MACROECONOMICS is the study of the factors that influence all firms operating in the economy. Factors such as interest rates, inflation rates, unemployment, and economic growth have varying impacts on all firms. In this unit, we will examine the importance of understanding the various factors of macroeconomics.

Objective:

Describe the scientific study of macroeconomics and the factors important to understanding macroeconomics.

Key Terms:

- consumption
- fiat currency
- gross domestic product

The Scientific Study of Macroeconomics

Macroeconomics is the study of national economies and includes topics such as production, consumption, net exports, unemployment, and inflation.

MEASURING THE ECONOMY

Economists use many factors to determine if the economy is healthy. A “sick” or weak economy meets far fewer of the needs and wants of individuals than a healthy economy. Gross domestic product (GDP) measures the value of all the final goods and services produced within a country’s borders. GDP is composed of consumption, investment, government spending, and net exports. GDP = C + I + G + NX.
**Consumption** (C) is the value of household spending on goods and services (e.g., food, clothing, medical expenses, and dining at restaurants). Consumption makes up the bulk of the U.S. economy—accounting for more than 70 percent of all economic activity.

Investment (I) is the value of household or business spending on capital. Examples of capital are purchases of new land, buildings, or equipment. Household purchases of housing are included in investment rather than consumption. Investment makes up about 15 percent of GDP. The remaining portion of GDP is made up of spending by the federal, state, and local governments.

Government spending (G) includes all of the spending done by national, state, and local governments on goods and services. For example, governments build roads, hire and pay teachers, and hire firms to build military equipment.

**Net Exports**

Net exports is composed of exports and imports. In GDP, net exports is equal to exports minus imports. This is because exports are produced in the country, but they are consumed in other countries. Alternatively, imports are produced in other countries, but they are consumed in the country. Because GDP focuses on production within the borders of the country, exports are added to GDP and imports are subtracted.

**Use of GDP**

Some people criticize the use of GDP as a measure of the health of a nation’s economy because economic activity is not necessarily equal to the well-being of the citizens. For instance, a natural disaster (e.g., a hurricane or a tornado) can create additional economic activity and a higher GDP despite the plight suffered by the victims. In addition, the measure does not directly account for the health and education levels of citizens. Alternative measures of society well-being have been offered, but they are more difficult to quantify than GDP.

**GNP**

Although GDP is the most commonly used measure of the economy, other measures exist. Gross national product (GNP) measures the value of all goods and services produced by nationals of the country in question, despite where the producers live—in this country or other countries. GDP measures the value of goods and services produced within the borders of a country by all the people who live there (nationals and non-nationals), while GNP measures the value of goods and services produced by the nationals of the country regardless of where they live. Net national product (NNP) is equal to GNP minus depreciation. Depreciation accounts for the decline in the value of an asset as it is used. For example, new tractors are worth more than used tractors because their values have not yet depreciated.

**Unemployment Rate**

The unemployment rate is a measure of the percent of the population that is actively seeking to find work but that is not currently working. Low unemployment rates are favorable, but
it is unlikely that zero percent unemployment is attainable. Many economists believe that some unemployment will exist due to natural factors, such as seasonal demand for goods and individuals changing jobs. Unemployment does not measure the percent of the population that is not employed. It measures the percentage of the population that is actively seeking employment and is not currently employed. This is an important distinction. For example, people who are retired do not have jobs, but they are not counted as part of the unemployment rate.

**Inflation**

Most economies experience a general and gradual rise in the prices of goods and services (inflation). One commonly used measure of inflation is the consumer price index (CPI). The CPI measures the cost of a “basket” of consumer goods (e.g., food, clothing, and transportation) at different points in time. The cost of this basket often rises over time. If the cost of the basket ever falls, it is called deflation. Generally, monetary policies are used by the central bank of a government to control inflation so it is low and predictable. Some groups stand to benefit from inflation, and eliminating all inflation would be difficult.

**INFLATION AND FIAT CURRENCY**

**Fiat currency** is money that exists because an authority states that it can be used to settle public and private debts. Economies that use fiat currencies believe that the currency will be relatively stable. As a result, there will not be large amounts of inflation or deflation from year to year. Central banks can use monetary policy to influence the inflation rate. Typically, higher rates of interest are used to reduce high inflation rates. In the early 1980s, the Federal Reserve raised interest rates dramatically to control high inflation rates.

**Inflation and Who It Benefits**

Inflation in the prices of goods and services tends to benefit some groups at the expense of other groups. Businesses tend to benefit from inflation because they buy inputs at low prices and sell at higher prices that include inflation. The lag between these transactions can improve profit outlooks. Inflation is likely to benefit sellers because their prices are rising. Inflation is likely to hurt consumers because the price they pay for goods and services is rising.

Inflation typically benefits borrowers of money because the borrowed dollars are worth more than the dollars used to repay the loan. Conversely, inflation is likely to harm lenders because they lend dollars that are worth more than the dollars they receive as repayment. Inflation hurts people on a fixed income. For instance, many retired people receive the same payment every year. When prices rise, the fixed income buys fewer goods.

Generally, young individuals are borrowers who are not on fixed incomes. Thus, young individuals often stand to gain the most from inflation. Older individuals often are retired and have less debt than their younger counterparts. Therefore, they typically stand to be hurt by high inflation rates, especially if their retirement incomes are fixed.
BUSINESS CYCLES

The macro economy (measured by GDP) generally grows at a relatively steady pace. There are periods, however, when the economy shrinks, does not grow as fast, or grows really fast. These up-and-down fluctuations in GDP are called the business cycle. Technology, changes in interest rates, and government spending innovations might cause fluctuations in the production of goods and services.

A business cycle contraction is called a recession and occurs when GDP has negative growth (declines) for at least two consecutive quarters (six months), as defined by the National Bureau of Economic Research. The United States experienced recessions in 2001 and a prolonged recession beginning in 2008. A particularly long and deep recession is called a depression. Most economists generally agree that the recession must include a drop in GDP of at least 10 percent and three years of GDP declines to be a depression. The last depression (The Great Depression) in the United States occurred in the 1930s.

Summary:

Macroeconomics is the study of national economies and includes topics such as production, consumption, net exports, unemployment, and inflation.

Gross domestic product (GDP) measures the value of all the final goods and services produced within a country’s borders. GDP is composed of consumption, investment, government spending, and net exports. Consumption is the value of household spending on goods and services. Investment is the value of household or business spending on capital. Government spending includes all of the spending done by national, state, and local governments on goods and services.

Some people criticize the use of GDP as a measure of the health of a nation’s economy because economic activity is not necessarily equal to the well-being of the citizens. Gross national product (GNP) measures the value of all goods and services produced by nationals of the country in question, despite where the producers live.

Fiat currency is money that exists because an authority states that it can be used to settle public and private debts. Businesses tend to profit from inflation, but inflation hurts consumers.
Checking Your Knowledge:

1. What are the four components of GDP?
2. List three groups of individuals that tend to benefit from inflation.
3. Explain why retired seniors living on fixed incomes are harmed by inflation.
4. What factors do economists consider when determining if the economy is in a recession or a depression?
5. When was the last depression in the United States?

Expanding Your Knowledge:

Use the Internet to study the historical business cycles that have occurred in the U.S. economy. Create a chart or a graph based on your findings to share with the class.

Web Links:

- National Bureau of Economic Research—Business Cycle Expansions and Contractions
  http://www.nber.org/cycles/cyclesmain.html
- Inflation Calculator
  http://data.bls.gov/cgi-bin/cpicalc.pl
- The Age of the Fiat Currency
- About the Great Depression
  http://www.english.illinois.edu/maps/depression/about.htm
- What Are the Components of GDP?
  http://useconomy.about.com/od/grossdomesticproduct/f/GDP_Components.htm
- The Telltale Signs of Recession
  http://www.msnbc.msn.com/id/23223104/
- Agricultural Career Profiles
  http://www.mycaert.com/career-profiles