Chapter 23: An Introduction to Macroeconomics

We've spent a lot of time exploring the microeconomic decisions of consumers, firms, and government. Now we turn to macroeconomics, the study of the entire economy resulting from millions of individual microeconomic decisions. Macroeconomics explores long-run economic growth, short-run business cycles, and several theories about government intervention to stabilize markets. Chapter 23 introduces measures of economic performance which serve as a foundation for the study of macroeconomics.

A number of statistics are used to measure economic performance. Gross domestic product measures the value of all final goods and services produced in a country in one year. Nominal GDP measures output in current prices, while real GDP removes the inflation distortion and allows comparisons of national output across time. Unemployment occurs when a person is not working but is actively trying to find a job. Inflation is a general increase in the level of prices.

Economic growth is a primary goal of economic activity. Economic growth is measured as an increase in real GDP per capita, in order to correct for changes in population. In order to raise the standard of living over time, households and firms must devote some level of income to saving and investment, rather than immediate consumption of goods and services. By making funds available to expand factories and buy equipment, a nation invests in its future growth. Expectations play an important role in investment, because firms will only invest if they expect to earn a higher return on the investment.

Economic shocks play an important role in economic performance. A positive supply shock, such as widespread application of a new technology, can increase output and reduce the price level. On the other hand, a negative supply shock, such a widespread crop failure, can reduce output and increase the price level. Economists believe that most short-run fluctuations in GDP result from demand shocks. If consumer confidence significantly decreases, the reduced demand for products reduces output and possibly price levels (though prices and wages tend to be downwardly "sticky"). If the government significantly increases spending, increased demand for products increases both output and price levels.

But the initial shock is not the end of the story. In the case of a negative demand shock, as firms experience lower demand for their products, they reduce production and lay off workers. Those laid off workers then demand even fewer products, leading to further layoffs. The economy as a whole declines, with real GDP falling and unemployment rising. Economic fluctuations are harmful in the short run because of the need for constant adjustments. But such fluctuations also have long-run ramifications, because households and firms are less likely to invest if they have little confidence in their expectations, harming long-run economic growth.

This overview of macroeconomics lays the groundwork for a more detailed study of the economy and potential policy solutions to macroeconomic instability. Material from Chapter 23 may appear in a question or two on the multiple-choice portion of the AP Macroeconomics Exam, though the more thorough analysis of Chapters 24-26 is likely to be the source of more detailed questions.