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Week 1 (Lecture + Chapter 5 – Measuring a Nation's Income)

Microeconomics – study of how individual households and firms make decisions and how they interact with one another in markets

Macroeconomic – study of the economy as a whole (aggregates). Goal to explain economic changes that affect many households, firms and markets at once. Answers questions such as:

- Why is average income high in some countries and low in others?
- Why do prices rise rapidly in some periods while they are more stable in other periods?
- Why do production and employment expand in some years and contract in others?

The Economy's Income and Expenditure

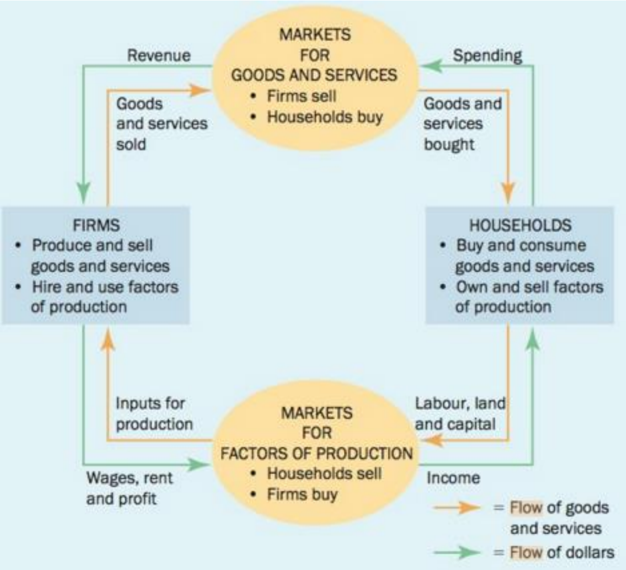
For an economy as a whole, income (I) must equal expenditure (E) because every transaction has a buyer and a seller, and, every dollar of spending by some buyer is a dollar of income for some seller

The Measurement of Gross Domestic Product (GDP)

GDP is the total market value ($) of all final (not intermediate – don't want to double count) goods and services (includes both tangible goods and intangible services) produced (includes goods and services currently produced, not transactions involving goods produced in the past) within a country (geographic confines) in a given period of time (usually a year or a quarter)

GDP is a measure of the total income and expenditures of an economy. GDP excludes most items that are produced and consumed at home and that never enter the marketplace as well as items produced and sold illicitly.

The equality of income and expenditure can be illustrated with the circular-flow diagram.



The Components of GDP

GDP (Y) is sum of consumption (C), investment (I), government purchases (G) and net exports (NX)
Y = C + I + G + NX

Consumption accounts for the majority of GDP

Real v Nominal GDP

<u>Nominal GDP</u> – values the production of goods and services at current prices ($Y = P_{year\ x} \times Q_{year\ x}$)
<u>Real GDP</u> – values the production of goods and services at constant prices ($Y = P_{base\ year} \times Q_{year\ x}$)

The GDP Deflator

GDP deflator is measure of price level calculated as the ratio of nominal GDP to real GDP times 100

$$GDP\ deflator = \frac{Nominal\ GDP}{Real\ GDP} \times 100$$

Tells us rise in nominal GDP attributable to rise in prices rather than a rise in the quantities produced

GDP and Economic Wellbeing

GDP is the best single measure of the economic wellbeing of a society. GDP per person tells us the income and expenditure of the average person in the economy (GDP divided by population). Higher GDP per person indicates a higher standard of living. However, GDP is not a perfect measure of the happiness or quality of life.

Some things that contribute to wellbeing are no included in GDP are value of leisure, clean environment, almost all activity that takes place outside of markets (ex. value of the time parents spend with their children and the value of volunteer work).