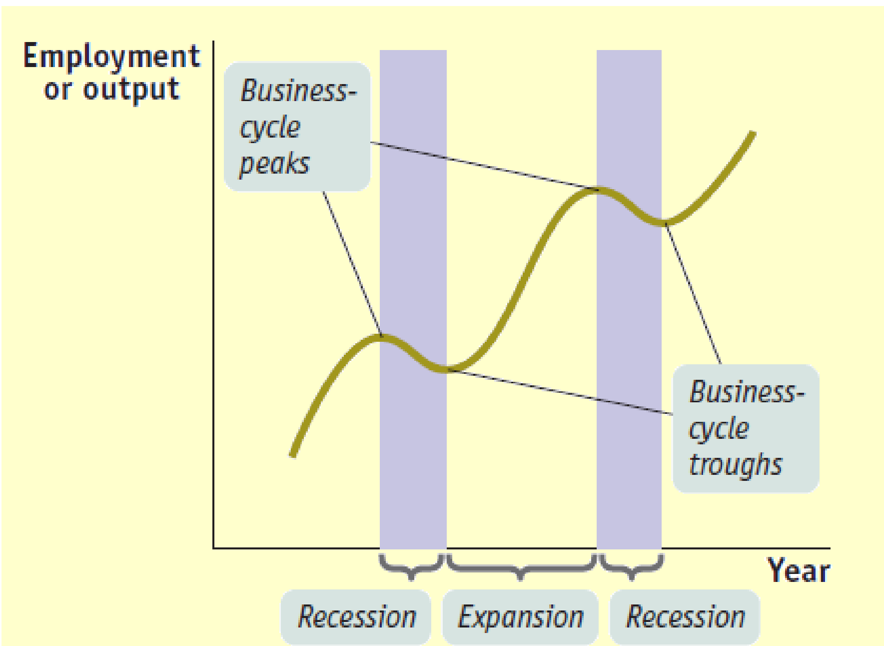
Macroeconomics

- **Macroeconomics** examines the *aggregate* behavior of the economy (i.e. how the actions of all the individuals and firms in the economy interact to produce a particular level of economic performance as a whole).
- In macroeconomics, the behavior of the whole macro-economy is, indeed, ***greater than the sum*** of individual actions and market outcomes

The Business Cycle

- The **business cycle** is the short-run alternation between economic downturns and economic upturns.
- A **depression** is a very deep and prolonged downturn.
- **Recessions** are periods of economic downturns when output and employment are falling.
- **Expansions**, sometimes called *recoveries*, are periods of economic upturns when output and employment are rising.
- The point at which the economy turns from expansion to recession is a **business-cycle peak**.
- The point at which the economy turns from recession to expansion is a **business-cycle trough**.
- In many countries, economists adopt the rule that a recession is a period of at least 6 months, or two quarters, during which aggregate output falls.



Long-Run Economic Growth

- **Long-run economic growth** is the sustained upward trend in the economy's output over time.
- A country can achieve a permanent increase in the standard of living of its citizens only through long-run growth.
- A central concern of macroeconomics is what determines long-run economic growth.

Inflation and Deflation

- A rising aggregate price level is **inflation**.
- A falling aggregate price level is **deflation**.
- The **inflation rate** is the annual percent change in the aggregate price level.
- The economy has **price stability** when the aggregate price level is changing only slowly.

International Imbalances

- An **open economy** is an economy that trades goods and services with other countries.
- A country runs a **trade deficit** when the value of goods and services bought from foreigners is more than the value of goods and services it sells to them.
- It runs a **trade surplus** when the value of goods and services bought from foreigners is less than the value of the goods and services it sells to them.

Production and Growth

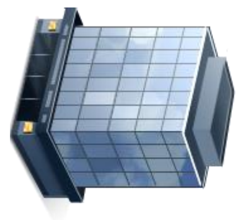
- Productivity refers to the amount of goods and services produced for each hour of a worker's time.
- A nation's standard of living is determined by the productivity of its workers.
- To understand the large differences in living standards across countries, we must focus on the production of goods and services.
- The inputs used to produce goods and services are called the factors of production.
- The factors of production directly determine productivity.
- The Factors of Production
  - Physical capital
  - Human capital
  - Natural resources
  - Technological knowledge

Is World Growth Sustainable?

- Long-run economic growth is sustainable if it can continue in the face of the limited supply of natural resources and the impact of growth on the environment.
- Differing views about the impact of limited natural resources on long-run economic growth turn on the answers to three questions:
- How large are the supplies of key natural resources?
- How effective will technology be at finding alternatives to natural resources?
- Can long-run economic growth continue in the face of resource scarcity?

Circular Flow of Income

- A circular flow of funds connects the four sectors of the economy—households, firms, government, and the rest of the world—via three types of markets:
  - the factor markets
  - the markets for goods and services
  - the financial market
- Funds flow from firms to households in the form of wages, profit, interest, and rent through the factor markets.
- After paying taxes to the government and receiving government transfers, households allocate the remaining income— disposable income—to private savings and consumer spending.
- Via the financial markets, *private savings and funds from* the rest of the world are channeled into investment spending by firms, government borrowing, foreign borrowing and lending, and foreign transactions of stocks.
- In turn, funds flow from the government and households to firms to pay for purchases of goods and services.
- Finally, exports to the rest of the world generate a flow of funds into the economy and imports lead to a flow of funds out of the economy.



Circular Flow of Income

The Financial System

- The financial system consists of the group of institutions in the economy that help to match one person's saving with another person's investment.
- It moves the economy's scarce resources from savers to borrowers.
- The *financial system* is made up of financial institutions that coordinate the actions of savers and borrowers.
- Financial institutions can be grouped into two different categories: financial markets and financial intermediaries.
- *Financial markets* are the institutions through which savers can directly provide funds to borrowers.
  - Stock Market, Bond Market
- *Financial intermediaries* are financial institutions through which savers can indirectly provide funds to borrowers
  - Banks, Mutual Funds, Insurance Funds, etc.

Three Tasks of a Financial System

- Reducing **transaction costs —** the cost of making a deal.
- Reducing **financial risk —** uncertainty about future outcomes that involves financial gains and losses.
- Providing **liquid** assets **—** assets that can be quickly converted into cash (in contrast to **illiquid** assets, which can't).

Financial Fluctuations

- Financial market fluctuations can be a source of macroeconomic instability.
- There are two principal competing views about how asset price expectations are determined.
- One view, which comes from traditional economic analysis, emphasizes the rational reasons why expectations should change.
- The other, widely held by market participants and also supported by some economists, emphasizes the irrationality of market participants.
- One view of how expectations are formed is the **efficient markets hypothesis,** which holds that the prices of financial assets embody all publicly available information.
- It implies that fluctuations are inherently unpredictable—they follow a **random walk.**
- Many market participants and economists believe that, based on actual evidence, financial markets are not as ***rational*** as the efficient markets hypothesis claims.
- Such evidence includes the fact that stock price fluctuations are too great to be driven by fundamentals alone.

Economic Goals

What are the three macroeconomic goals?

Financial Crisis 'Cheat' Sheet

Sources:

- Wikipedia; BBC News - The layman's finance crisis glossary; Investopedia; Clay Bennett Cartoons, Times Free Press

Financial Institutions

Investment Bank

- A financial intermediary that performs a variety of services. This includes underwriting, acting as an intermediary between an issuer of securities and the investing public, facilitating mergers and other corporate reorganizations, and also acting as a broker for institutional clients.

'A share of Lehman Brothers for your thoughts.'

Hedge Fund

- An aggressively managed portfolio of investments that uses advanced investment strategies such as leveraged, long, short and derivative positions in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark).

Rating Agency

- Companies that assess the creditworthiness of both debt securities and their issuers.

Fannie Mae and Freddie Mac

- Fannie Mae and Freddie Mac purchase and guarantee mortgages through the secondary mortgage market.
- Mortgage originators sell mortgages directly to Fannie Mae and Freddie. When mortgage originators sell mortgages to Fannie Mae or Freddie Mac it frees up the funds used to originate those mortgages so that the originators can then create even more mortgages.

Financial System Terms

Liquidity

- The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid assets.

Propriety Trading

- When a firm trades for direct gain instead of commission dollars. Essentially, the firm has decided to profit from the market rather than from commissions from processing trades.

Toxic Assets

- An asset that becomes illiquid when its secondary market disappears. Toxic assets cannot be sold, as they are often guaranteed to lose money.

Negative Equity

- Refers to a situation in which the value of your house is below the amount of the mortgage that still has to be paid off.

Short selling

- A technique used by investors who think the price of an asset, such as shares, currencies or oil contracts, will fall. They borrow the asset from another investor and then sell it in the relevant market.
- The aim is to buy back the asset at a lower price and return it to its owner, pocketing the difference.

Credit crunch

- The situation created when banks hugely reduced their lending to each other because they were uncertain about how much money they had

AAA-rating

- The best credit rating that can be given to a corporation's bonds, effectively indicating that the risk of default is negligible.

Financial Instruments

Derivatives

- A way of investing in a particular product or security without having to own it. The value can depend on anything from the price of coffee to interest rates or what the weather is like.
- Can be used as insurance to limit the risk of a particular investment.

Mortgage-backed securities

- Securities made up of mortgage debt or a collection of mortgages. Banks repackage debt from a number of mortgages which can be traded.

CDOs (Collateralized Debt Obligations)

- An investment-grade security backed by a pool of bonds, loans and other assets.
- Different types of debt are often referred to as 'tranches' or 'slices'. Each slice has a different maturity and risk associated with it. The higher the risk, the more the CDO pays.

Credit default swap

- A swap designed to transfer credit risk, in effect a form of financial insurance. The buyer of the swap makes periodic payments to the seller in return for protection in the event of a default on a loan.

After watching the documentaries, answer the following questions:

What does 'Too Big To Fail' mean?

What is moral hazard?

What is systemic risk?

What are conflicts of interest?

Who is responsible for the financial crisis?

How did problems in the financial world spread to the general global economy?