Our Economy II: Economic Measures & Government Intervention

Economic Indicators (ways to measure how the economy is doing)

GDP … Is the economy growing? (GDP growth rate)
Inflation … Are prices stable? (Inflation rate)
Unemployment … Are people working? (Unemployment rate)

Gross Domestic Product (GDP)
GDP represents total spending on goods and services produced in the U.S. The goods & services must be made within the borders of the U.S., although they may be sold anywhere in the world. Note: the goods and services must actually be purchased by someone.

GDP is made up of household spending on goods and services (C), business investment spending (I), government spending on goods & services (G), and net exports (X-M).

GDP = C + I + G + (X-M) … all the goods & services made/provided in US

Unemployment (% of people who are out of work but looking for work)
The unemployment rate is the % of the labor force that is unemployed. It is calculated by dividing the number of unemployed people (16+ who are looking for work) by the number of people in the workforce. Unemployment is measured by the Bureau of Labor Statistics.

- **Types of Unemployment**: Frictional, Seasonal, Structural, Cyclical

Inflation (Increasing prices; also Deflation, Hyperinflation)
The inflation rate, as measured by the CPI (Consumer Price Index), represents how much prices are increasing or decreasing in the economy. There are two primary causes of inflation …

- **Supply & Demand**. Changes in supply & demand for goods in the economy can cause prices to rise (inflation) or fall (deflation).
- **Money Supply**. Changes in the money supply (printing more money, changing bank's reserve requirements, buying/selling government securities) can cause inflation or deflation.

Business Cycle: Expansion and Contraction

Economies move through various ups and downs over time … this is called the business cycle.

- As GDP is growing (everyone is spending and buying), prices tend to go up (supplies decrease due to increased demand) and unemployment tends to go down (businesses hire more people to keep up with demand). The reverse is also true.

EXPANSION (prosperity or good times): GDP is growing / inflation + / unemployment -

- We may move from a period of expansion (or prosperity) to a period of contraction (or a slowdown) in the economy, then we bottom out and start moving into a recovery.

CONTRACTION (slow down or bad times): GDP is shrinking / inflation - / unemployment +

- If GDP shrinks for 2 quarters (six months) in a row, we are in a recession

Balance of Payments

CURRENT ACCOUNT: Goods & Services Trade, Current Income – Dividends & Interest on Foreign Investments/Loans, Foreign Aid and Gifts
CAPITAL/FINANCIAL ACCOUNT: Building Factories or Starting Businesses in Other Countries, Making or Receiving Loans, Making or Receiving Investments
NET ERRORS & OMISSIONS: Mistakes and Illegal Trade
OFFICIAL RESERVES: Currency Reserves & Related Items

CREDITS are cash inflows into a country. **DEBITS** are cash outflows from a country.

Government Intervention in the Economy

The government tries to stabilize the economy through Monetary Policy and Fiscal Policy.

- This is challenging, because they need to strike a balance between expansion (with a risk of more inflation) and contraction (with a risk of more unemployment).

Government INDIRECTLY Influencing the Economy. The government CANNOT directly control how much consumers (C) or businesses (I) spend, so it provides incentives to consumers and businesses to spend more (or less):

- INTEREST RATES (C,I). Raise/lower interest rates (make it easier or harder to borrow)
- TAXES (C,I). Raise/lower taxes (gives consumers & businesses less/more money to spend)

Government DIRECTLY Influencing the Economy. What the government CAN control directly is government spending – Congress.

- GOVERNMENT SPENDING (G). Increased Government spending

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Monetary Policy (affects Interest Rates, Borrowing) … done by the Federal Reserve

Monetary Policy refers to changes in the money supply and the willingness of banks to lend $

The Federal Reserve
One of the main purposes of the Fed is to maintain a healthy economy. It does this through monetary policy. Monetary policy essentially means influencing the money supply.

- Created by Congress in 1913; set up to have some degree of independence to keep it from political pressures (it has a unique public/private structure)

The Federal Reserve has three ways in which it affects the money supply:

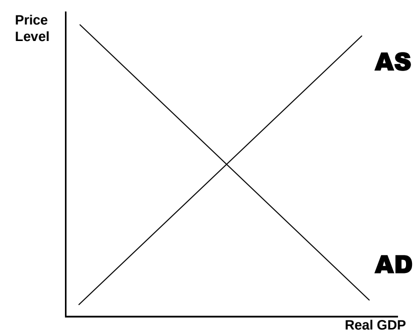
- **Discount Rate** – rate charged to member banks to borrow money
- **Reserve Requirements** – affects how much money banks can lend (against deposits)
- **Open Market Operations** – MOST FREQUENTLY USED … buy/sell gov't securities … affects how much money banks have to lend

Fiscal Policy (affects Taxes and G Spending) … done by acts of Congress

Fiscal Policy is defined as changes in government spending or taxes designed to promote full employment, price stability, and reasonable rates of economic growth.

- **Expansionary Fiscal Policy:** An increase in gov't spending and/or decrease in taxes designed to increase demand in the economy (increase GDP & decrease unemployment).
- **Contractionary Fiscal Policy:** A decrease in government spending and/ or an increase in taxes designed to decrease aggregate demand in the economy (control inflation).

Aggregate Demand & Supply



Aggregate demand and aggregate supply are used to analyze the causes and effects of economic problems. Changes in aggregate demand and aggregate supply also provide guidance in analyzing the effects of government monetary and fiscal policies on inflation, unemployment, and economic growth. Understanding these macroeconomic forces helps you anticipate and respond intelligently to economic events. This allows you to predict the economic consequences of proposed government policies and to make informed choices among alternative political candidates and public-policy proposals.

Aggregate Demand: The aggregate demand curve shows the total amounts of goods and services that consumers, businesses, governments, and people in other countries will purchase at each and every price level. It represents all the demand in the economy.

- Shifts in aggregate demand show the effects of events and government policies on the price level and real GDP. Anything that causes an increase in consumer, business, or government spending, or in net exports, will increase AD. For example, higher incomes increase consumer spending and therefore increase AD. More business investment increases AD. Higher government spending increases AD. If U.S.-made goods and services become more desirable in other countries, AD increases.

Aggregate Supply: The aggregate supply curve shows the total amounts of goods & services that suppliers will produce at each and every price level. In the short run, the aggregate supply curve is upward-sloping. This means that during a period of a year or two, a higher price level increases the quantity of goods & services supplied. A decrease in the price level reduces the quantity of goods & services provided.

- Many events can shift short-run AS, but here is a simple way to analyze the effects of these events. Anything that changes production costs shifts aggregate supply. An increase in production costs decreases AS, and a decrease in production costs increases AS. For example, an increase in the price of oil would increase the cost of energy, an important production cost. This would decrease AS. An increase in productivity reduces the costs of production, which would increase AS.