Economics for Managers

Session 18-20| 08-Sep-2019

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Quiz

1. Relative Shapes of Demand curve for Cars and Maruti Cars

- Demand curve for cars will be relatively steeper
- Demand curve for Maruti cars will be relatively steeper

2. Producer Surplus is

- Difference b/w the market price and the willingness of supplier to supply
- Difference b/w the market price and the willingness of consumers to pay

3. For substitute goods A & B, what happens when price of A goes up

- Demand for A will go up
- No impact on demand for B
- Demand for B will go up

4. If a consumer considers a good inferior, what can you expect when income increases

- Demand for inferior good to increase because income has increased
- Demand for inferior good to decrease despite increase in income
- No change in demand

5. Good X is a small part of my budget, what do you expect elasticity of demand to be?

- less
- more

We continue our discussion on GDP

- https://vimeo.com/328029183

GDP Income Approach

GDP = Wages + Rent + Interest + Profits

Workers Property Owners Lenders Firms

GDP Expenditures Approach

(Exports – Imports)

GDP = Consumption + Business Investment + Gov't Spending + Net Exports

GDP Expenditures Approach

The "GDP Keynesian Equation"

↑

GDP = Consumption + Business Investment + Gov't Spending + Net Exports

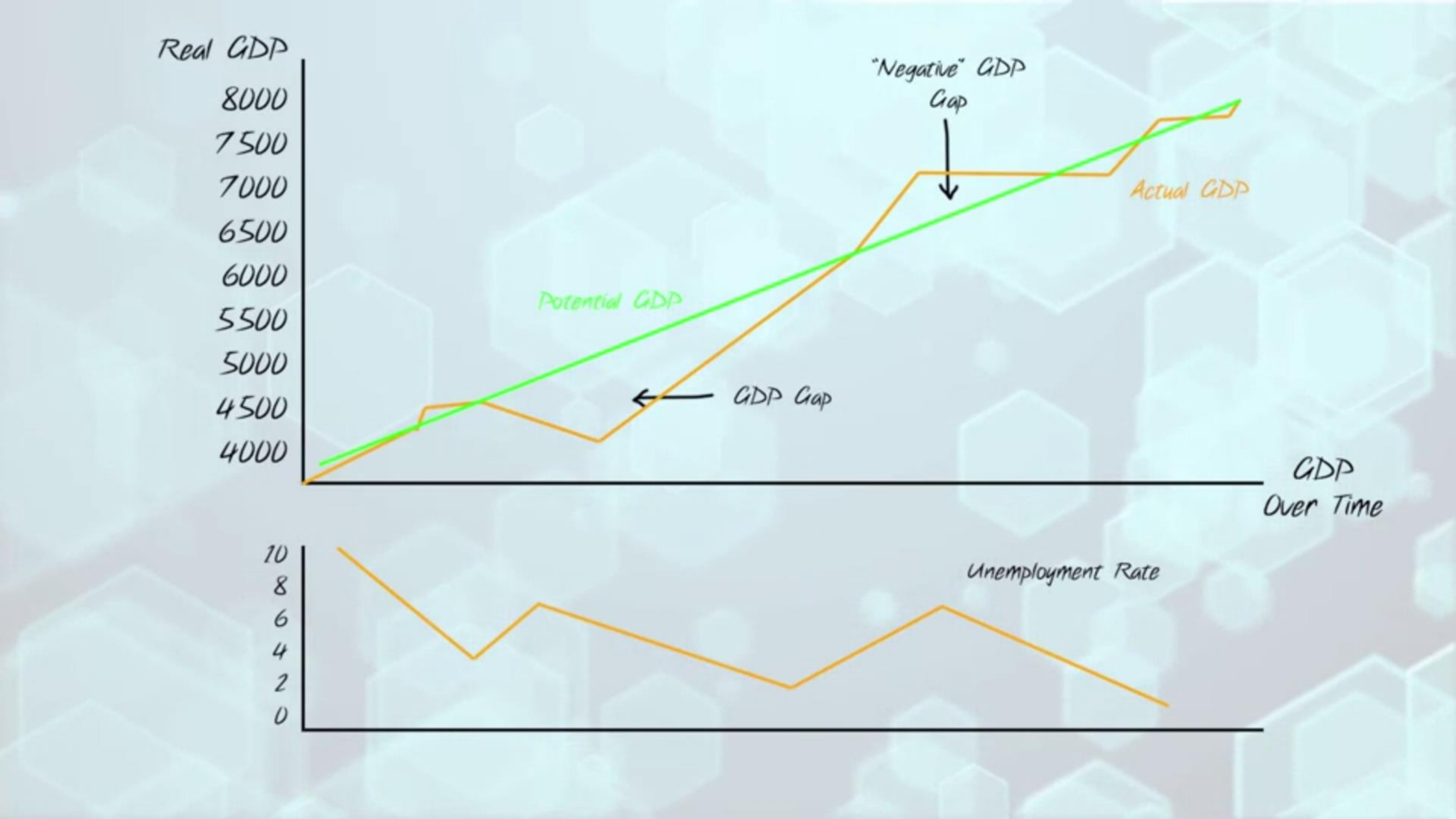
↓

"GDP Forecasting Model"

Will these be in India’s GDP?

1. A license to use software created this year in Germany, purchased in India
2. Rafaele jet purchased by the Indian Air Force this year.
3. Pension received this month by your grandfather.
4. Eggs bought by you to make an omelette at your house.
5. A house built in 1999 and sold this year.
6. The value of the relative cleanliness of Ganga and other rivers this year.

Actual vs Potential GDP



Nominal vs Real GDP

Measuring GDP

Nominal GDP → Measured with actual prices → Distorted Picture

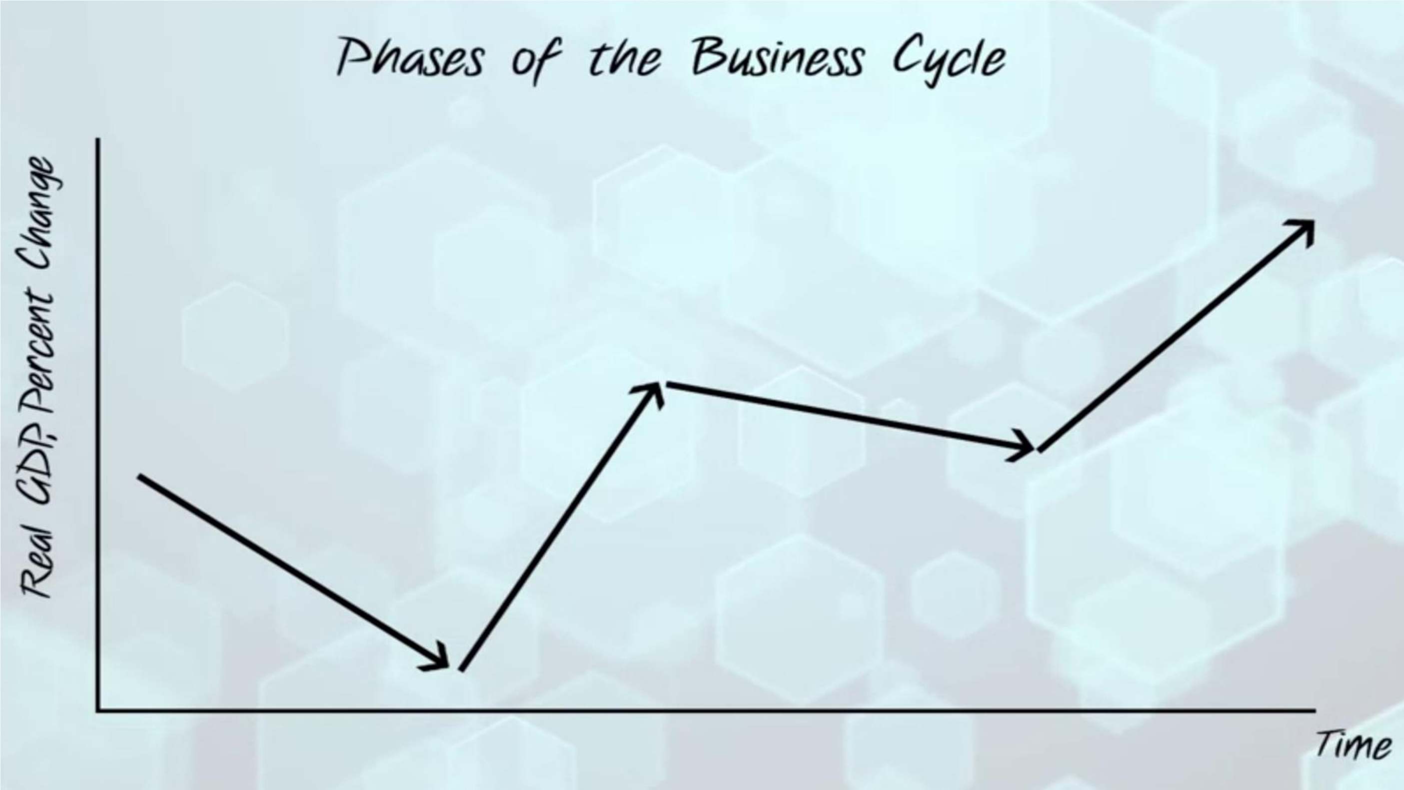
Real GDP → Adjusted for inflation → Constant prices for benchmark year

Key Point

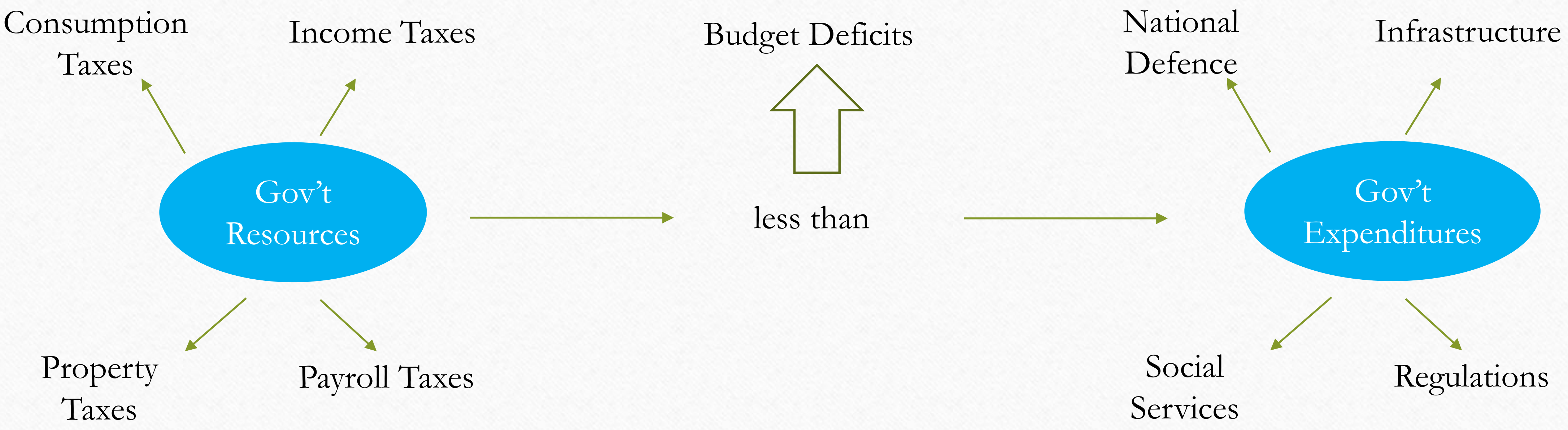
Best measure of a Nation's Output

Real Inflation-adjusted GDP

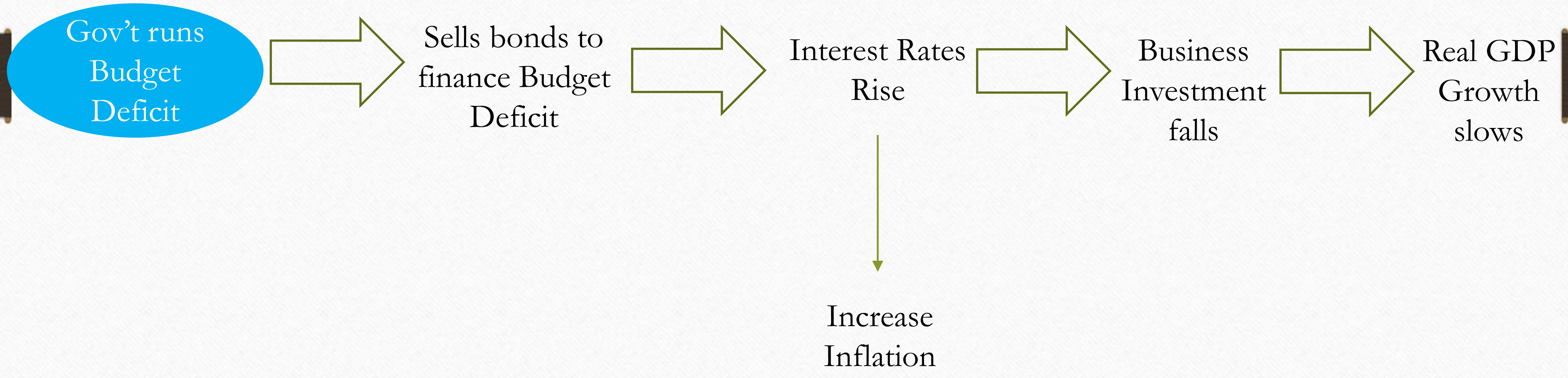
Movements in Real GDP chart the Business Cycle



The Big Macro Problems: Budget Deficits



The "Crowding Out" Effect



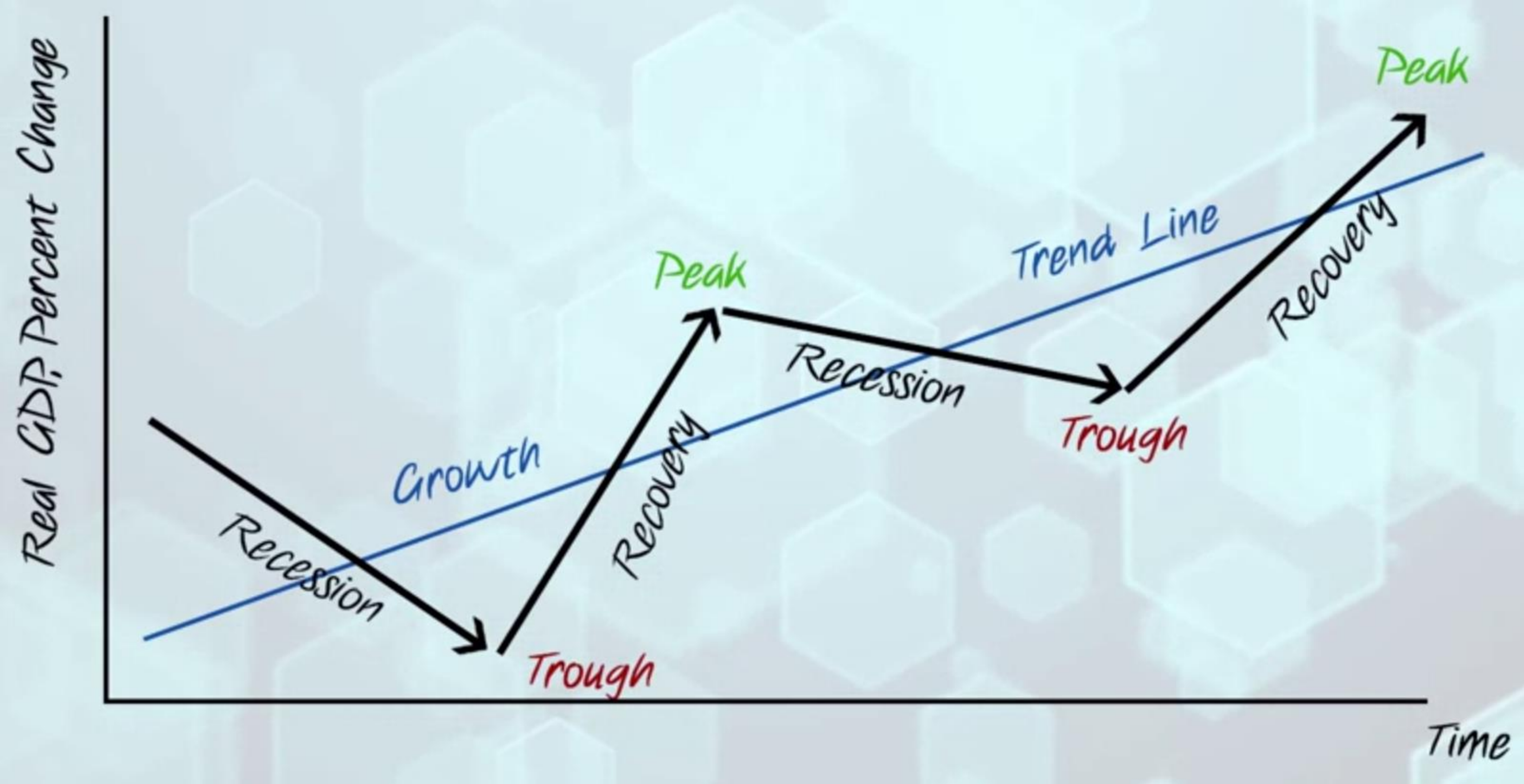
The Big Macro Problems: Trade Imbalances

GDP = Consumption + Business Investment + Gov't Spending + Net Exports

If Exports < Imports,
then GDP goes down

Key Point: Trade Deficits Drag Down GDP

Phases of the Business Cycle



Key Point

Business Cycles lack "Periodicity" → Nonrepeatable Internal Pattern → Can't Predict Future Cycles with Historical Data

What is a Leading Indicator?

Leading Economic Indicator → Measurable Economic Indicator → Changes in Advance of underlying Business Cycle

Example of a Leading Indicator

Consumer Confidence Rises → More Confident Consumers Spend More → “C” up => GDP up → Bullish Forecast

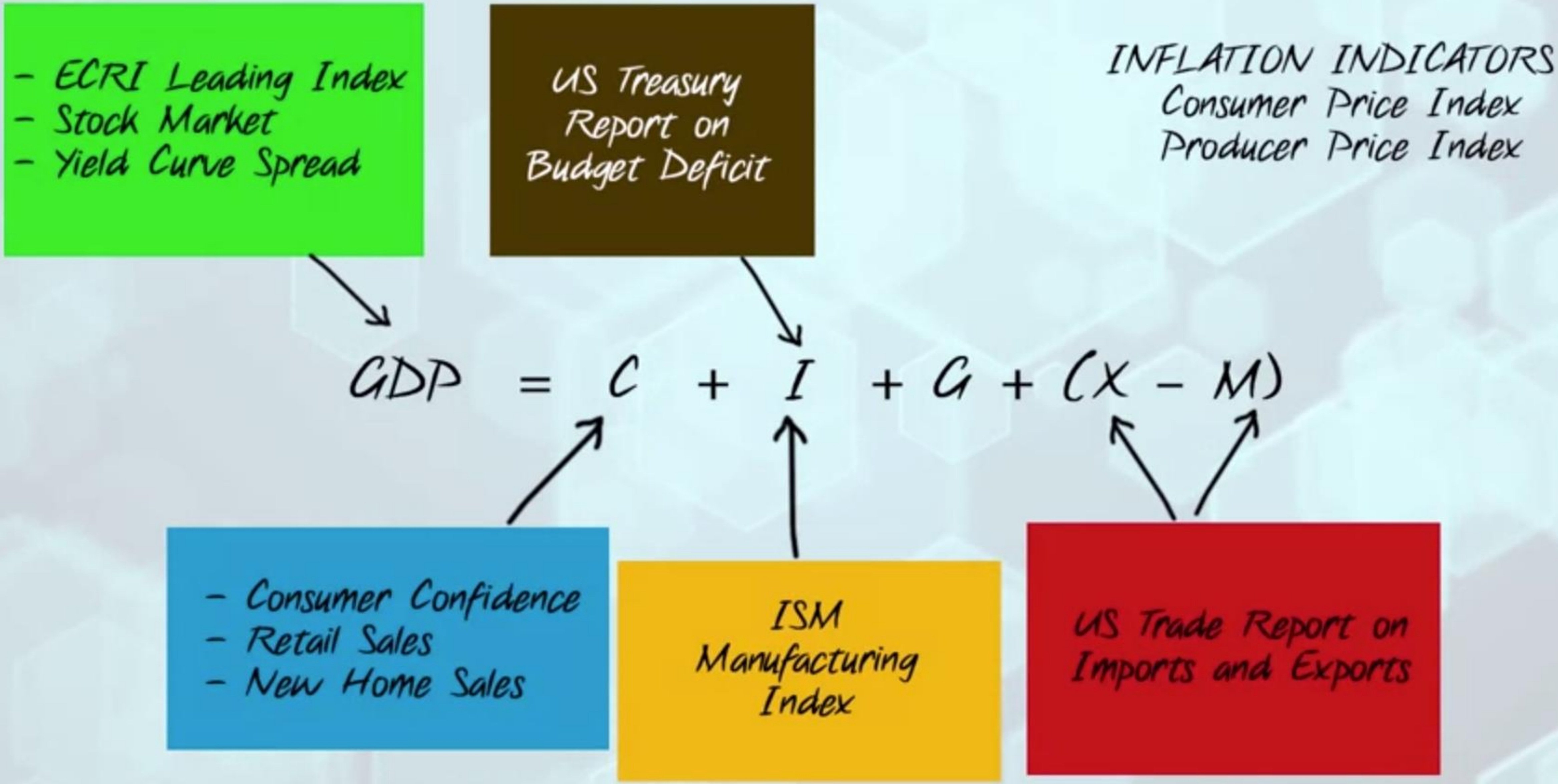
Consumer Confidence Falls → Less Confident Consumers Spend Less → “C” down => GDP down → Bearish Forecast

Key Point

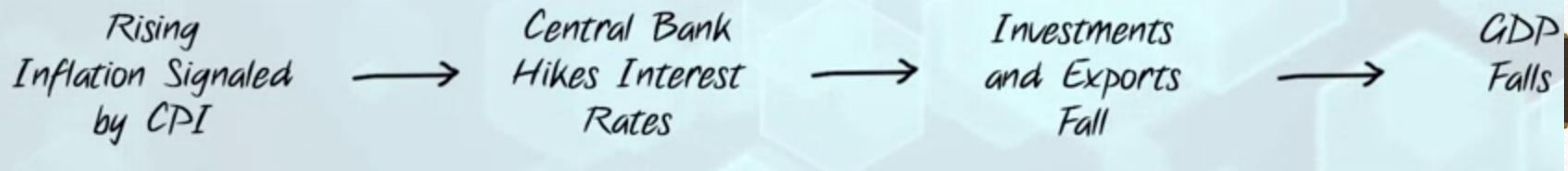
GDP = Consumption + Business Investment + Gov't Spending + (Exports – Imports)

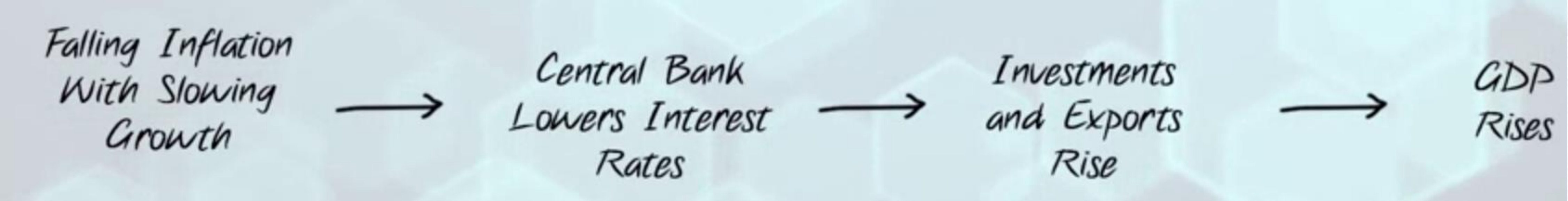
To forecast the business cycle, find & follow leading economic indicators for each of the five components of the GDP equation

An Illustrative Forecasting Model



Why Inflation Matters





Today's agenda

1. AD-AS Model

Key Debate in Macroeconomics

- **Do governments have a role to play in the economy?**
  - Correcting imbalances
  - Some economists advocate <u>active role</u> for government (Keynesians) vs
  - Other economists advocate <u>no role</u> for government intervention (Classicals)

  - Started with how to end "The Great Depression of 1930s"

Key Point

- How Macroeconomy adjusts during a recession and finds its way back to full employment?

Classical School: Prices adjust to cure the economy

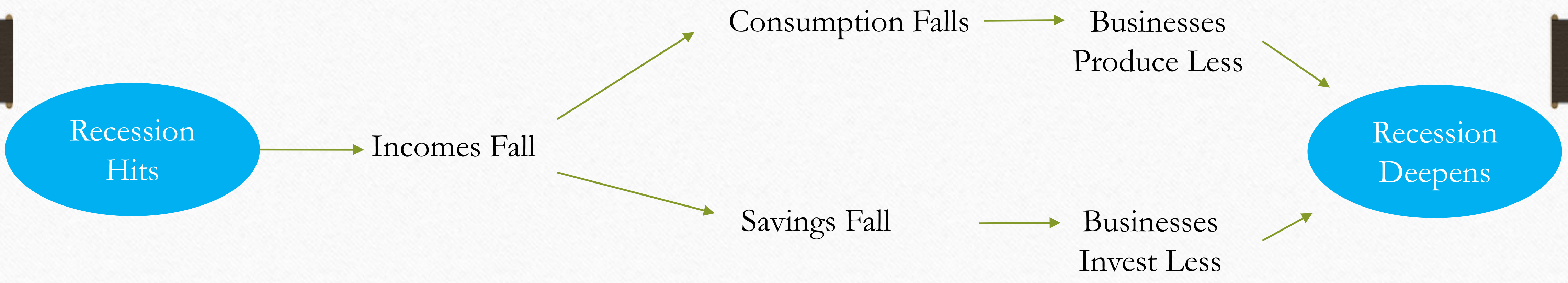
Recession Hits → Prices Fall → Consumption Rises → Economy Returns to Full Employment

Recession Hits → Wages Fall → Production Rises → Economy Returns to Full Employment

Recession Hits → Interest Rates Fall → Investment Rises → Economy Returns to Full Employment

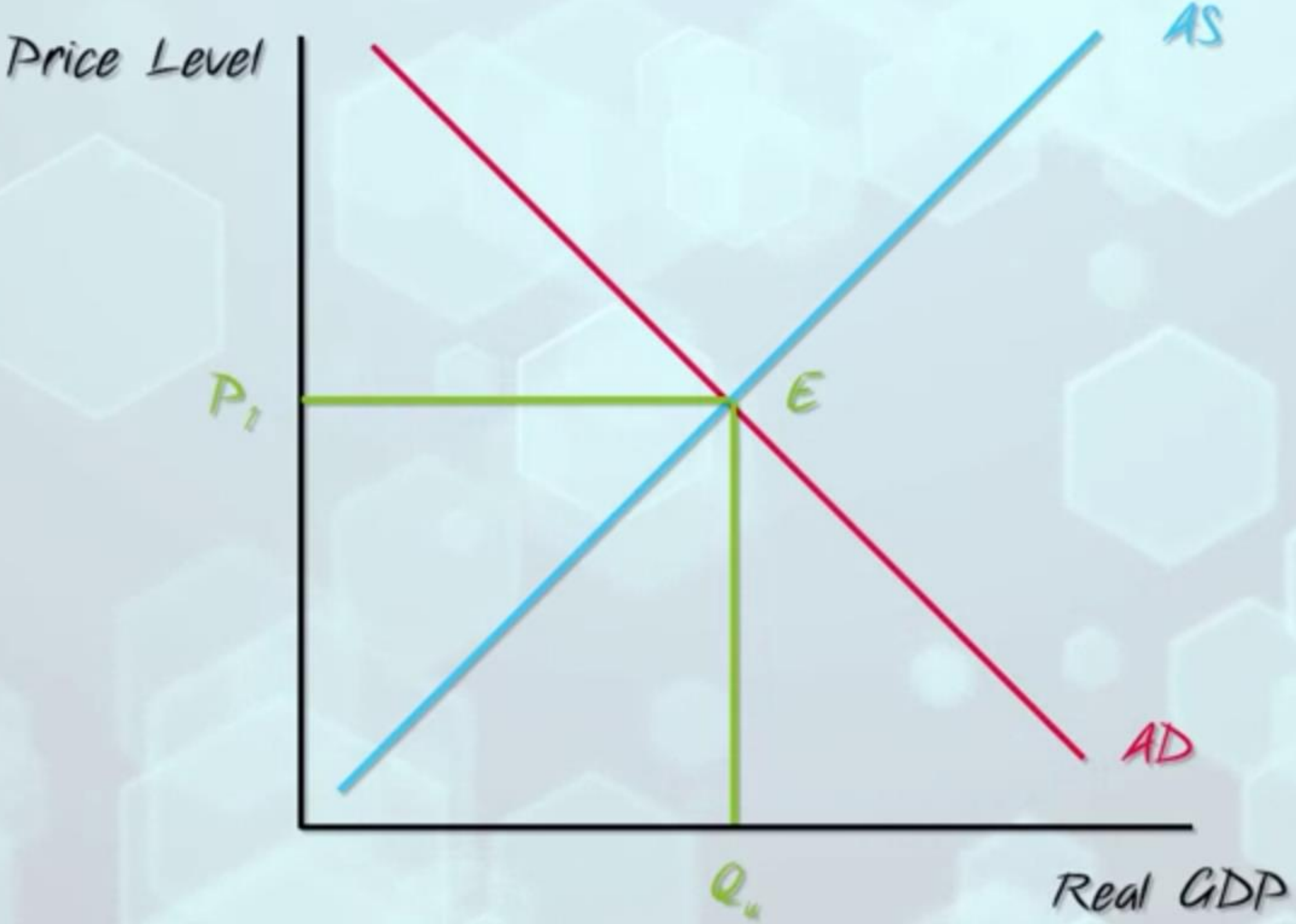
Implication: No Government Intervention Required (Markets are Self-Correcting)

Keynesian School: Before prices can correct, incomes will get severely impacted

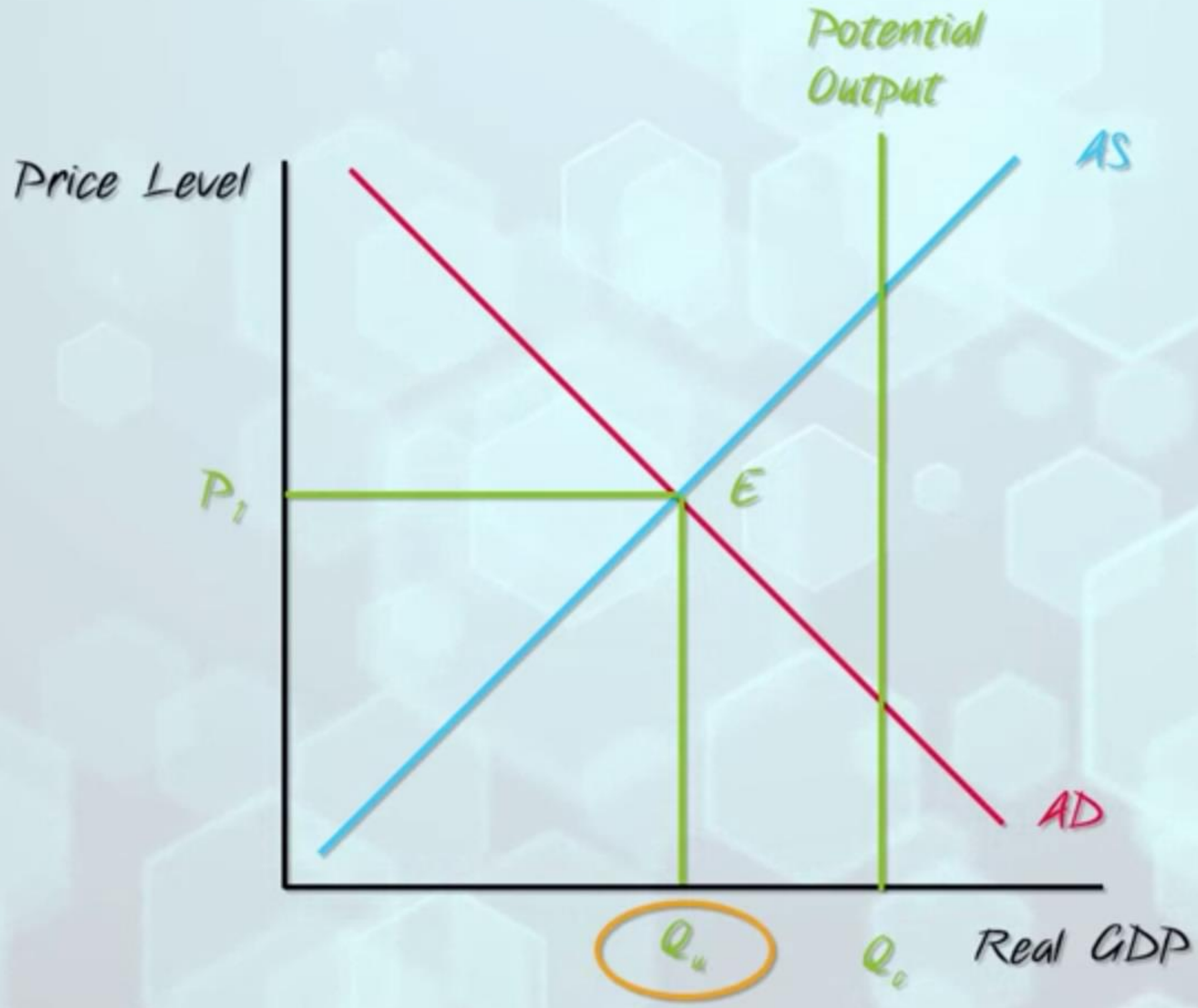


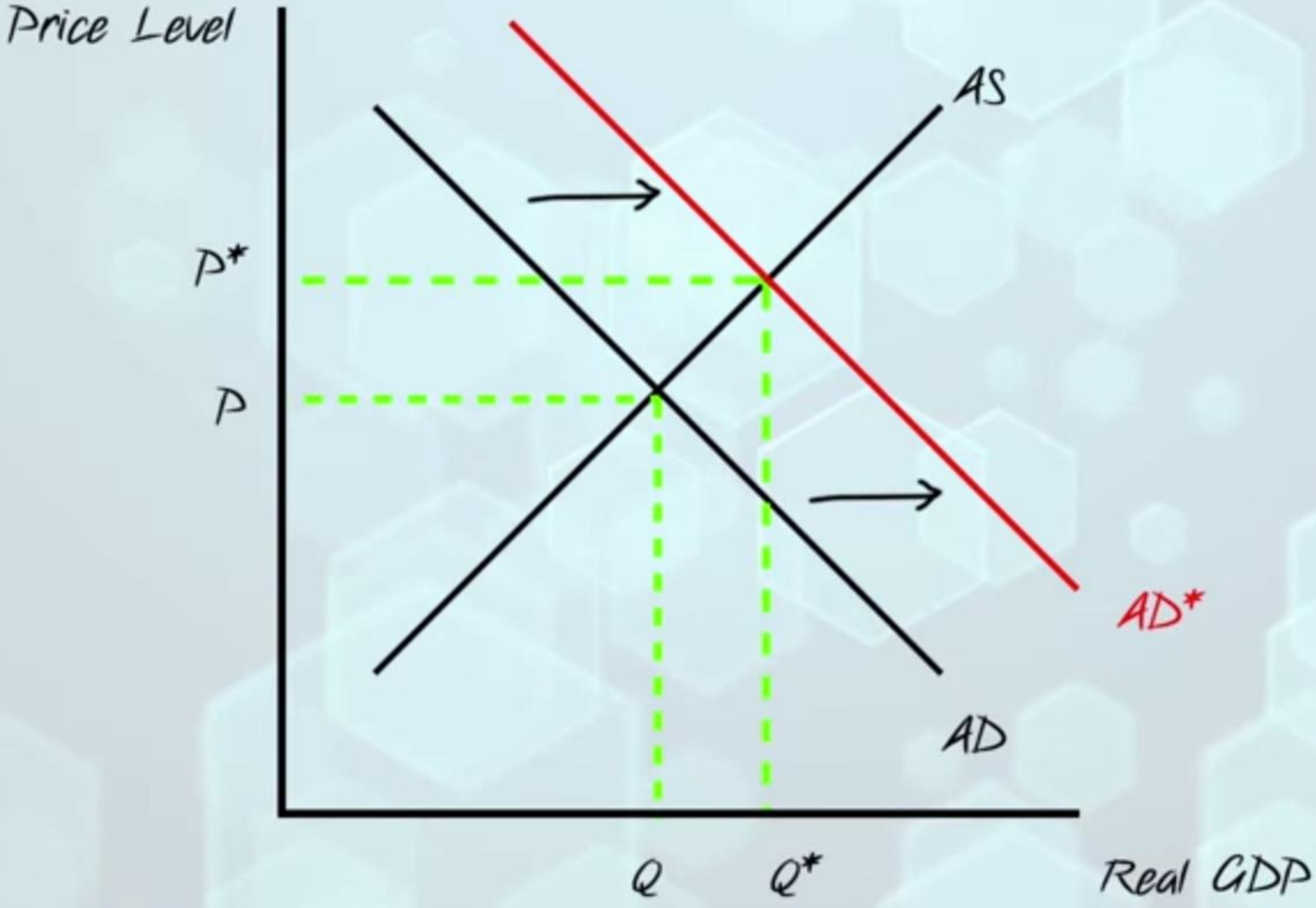
Implication: Active Government Intervention Required via Fiscal & Monetary Policies (No Self-Correcting Economies)

Aggregate Supply–Aggregate Demand Model



Aggregate Supply–Aggregate Demand Model




Price Level
AS
P*
P
AD*
AD
Q
Q*
Real GDP

Shift Factors for AD Curve

GDP = Consumption + Investment + Gov't Spending + Net Exports

Consumption
- Consumer Wealth
- Consumer Expectations
- Household Debt
- Tax Policy

Investment
- Interest Rates
- Profit Expectations
- Business Taxes
- Technology
- Excess Capacity

Gov't Spending
- Fiscal Policy
- Gov't Debt
- Political Control

Net Exports
- Exchange Rates
- Growth Rates in Other Countries

Aggregate Supply Shift Factors

- Factor Input Prices
  - Land
  - Labor
  - Capital
  - Energy
- Business-Government Environment
  - Legal
  - Regularity
  - Tax
- Technology
  - Innovation
  - Productivity

Think about these situations

- What happens when there is a shock such as disruptions in Oil Supply?
    - Prices & Quantity
- What would you vote for?
    - An income tax cut
    - Stricter environmental regulations
- What happens when technological inventions increase productivity?

Group Assignments 3 & 4

- #3: 15 marks out of 90
- #4: 20 marks out of 90