CHAPTER 12. MACROECONOMIC AND INDUSTRY ANALYSIS

Both the Global Economy and the Domestic Macroeconomy affect financial markets.

In the sense of the Global Economy, exchange rates, political risks of the countries, balance of payments are essentials that affect domestic and international financial markets.

The Domestic Macroeconomy

GDP
Employment
Inflation

Interest Rates:

High interest rates reduce the PV of future cash flows, thereby reducing the attractiveness of investment opportunities.

Budget Deficits:

Any budgetary short fall (deficit) must be offset by government spending. This will force interest rates up by increasing the total demand for credit in the economy. Thus, excessive government borrowing will “crowd out” private borrowing and therefore, private investment.

INTEREST RATES

Real Interest Rates = Nominal Interest Rates – Expected Rate of Inflation

\[ r = i - \Pi \]

When \( r \) is (+), households’ savings are superior to inflation.

When \( r \) is (-), households’ purchasing power deteriorates.

When \( r \) increases, households will choose to postpone current consumption and set aside or invest more of their disposable income for future use.

Figure 12.3, p. 376

The supply curve slopes up because the higher the real interest rate, the greater the supply of households’ savings.
The demand curve slopes down because the lower the real interest rate, the more the businesses will want to invest in capital.

The government can shift the supply and the demand curves by fiscal and/or monetary policies.

**In the case of budget deficit:**

Government borrowing will increase and demand curve will shift to the right (restrictionary fiscal policy).

This increase in the interest rates can be offset by expansionary monetary policy (M2 increases) where the supply of loanable funds will increase and this will shift supply curve to the right.

- In the long-run, an increase in Money supply causes increases in general price level and nominal interest rates.
- But an increase in Money Supply would have no sustained impact on the real interest rates. However, in the shorter-run, it may have an impact on the real interest rates.

**Demand and Supply Shocks**

**Demand Shock** is an event that affects the demand for goods and services in the economy.

Ex. Positive demand shocks = tax rate reductions, increases in Money supply, increase in government spending, and increases in foreign export demand.

**Supply shock** is an event that influences production capacity and costs in the economy.

Ex. Changes in the price of imported oil; freezes, floods, or droughts that might destroy large quantities of agricultural crops; changes in the educational level of an economy’s workforce; or changes in the wage rates at which the labor force is willing to work.

**Demand shocks** are usually characterized by aggregate output moving in the same direction as interest rates and inflation.

Ex. A big increase in government spending will tend to stimulate the economy and increase GDP.
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Supply shocks are usually characterized by aggregate output moving in the opposite direction as inflation and interest rates.

Ex. A big increase in the prices of imported oil will be inflationary because costs of production will rise, which will cause an increase in the general price level. Inflation will lead to higher nominal interest rates, thus, aggregate output will fall down.

So, how do demand and supply shocks relate with investments in financial and goods/services markets?

Simply, INTEREST RATES.

Government Policy

Before 1980s, primary focus was on demand-side policy that affects the demand for goods and services including fiscal and monetary policies especially in the USA.

But, after 1980s, an increasing attention has also been focused on supply-side economics.

However, in the case of Turkey, focus is always mainly on demand-side economics.

Supply-side economics broadly deals with the production capacity of the economy, rather than increasing the demand for goods/services the economy can produce.

Demand-Side Economics:

Fiscal Policy: Tools and Impacts on the economy? When and how is it done? Deficit or Surplus in Budget Deficits?

When there is deficit, Fiscal Policy will be RESTRICTED. Government spending is reduced or tax rates are increased. This will cause a fall in output. But the behavior of interest rates depend on macroeconomic conditions.

Monetary Policy: Tools and Impacts on the economy?

Expansionary monetary policy will lower interest rates and stimulate investment and consumption demand in the short run. This cause INFLATION.

Supply-Side Economics:
While demand-side economics look at the effect of taxes on consumption demand (for example), supply-side economics focuses on incentives and marginal tax rates. This argues that lowering tax rates will elicit more investment and improve incentives to work, thereby enhancing economic growth. Thus, the assumption is that lower tax rates will have more positive effects on the economy than the tax rate is reduced.

**Business Cycles**

**Relationship of Up(s) and Down(s) with financial markets?**

Business Cycles are Repetitive Cycles of Recession and Recovery.

Peak: The transition from the end of an expansion to the start of a contraction.

Trough: The transition point between recession and recovery.