

Lecture Notes for Chapter 1 of
MACROECONOMICS
An Introduction
An Overview of Economics
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2008 – what a year!

- Faltering real estate market triggers credit crisis!
- Iffy mortgage loans cause huge losses.
- Of 5 major Wall St investment banks, only two remain independent, two collapsed.
- Major banks have been forced to merge, WaMu, Wachovia, IndyMac.
- Stocks down nearly 40%, bonds down 20%.
- Interest rates at near zero for US Treasury!

Recession is here!

- Lay-offs follow rapid decline in orders.
- Retail sales fall, holiday season is abysmal.
- Detroit Big 3 automakers beg for rescue.
- Mutual funds report record losses and investor withdrawals. Hedge fund imploding daily.
- Wall Street rocked by disclosure of \$50billion 'Ponzi scheme' run by major player.
- Obama considers huge stimulus program.

In this lecture we will discuss:

- Basic concepts about the economy.
- Sectors of the economy.
- What is micro economics?
- What is macro economics?
- A review of micro is at end of Chap 1

What is the Economy?

All the activities involved in the production and distribution of goods and services.

Economics addresses three basic questions:

- What are the fundamental principles?
- How well does the economy perform?
- What public policies are best?

There are four factors of production:

- Land - our natural endowment.
- Labor - people, their effort & skills.
- Capital - the tools of production.
- Entrepreneurship - organization.

Who are some famous entrepreneurs?
What do they have in common?

How do we measure the success of an economy?

By the standard of living it delivers

- o Quantity of goods and services
- o and their quality.
- o Leisure time.
- o Environmental quality.

What about the distribution of income across people?

- o Is equality of income more important than how high average income is?
- o How do we try to balance these?
- o Role of progressive income tax.

How can we achieve a higher standard of living?

- By becoming more productive.
- Productivity means:
Output of goods and services per hour of labor effort.

Higher productivity makes possible :

- o Greater quantity of goods & services and higher quality.
- o More leisure.
- o Better environment.
- o A combination of all.

Productivity is determined by -

- o Land and capital per worker.
- o Technology.
- o Skills.
- o Creativity of entrepreneurs.

Economies with a high standard of living are notable for:

- o Lots of capital,
- o advanced technology,
- o better education.
- o Sometimes, lots of natural resources.

Are large amounts of land or natural resources necessary for prosperity?

- o Are there rich countries with little in natural resources?
- o What makes them rich?

Why are many countries poor?

- Productivity is low – but why?
- They do not accumulate capital – why?
- Corruption, lack of rule-of-law, inefficient government sector.
- Poor educational system – more corruption.
- Protectionist trade policies that shield local industry that has political influence but is inefficient.

Economic growth:
improvement in the standard of living over decades.

Income per capita in the U.S. has doubled over the last 30 years.

Economic growth requires investment in:

- o More and better capital goods.
- o Research and development.
- o Education and training.

Sectors of the Economy

We think of four:

The business sector:
Firms

- o Where entrepreneurship brings land, labor, and capital together.
- o Where production and distribution of goods and services happens.

What is a *capitalist* or *private enterprise* economy?

- o Firms are privately owned.
- o Alternative is government ownership.
- o Communism attempted central control.
- o “Socialism” today refers to the welfare state.
- o Government ownership is out of fashion.
- o Hey, what about the current bail-outs???
- o Have we privatized profit and socialized loss?

Why is capitalism so unpopular

- o With moral philosophers and theologians?
- o With intellectuals in arts and literature?
- o With politicians?

Why has capitalism survived?

- What are the alternatives?
- What is the historical record?

What is a corporation?

- o A corporation is a legal entity.
- o Many of rights and privileges of individuals.
- o Owners are “shareholders,” have limited liability.
- o Profit goes to shareholders, reward for use of their capital.

The HOUSEHOLD sector:

- o Family units of society.
- o Consumes goods and services.
- o Supplies labor, receives wages in return.
- o Owns the business sector.
- o Judges success of economy:

How well does it serve the household sector?

The GOVERNMENT Sector

What are its functions?

1. Provides the legal framework, the "rules of the game" by which the economy functions

- o Property rights:
 - o who can use property and what can they do with it.
- o Commercial law:
 - o rights and obligations in business transactions
- o Licensing:
 - o who is allowed to practice a profession?
- o Regulations:
 - o what a firm can't do, or must do.

2. Collects taxes.

- o From households and firms.
- o At federal, state, and local levels
- o Based on income, wages, retail sales, estates.

3. Produces public goods

- o Fire & police,
- o K-12 education,
- o National defense.

4. Transfer payments under

- o Social Security
- o Medicare
- o Medicaid
- o Food Stamps
- o “Entitlements” by law.

The REST-OF-THE-WORLD

- o All countries we do business with.
- o “ROW” buys goods and services we export, sells goods and services imported to the USA
- o ROW invests in U.S. firms, lends money to the U.S. government.
- o We invest in the ROW too.
- o Two way flows of goods and capital.

International trade growing fast.
Politically sensitive issues:

- o Foreign ownership of U.S. firms.
- o Fluctuating in exchange rates.
- o Is free trade good?
- o Agreements like NAFTA, GATT, WTO.
- o “Fast track” authority for President.
- o Trade “deficit” with China, Japan, and Europe.

Microeconomics
is the study of markets

- We assume you have taken micro-economics.
- Or read the review of micro supplement.

In private enterprise economies,
it is in the *marketplace* that three
fundamental decisions are made:

- 1. What will be produced?
- 2. How will it be produced?
- 3. Who will consume it?

Adam Smith wrote
in *The Wealth of Nations*:

- "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest."
- Market economy harnesses self-interest for benefit of society.
- Altruism is rare.
- True evil is rare too!

Questions for Microeconomics:

- o Has deregulation of airlines been a success?
- o Should Amtrak be subsidized?
- o Are smokestack scrubbers cost effective?
- o What is the effect of price controls?
- o Is Microsoft Corp. a monopoly? What to do?

Macroeconomics is the big picture.

- o National Income
- o Cost of living and inflation
- o Interest Rates
- o Recession, Unemployment, Growth
- o Money and Banks
- o The Federal Reserve and Monetary Policy
- o Government Taxation, Spending, and Deficits
- o International Trade and Exchange Rates

What are some major
macroeconomic issues and
concerns today?

Macro issues are central to politics:

- o What to do about the recession?!
- o Should Congress cut taxes? Increase spending?
- o Should the Fed cut interest rates? Can it??
- o Is inflation really dead?
- o Is recovery possible in '09?
- o Are trade agreements like NAFTA good?
- o Or does free trade "cost jobs"?

Entitlements are a major issue:

- o Social Security & Medicare: transfer from young to old, or insurance benefits that were paid for?
- o Can the "birth dearth" generation afford the "baby boomers'" benefits?
- o Will they be willing to pay the tab?
- o Is there any way out of the mess?
- o Is it actually a huge Ponzi scheme??!!

How are entitlements affecting:

- o Medical care?
- o Education?
- o Economic growth?
- o The welfare of young families?

Economics and elections:

- o Economy is usually the # 1 issue
- o Bill Clinton's mantra in '92:
"It's the economy, stupid!"
- o Candidates promise something for nothing,
always more than they can deliver.
- o Economy is best predictor of election.
- o Recession means incumbents in trouble!

The End!
