

MACROECONOMICS
SUMMARY 2011
(BEGINNERS)



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SAMPLE ONLY

TOPIC 1: MEASURING MACROECONOMIC PERFORMANCE: OUTPUT AND PRICES

1.1 When is the economy performing well?

At a broad level, we would say the macro economy is performing well if it meets the following criteria:

1. rising living standards in the long run
2. avoiding extremes of macroeconomic performance
3. maintaining the real value of currency
4. ensuring sustainable level of **public** and **national debt**
5. balance current expenditure against the need to provide resources for the future
6. providing employment for all individuals seeking work, i.e. full employment

Definitions:

Public debt: The amount owned by the government to non government

National debt: The amount owned by the nation to other countries

1.2 Gross Domestic Product (GDP): Measuring the Nation's Output

The first two indicator of good macroeconomic performance, rising long run living standards and the avoidance of extremes in the short run macroeconomic performance, are usually judged in the context of a nation's **gross domestic product** or **GDP**.

Definition:

GDP: The market value of the final goods and services produced in a country during a given period

Market value: Market prices for publicly provided goods and services, or if these don't exist, the cost of providing those goods and services as rough measure of their economic value

Final goods or services: Goods or services consumed by the ultimate user: because they are the end products of the production process, they are counted as part of GDP

Intermediate goods or services: Goods or services used up in the production of final goods and services and therefore not counted as part of GDP

Value added: for any firm, the market value of its product or service minus the cost of inputs purchased from other firms

Economists' interest in GDP extends across two different time dimensions, which correspond to our first two macroeconomic performance indicators: the long run and the short run.

Over reasonably short period of time, e.g. 1-4 years, GDP can fluctuate quite markedly, growing relatively strong at times- **economic expansions**, and relatively sluggish at other times- **economic recession**. Macroeconomists call these fluctuations the **business cycle**.

Over longer period of time, most countries experience reasonably steady growth in their GDP.

1.2.1 The expenditure method for measuring GDP

Final goods and services that are produced in a given year will be purchased and used by some economic agent. Economic statisticians divide all the users of the final goods and services that make up the GDP for any given year into four categories:

- households
- firms
- governments
- foreign sector (i.e. foreign purchase of domestic products)

As a result, GDP can be measured by adding up the total amount spent by each of the four groups on final goods and services and subtracting spending on imported goods and services

Corresponding to the four groups of final users are four components of expenditures:

- consumption expenditure
- investment
- government purchases
- net exports

Definitions:

Consumption: spending by households on goods and services

Investment: Spending by firms on final goods and services, primarily capital goods, housing, and inventories

Government purchase: purchases by federal, state and local governments of final goods and services. Government purchases do not include transfer payments, nor do they include interest paid on the government debt.

Transfer payment: payments made by government in return for which no current goods or services are received

Net Exports: export minus imports

The relationship b/w GDP and expenditure on goods and services can be summarized by an equation.

Let

Y= GDP

C = Consumption expenditure

I = investment

G =Government purchases

NX =net exports

$$Y = C + I + G + NX$$

This equation is known as the **national income accounting identity**.

1.2.2 Measuring GDP by production

GDP = Value added by each firm in the production process
= gross output – value of intermediate inputs
= value of final goods and services

1.2.3 Measuring GDP by incomes of capital and labour

Whenever a good or service is produced or sold, the revenue from the sale is distributed to the workers and the owners of the capital involved in the production of the goods and services. Thus, GDP also equals labour income plus capital income.

GDP =

+ Compensation to employees
+ gross operating surplus
+ gross mixed Y = total factor Y
+ indirect taxes less subsidies

1.2.4 Nominal GDP versus real GDP

If a country has experienced inflation (i.e. price increase) over a period of some years, **nominal GDP** will be misleading gauge of economic growth, since it is the physical quantities of the goods and services produced in any given year, not the dollar values, are what determine people's economic wellbeing.

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Definitions:

Real GDP: A measure of GDP in which the quantities produced are valued at the price in a base year rather than at current prices; real GDP measures the actual physical volume of production

Nominal GDP: a measure of GDP in which the quantities produced are valued at current-year prices; nominal GDP measures the current dollar value of production

Real GDP can be calculated by:

Real GDP for 200X + Y years
= Q produced in 200X + Y years x Price of 200X

200X being the base year

Example

	Quantity of pizzas	Price of pizzas	Quantity of pasta	Price of pasta
2000	10	\$10	15	\$5
2004	20	\$12	30	\$6

Nominal GDP for year 2004 = (20 pizzas x \$12/pizza) + (30 pastas x \$6/pasta)
=\$420

Real GDP for year 2004, assuming 2000 is the base year

= (year 2004 quantity of pizza x year 2000 price of pizza) + (year 2004 quantity of pasta x year 2000 price of pasta)
= (20 x \$10) + (30 x \$5)
= \$350

By using real GDP, we can eliminate the effects of price changes and obtain a reasonable measure of the actual change in physical production over the time span.



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