Macro Economics 101 – An Overview

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In our troubled times with recession seemingly unending, it seems wise to review a few basics of economics—the very basics.

"All production is for the purpose of ultimately satisfying the consumer." British economist John Maynard Keynes said this in the 1930s and he was right. All the things we produce are ultimately for the purpose of consumption. In fact, all life both consumes to live and lives to consume. For those who complain about our consuming ways, think about it.

The production of the goods and services we consume requires the application of capital and labor. Capital is the physical and intellectual means of production: our tools, land, buildings, knowledge and knowhow. Labor is the physical and intellectual efforts that we, humans, provide.

Although all production is for ultimately satisfying the consumer, it is not all for the immediate satisfaction of the consumer. Some of our capital and labor must be applied toward creating the means of production, i.e., toward creating future capital for future production. Capital wears out over time and must be replaced for production and consumption to continue. Furthermore, an expanding population requires additional capital to produce for its growing membership. And if we wish to increase our standard of living, new capital must be more productive than that it replaces. This enables us to gradually produce more with our individual labors, and our standard of living is defined by the quality and quantity of what we produce.

Real economic growth is defined by production; more specifically, how quickly the quality and quantity of production grows (goods and services). This growth is controlled by how rapidly we accumulate additional capital and how rapidly the productivity of that capital improves. Capital accumulation and productivity improvement are driven by how we allocate our current capital and labor—toward producing capital or consumables. The more of our capital and labor we apply toward creating future capital the faster the economy can grow. The more of our capital and labor we apply toward creating consumables the slower the economy grows.

Income is generated by the successful exchange of goods and services produced. Money provides a means of indirect exchange, and money income is generated when the exchange of production is for money instead of others goods or services. There is a time element to the production, exchange and income process. Yesterday's production can be exchanged today for income which can be spent tomorrow on goods and services. Today's income is limited by how much has previously been produced for exchange.

It is the allocation of each day's income that determines present and future living standards, and there is an explicit trade between the present and future in this allocation. As observed, growing the production that generates income requires allocating income toward capital creation. Current consumption must be curtailed to grow future income and consumption. The more current consumption is curtailed, the more income can be allocated toward capital production, and the more future consumption can grow. The less current consumption is curtailed, the less income is allocated toward capital production, and the less future consumption can grow.

How much money income can be generated via the exchange of production and how much can be purchased with that money income (consumables or capital) is determined by prices. Prices set the relative valuation of goods and services produced.

Price is the great communicator. Prices tell us how people value the various goods and services produced and provide a means for suppliers and consumers to communicate that valuation. Price per se does not motivate suppliers to alter production. Profits do. Price tells suppliers whether they can profit by bringing products to the market or not. Only those who can profit will supply the market place. Price per se does not set demand. The subjective desires of the consumer balanced with the limits of their income and prices determine how much the consumer will purchase. In a free market, price is a very dynamic quantity, and the competition for supply and demand push prices up and down.

As stated, prices determine the relative valuation of goods and services, but the absolute magnitude of prices is a function of the value of money itself. There is a supply and demand for money that is connected with quantity of money in the market place and the quality and quantity of goods and services produced. When the value of money changes, all prices are forced to reset. If the value of money increases, all prices are forced downward: deflation. If the value of money decreases, all prices are forced upward: inflation. Inflation and deflation affect the exchange of goods and services produced because not all prices change with the same speed—some prices change faster (commodities), some slower (wages). Inflation and deflation temporarily distort the relative valuation of goods and services and can lead to money-induced changes in how income is allocated.

Debt is a means to shift saved income from one person or organization to another. Often an individual or organization will have savings but no good prospects for investing that savings themselves. These people often loan their savings to someone who has a use for that income. Such loans may be direct from saver to spender or through an intermediary such as a bank, money market fund or other financial institution. The supply of loans in society is limited by the amount of income saved.

Whether debt is beneficial to economic growth or not depends upon what the borrowed income is spent on. As observed earlier, economic growth is driven by investment. If debt is undertaken to purchase capital that can be used to create goods and services that people want to buy, that debt promotes economic growth. If debt is used to finance other activities such as consumption or the acquisition of non-productive assets, it cannot support economic growth; it is as if the original income were never saved at all.

Government would do well to remember that economic growth is driven by productive private investments. Employment and unemployment are driven by economic growth. What makes an investment productive is whether it enables the production of goods and services that people are freely willing to exchange their income for.

Every dollar government spends comes from income created by someone that was taxed or borrowed. Every dollar government spends has an opportunity cost, i.e., someone in society has less income to spend and potentially invest. If government wishes to promote economic growth, it should ponder how its actions will affect private investment.