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Macroeconomics II

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This powerpoint serves as a study material for the students of the course Introduction to economics (MEB435/MEBn5035) at FSS MU in Fall 2019. Using this presentation for other purposes without consent of the author is prohibited.

Sectoral balances perspective

- The most basic macroeconomics rule is that one person's spending is another person's income.
- The sectoral balances approach helps us to understand the relations among the spending and income balances of the households, firms, government, and foreign sectors of the economy.
- The sectoral balances must sum to zero.
- **A flow** is measured as a certain quantity that is spent per unit of time.
- **A stock** is measured at a point in time and is the product of prior, relevant flows.

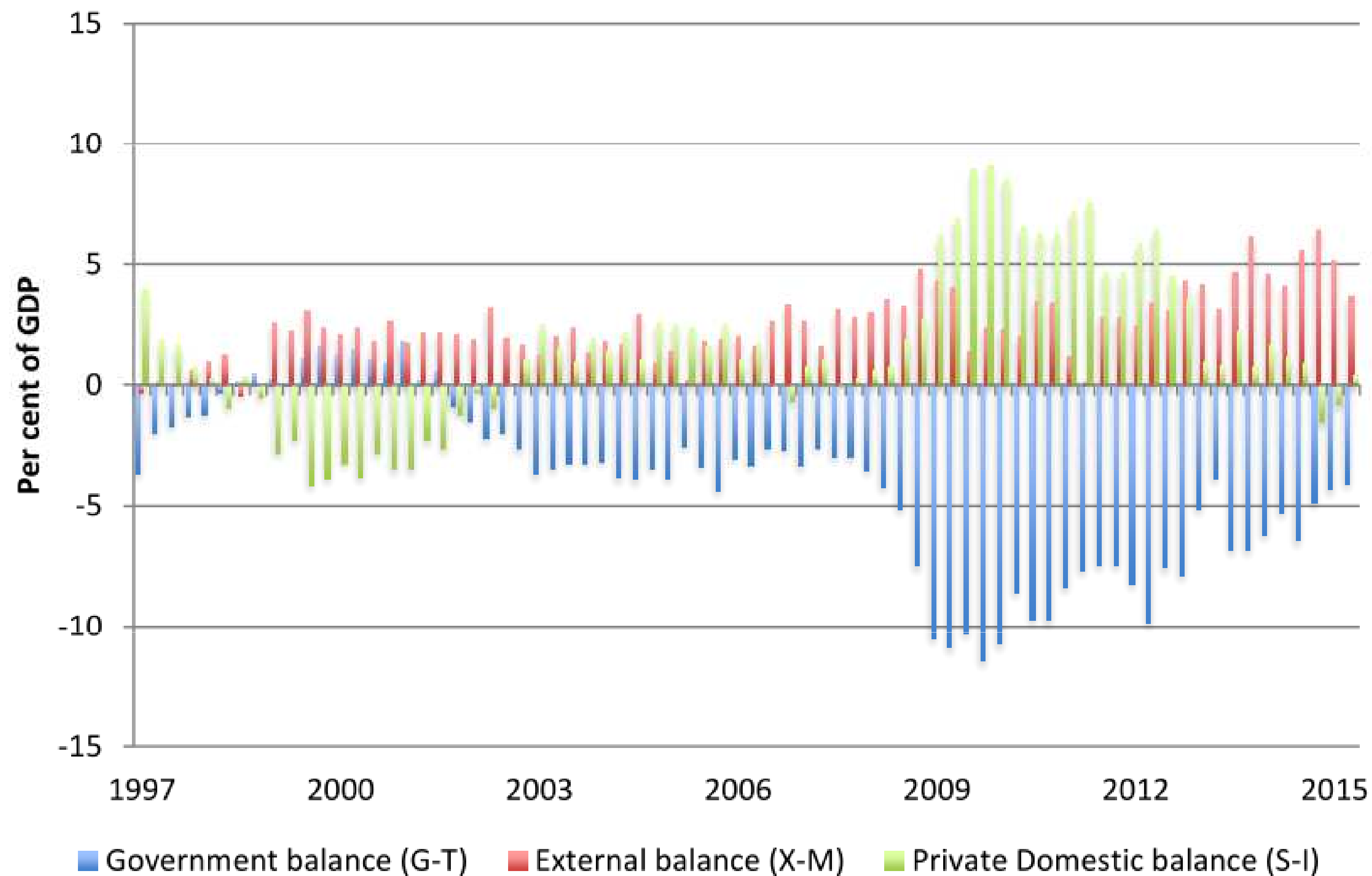
The Sectoral Balances View of the National Accounts

- Identity – a formula that is true by definition
- GDP ≡ C + I + G + (X – M)
- When these components of spending are summed, they equal **aggregate demand** for goods and services in a particular period.
- Macroeconomic policy aims at influencing the individual components of GDP.
- Net external income flow (FNI) - we have to add this to get the total sum of financial flows between the domestic economy and the external sector.
- GNP ≡ C + I + G + (X – M) + FNI

The Sectoral Balances View of the National Accounts

- $(GNP - C - T) - I \equiv (G - T) + (X - M + FNI)$
- $(GNP - C - T) - I$ - overall saving of the private domestic sector or **private domestic financial balance.**
- $(G - T)$ **is the government financial balance.**
- $(X - M + FNI)$ **is the external financial balance** or **Current Account Balance** (CAB)
- **The private domestic financial balance equals the sum of the government financial balance plus the current account balance.**
- It is impossible for all sectors to accumulate net financial wealth by running surpluses.

UK sectoral balances, 1997 to 2014



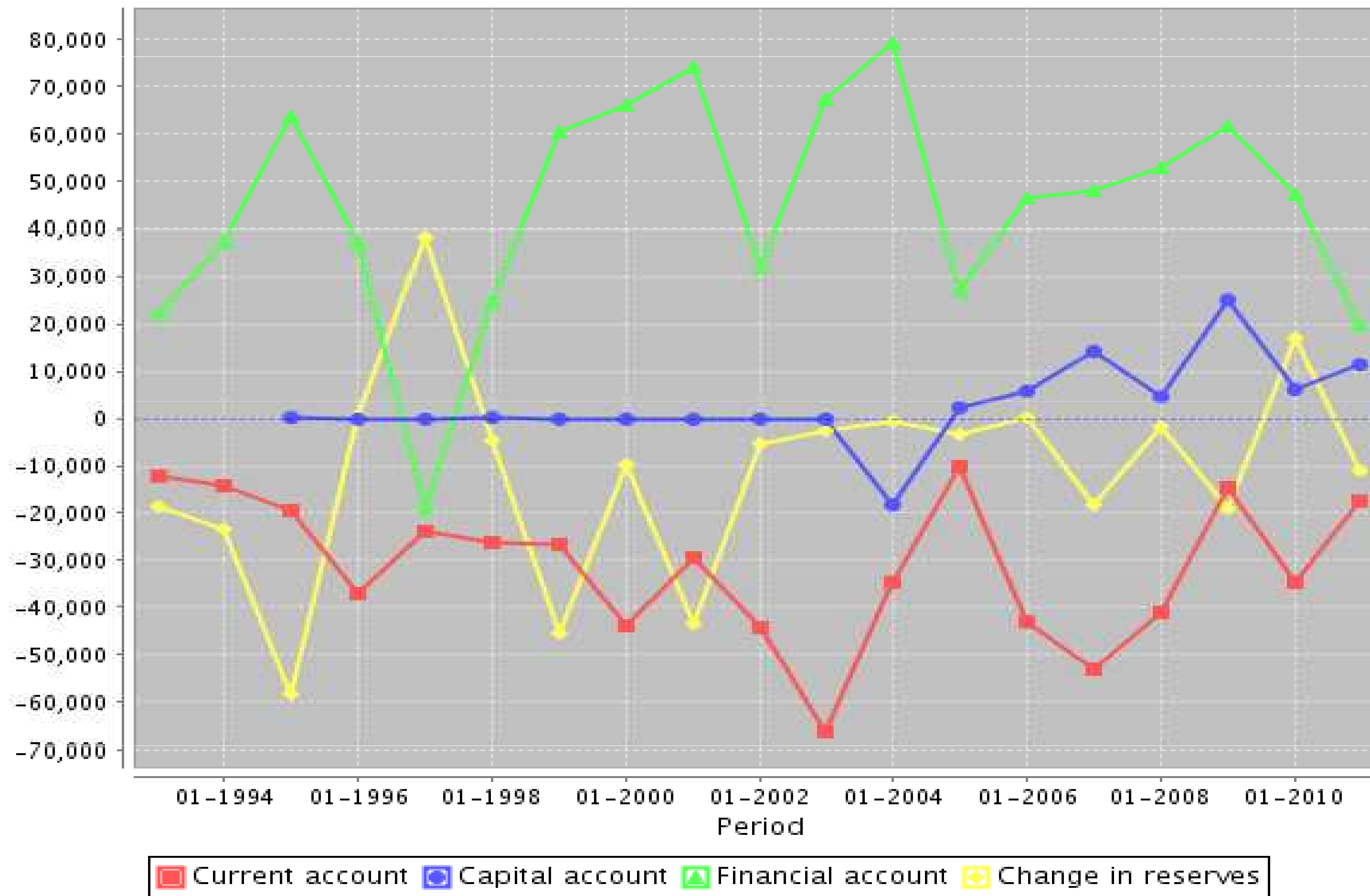
Important remarks

- One's financial asset is another's financial liability.
- Inside vs outside sector wealth.
- Real assets
- Examples of economic behavior (theory, causal relationships)
  - The response of consumption to a change in income is called the **Marginal Propensity to Consume** (MPC). It is normally hypothesised that the MPC will be less than one, so that the residual of disposable income not consumed will be positive. That constitutes saving.
  - Automatic stabilizers – net government expenditure higher when national income is lower and vice versa.
  - Lower interest rates should lead to higher investment which should in turn increase output.

Balance of payments

- Accounting accord of all monetary transactions between a country and the rest of the world
- The sum of all accounts has to be equal 0 by definition
- Composition (IMF × USA!)
  - **Current account (CA)** – trade + factor income
  - **Financial (capital) account** (including the reserve account) – net change of ownership of international assets
  - Balancing item (statistical errors)
- Relations between individual accounts
- **Net international investment position**
  - Accumulated CA, asset price changes, currency moves

Balance of payment statistics (in millions of CZK)



Source: The Czech National Bank

Net international investment position (% of GDP in 2014)

Switzerland	119,6	United States	-39,7
Japan	74,8	Slovakia	-70
Germany	36,4	Spain	-94,5
China	17,1	Ireland	-106,7
Russia	16,7	Portugal	-111,6
CZ	-35,6	Greece	-121,9

Source: IMF

Balance of payments adjustment

- **CA deficits and the household analogy**
  - Most countries have to “earn” money from abroad to pay for imports and previously accumulated debts
- **CA deficits and governments deficits and debts**
- Financial crises are often accompanied by prolonged CA deficits and are solved through and adjustment process, often assisted by the IMF
- **Balancing mechanisms**
  - Exchange rate adjustment
  - Internal prices adjustment
  - Various others (debt forgiving, war, emigration)

Inflation and its causes

- Inflation, hyperinflation and deflation
- Neoclassical theory – **Quantity theory of money**
  - $M \times V = P \times Y$
- **Cost push inflation**
  - Distributional struggle over the share of GDP between labor and capital
  - Market structures and natural resources
- **Demand pull inflation**
  - Economy operating at full capacity