Macroeconomics

The level of economic activity

Macroeconomic Goals

Economic growth in the national output

Growth will:

- **boost firms' revenues and profits**
- **boost output, incomes, jobs and living standards**
- **boost investments by firms in new capital and businesses**
- **increase tax revenues for government to finance its spending**

High and stable employment

High unemployment will:

- cause hardship for people who lose their jobs
- reduce spending on goods and services and cause production to fall
- increase public spending welfare payments to support the unemployed and their families (other public spending may be cut)

Price stability

Inflation is usually defined as a sustained rise in the general level of prices.

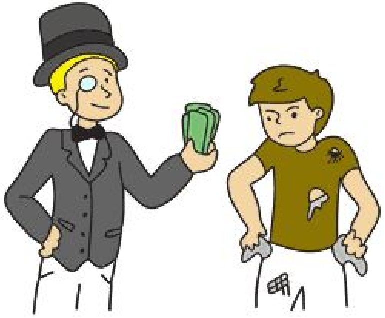
High inflation will:

- reduce the purchasing power of people's incomes
- cause hardship for people on low incomes
- increase business costs
- make goods and services produced in the economy less competitive

A stable balance of international payments and trade

If a country has a deficit on its balance of payments with the rest of the world:

- it may run out of foreign currency to buy imports
- the value of its currency may fall against other foreign currencies and make imports more expensive to buy (causing imported inflation)



Equitable distribution of income

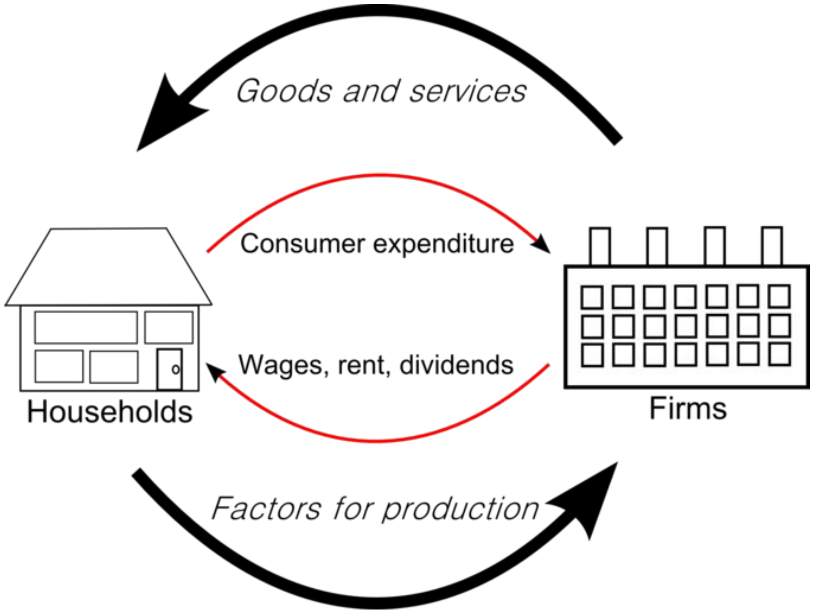
An equitable distribution of income means that the gap between rich and poor is not excessive, but still enough to create incentives to work.

If the gap is too large incentives to work may be reduced

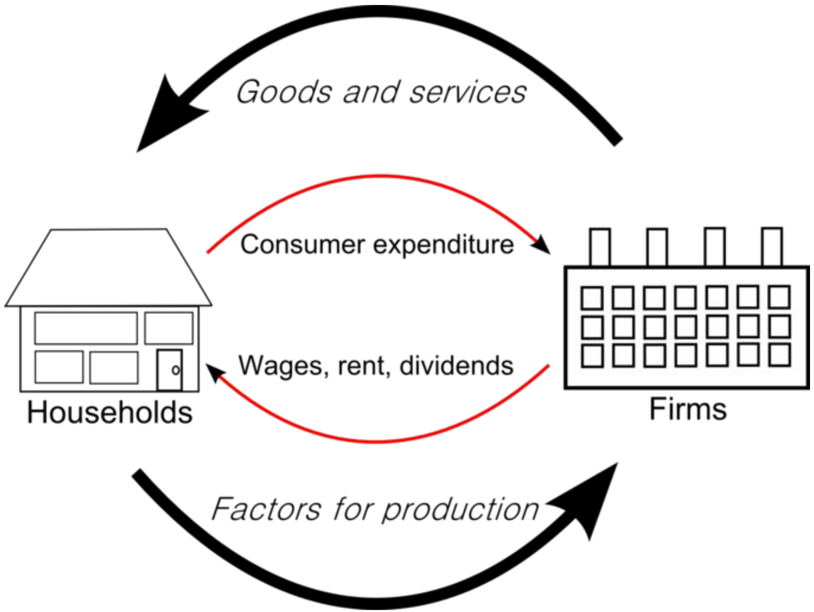
The circular flow of income

Have you heard of the term Gross Domestic Product?

The circular flow of income



1. Households provide the factors of production
2. Firms produce goods and services
3. Consumers “consume” goods and services.
4. Firms produce goods and services
5. Consumers “consume” goods and services.
6. …...and so on



The **income** flow is numerically equivalent to the **expenditure** flow and the **value of output** flow

Income for the factors of production. = Goods and services **expenditure** = **Total value of all goods and services produced**

Always Draw your he circular flow diagram like this….

1. “Households” at the top, “Firms” at the bottom
2. Factors of production to firms, then goods and services to households
3. Households receive factor incomes from firms and label
4. Households expenditure to firms
5. ALWAYS include arrows

Basic Two-Sector Circular Flow of Income Diagram complete

Everything is easy from now on!

Be sure to label the four factor (of production) incomes which are paid to households by firms. These are: wages for labour, rent for the use of land, interest paid on capital, and profits from enterprise.


THAT'S NOT ENOUGH
WE HAVE TO GO DEEPER
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But, we know that the two sector model is ***too simple***. We know that in the 'real world' there is the open economy and international trade, and the government plays a role as well

- These lead to ways in which money can leave the economy = ***LEAKAGES***
- And ways in which money can enter the economy = ***INJECTIONS***

Injections and **withdrawals** in the circular flow model of income

Injections: (Economic growth)	**Withdrawals:** (Economic contraction)
▪ Investment	▪ Savings
▪ Government spending	▪ Taxes
▪ Export receipts	▪ Import payments

What makes an economy expand or contract?

- **Injections** into the circular flow are additions to investment, government spending or exports so boosting the circular flow of income leading to a multiplied expansion of output. More simply, the economy will grow and expand, national output and incomes will increase

- **Leakages / Withdrawals** are increases in savings, taxes or imports so reducing the circular flow of income and leading to a multiplied contraction of production (national output). More simply, the economy will grow and expand, national output and incomes will increase. Withdrawals are increases in savings, taxes or imports so reducing the circular flow of income and leading to a multiplied contraction of production (national output). More simply, the economy will shrink and contract, national output and incomes will decrease.

Real Flows vs. Money Flows

Real flows include the factors of production, such as labor or land, that flow from individuals to companies, as well as the flow of goods and services from companies to individuals.

Money flows occur when companies pay wages in return for labor or services provided by individuals, as well as when individuals spend money to obtain goods or services produced by companies.

Play Kahoot!

Circular Flow: Multiplier effect

Positive multiplier

When an initial increase in an injection (or a decrease in a leakage) leads to a greater final increase in real GDP.

Negative multiplier

When an initial decrease in an injection (or an increase in a leakage) leads to a greater final decrease in real GDP.

GDP vs GNP / GNI

- GDP includes all economic activity in a country. Therefore if a British company operating and earning profits in Japan, then its income is included on the Japanese GDP

- GNP / GNI is the total income earned by a country's factors of production regardless of where the assets are located. So, the British company would not appear in the Japanese GNP / GNI. But, the profits of a Japanese firm operating in Britain would be included in the GNP / GNI, but not the GDP

Exam practice

Identify the four factors of production and their respective payments (rent, wages, interest and profit) and explain that these constitute the income flow in the model. [10 marks]