Macroeconomic problems

Lecture 5. Circular Flow and GDP

Foundations of Economics, WIUT 2021

LECTURE OUTLINE

- Introduction to macroeconomics
- Circular flow model
- GDP and business cycles

Drawing a Line Between Macro and Micro

- Microeconomics
  - How *individual* decision-making units behave
- Macroeconomics
  - Behavior of *entire* economies
  - Study economic aggregates such as price level, production, unemployment

Three macroeconomic concerns

- Economic growth
- Low Unemployment
- Low inflation

Gross Domestic Product (GDP)

- *GDP* is the sum of the value of new, final goods produced within the domestic borders of an economy.
- *Final goods are goods sold to their end-users*

GDP does not include:

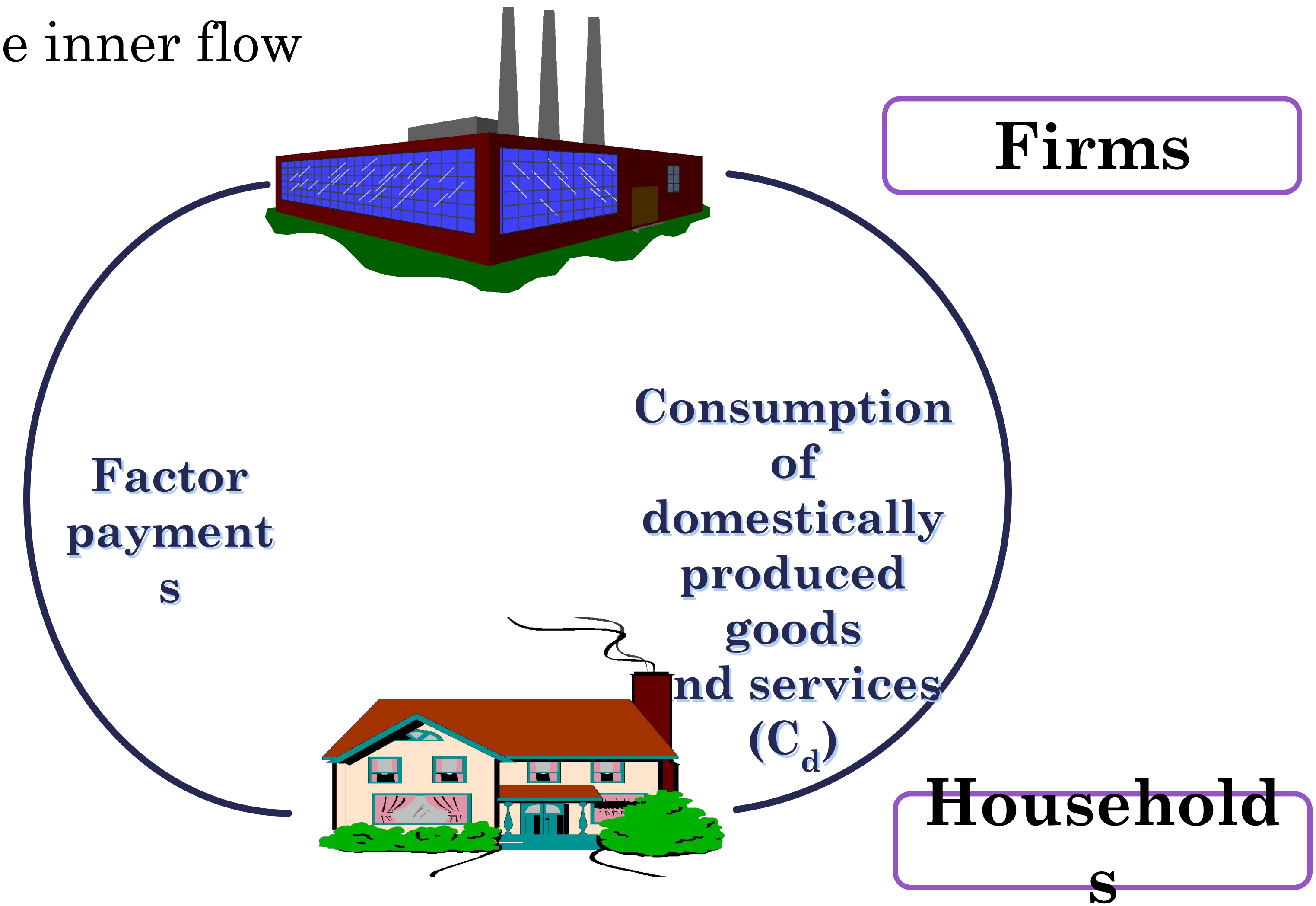
- Intermediate goods which are sold from one firm to another for immediate transformation into other goods.
- financial transactions like buying stocks.
- purchases of used goods which have been sold before.
- goods produced overseas by domestic firms.

Gross Domestic Product

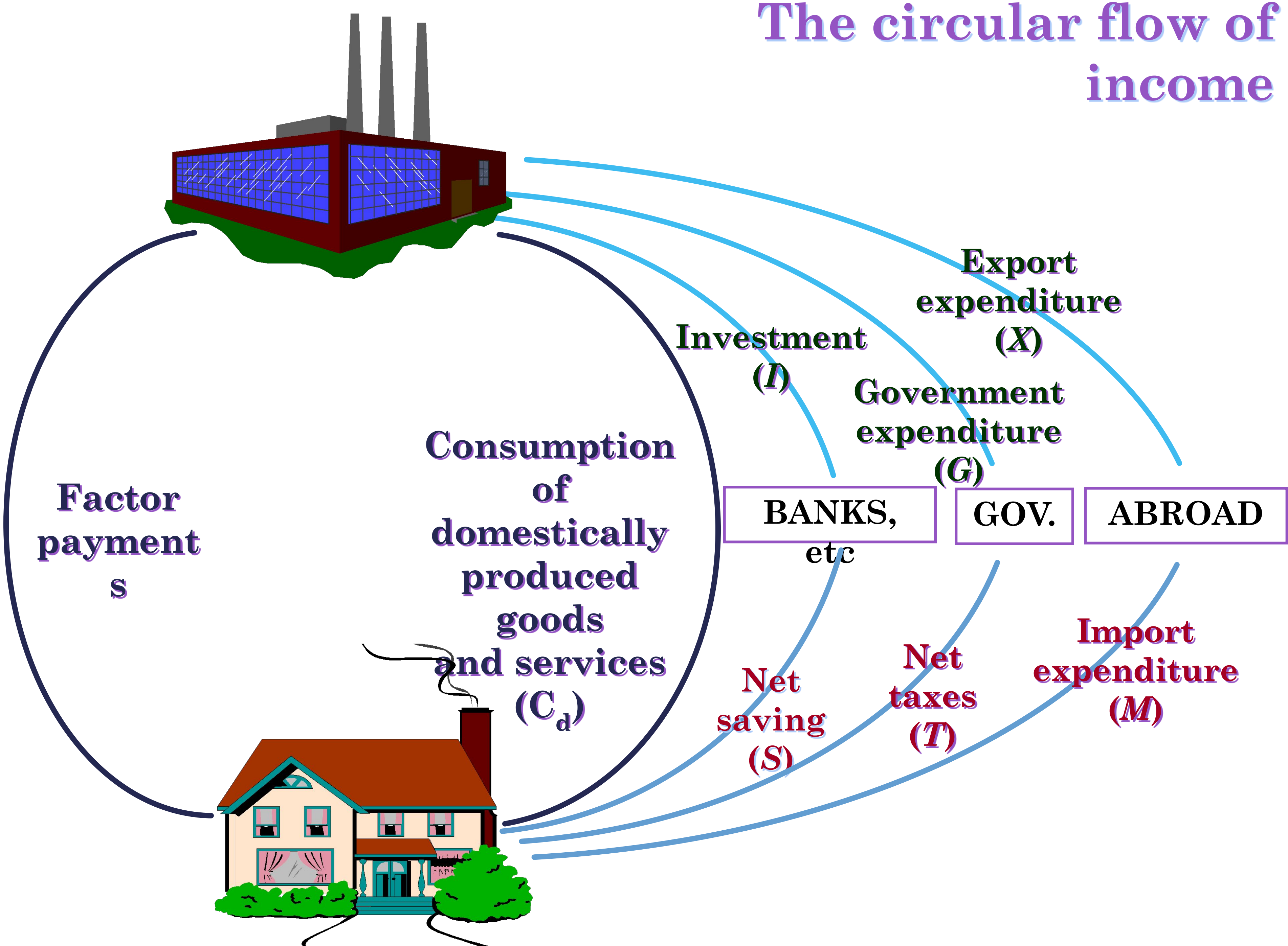
- Limitations of GDP
  - Not a measure of the nation’s economic well-being
  - Includes only market activity
    - Creates a problem when making international comparisons
    - Ignores the underground economy
    - Do people in poor countries really live on $5/week?
  - Places no value on leisure

The Circular Flow of National Income
Closed economy with no government

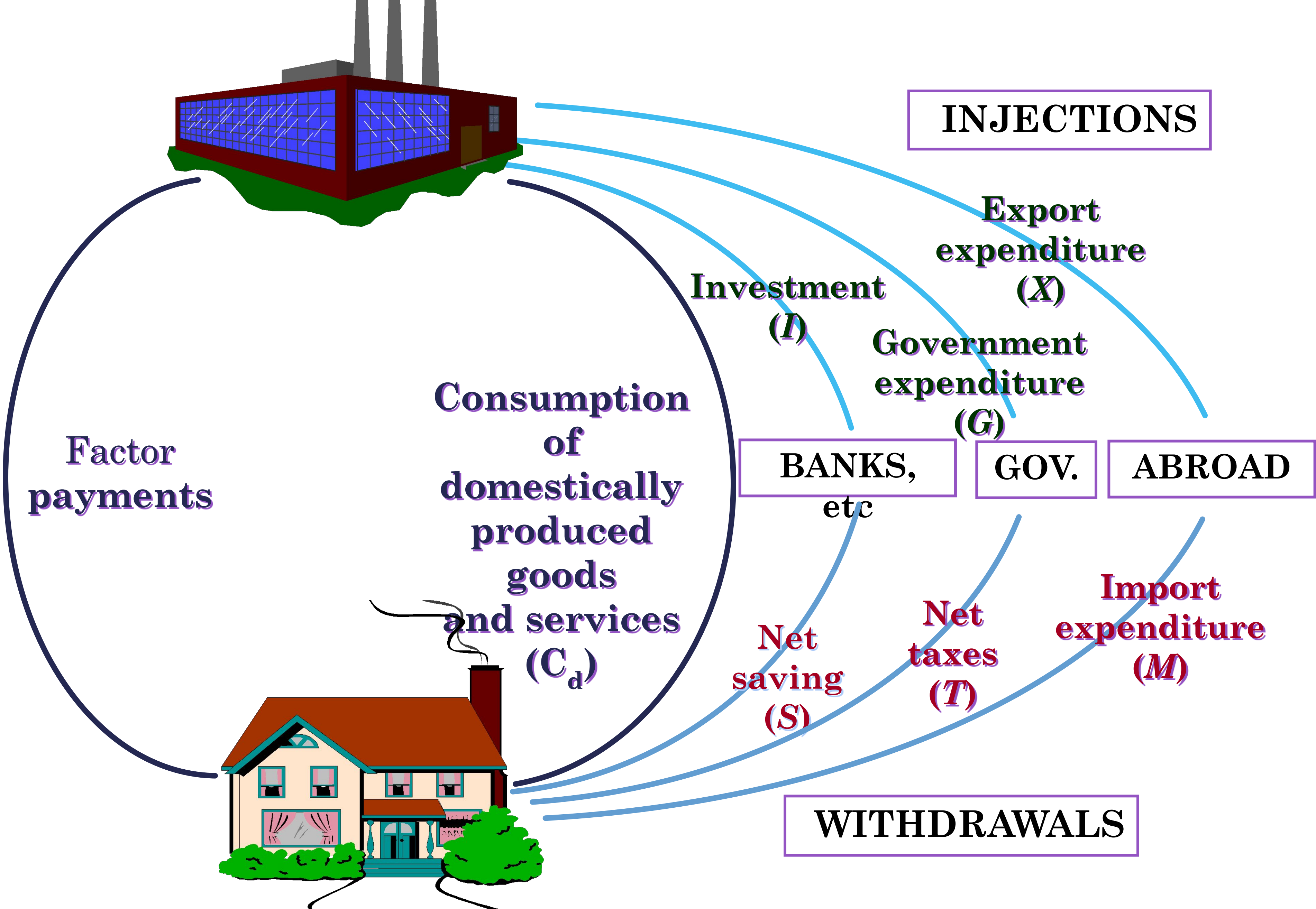
- The inner flow



The circular flow of income



The circular flow of income



The Circular Flow of Income

- $W = S + T + M$
- $J = I + G + X$

$$W = J$$
$$(S+T+M) = (I+G+X)$$

But it does NOT guarantee that

$$S = I$$
$$G = T$$
$$M = X$$

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AGGREGATE DEMAND

Aggregate demand – **total spending on the goods and services made within the country**

$$AD = C + I + G + X - M$$

or

$$AD = Cd + I + G + X$$

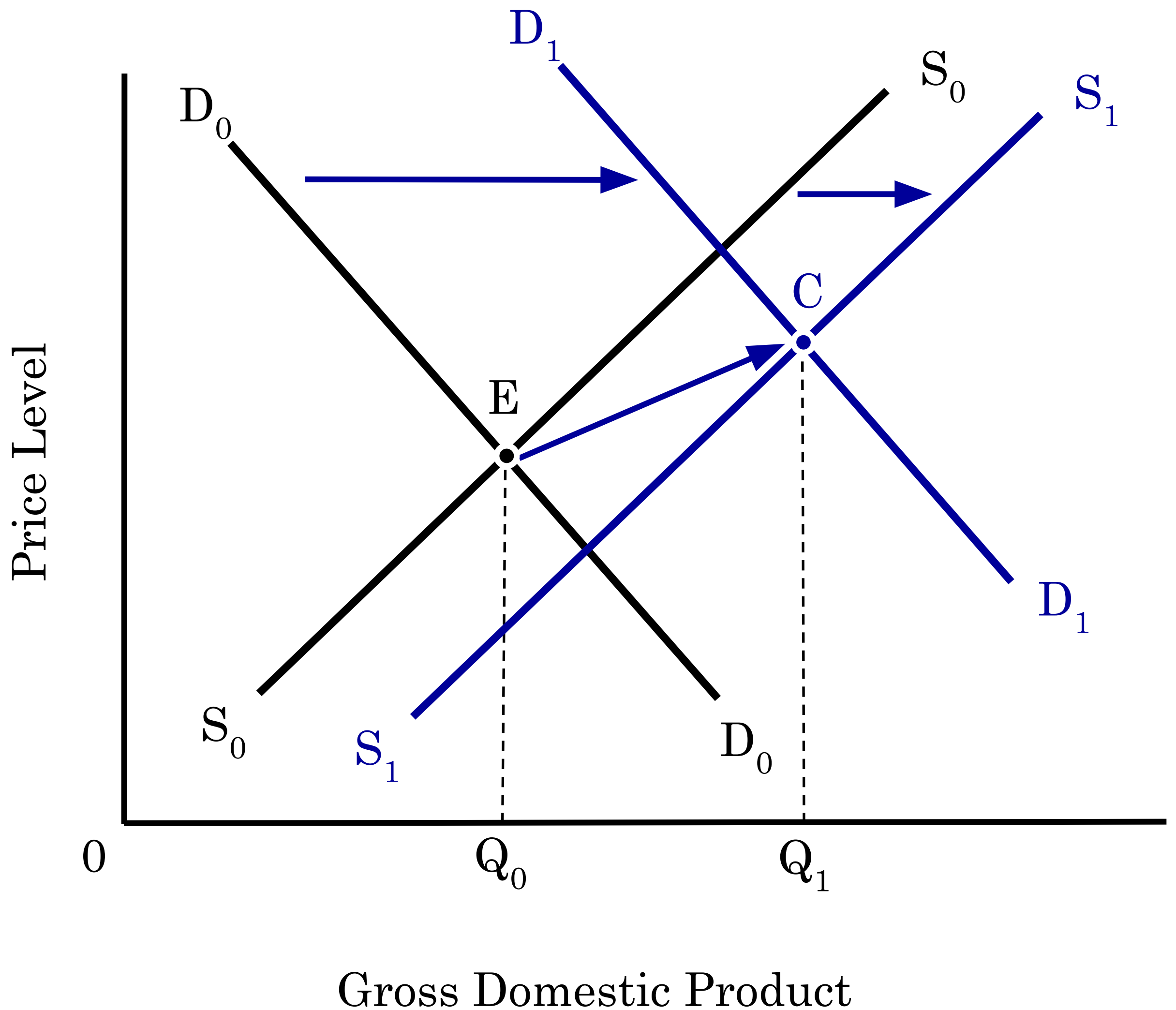
Circular flow of income and macroeconomic objectives

Rise in AD will lead to:

- Output ↑ or Economic growth
- Unemployment ↓
- Inflation ↑
- Import (M) ↑

  Balance of payments will deteriorate

Economic Growth



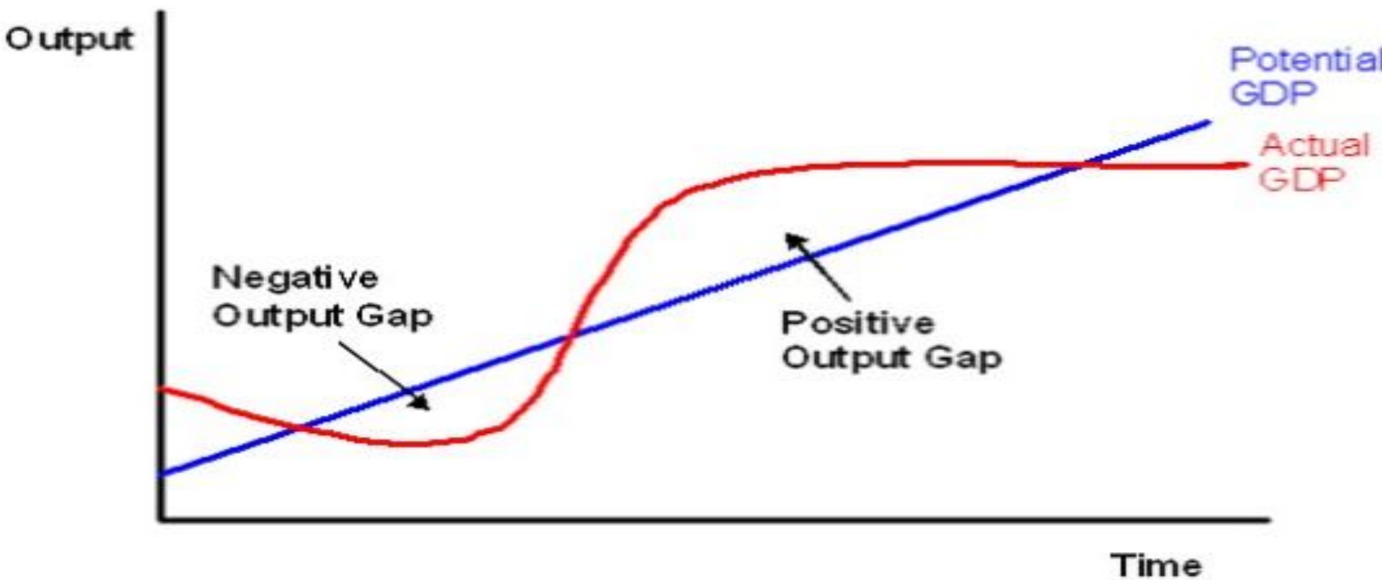
Economic Growth and the Business Cycle

Economic growth

Actual

Potential

Output gap = Actual output – Potential output



Trend growth line

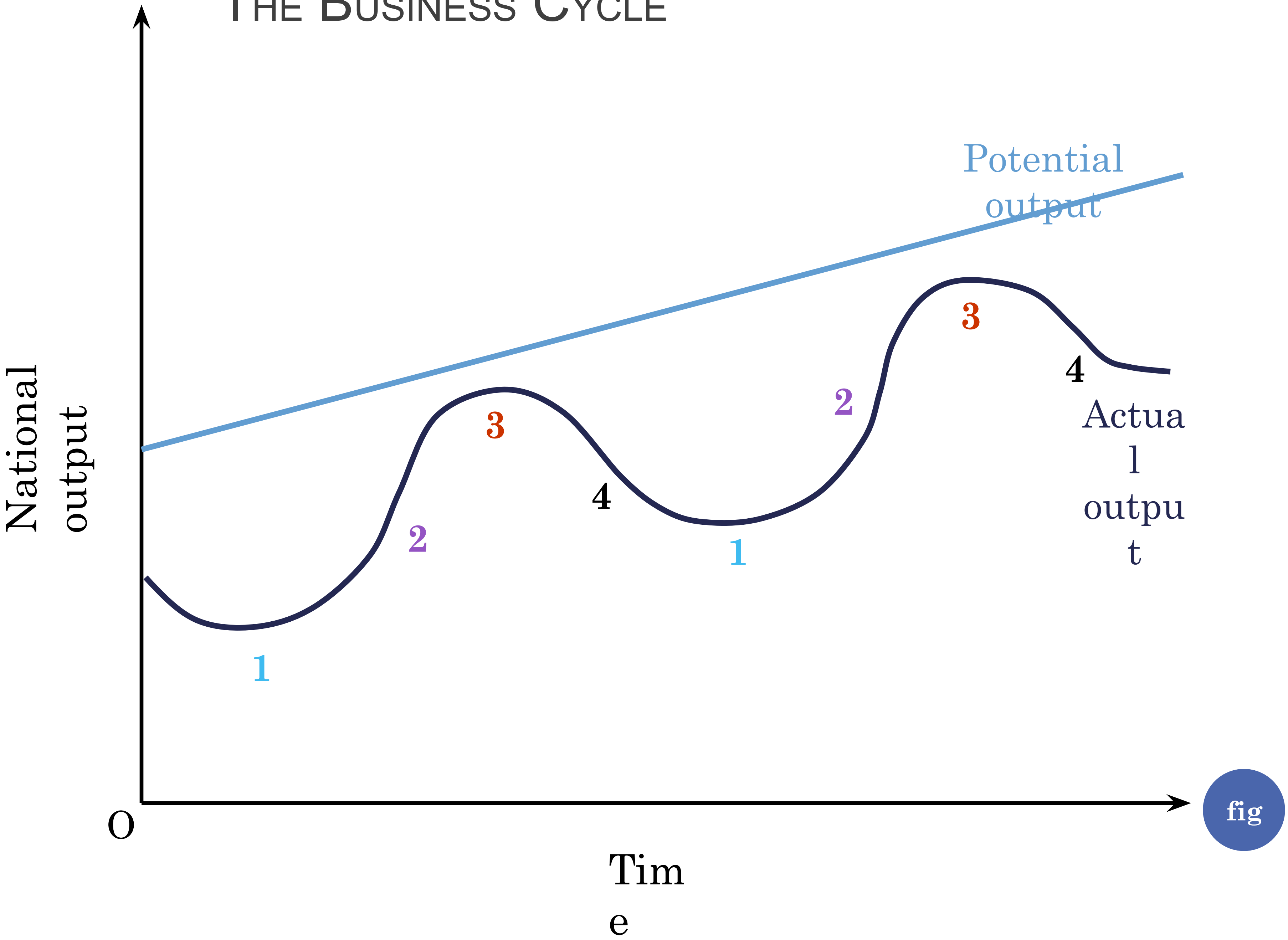
ECONOMIC GROWTH AND THE BUSINESS CYCLE

Business cycle – the periodic fluctuations of national output round its long-term trend

‘Phases’ of the business cycle:

1. The upturn
2. The rapid expansion
3. The peaking out
4. The slowdown, recession or slump

The Business Cycle



Business Cycle Theories

- Endogenous theories
  - Innovation theory
  - Psychological theory
  - Inventory cycle theory
  - Monetary theory
  - Under-consumption theory

- Exogenous theories
  - Sunspot theory
  - War theory

UPTURN

- During a period of expansion:
  - Wages increase
  - Low unemployment
  - People are optimistic and spending money
  - High demand for goods
  - Businesses start
  - Easy to get a bank loan
  - Businesses make profits and stock prices increase

Peak

- When the economic cycle peaks:
  - The economy stops growing (reached the top)
  - GDP reaches maximum
  - Businesses can't produce any more or hire more people
  - Cycle begins to contract

Contraction

- During a period of contraction:
  - Businesses cut back production and layoff people
  - Unemployment increases
  - Number of jobs decline
  - People are pessimistic (negative) and stop spending money
  - Banks stop lending money

Trough

- When the economic cycle reaches a trough:
  - Economy "bottoms-out" (reaches lowest point)
  - High unemployment and low spending
  - Stock prices drop

But,
when we hit bottom, no where to go but up!
UNLESS….

READINGS

Sloman J. (2016), Essentials of Economics, 7th edition, Prentice Hall, Chapter 8.

Mankiw E. (2018), Principles of Economics, 8th edition, Cengage learning. Chapter 8