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# Topic 1 ► Introduction to Macroeconomics

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Define macroeconomics;
2. Discuss five main issues in the study of macroeconomics;
3. Elaborate on the two main macroeconomic policies, namely the financial policy and the fiscal policy;
4. Discuss three objectives of macroeconomics;
5. Describe the economic phases in the business cycle;
6. Differentiate between classical and Keynesian economic theories in relation to macroeconomics; and
7. Examine the meaning of aggregate demand and aggregate supply in economics.

## ► INTRODUCTION

Macroeconomics is an analysis of a country's economic structure and performance and the government's policies in affecting its economic conditions. Economists are interested to know the factors that contribute towards a country's economic growth because if the economy progresses, it will provide more job opportunities, goods and services and eventually raise the people's standard of living. Macroeconomics can progress as it tests a particular theory to see how the overall economy functions, whereby the theory is used to forecast the effects of a particular policy and event that was carried out.

## 1.1 MACROECONOMICS

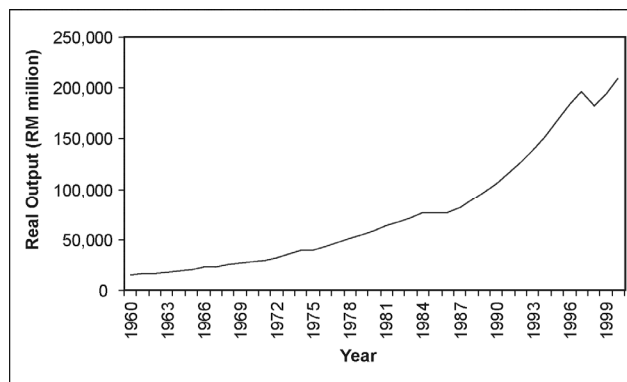
Economists define macroeconomics as a field of economics that studies the relationship between aggregate variables such as income, purchasing power, price and money. This means macroeconomics examines the function of the economy as a whole system, looking at how demand and supply of products, services and resources are determined and factors that influence them.

### 1.1.1 Issues in Macroeconomic Analysis

The issues in macroeconomic analysis are stated below:

(a) **What are the Determinants of Economic Growth and Living Standards in a Country?**

Since a century ago, developed nations have achieved a high rate of economic growth which in turn raised their people's standard of living. Macroeconomics examines the reasons behind the speedy economic growth in the developed nations and understands the reason why this growth is different between the various countries.

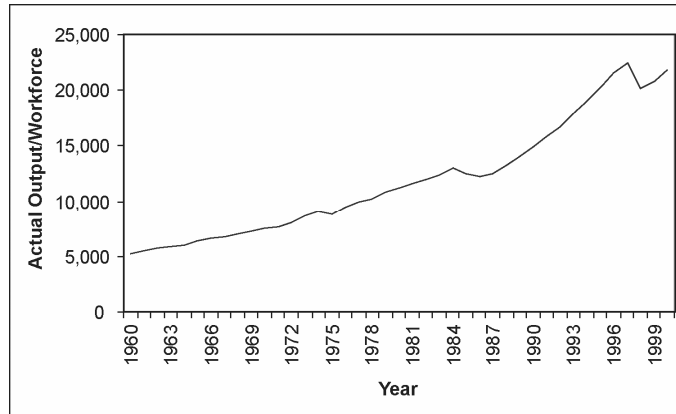


**Figure 1.1:** Malaysia's real output

Figure 1.1 shows Malaysia's real output (measured using the real gross domestic product) from years 1960 to 2000. This shows a steady increase in the country's output whereas there is a decline in the economy from 1974 until 1975 (oil crisis); from 1985 until 1986 (commodity price crisis) and from 1997 until 1998 (Asian financial crisis).

(b) **Productivity**

The average labour productivity or the output of a single worker is important to determine the standard of living. Macroeconomics will question the factors which decide on the employee productivity growth rate.



**Figure 1.2:** Productivity per employee in Malaysia

Figure 1.2 shows the average productivity per employee in Malaysia from the year 1960 to 2000. This is also increasing except for the years between 1974 and 1975, 1985 and 1986 and 1997 and 1998 due to the economic downturn.

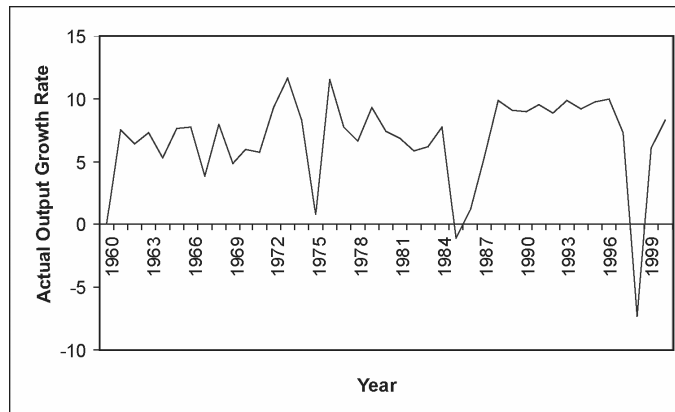


**ACTIVITY 1.1**

Can employee productivity decline even if there is an increase in total output?

(c) **What is the Cause of Decline and Growth in an Economy?**

Any economy will surely go through decline and growth. In relation to this, macroeconomics will look at the causes of these changes in the economy and the government policies that can be implemented to overcome an economic problem.

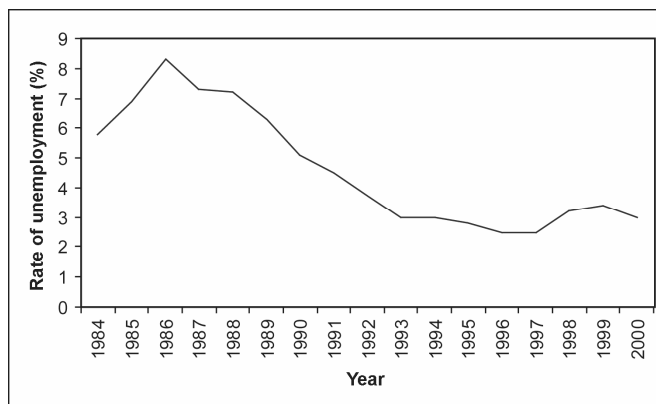


**Figure 1.3:** Rate of economic growth in Malaysia

Figure 1.3 shows the rate of economic growth in Malaysia for the years 1960 to 2000. It shows the economic growth and decline. For example, an obvious economic downturn in Malaysia happened during the years 1974 to 1975 owing to the oil crisis; in 1985 to 1986 due to the commodity price crisis; and in 1997 to 1998 because of the currency crisis in Asia. These three situations slowed down the Malaysian economy, causing the growth rate to be in the negative during the years 1985 and 1998.

**(d) What are Factors Affecting Unemployment?**

Rate of unemployment means there is an available work force that wants to work but has no jobs. The rate of unemployment will increase when there is a decline in the economy, but unemployment also happens when the economic situation is good. Macroeconomics will examine the reasons for unemployment, types of unemployment and ways to overcome unemployment.



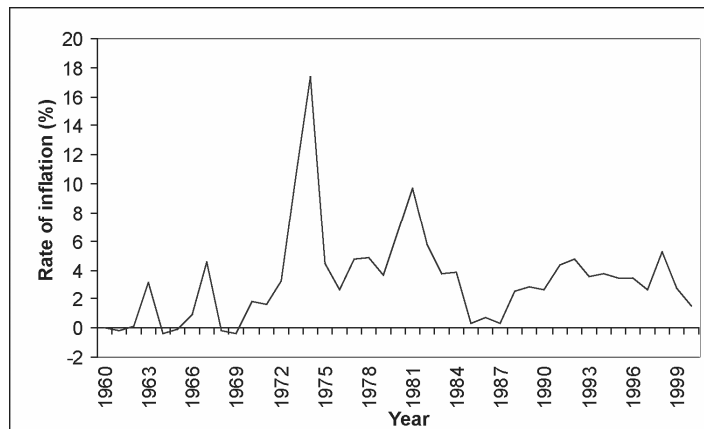
**Figure 1.4:** Rate of unemployment in Malaysia

Figure 1.4 shows the rate of unemployment in Malaysia from the years 1984 to 2000, whereby the rate of unemployment was highest during the years 1985 to 1986 due to the economic downturn (the fall in commodity prices). After 1986, the rate declined but rose again from 1998 to 1999 due to the Asian financial crisis. The rate then dropped again in 2000.

(e) **What are Factors that Cause the General Price Levels or Inflation to Rise?**

Inflation is an increase in the general price level which is usually measured by changes in the Consumer Price Index. The questions asked in a macroeconomics analysis are:

- What are the factors affecting inflation?
- Why does inflation rate differ from time to time?
- Why does inflation rate differ from one country to another?



**Figure 1.5:** Rate of inflation in Malaysia

Figure 1.5 shows the rate of inflation in Malaysia from 1960 to 2000. The highest rate of inflation was recorded for the year 1974 owing to an increase in the oil price crisis, followed by the second oil price crisis in 1981. After 1981, the rate of inflation in Malaysia was low and was less than 5%.



### ACTIVITY 1.2

In Malaysia, prices were higher in 2003 compared to prices in 1980. Does this mean that the quality of life of Malaysians was much better in 1980? Do you agree? Give your reasons.

**EXERCISE 1.1**

Define inflation. Compare the rate of inflation in Malaysia before and after the Asian financial crisis which lasted from 1997 to 1998.

**1.2****MACROECONOMICS POLICIES**

The study of macroeconomics relates to the economic growth of a country. Although many factors contribute towards economic growth such as natural resources, human resources, capital stocks, technology, and people's choice of economy, government policies also play an important role in this aspect. Therefore, it is also important for you to understand the effects of the many policies and the need to develop a better policy as this is an important aim in macroeconomics.

Macroeconomic policies affect the overall performance of the economy. Two main macroeconomics policies are the financial policy or monetary policy and fiscal policy.

(a) **Financial Policy/Monetary Policy**

**Financial policy** influences the supply of money in the economy.

Economists believe that changes in the money supply will influence important macroeconomics variables such as national output, labour force, interest rate, inflation, share prices and foreign currency exchange. Financial policy is controlled by the central bank which acts as a government agency (in Malaysia, it is dealt with by Bank Negara). Figure 1.6 shows the money supply M2 in Malaysia from 1960 to 2000, whereby there was a steady increase especially in the 1990s.

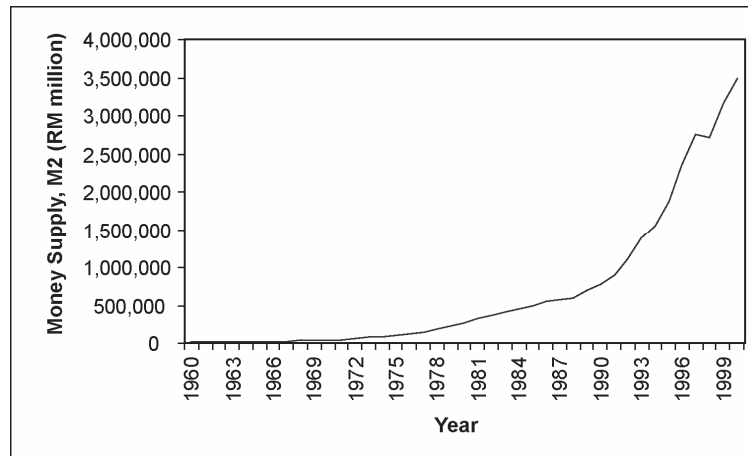


Figure 1.6: Money Supply M2 in Malaysia

(b) **Fiscal Policy**

A good balance between government expenditure and government revenue is important. When government spends more than the income tax collected, it suffers a budget deficit. Meanwhile, if the government's revenue is more than its expenditure, then the government will have a budget surplus.



**SELF-CHECK 1.1**

What is the difference between financial/monetary policy and fiscal policy?

**1.3**

**OBJECTIVES OF MACROECONOMICS**

Among the vital objectives of macroeconomics to be achieved are:

(a) **Achieving Full Employment**

This does not mean that there will be no unemployment at all or that the rate of unemployment will be zero in a country. Basically, economists agree that there can still be unemployment although the economy is at a level where it has achieved full employment, meaning that where those who are able and willing to have a job can get one. Topic 6 will discuss further the concept and issues of unemployment.

(b) **Price Stability**

Generally, price stability means there are no changes in general price levels. This also means that the prices of some goods and services may increase, while some other prices may drop at the same time. When prices remain largely stable, there is no rapid inflation or deflation.

(c) **Good Economic Growth**

Achieving good economic growth is also one of the aims of macroeconomics. This would mean there is an increase in the real per capita income from year to year.

**ACTIVITY 1.3**

Referring to websites of Bank Negara: [www.bnm.gov.my](http://www.bnm.gov.my) and the National Statistics Department: [www.statistics.gov.my](http://www.statistics.gov.my), what is the inflation rate and unemployment rate in Malaysia in 2004?

## 1.4 BUSINESS CYCLE

Before we discuss the meaning of the business cycle, think for a moment of the meaning of a booming economy and economic downturn/recession.

**Business cycle** is the recurring and fluctuating levels of economic activity that an economy experiences over a long period of time.

Economic growth and recession generally involves the entire country and the world, where you will find that it affects almost all economic activities, not just confined to purchasing power and production.

### 1.4.1 Phases in Economic Activities

Economic activities can be divided into two main phases, namely the expansion (growth) phase and the contraction (recession) phase.

(a) **Expansion Phase**

A phase where economic activities are on the rise as shown by the growth in domestic production.



(b) **Contraction Phase**

There are two types of contraction, namely:

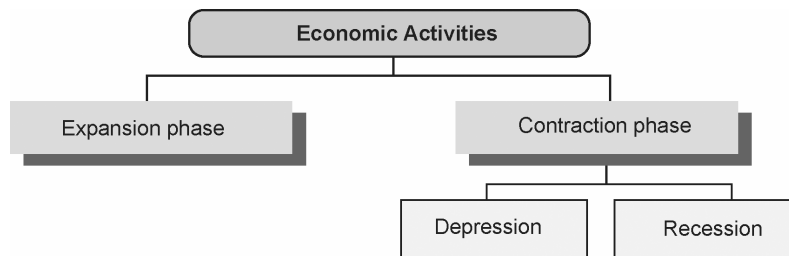
(i) **Depression**

If the economic downturn is very bad, then it is known as depression. Although there is no official definition, depression is a sudden depreciation in the national production, followed by an increase in the unemployment rate, which lasts for more than a year.

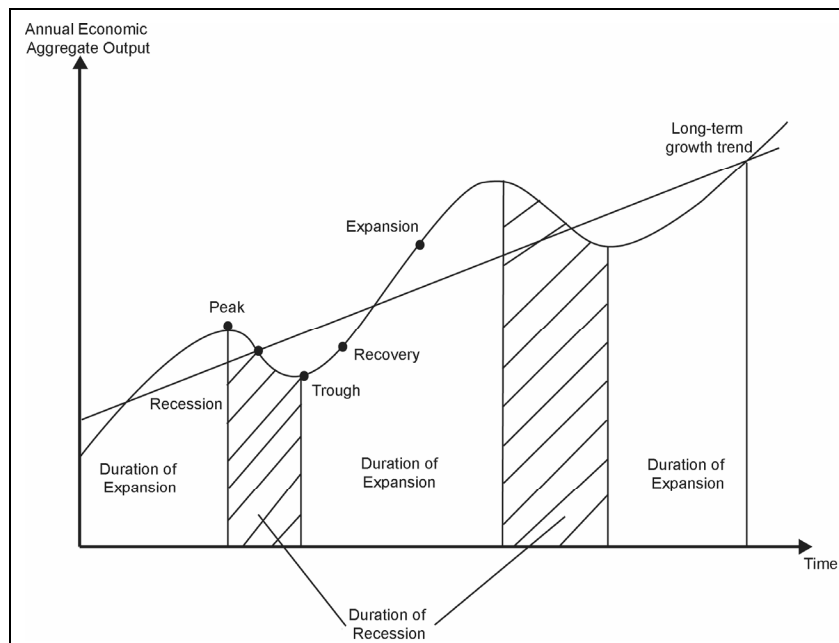
(ii) **Recession**

Recession is a more moderate economic slowdown, which involves a decrease in total production and purchasing power, usually lasting for at least six months.

Figure 1.7 shows a summary of various phases in economic activities.



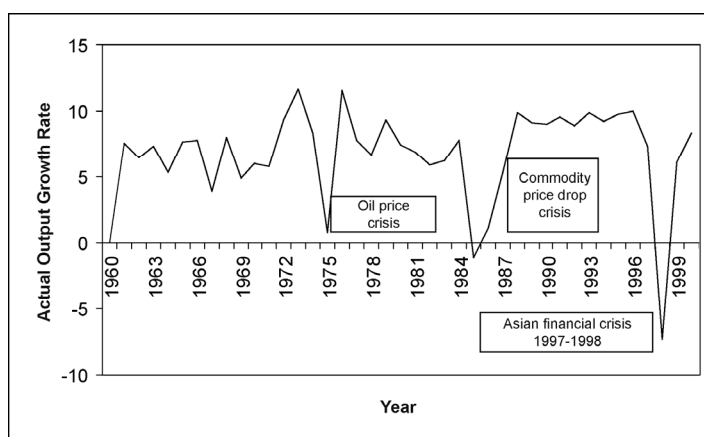
**Figure 1.7:** Summary of phases in economic activities



**Figure 1.8:** Business cycle

With reference to Figure 1.8, the business cycle shows economic activities and movements along the long-term growth trend line. Recession will occur when the previous economic expansion has reached its peak and has fallen into a pit, which is the trough. Economy will then begin to boom again after experiencing a recession and it will continue to grow until it reaches a new peak. Therefore, the point from one peak to another peak is called a cycle. Similarly, the point from one trough to the next one is also a complete cycle.

Figure 1.9 shows the business cycle in Malaysia from 1960 to 2000 which is reflected through the actual national output growth rate. Referring to the same figure, we can see that Malaysia suffered a recession during the years between 1974 and 1975, 1985 and 1986 and 1997 and 1998 when the economy was at the trough level in those periods.



**Figure 1.9:** Business cycle in Malaysia



#### ACTIVITY 1.4

In your opinion, is the Malaysian economy currently in the level of expansion? What do you understand by the terms recession, trough and recovery?



#### EXERCISE 1.2

What does business cycle mean? How does the change in the unemployment rate relate to business cycle? Can the unemployment rate become zero?

**1.5****WHAT DO MACROECONOMISTS DO?**

Macroeconomists will use their expertise to do:

- (a) Macroeconomic forecasting
- (b) Macroeconomic analysis
- (c) Macroeconomic research
- (d) Develop and test an economic theory
- (e) Collect data

**EXERCISE 1.3**

List down the main activities of macroeconomists. What is the role of their analysis in each of these activities?

**1.6****CLASSICAL VERSUS KEYNESIAN VIEWS**

The classical view is based on the notion that individuals and firms or businesses act in accordance with their own interests and wants. Wages and prices will change rapidly to achieve market equilibrium. Classical view can be seen as an “invisible hand” whereby free market economy will solve all problems on its own and government intervention in the economy is restricted.

The Keynesian theory states that wages and prices do not change rapidly and do not believe that the “invisible hand” can solve all problems effectively. The view stated is that because wages and prices change rather slowly, unemployment will remain at a high rate for a longer period of time. Keynesians believe that government intervention will definitely help improve a country’s economic performance.

**EXERCISE 1.4**

Compare the classical and Keynesian views on the changes in wages and prices. What are the implications of these different views?

## 1.7 AGGREGATE DEMAND AND AGGREGATE SUPPLY

In this section, we will learn about:

### (a) Aggregate Output and Price Level

**Aggregate output** is the economy's total production, which means the total sum of an economy's production of goods and services in a given period.

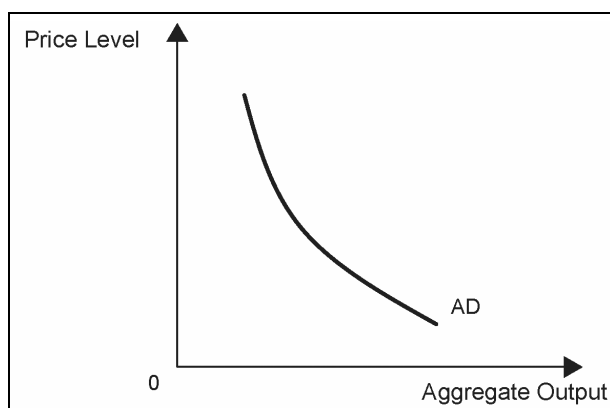
**Aggregate demand** is the total amount of goods and services demanded in the economy at a given overall price level and in a given time period.

Price level in the economy is the weighted average of the prices of all goods and services such as food, housing, clothes, entertainment, transport, medical and all other products.

### (b) Aggregate Demand Curve

**Aggregate demand curve** is a graph showing the connection between price level of economy with the total aggregate output in a given period, assuming that all other factors remain the same.

Figure 1.10 shows an aggregate demand curve (AD).



**Figure 1.10:** Aggregate demand curve

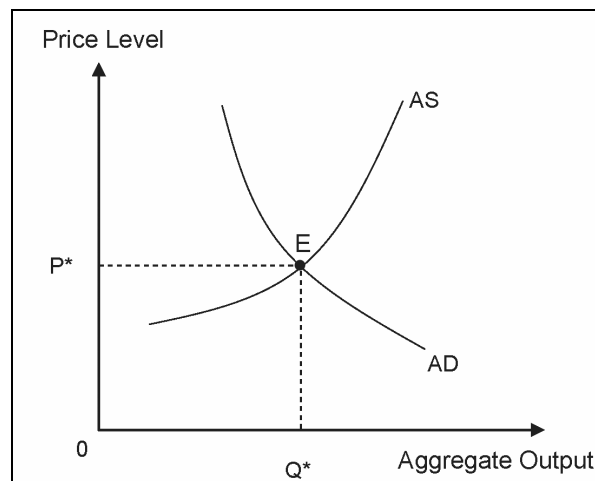
The figure above shows the aggregate demand curve, where the vertical axis (y-axis) shows the average price level, whereas the horizontal axis (x-axis) shows the aggregate output or the actual Gross Domestic Product (GDP) which will be discussed at length in Topic 2. The negative slope of the aggregate demand curve captures the inverse relation between the aggregate output and the price level. This means that if the price level drops, consumers will demand more goods and services, thus increasing expenditure.

(c) **Aggregate Supply Curve**

Aggregate supply curve shows the output quantity that firms are willing to provide at a particular price level. Normally, there is a positive relationship between the aggregate supply and price level.

(d) **Equilibrium**

The intersection of aggregate demand and supply will determine a balance between price level and economic output, as shown in Figure 1.11.



**Figure 1.11:** Equilibrium

Referring to the curve above, equilibrium is attained at “E” where the AD curve and the AS curve meet. The equilibrium price level is at  $P^*$ , while the equilibrium aggregate output is at  $Q^*$ .

## SUMMARY

- Macroeconomics is a field related to the connection between aggregate variables that analyse the economy as a whole system.
- Macroeconomics focuses on national economic growth which is measured based on national income.
- Two important macroeconomic policies are financial policy and fiscal policy. These policies will be used to achieve macroeconomics objectives, such as full employment, price stability and satisfactory economic growth.
- Economic changes related to the increase and decrease in output can be seen from the business cycle aspect.
- Normally, the business cycle has two important phases – Expansion and contraction. This can be seen in detail from its different levels – Peak, recession, trough, recovery and expansion.
- This topic also discusses two macroeconomic views – Classical and Keynesian.
- Aggregate demand curve has a negative slope which shows the inverse relation between the price level and the aggregate output demanded.
- Meanwhile, aggregate supply curve shows a positive relationship between price level and aggregate output quantity supplied. The interaction between both these curves will determine a balance between price level and aggregate output in the economy as a whole.



## KEY TERMS

Depression

Equilibrium

Financial policy

Fiscal policy

Productivity

Recession