Lesson 2

Macroeconomic environment

Structure

1. Macroeconomics: objectives
2. Macroeconomics: instruments
3. Aggregate demand and supply model
4. Evolution of macro-magnitudes

Macroeconomics: objectives and instruments

Microeconomics and macroeconomics

Microeconomics

Studies output and prices in individual goods markets

Demand and supply curves

Production factors can move across markets

Macroeconomics

Aggregates all goods and markets into one "general" market (all goods and services produced in an economy)

Aggregate demand and aggregate supply curves

Factors' reallocation across sectors is not modeled explicitly

Macroeconomics objectives

- Production growth
- Employment
- Price stability
- Other

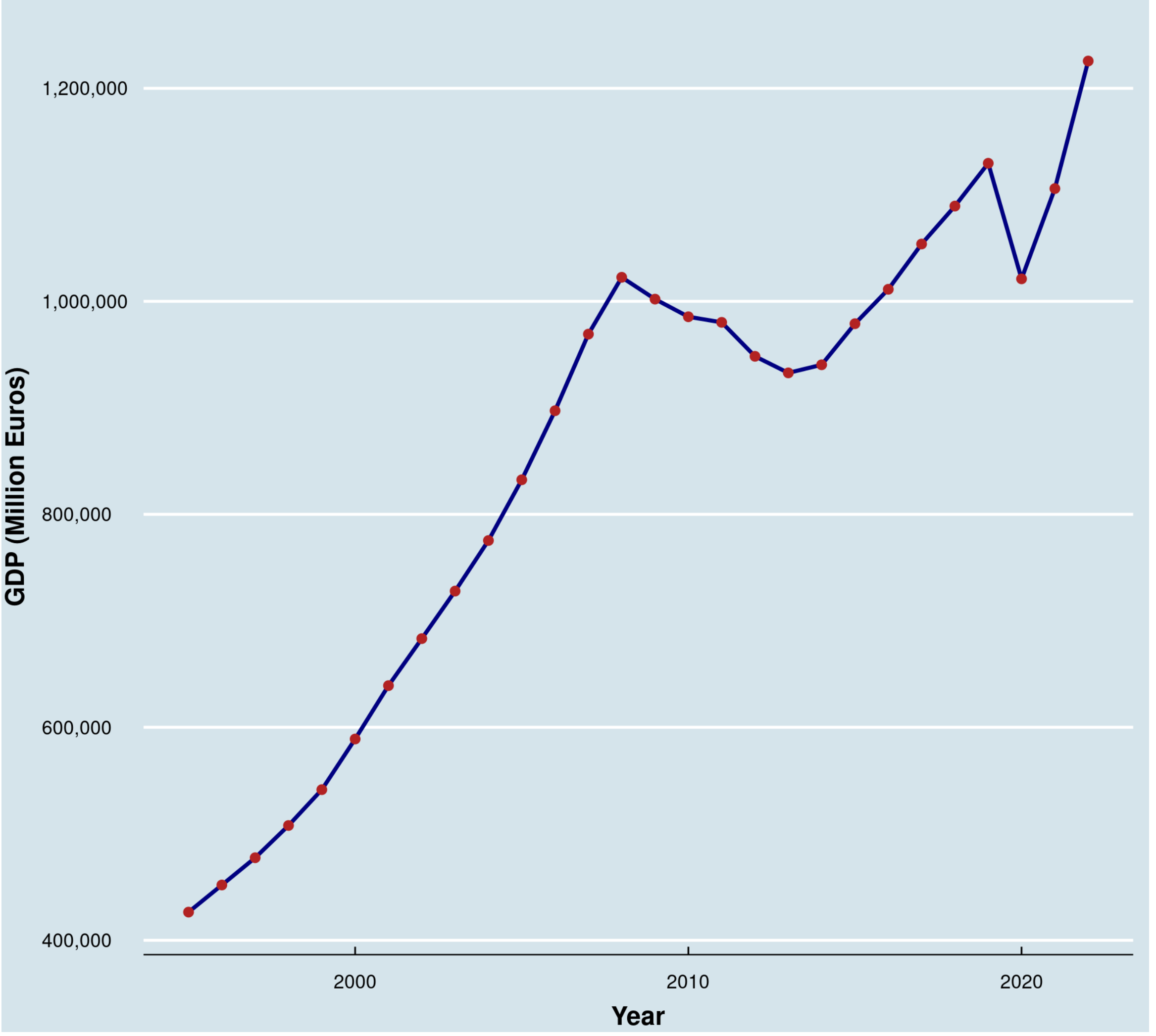
> **Important**
>
> To maintain a strong economy, governments typically pursue three policy goals:
>
> stable prices, full employment, and economic growth

Production growth

- GDP Gross Domestic Product measures the value of a country's production
- Gross domestic product (GDP) is the total monetary or market value of final goods and services produced within a country in a given period
- It indicates the size and performance of the economy and helps identify expansions and recessions.
- Potential GDP: an estimate of the value of the output that the economy would have produced if labor and capital had been employed at their maximum sustainable rates
- GDP gap = Potential GDP − GDP. Economic growth raises income and living standards but does not ensure fair income distribution.
- GDP gap = Potential GDP - GDP
- Economic growth is essential to increase people's income and standard of living. It is usually seen as the most important macroeconomic goal.
- Economic growth does not imply fair income distribution

Production growth: GDP

- Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period
- It gives information about the size of the economy and how an economy is performing
- It can be used to determine whether an economy is growing or experiencing a recession



Production growth: GDP change

https://datos.bancomundial.org/indicador/NY.GDP.MKTP.KD.ZG?locations=ES

Employment

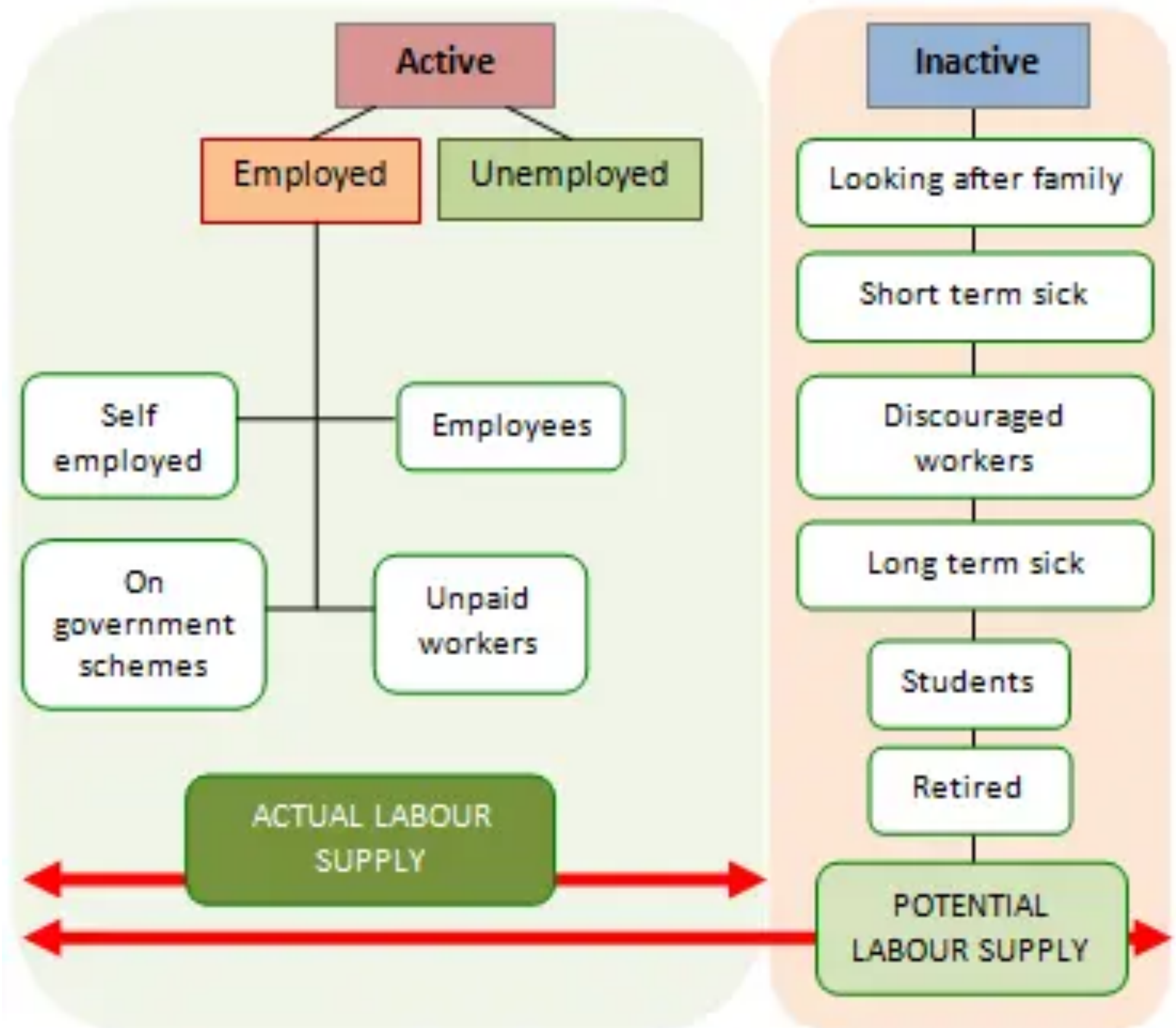
- Employment level: number people engaged in productive activities in an economy. The concept includes both employees and the self-employed
- The unemployed are people of working age who are without work, are available for work, and have taken specific steps to find work
- Key variable for people: Governments are usually worried by the unemployment rate
- Full employment: when the economy uses its productive resources, including labour. That doesn’t mean everyone is working. Instead, those who are able and want to have a job can get one

Unemployment

- Low employment levels are defined with low but not zero rates
- It is not so simple as classifying people into employed and unemployed

More on unemployment rate

Unemployment in Spain



Price stability

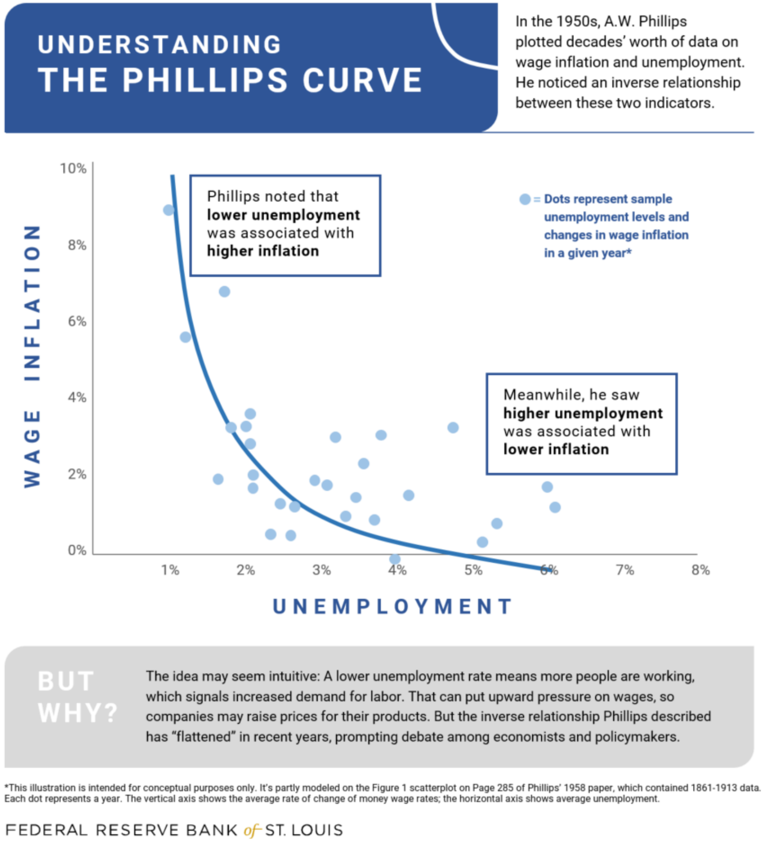
- Price stability is important because the purchasing power of money is maintained. To get the same number of items, you don't have to spend more nominal money
- Price stability requires a **low inflation rate**. It is not the same as zero inflation
- Inflation is the rate at which prices for goods and services rise
- Measured by CPI (Consumer Price Index) is a measure of the average change overtime in the prices paid by consumers for a market basket of consumer goods and services

If inflation goes up the purchasing power of money goes down (if your salary is not updated). If prices rise faster than wages, purchasing power falls.

Price stability II

The inflation - unemployment dilemma:

- Inflation has historically had an inverse relationship with unemployment (short-run)
- This means that when inflation rises, unemployment drops
- Higher unemployment equates to lower inflation



The Phillips curve

Price stability III

A stable low-moderate inflation rate is often considered ideal

2% inflation, is targeted in some countries such as the United States

Why is high inflation bad?

- Erodes purchasing power
- Disproportionately hurts low-income households
- Feeds on itself (wage-price spiral)
- Raises interest rates
- Can cause painful recessions

CPI in Spain query

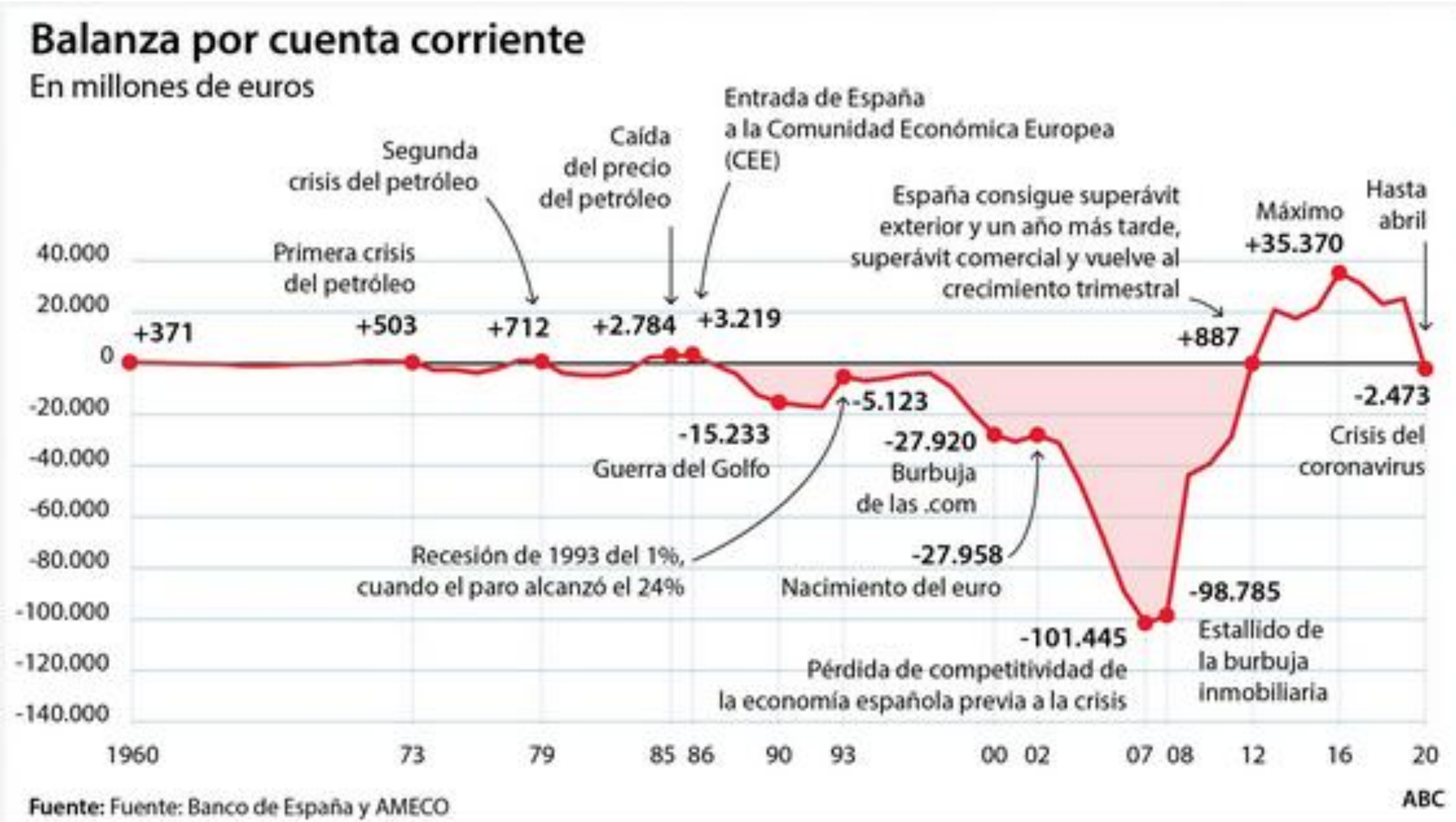
CPI is used to measure inflation, indexation of wages and rents

Other objectives

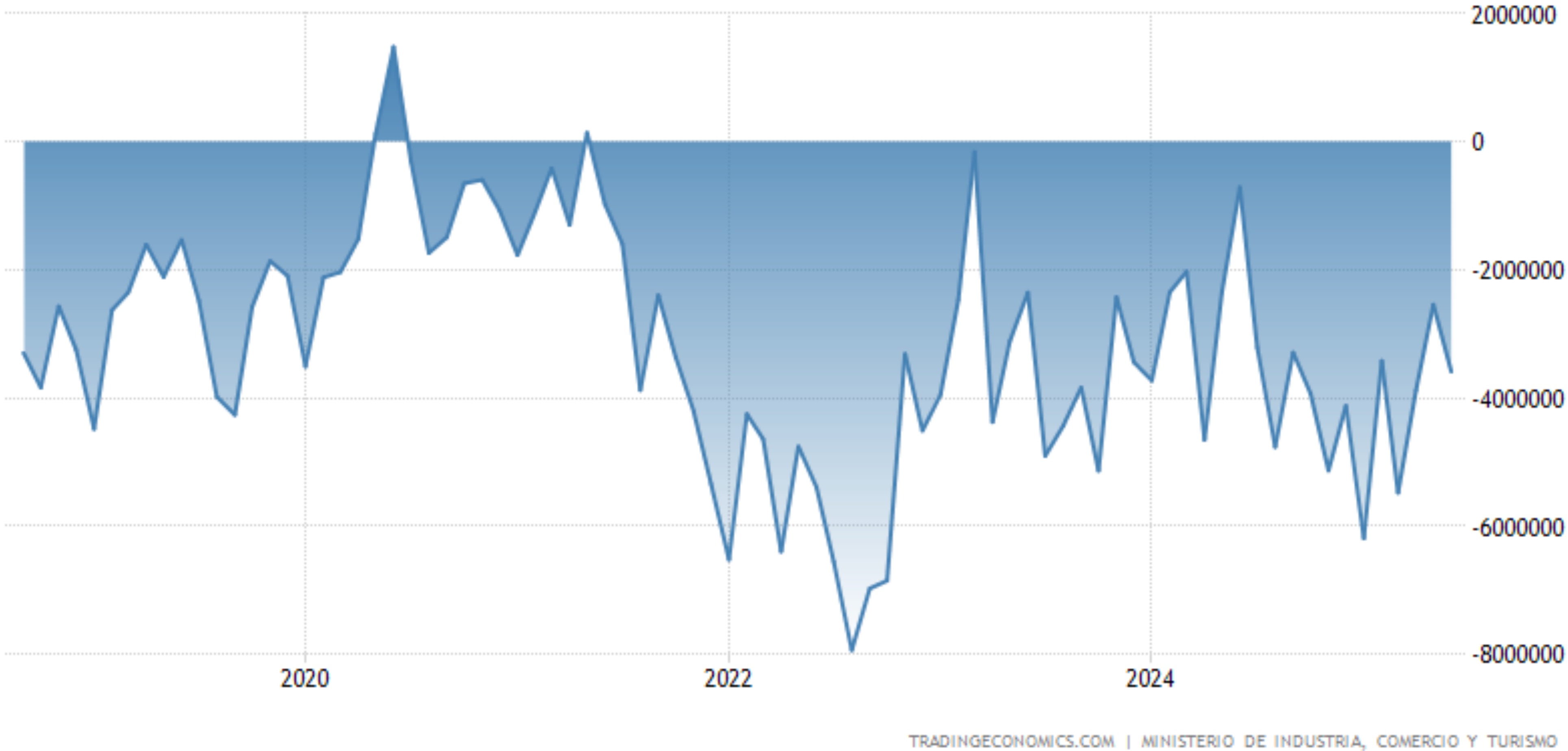
- Besides the main objectives economic policy (Governments) have more objectives:
  - A balanced budget (or at least a budget with a reduced deficit from the previous budget)
    - Public (budget) deficit: expenses> revenue
  - Trade balance with other countries (positive?)
  - Currency stability: EUR - $ Exchange rate

Public budget

Trade balance



Trade balance. Spain last years



Structure

1. Macroeconomics: objectives
2. Macroeconomics: instruments
3. Aggregate demand and supply model
4. Evolution of macro-magnitudes

2. Macroeconomics: instruments

Economic policy instruments

- Monetary policy
- Fiscal policy
- Others

Monetary policy

- Set of actions to control a country's money supply and achieve economic growth
- Expansionary - contractionary
- It is ruled by the Central Banks (Central European Bank), they control the amount of circulating money and the interest rates
- Contractionary:

  Interest rates: UP ➡️ investment, consumption, GDP, inflation DOWN
- Expansionary:

  Interest rates DOWN ➡️ investment, consumption, GDP, inflation UP

Fiscal policy

- Use of government spending and taxation to influence a country's economy
- Spending: infrastructure, pensions, health, defense, education, etc
- Taxation: government revenue collection
- Taxes:
  - reduce individuals income: it influences expense and savings
  - basis of the welfare state

External policy

- Trade policy: tariffs
- Currency exchange

Incomes policy

- Governments try to control the incomes of labour and capital, usually by limiting wages and prices
- Government attempts to influence wages and prices
- Voluntary wage and price guidelines, union agreements

Structure

1. Macroeconomics: objectives
2. Macroeconomics: instruments
3. Aggregate demand and supply model
4. Evolution of macro-magnitudes

3. Aggregate demand and supply model

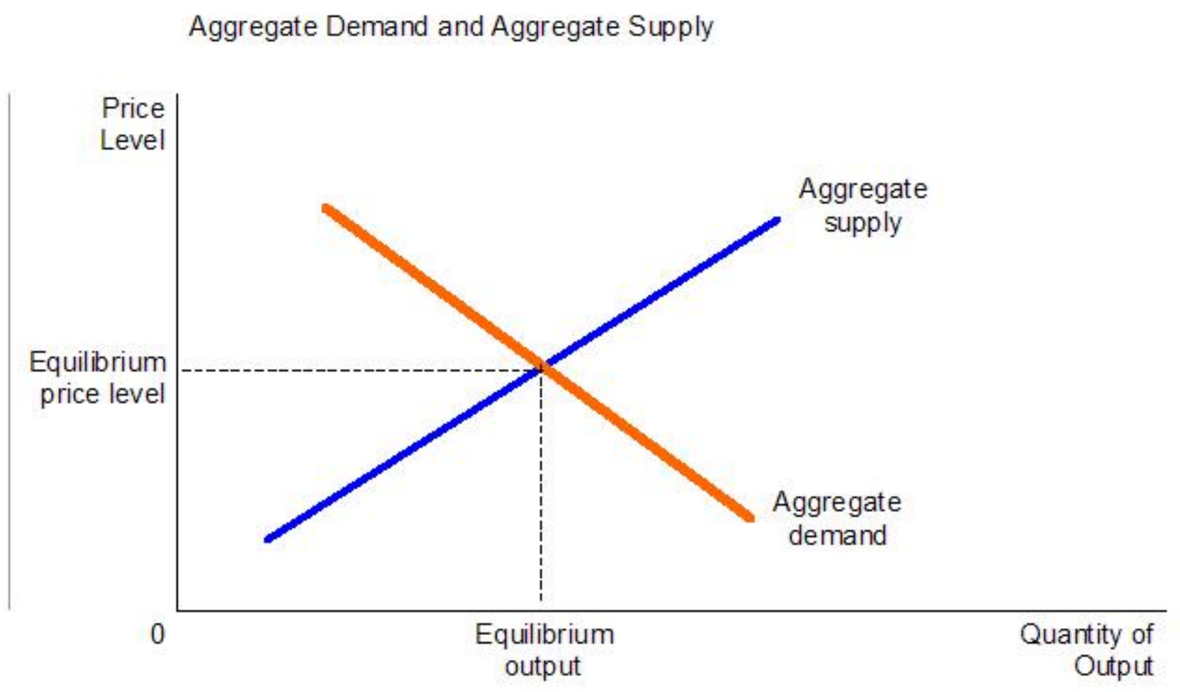
Model

The aggregate demand/aggregate supply model is a model that:

shows what determines total supply or total demand for the economy

and how total demand and total supply interact at the macroeconomic level.

Aggregate supply is the total quantity of output firms will produce and sell (the GDP)



Aggregate demand

total amount of goods and services in an economy that consumers are willing to purchase during a specific time frame

depends on:

- consumption
- investment
- government spending
- net exports

Aggregate supply

or total output, total supply of goods and services produced within a economy at a given overall price in a given period

depends on:

- factor prices
- technology
- labour and capital productivity
- government rules, subsidies, taxes
- availability of production factors

Structure

1. Macroeconomics: objectives
2. Macroeconomics: instruments
3. Aggregate demand and supply model
4. Evolution of macro-magnitudes

4. Evolution of macromagnitudes

Current prices vs constant prices

- Current prices: nominal prices
- Constant prices: real prices (without inflation)
- To measure the real GDP growth we use constant prices
- That implies inflation adjustment or deflation with an index (e.g. the CPI)

deflating nominal values to real values

GDP and GDP per capita

- GDP: total value of goods and services a country produces annually
- GDP per capita: country's economic output per person
- GDP per capita is a better measure of prosperity

top economies