Chapter One: Measuring Macroeconomic Performance, Output and Prices.

Introduction

- Macroeconomics is concerned with three broad themes. The first involves making judgements about the performance of the economy. The second involves understanding the factors that have produced particular macroeconomic outcomes. The third relates to the role of the government in influencing macroeconomic performance.

When is the economy performing well?

- Rising Living Standards.
- Avoiding Extremes of Macroeconomic Performance.
    - An economy that is growing excessively may be prone to inflation.
- Maintaining the real value of the currency.
- Ensuring sustainable levels of public and foreign debt.
- Balancing current expenditure against the need to provide resources for the future.
- Providing employment for all individuals seeking work.

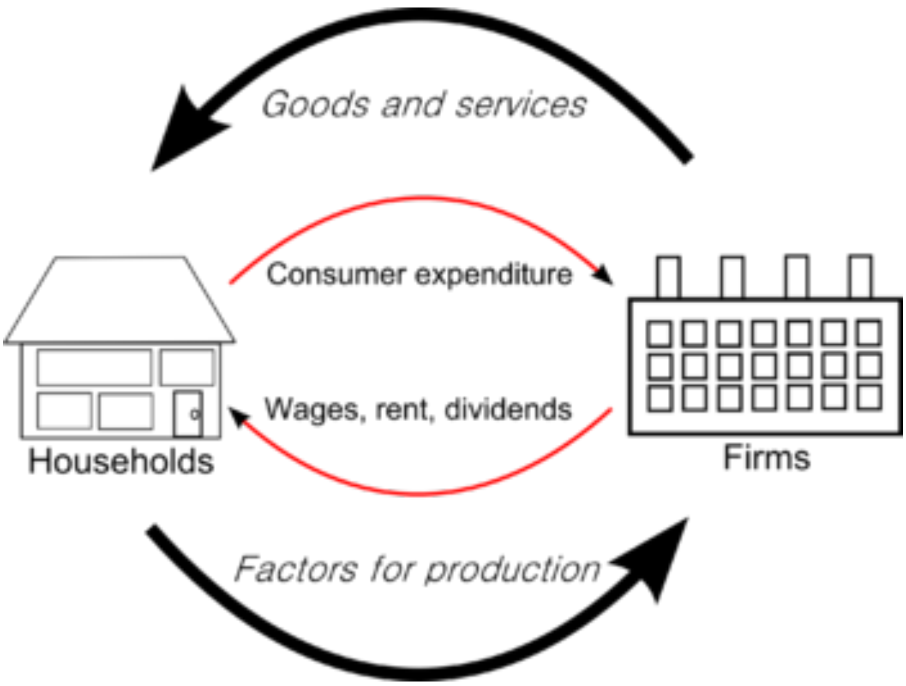
Gross Domestic Product, Measuring the nations output

- Defined as the Market Value of all final goods and services produced in a country during a given time period.
- Indicator of
    - Rising living standards
    - Fluctuations of macroeconomic performances
- Interest in GDP is dependent on long run and short run. Fluctuations happen in short run where as most economies in the long run experience GDP growth.
- Ways of measuring GDP:
    - Value-added Method
        - Intermediate goods and services are not counted when determining GDP, as this would mean 'double counting'
        - In practice this rule is not easy to apply however as there are so many production processes.
        - Economists determine the market value of final goods and services indirectly, by adding up the value added by each firm in the production process.
    - The Expenditure Method
        - Assume that all final goods and services produced in a country in a given year will be purchased and used by households, firms, governments and the foreign sector.
        - C, I, G, X, M **COMPONENTS OF AE - further explained yr. 12 notes**
        - Goods that are produced but not sold in a period are called inventories, by convention; economists regard these unsold goods as having been purchased by the firms that produced them.

- The income method
  - When a good or service is sold, the revenues from the sale are distributed to the workers and the owners of capital involved in the production. Therefore GDP also is labour income plus capital income.
  - Capital income (25% of GDP) comprises payments to owners of physical capital (factories, office buildings) and intangible capital (copyrights and patents)
  - Labour income (75% GDP) comprises wages, salaries, and the incomes of the self-employed.

<u>Circular flow of income</u>

- Product Market – households use the income earned to purchase goods and services
- Factor Market – Households supply labour and capital to firms, they are compensated by wages, interest, dividends and rent.
- Y=O=AE



<u>Real GDP is not the same as economic wellbeing</u>

- GDP is not the same as economic wellbeing, GDP captures only those goods that are priced and sold in the markets. Many factors that contribute to peoples economic wellbeing are not priced and sold in the markets and thus are largely or even entirely omitted from GDP
- Leisure Time
- Non-market economic activities
  - Value of unpaid or volunteer services
- Quality of the environment
- Quality of life indicators such as crime rate and the degree of economic inequality

- **However**, GDP is believed to be positively related to these factors, so monitoring GDP does give some insight into peoples general economic wellbeing.

The Consumer price index

- The CPI is a measure of the cost of living during a particular period.
- THE CPI measures the cost in a period of a standard set, or basket of goods and services relative to the cost of the same basket of goods and services in a fixed year (base year)

Inflation

- The % change of price index
- Along with GDP, the economies rate of inflation is a keenly monitored economic variable, as its variances have great effects on the economy.
- The true costs of inflation:
    - Shoe Leather Costs
        - Inflation erodes the purchasing power of any given amount of cash
        - The longer cash is held during a period of inflation, the larger is the reduction in purchasing power
        - Hence people economise on their money holdings, this is done by leaving as much money as possible in bank accounts where the interest paid on deposits compensate for inflation.
        - However there is a trade-of with this behaviour, more likely people will visit banks more, this is an inconvenience.
    - Noise in the price system
        - In an economy with little or no inflation, the supplier of specialty foodstuff would immediately recognise an increase in mushroom prices as a signal to bring more to the market (higher demand).
        - If inflation is high, the supplier must ask wether the price increase reflects demand or inflation.
        - Can only know by checking if all other prices have gone up, this requires time and effort and the supplier's response more likely to be tentative.
    - Distortions of the Tax system
        - Bracket Creep, the inflation usually increases income and this means people pay higher tax
    - Unexpected Redistribution of wealth
        - Those workers not compensated for inflation with wage increase are worse off.
        - Employers who do not have to compensate wage increase due to contract are better off.
        - High inflation help borrowers than lenders
        - Like casino, winners are lucky.
    - Interference with Long run planning
        - Many economic decisions take place within a long time horizon. Such as retirement and business investment decisions
        - High and erratic inflation can make planning difficult and unpredictable!

- Menu Costs
  - If inflation is high, any firm that publicly lists its prices will incur costs when the prices change i.e. printing and there is an opportunity cost.