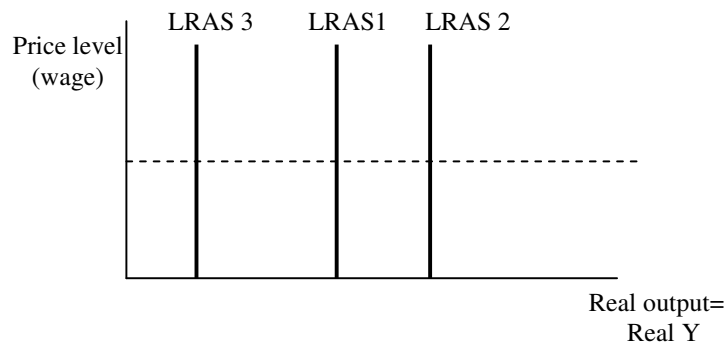
Classical point of view. **CLASSICAL ECONOMISTS** assume that in the long run, wages and prices are flexible and therefore the long run aggregate supply. LRAS is **vertical**.



Keynesians point of view. However, **KEYNESSIANS** do not distinguish between the short-run and long-run. They believe in a curve more like:



SHIFT IN THE LRAS curve

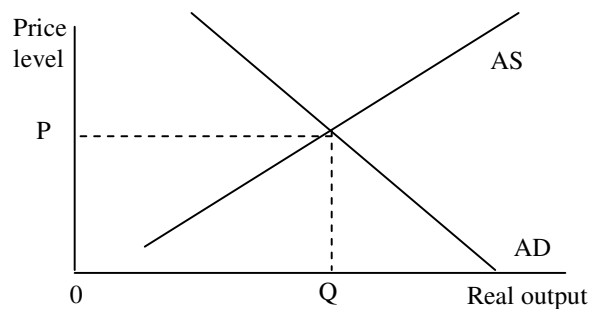


Assume that the education and skills of the workforce increases. Labour will be more productive and ultimately the productive potential of the economy is increased at full employment. The LRAS 1 to LRAS 2 showing that at a given level of prices the economy can produce more output.

EQUILIBRIUM OUTPUT

IN THE SHORT RUN

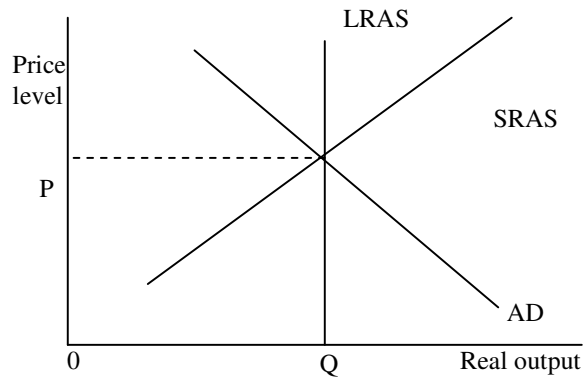
The economy is in equilibrium when aggregate demand equals aggregate supply. The equilibrium level of output in the short run occurs at intersection of the AD and AS curves.



IN THE LONG RUN

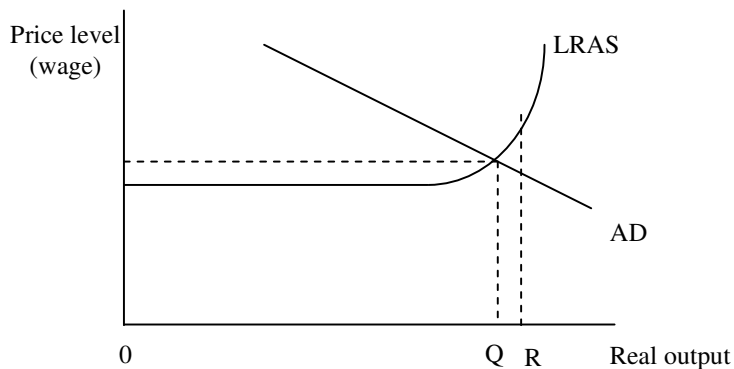
The main disagreement among economists is about long run equilibrium in the economy. Classical economists argue that in the long run, the AS curve is vertical as shown in the below diagram. Long run equilibrium occurs where the LRAS curve intersects with the aggregate demand curve (AD curve). Hence equilibrium output Q and the equilibrium price level is OP .

Long run equilibrium in the classical model.



Associated with the long run equilibrium price level is a SRAS curve which passes through the point where LRAS = AD. The long run aggregate supply curve shows the supply curve for the economy at full employment.

Keynesian economists argued that the LRAS curve is as shown below.



The economy is at full employment where the LRAS curve is vertical at output OR - a point of agreement with classical economist. However, the economy can be in equilibrium at less than full employment. In the above figure, the equilibrium level of output is OQ where the AD curve cuts the LRAS curve. The key point of disagreement between classical and Keynesian economists is the extent to which workers react to unemployment by accepting real wage cuts.