CHAPTER 1

The Science of Macroeconomics

Modified for ECON 2204 by Bob Murphy

Macroeconomics
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Important issues in macroeconomics

Macroeconomics—the study of the economy as a whole—addresses many topical issues, e.g.:

- What causes recessions? What is “government stimulus” and why might it help?
- How can problems in the housing market spread to the rest of the economy?
- What is the government budget deficit? How does it affect workers, consumers, businesses, and taxpayers?
Important issues in macroeconomics

Macroeconomics—the study of the economy as a whole—addresses many topical issues, e.g.:

- Why does the cost of living keep rising?
- Why are so many countries poor? What policies might help them grow out of poverty?
- What is the trade deficit? How does it affect a country’s well-being?
U.S. real GDP per capita (2009 dollars) (1 of 2)

- World War I
- Great Depression
- World War II
- Korean War
- Vietnam War
- First oil-price shock
- Second oil-price shock
- 9/11 terrorist attack
- Financial crisis

Mankiw, *Macroeconomics*, 10e, © 2019 Worth Publishers
The Great Recession
The Great Recession

Jobs recovery
Unemployment rate (%) and successive consensus forecasts (2010-2016)

Sources: CEA; BLS; NBER
The Great Recession

Prime numbers
Labour force participation rate, males aged 25-54 (%)
Economic models

...are simplified versions of a more complex reality.

- irrelevant details are stripped away

...are used to:

- show relationships between variables
- explain the economy’s behavior
- devise policies to improve economic performance
Endogenous vs. exogenous variables

- The values of **endogenous variables** are determined in the model.
- The values of **exogenous variables** are determined outside the model: The model takes their values and behavior as given.
- In the model of supply & demand for cars,
  - endogenous: $P, Q^d, Q^s$
  - exogenous: $Y, P_s$
The use of multiple models

- No one model can address all the issues we care about.

- *E.g.*, our supply–demand model of the car market...
  - *can* tell us how a fall in aggregate income affects price & quantity of cars.
  - *cannot* tell us why aggregate income falls.
The use of multiple models

- So we will learn different models for studying different issues (e.g., unemployment, inflation, long-run growth).

- For each new model, you should keep track of:
  - its assumptions
  - which variables are endogenous, which are exogenous
  - the questions it can help us understand, those it cannot
Prices: flexible vs. sticky

- **Market clearing**: An assumption that prices are flexible, adjust to equate supply and demand.

- In the short run, many prices are **sticky**—adjust sluggishly in response to changes in supply or demand. For example:
  - many labor contracts fix the nominal wage for a year or longer
  - many magazine publishers change prices only once every 3 to 4 years
Prices: flexible vs. sticky

- The economy’s behavior depends partly on whether prices are sticky or flexible:
  - If prices are sticky (short run), demand may not equal supply, which explains:
    - unemployment (excess supply of labor)
    - why firms cannot always sell all the goods they produce
  - If prices are flexible (long run), markets clear and economy behaves very differently.
Outline of this course:

- Introductory material (Chaps. 1, 2)
- Classical Theory (Chaps. 3–7)
  How the economy works in the long run, when prices are flexible
- Growth Theory (Chaps. 8, 9)
  The standard of living and its growth rate over the very long run
- Business Cycle Theory (Chaps. 10–14)
  How the economy works in the short run, when prices are sticky
Outline of this course:

- Macroeconomic theory (Chaps. 15 and 19)
  Macroeconomic dynamics, models of consumer behavior, theories of firms’ investment decisions

- Macroeconomic policy (Chaps. 16–18)
  Stabilization policy, government debt and deficits, financial crises