

Unit II – GDP, Price Indices, Supply & Demand, and other Universals (Chapters 7 and 8)

GDP (Gross Domestic Product) is the market value of all final goods and services produced within a nation in a year. (Exclude intermediate goods!)

EXPENDITURES APPROACH: $C + I + G + X$

- Consumption of Final Goods
- Investment in Capital Stock
- Government Expenditures
- Net Exports ($X - M$) = (eXports – iMports)

INCOME APPROACH:

- Compensation to employees (wages)
- Consumption of fixed capital
- Rents and interest
- Proprietor's income
- Dividends
- Undistributed Corporate profits
- Net foreign factor income
- Corporate income TAXES
- Indirect business TAXES

NDP (net domestic product) $GDP - \text{consumption of fixed capital}$.

NI (National Income): income earned by Resource suppliers.

- $NDP - \text{net foreign factor income} - \text{indirect business taxes}$
- $GDP - \text{consumption of fixed capital} - \text{net foreign factor income} - \text{indirect business taxes}$

PI (Personal Income): total paid to households (gross)

DI (Disposable Income): $PI - \text{personal taxes}$

PRICE INDICES and PERCENT CHANGE FORMULAS

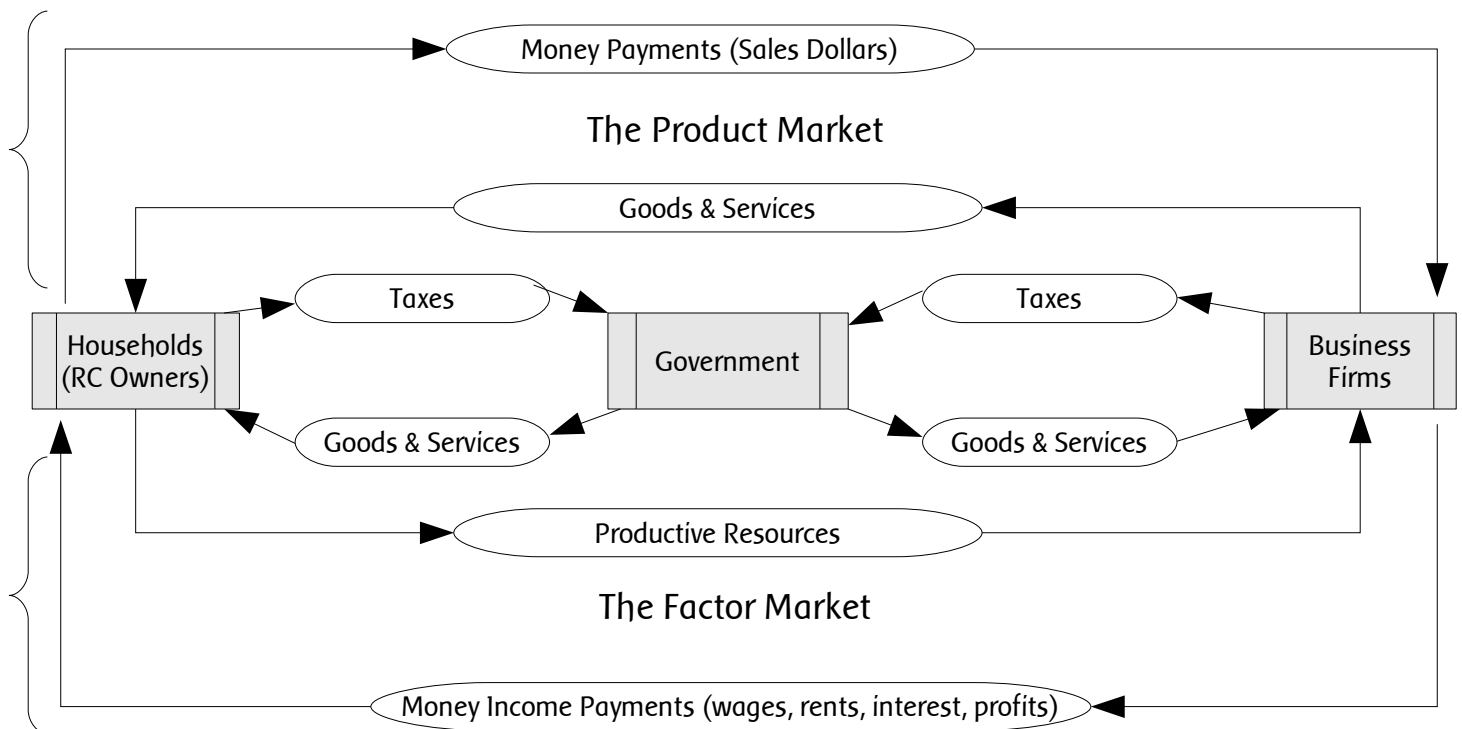
Price Index: Ratio of Nominal GDP to Real GDP

also calculated using: $\frac{\text{now} - \text{base}}{\text{base}} \times 100$

Nominal GDP is Real GDP + inflation:

$$GDP_R = \frac{GDP_N}{(\text{Price Index})(0.01)}$$

The Circular Flow Model of the Economy

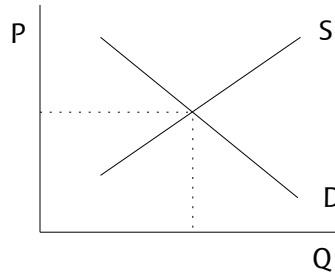


- Money on the outside
- Goods and services on the inside
- Top Brace is the Expenditures Approach to GDP
- Bottom Brace is the Income Approach to GDP

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SIMPLE SUPPLY and DEMAND

- Supply has Positive Slope
- Demand has Negative Slope
- Graph on Price vs. Quantity plane
- Show the Equilibrium Price and Quantity
- Change in Price leads to Change in Quantity, NO SHIFT!



DETERMINANTS OF SUPPLY

- Input cost or Resource prices (Labor is a resource!)
- Technology
- Number of Producers
- Government Policies

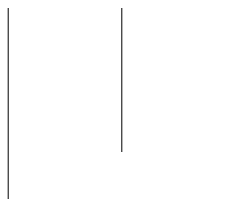
DETERMINANTS OF DEMAND

- Consumer Expectations or Tastes
- Number of Consumers
- Income
- Price of Substitute or Price of Complement Good

ELASTICITY

**Everything in economics can have an elasticity component (e.g. how the elasticity of a schedule affects policy action)

**Either ELASTIC or INELASTIC



Inelastic Curve



Elastic Curve

Necessity : Luxury

Expensive : Inexpensive

Need Now : Can go without

Narrow Market : Broad market

One Quantity, any Price

One Price, any Quantity

GOVERNMENT POLICIES

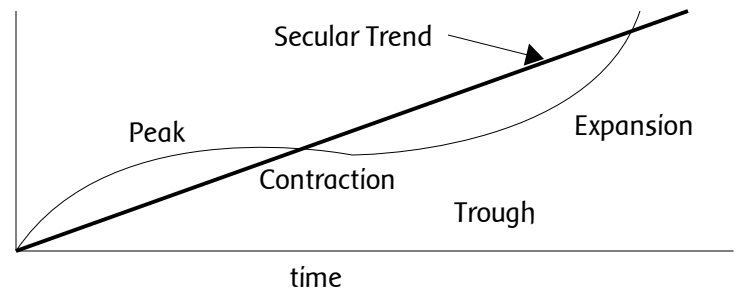
- The Employment Act of 1946 – Goals of Full employment, Price Stability, Economic Growth
- The Humphrey-Hawkins Act of 1978 – “Full employment and Balanced Growth” - Unemployment 4% and inflation 0%!!
- Fiscal Policy (Congress) Taxes and Spending
- Monetary Policy (The Federal Reserve Board: “the Fed”)

THE BUSINESS CYCLE

***Affects capital goods & durable consumer goods more than services & nondurable goods.

***Price fluctuations are greater in competitive industries (as opposed to monopolistic ones)

Two consecutive quarters of a trend: RECESSION or RECOVERY



UNEMPLOYMENT:

The Natural Rate of Unemployment: 5%

(+) Frictional: in between jobs; confidence in the economy.

(+) Structural: technology/skills/education outdated

(-) Cyclical: left out by the business cycle

***Not seeking a job = not in the workforce

GDP GAP/OKUN'S LAW

Every 1% over the natural unemployment rate means a 2% GDP Gap. This is caused by idle resources.

INFLATION

• Demand-pull: Some inflation is necessary to bring about a high output and low unemployment economy.

• Cost-push: coming along with declines in GDP and increases in unemployment. Also wage-push inflation and supply shocks.

UNANTICIPATED INFLATION

• Fixed-rate creditors sad; debtors happy: CHEAPER DOLLARS

HYPERINFLATION

• Injudicious government policy, undermining the money system, leading to economic collapse.

Cost of Living Adjustment: COLA

• CAUTION: May not fully combat inflation!