Learning Objectives

Upon completion of this unit, students should be able to:

1. Discuss macroeconomics and the national economy.
2. Discuss economic fluctuations and growth.
3. Explain aggregate demand and aggregate supply.
4. Describe the history of the U.S. economy.

Written Lecture

The National Economy

An important measure of the performance of the national economy is the gross domestic product: the market value of final goods and services currently produced in the country. We focus on the national economy because there are few differences within a country with respect to economic activity; however, there are considerable differences between countries.

Money is a medium that circulates throughout the economy and facilitates the exchange of goods and services. At any given time there are a certain number of dollars in the economy. This amount of dollars is referred to as the money stock. But the average dollar is spent more than once in a year, so we can also speak of money as a flow variable. The distinction between stocks and flows is an important one in economics, and you should pay special attention whenever the distinction is made in the text.

Macroeconomics seems difficult to grasp at times. In part this difficulty is due to the complexity of the economy. Unfortunately, macroeconomic theories are difficult to test because controlled laboratory experiments are not feasible.

Economic Fluctuations and Growth

All industrial market economies experience fluctuating periods of expansion and contraction. Over the long run, economic output tends to increase, but it does not do so without fluctuations. Expansions tend to last longer than contractions, and the overall trend in the United States has been an increase in the standard of living. There are some similarities between various contractions and between various expansions, so economists have tried to look for signals that indicate when a turning point is coming. This process is still rather undeveloped.

Aggregate Demand and Aggregate Supply

The total demand for goods and services at various price levels, other things being constant, is known as aggregate demand. The aggregate quantity demanded increases as the price level falls. The behavior of the aggregate demand curve is similar to that of a demand curve for a particular commodity, and the reason is similar. At a lower price level people are willing and able to
buy more, so the quantity demanded of all goods and services increases. The aggregate quantity supplied at various price levels, other things being constant, is known as aggregate supply. The shape of the aggregate supply curve is a source of debate among economists and will be discussed further in a later chapter. An upward-sloping curve indicates a positive relation between the price level and the quantity of aggregate output supplied. The equilibrium of the economy as a whole is determined by the intersection of the aggregate demand and the aggregate supply curves.

**Brief History of the U.S. Economy**

Before World War II, the economy was characterized by numerous fluctuations, and the government did not actively intervene to stabilize the economy except in a few rare circumstances. The worst depression occurred during the 1930s. In response to this economic event, John Maynard Keynes developed a theory that argued that depressions are not necessarily self-correcting and that if left to itself, the economy might remain in a depression for a long period of time. To help restore economic expansion, he argued, the federal government should engage in deficit spending.

Between the end of the Great Depression and the inflation associated with the Vietnam War, Keynesian policies seemed to work well. However, when the aggregate supply shocks of the 1970s led to stagflation, Keynesian policies fell into disrepute. To stimulate aggregate supply, the Reagan administration attempted to increase incentives to work and invest by cutting income taxes. One result was large federal deficits through the 1980s. A combination of economic growth, reductions in government spending, and tax increases led to a budget surplus in 1998. Both unemployment and inflation were at low levels by post-war standards.

The longest expansion in U.S. history ended in early 2001. The recession that followed was short but the recovery was slow.