

MACROECONOMICS 101

Chapter 1: Introduction to Macroeconomics

Course alignment: ECON1102 — equivalent to first-year macroeconomics courses across Australian universities

Prerequisites: None

Chapter covers: Scope of macroeconomics, key macroeconomic questions, economic agents and markets, the circular flow of income, macroeconomic goals, and the distinction between macroeconomics and microeconomics

1. What is Macroeconomics?

Economics is the study of how individuals, firms, and governments make decisions under scarcity. Macroeconomics zooms out from individual decisions to ask how entire economies behave. Rather than asking why one consumer buys more coffee when its price falls, macroeconomics asks why an entire country's output might shrink in a recession, or what causes prices across the whole economy to rise together.

Macroeconomics emerged as a distinct field in the 1930s, largely in response to the Great Depression — an economic collapse so widespread and severe that existing frameworks focused on individual markets could not explain it. Today, macroeconomics is the analytical foundation for understanding business cycles, inflation, unemployment, economic growth, and the tools governments and central banks use to influence them.

Macroeconomics

The branch of economics that studies the behaviour and performance of an economy as a whole, including economy-wide phenomena such as output, unemployment, inflation, and the policy responses of governments and central banks.

Three questions sit at the heart of macroeconomics:

- What determines how much an economy produces?
- What causes output and employment to fluctuate in the short run?
- What drives long-run improvements in living standards?

These questions connect directly to the three core macroeconomic goals: high and stable output growth, low and stable inflation, and low unemployment. Much of this course is structured around understanding what causes these variables to move and how policy can — and cannot — influence them.

2. Macro vs Micro: The Key Distinction

Microeconomics and macroeconomics share the same foundational tools — supply and demand, incentives, opportunity cost — but they operate at different levels of analysis and ask fundamentally different questions.

Microeconomics	Macroeconomics
Studies individual markets, firms, and consumers	Studies the economy as a whole
Asks: Why does the price of petrol rise?	Asks: Why does inflation rise across the economy?
Asks: Why did this firm lay off workers?	Asks: Why does unemployment rise in a recession?
Analyses: Market equilibrium and efficiency	Analyses: GDP, unemployment rate, price level
Policy focus: Regulation, competition, taxes on specific goods	Policy focus: Fiscal policy, monetary policy, exchange rates
Example: Demand and supply of housing in Sydney	Example: Australia's GDP growth rate in 2024

A critical point: macroeconomic outcomes cannot simply be read off from microeconomic principles. The fallacy of composition — the error of assuming that what is true for one part is true for the whole — is a recurring trap in economics. For example, if one household saves more, that household is better off. But if every household saves more simultaneously, total spending falls, output may contract, and the economy may end up worse off. Macroeconomics exists precisely to study these economy-wide interactions.

3. Economic Agents and Markets

Macroeconomists group economic decision-makers into four sectors. Understanding how these sectors interact is the starting point for all macro models.

Sector	Who They Are	Primary Role
Households	Individuals and families	Supply labour and capital; demand goods and services; save
Firms	Businesses of all sizes	Hire labour and capital; produce goods and services; invest
Government	Federal, state, and local governments	Tax, spend, and regulate; run fiscal policy
Rest of World	Foreign households, firms, governments	Buy exports; sell imports; lend and borrow internationally

These four sectors interact across three primary markets:

- Goods and services market — where output is bought and sold
- Labour market — where households supply labour and firms demand it
- Financial (loanable funds) market — where savings are channelled into investment

Macroeconomic models trace how shocks or policy changes in one sector ripple through these markets to affect the economy as a whole.

4. The Circular Flow of Income

The circular flow model is the simplest representation of how an economy works. It shows how money, goods, and factor services flow between the main sectors.

Circular Flow of Income

A model showing the continuous flow of money, goods, services, and factor inputs between economic sectors. In its simplest form, households supply factors of production to firms and receive income in return; firms sell goods and services to households and receive revenue in return.

The Simple Two-Sector Model

In the most basic version, only households and firms exist:

- Households supply labour (and other factors) to firms via the factor market
- Firms pay wages and profits back to households as income
- Households spend their income buying goods and services from firms
- Firms receive revenue and use it to pay factors again

This creates a closed loop: spending by households becomes revenue for firms, which becomes income for households, which becomes spending again. In this simplified model, total income equals total output equals total expenditure — a relationship that becomes central when we measure GDP in Chapter 2.

Adding Leakages and Injections

The two-sector model is unrealistic because it ignores saving, government, and trade. In a fuller model, money can leak out of or be injected into the circular flow:

Leakages (withdrawals from the flow)	Injections (additions to the flow)
Saving (S) — income not spent on domestic goods	Investment (I) — firm spending on capital
Taxation (T) — income paid to government	Government spending (G) — public expenditure on goods and services
Imports (M) — spending on foreign goods	Exports (X) — foreign demand for domestic goods

In equilibrium, total leakages equal total injections: $S + T + M = I + G + X$. This identity underpins the national accounting relationships developed in Chapter 2. If injections exceed leakages, the economy is expanding; if leakages exceed injections, it is contracting.

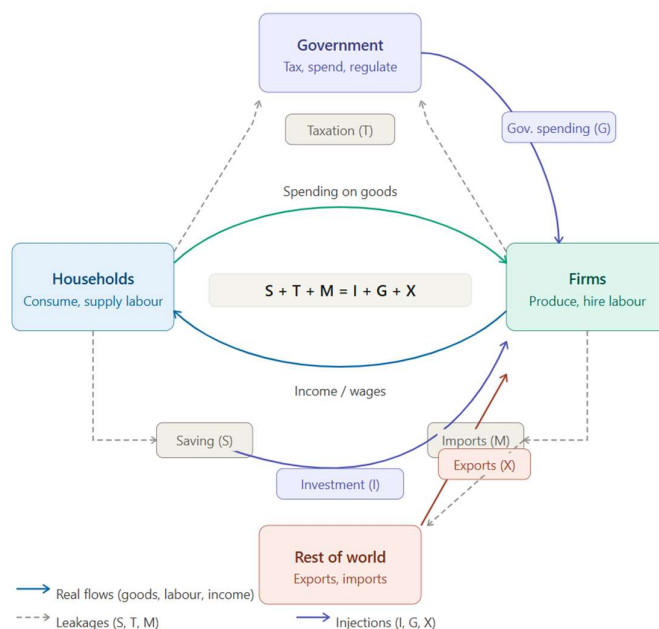


Figure 1.1 — The circular flow of income. Leakages (S , T , M) drain money from the flow; injections (I , G , X) add money back. Equilibrium requires leakages = injections.

5. The Three Core Macroeconomic Goals

Virtually all macroeconomic policy is ultimately directed at three objectives. Understanding what these goals mean — and why each matters — frames every topic in this course.

1. High and Stable Output Growth

An economy's output — the total quantity of goods and services produced — determines the material living standards available to its population. Sustained growth in real output raises real incomes and widens the range of goods and services people can consume. Stability matters too: sharp swings in output (booms and recessions) impose costs even when average growth is acceptable.

2. Low and Stable Inflation

Inflation is a sustained rise in the general price level. Low inflation (around 2–3% in Australia) allows prices to do their job of signalling value without distorting long-term planning. High inflation erodes the real purchasing power of money and savings. Deflation — falling prices — can be equally damaging, as it encourages consumers to delay spending, which depresses output further.

3. Low Unemployment

Unemployment represents wasted productive capacity: people who want to work cannot find jobs. Beyond lost output, unemployment carries significant social costs — reduced household incomes, deteriorating skills, and psychological harm. Macroeconomic policy typically aims to keep unemployment near its natural rate: the rate consistent with stable inflation, which we examine in Chapter 3.

The Policy Trade-off

These three goals often conflict in the short run. Policies that stimulate output and reduce unemployment can also push inflation higher. Understanding why these trade-offs exist — and how severe they are — is one of the central problems of macroeconomics.

6. The Two Branches of Macroeconomic Analysis

Macroeconomists distinguish between two time horizons, each with its own models and questions.

Short-Run Macroeconomics	Long-Run Macroeconomics
Time horizon: months to a few years	Time horizon: decades
Focus: Output fluctuations, unemployment, inflation	Focus: Trend growth, living standards, productivity
Prices are often assumed sticky (slow to adjust)	Prices are flexible — all markets clear
Key question: Why do recessions happen, and how do we end them?	Key question: Why are some countries richer than others?
Main tools: Keynesian expenditure model, IS-LM, aggregate demand/supply	Main tools: Solow growth model, production function analysis
Policy focus: Fiscal and monetary stabilisation policy	Policy focus: Structural reform, education, institutions, innovation

This course covers both dimensions. Chapters 2–4 build the measurement tools. Chapters 5 covers long-run growth. Chapters 6–9 address the short-run models and stabilisation policy. Chapter 10 extends all of this to the open economy.

7. Models and Their Limitations

Macroeconomics proceeds through models: simplified representations of the economy that highlight key relationships while deliberately omitting complexity. A good model is not one that captures everything — it is one that isolates the mechanism relevant to the question being asked.

All macroeconomic models rest on assumptions. When those assumptions are violated, the model's predictions may fail. As you work through this course, pay attention not just to what each model says but to the conditions under which it applies and where it breaks down.

Positive vs Normative Economics

Positive economics describes and predicts economic outcomes ('Raising interest rates tends to slow inflation'). Normative economics makes value judgements about what policy should aim for ('Inflation control should take priority over employment'). Most macroeconomic controversy is either about positive disagreements — what the model predicts — or normative disagreements about which goals matter most.

A recurring theme in this course is the distinction between what models predict in theory and what actually happens in economies. Where those diverge, the explanation is usually one of: a violated

assumption, a missing market, an expectational effect, or an institutional constraint. Being able to identify which is a key analytical skill.

8. Key Propositions

Students should be able to state and apply the following after completing this chapter:

Concept	Statement	Why It Matters
Macroeconomics	Studies economy-wide outcomes rather than individual markets	Frames all subsequent analysis
Circular Flow	Income = Output = Expenditure in a closed economy	Foundation of national accounting
Leakages = Injections	$S + T + M = I + G + X$ in equilibrium	Links sectors; underpins GDP identity
Three Goals	Output growth, low inflation, low unemployment	All macro policy is evaluated against these
Short vs Long Run	Short run: prices sticky, output fluctuates. Long run: prices flexible, growth is the focus	Determines which model applies
Fallacy of Composition	What is true for one part need not be true for the whole	Essential caution for macro reasoning
Positive vs Normative	Separate factual claims from value judgements	Clarifies policy debates

9. Common Student Mistakes

- Treating macroeconomics as just 'big microeconomics'. The two disciplines use different models precisely because economy-wide interactions produce outcomes that individual-market analysis cannot explain.
- Confusing the level of GDP with the growth rate of GDP. A country with very high GDP but zero growth is stagnating; a country with modest GDP but rapid growth is catching up. Both are described as macroeconomic outcomes but have very different implications.
- Applying the fallacy of composition — assuming that what works for one household or one firm (e.g. cutting spending to save) must work for the whole economy. Aggregate outcomes depend on how everyone responds simultaneously.
- Thinking that macroeconomic goals are always compatible. In the short run, boosting output typically puts upward pressure on inflation. Ignoring this trade-off leads to unrealistic policy expectations.
- Forgetting that leakages and injections must be equal in equilibrium — not that saving must equal government spending or that imports must equal exports individually, but that the three leakages combined equal the three injections combined.
- Mixing up positive and normative claims. Saying 'unemployment rose by 2%' is a positive statement (verifiable). Saying 'the government should prioritise unemployment over inflation' is normative (a values judgement).