Example Economics & Business Economics

Preface

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If you have any further questions, you can call our customer service. We are available on working days from 09.00 until 17.00 at the following phone number: 010-2142394.

We hope you will enjoy your student life in Groningen and of course we hope to see you pass your exams efficiently by using summaries of SlimStuderen.nl. In the meantime, take a look at Chapter A and B of the summary for the mid-term of Introduction to International Business.

Best wishes,
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Table of contents

Preface 3

Table of contents 5

A. Around the world 6

B. Understanding the Book 9

C. Want to pass your exams? Follow a Capita Selecta course! 12

A. Around the world

In order to define what macroeconomics is about, in this chapter we will take an economic tour of the world, to give a description of the main economic evolutions and of the issues that are of big interest for macroeconomists and macroeconomic policy makers.
It is important to keep in mind that at the time of writing (early 2010), the impact of financial crisis that has shaken the U.S.A. and Europe before spreading to the rest of the world was the issue on which all the attention was concentrated. Moreover, in the autumn of 2008, the world economy has experienced the deepest recession since the Second World War.
However, apart from the crisis, for more than two decades the world economy grew more rapidly than ever before, in both advanced economies and in emerging and developing countries.

Europe and the currency used, the Euro
The European Union, or *EU27,* was founded in 1967, when six European countries decided to form a common market, an economic zone where the free movement of people and goods is allowed. Since then, 21 more countries have joined the EU, bringing the total to 27, countries who form a strong economic power, comparable to that of the U.S.A.
In order to study an economy, macroeconomists look at the following three variables: · *Output*: the term refers to the level of production and its growth rate;

- The *unemployment rate*: it is the proportion of unemployed workers who are looking for a job in an economy;
- The *inflation rate*: the rate at which the average price of products in an economy is increasing over time.

In table 1.1, from page 3, these data for EU27 can be seen. We notice that the four largest Europe economies are Germany, the UK, France, and Italy and that the economic performance of the European countries after 2000 has not been as good as in the 1990s. The three main issues that have been the main reason of the economic debate for a long time are:

- The high unemployment: although it is lower than in the mid-1990s, it still remains very high. In the early 1990s, the Americans used to refer to the Europe as the land of *unemployment miracle*, because of the low unemployment rate; in the late 1970s however, the miracle has vanished. It is important to keep in mind that this rate is almost always nearly 2% higher that it is in the U.S.A.
- The growth of income per person: table 1.2, from page 5, shows the European income per capita, compared to the U.S.A.
- The introduction of the common currency, namely the Euro: it happened in 1999, and after more than ten year, a couple of issues are still discussed:
    - The Euro has an enormous symbolic importance, regarding the past wars between the European countries and the actual situation. Moreover, there are no more changes in the relative price of currencies for European firms, and no more need to change currency when travelling inside Europe.
    - On the other hand, some think that the Euro will bring some economic costs, then a common currency means a common monetary policy, so the same interest rate across the euro countries.

The economic situation in the U.S.A

In the early 2010, the USA was still in the middle of the severe recession triggered by the biggest financial crisis since the Great Depression from 1929. In table 1.3, page 7, we can find the growth, unemployment and inflation rate in the U.S.A, since 1990, and we observe that the situation for all three variables was better in the 1990s than after 2000.

The reasons why the US economy has slowed down in the recent years are the four economic shocks, which occurred, in a short period of time:

- An increase in oil prices, though now partially reversed: in figure 1.3, page 8 we can observe the oil prices in different time periods. It is important to acknowledge that if oil imports become more expensive, in order to import the same amount of oil the importing countries have to transfer a greater share of income to the oil producing countries. This will lead to impoverishing importers and reducing their consumption.
- A fall in the price of their homes: in figure 1.4 from page 8, house prices, adjusted for inflation in the U.S.A., are shown. House prices depend on population growth, construction costs and interest rates, but none of them can explain why the house prices experiences such a growth in the past ten years.
- A fall of the stock market: it reduced the value of households' wealth invested in equities.
- A restriction of credit: it became more difficult and expensive to access credit. What is also interesting about the U.S.A. is that since the mid-1980s, the USA has purchased each year more goods and services from abroad than those they could sell, so their imports exceeded their exports. Moreover, the US *trade deficit,* the difference between imports and exports has increases and reached a very high rate. In figure 1.5, page 9, the evolution of the US trade deficit in relation to GDP since 1990 can be observed. In order to finance this trade deficit, the U.S.A. had to borrow more and more from abroad.

BRIC countries

BRICs or Brazil, China, India and Russia have grown rapidly during the last decade and are known today as the largest economies outside the group of advanced countries. China, especially, has been growing very fast for more than two decades, and its growth rate is almost twice of the others. Table 1.4 from page 10 provides us with the output growth and inflation in the BRIC countries since 1991.

The growth comes from:

- High accumulation of capital: more capital means higher productivity, and higher output.
- Fast technological progress: China's strategies were to encourage foreign firms to come and produce in their countries but also to encourage joint ventures between China and foreign firms.

But why has China fared so much better than other countries?

- Some believe that this is the results of a slower, better managed, transition.
- Others think that the fact that the communist party has remained in control has actually helped the economic transition.

A look into the future

There are other regions that should be taken into account, too:

- Japan: although it is knows as an economic miracle because of the growth after the Second World War, in the past decade it has performed poorly. After a stock market crash in the early 1990s, Japan has been in a prolonged slump, having an average output growth less than 1% per year.
- Latin America: it went from very high to low inflation in the 1990s.
- Africa: although it had suffered decades of economic stagnation, since 2000 it has experienced high growth in most of the countries of the continent.

B. Understanding the Book

Aggregate Output

GDP: production and income

The gross domestic product or the GDP is used to measure the *aggregate* (total) output in the national income accounts and can be defined as:

- *The value of the final goods and services produces in the economy during a given period*: here we should count only the production of *final* goods, not intermediate goods. This leads to one way of constructing GDP: record and add up the production of all final goods.
- *The sum of value added in the economy during a given period*: the value added by a firm is calculated as the production minus the value of the intermediate goods used in the production.
- *The sum of incomes in the economy during a given period.*

The first two definitions are related to the production, while the second one is related to the income.

Nominal and real GDP

Nominal GDP or GDP at current prices is computed by multiplying the sum of the quantities of the final goods produced by their current prices. So, the nominal GDP increases for two reasons:

- The production of most goods increases over time; · The prices of most goods also increase over time.

Real GDP or GDP in terms of goods/ GDP at constant prices/ GDP adjusted for inflation represents the sum of the production of final goods multiplied by *constant* prices. The disadvantage of the real GDP is that there is obviously more than one good, and real GDP is the weighted average of the output of all final goods, so the question is what the weights should be.

In figure 2.1, page 19, we can see the evolution of nominal and real GDP rates in the EU, since 1970.

GDP: level versus growth rate

Real GDP per capita represent the ratio of real GDP to the population of the country. This measure provides us with the average standard of living in a country.

Expansions are periods of positive GDP growth, while *recessions* are periods of negative GDP growth. In figure 2.2, page 20, growth rates of GDP in the EU15 and in the USA since 1970 are shown, and the GDP growth in year *t* is constructed as $(Y_t - Y_{t-1})/ Y_{t-1}$.

Other Major Macroeconomic Variables

The Unemployment Rate

Employment (N) represents the number of people who have a job, while *unemployment (U)* is the number of people who do not have a job, but are looking for one (it is difficult to measure unemployment, since the number of people who are looking for a job varies across countries and time). So, the *labour force (L)* is the sum of employment and unemployment: L=N+U.

Unemployment rate (u) is the ratio of the unemployed people to the number of people in the labour force: $u = \frac{U}{L}$.

The Labor Force Survey (LFS) is a survey used in Europe, which relies on interviewing a sample of individuals. An individual is seen as employed if he has worked at least one hour during the preceding week.
This survey showed that the average unemployment rate in the EU15 in 2008 was 7.1%, while in the U.S.A. a similar survey called *the Current Population Survey (CPS)* registered an unemployment rate of 4.6%. The later survey classifies a person as employed if he has a job at the moment of the interview and sees a person as unemployed if he does not have a job but has been looking for one in the past four weeks.
Discouraged workers are the ones that give up looking for a job and are no longer counted as unemployed, because of a high unemployment.
Participation rate is the ratio of the labor force to the total population of working age.
Unemployment is important to economists because of two reasons:

- Unemployment has direct effects on the welfare of unemployed;
- Unemployment rate provides a signal that the economy may not be using some of its resources efficiently.

The Inflation Rate
The inflation rate is the rate at which the price level increases, while *deflation* represents a decline in the price level, so a negative inflation rate.
The GDP deflator ($P_t = \frac{Nominal\ GDP_t}{Real\ GDP_t} = \frac{€Y_t}{Y_t}$) in year *t,* is defined as the ratio of nominal GDP to real GDP in year *t:* P_t. This measure gives the average price of output, while the consumers care about the average price of consumption (the cost of living), and these two prices need not be the same, because of two reasons:

- Some of the goods in GDP are sold not to consumers but to firms, to the governments or to foreigners.
- Some of the goods bought by consumers are not produced domestically but are imported from abroad.

The most frequently used measure of cost of living is the *harmonised index of consumer prices (HICP),* which provides comparable measures of inflation in the euro area, the EU, the European Economic Area and for other countries such as accession and candidate countries.
After taking a look at figure 2.4 from page 25, we observe that there are two things that should be considered about the relation between the HICP and the GDP deflator:

- The HICP and the GDP deflator move together most of the time.
- There are also exceptions from the first conclusion: in 1998, 2002 and 2009, the HICP did not increase as much as the GDP deflator, so the price of goods consumed in the euro area was lower than the price of goods produced in the euro area. However, in 2008, the increase of the HICP was bigger than the one of GDP deflator.

Why do Economists care about Inflation?
Pure inflation refers to the case when a higher inflation means just a faster but proportional increase in all prices and wages.
Real wage is the wage that is measured in terms of goods rather than in euros.
The reason why economists care about inflation is because there is no such thing as pure inflation:

- During periods of inflation, not all prices and wages rise proportionately, and the income distribution is affected.
- Inflation leads to other distortions:
  - It leads to more uncertainty, which makes it more difficult for firms to make decisions about the future;
  - If tax brackets are not adjusted for inflation, then people will encounter higher tax brackets, since their nominal income increases, even if the real income stays the same.

After discussing this, we may think that if inflation is bad, deflation is good, thing that is completely wrong. Firstly, high deflation creates many problems as high inflation, such as distortions or increased uncertainty. Secondly, a low rate of deflation can limit the ability of monetary policy to affect output.

The Short Run. The Medium Run. The Long Run
Which are the determinants of the level of aggregate output in an economy?

- In the short run - movements in the demand of a good, because of consumer confidence or interest rates.
- In the medium run - the supply side, which depends on how advanced a technology is, how much capital it is using and the size and the skills of its labor force;
- In the long run - other factors such as a country's education system, its saving rate or the quality of its government.

C. Want to pass your exams? Follow a course at Capita Selecta!

Dear students,

To help you pass your exams, there is the opportunity to follow an exam course at Capita Selecta. As the biggest and oldest exam trainer we will optimally prepare you for your exam.

What is an exam course from Capita Selecta?
Capita Selecta offers courses, which help you, pass your exams. In the courses we go through all the content obligatory for your exam. Besides this we have several practice assignments, which are examples of those assignments you may possibly see back at your exam. The combination of the two offers the perfect preparation for your test.

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On behalf of the complete Capita Selecta team, we wish you an successful academic year. We hope to see you at one of our Capita courses.

Kind regards,
Carien Nieters
Business Unit Manager Capita Selecta