

EXAM 3 REVIEW:

I. Measuring the Economy

A. GDP and the Performances of the National Economy

- In measuring GDP, we divide the people in the economy into Four Sectors:
 - 1) Households → C
 - 2) Firms → I
 - 3) Government → G
 - 4) Rest of the World → NX

Two ways to measure GDP:

- 1) Expenditure approach
- 2) Value added approach

B. Real versus Nominal GDP:

Additional Measurements (definitions)

REAL GDP

Constant prices, Base year

Nominal Values: expressed in current \$.

→ doesn't necessarily reflect changes in production levels.

NOMINAL GDP

current prices

Real Values: adjusted for changes in price level.

→ do reflect changes in production level.

- Note: GDP includes only the values of *final* goods and services. It does NOT include
 - 1) Intermediate goods and services
 - 2) Used goods
 - 3) Purely Financial transactions (stocks, bonds, transfer payments)

C. How well does GDP Measure the Well-Being of a country?

THINGS NOT INCLUDED IN REAL GDP

- 1) Non-market production (doing your own cooking, cleaning, etc.).
- 2) Value of Leisure (recreation, household services)
- 3) Underground Economy (illegal goods and services, drugs, gambling, prostitution, etc.)

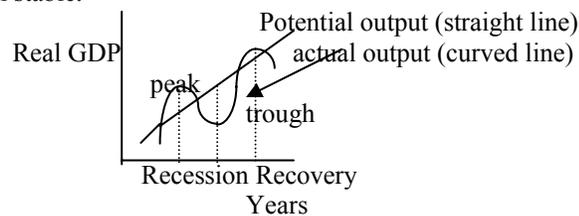
II. Unemployment and Growth and Prices and Inflation.

A. Business Cycles: the ups and downs in the economy

→ Measured by how much Real GDP fluctuates around Potential GDP (or a trend line)

When real output declines for a year or two with a small gap between actual and potential output we say we are in a recession, when the gap is large we are in a depression.

Remember that POTENTIAL output represents the maximum amount the economy can produce while prices remain stable.



The Business Cycle is characterized by peaks and troughs or by periods of contraction or expansion.

- If real GDP falls below potential GDP (the trend line), this is a **recession** or the economy is “slowing down”

B. Jobs and Unemployment

3 groups → know the difference between Employed, Unemployed, and Not in the labor force

The Labor Force is the sum of all people willing and able to work, employed or unemployed (must be working-age population – this includes people over 16 and not institutionalized).

$$LF = UN + EM$$

The Unemployment Rate is the percentage of people in the Labor Force who are unemployed.

$$UR = UN/LF$$

Maybe UR understates unemployment:

- **Discouraged Workers**
- **Involuntarily part time workers**

C. TYPES OF UNEMPLOYMENT

- 1) **Frictional Unemployment:** People entering the labor force or switching similar jobs (either voluntarily or involuntarily). Sometimes called normal labor turnover.
- 2) **Seasonal Unemployment:** unemployment due to weather, tourism, or seasons.
- 3) **Structural Unemployment:** People who are unemployed because of “structural” changes in the economy or technology that makes some skills obsolete and new skills are needed.
- 4) **Cyclical Unemployment:** Unemployment that rises and falls due to the business cycle.

Natural Rate of Unemployment: percentage of unemployed that are not due to fluctuations in the business cycle. This is considered “**full employment**” and exists when there is not **CYCLICAL** unemployment.

III. Money and The Economy

- Idea → Monetary Policy, changes the amount of “money” in the economy, can be used to affect aggregate demand by changing the short-term interest rates.

A. What is “MONEY”

Money is anything generally accepted as payment for goods and services.

1. Functions of Money:

- 1) Unit of Value
- 2) Means of Payment (double coincidence of wants)

2. Types of Money:

- 1) Commodity Money:
- 2) Convertible Paper Money:
- 3) Fiat Paper Money:

IV. Inflation and Price Levels

- A. **Price Index** – a number which represents how much the cost of a “market basket” of goods and services has changed through time.

Two important price indices are:

(1) **Consumer Price Index (CPI)** attempts to measure the “cost of living”.

$$\text{CPI} = \frac{\text{cost of the basket of goods in that year}}{\text{cost of the basket of goods in the base year}} * 100$$

CPI in the base year = 100

CPI gives a measure of the average level of prices at a point in time, relative to prices in the base year.

Inflation is a measure of how fast the average level of prices is changing over time.

RATE OF INFLATION – is the annual percentage of change in the average price level, measured by the CPI.

$$\text{Inflation} = \frac{\text{CPI}_{\text{year 2}} - \text{CPI}_{\text{year 1}}}{\text{CPI}_{\text{year 1}}}$$

(2) **GDP deflator** – measures the overall price level of all goods and services included in GDP.

$$\text{GDP deflator} = \frac{\text{nominal GDP}}{\text{Real GDP}} * 100$$

B. Adjusting for Inflation:

Purchasing Power of a Dollar – measures how much a dollar can buy.

(1) **Real Income** – purchasing power of your nominal income.

$$= \frac{\text{Nominal Income}}{\text{CPI}} * 100$$

(2) **Real Wages** – nominal wages deflated to adjust for changes in purchasing power.

$$= \frac{\text{Nominal Wage}}{\text{CPI}} * 100$$

(3) **Real Interest Rates**

%change in real = % change in Nominal Interest Rate per year – Inflation rate per year
→ Know when inflation is considered “bad”

C. Problems with the CPI and GDP deflator

There is one problem with the CPI and the GDP deflator → both tend to **overstate inflation**.

Why? There are three reasons:

- (1) NEW GOODS
- (2) QUALITY CHANGES
- (3) SUBSTITUTION
- (4) DISCOUNT STORES

V. Economic Growth

Potential output requires increases in

- 1) Labor
- 2) Capital, Human capital
- 3) Land and Natural resources
- 4) Technology