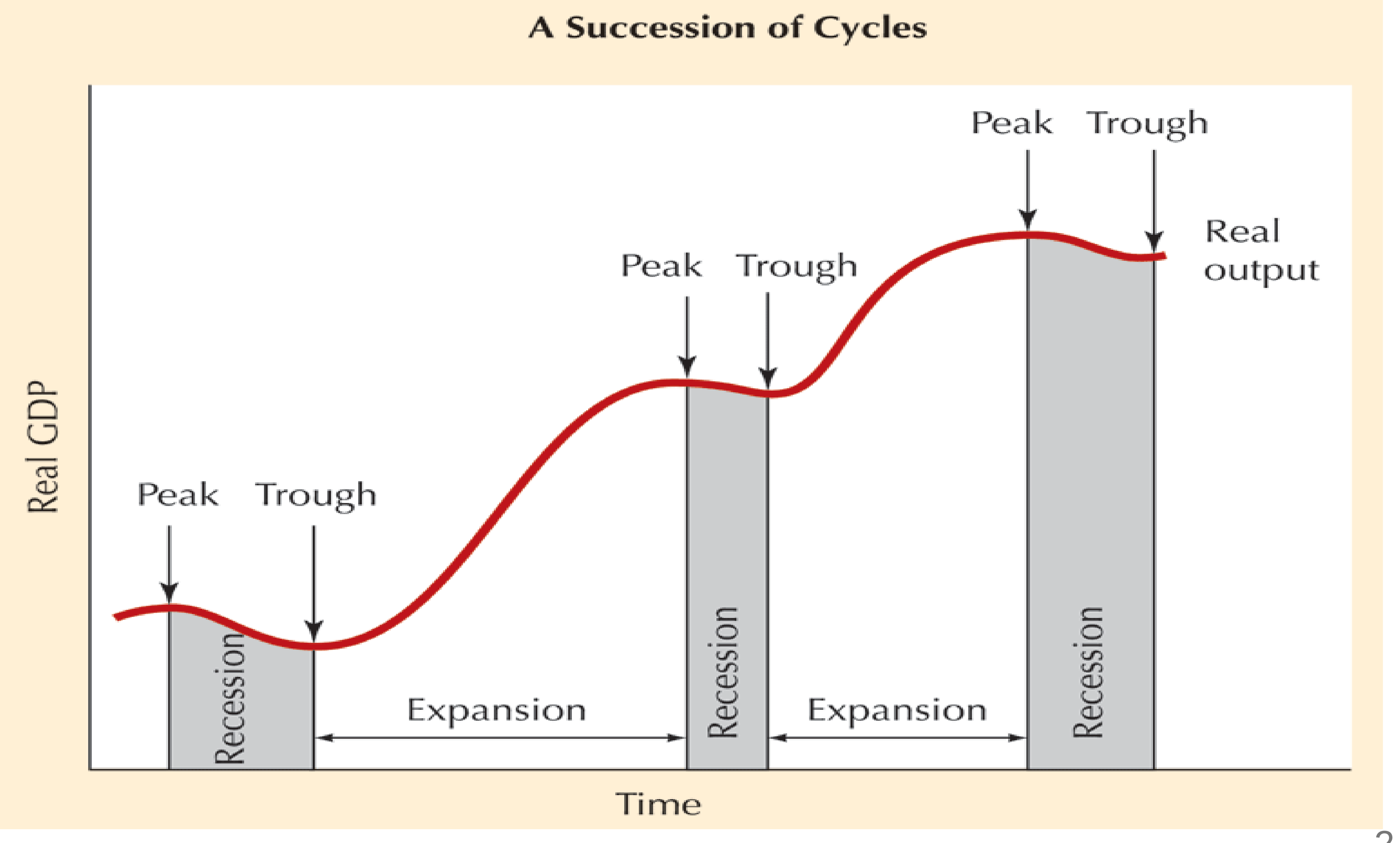
1. What is a Business cycle? What phase is the Bangladesh economy currently experiencing?

- **Business cycles** is the cyclical fluctuations and movements in the level of economic activity measured by changes in real GDP over a time horizon.

- The business cycle is a sequence of recurring but irregular fluctuations in economic activity - expansions or recessions

- A recession occurs when economic activity declines and real GDP per person falls

Basic Business-Cycle Concepts



Business Cycle: Phases

Economic activity typically follows a ‘cycle’ over time with four phases:

1. **Expansion** (boom) - economic activity is increasing
2. **Peak -** where economic activity maximizes after expansion before contraction
3. **Contraction** (recession)- economic activity is decreasing (recession/depression are severe)
4. **Trough -** where economic activity minimizes after contraction, before the upswing

The Business Cycle

- **Contraction** (downswing) is a significant decrease in aggregate economic activity or a slowdown in the growth rate of activity that lasts more than a few months
- A contraction begins just after the economy reaches a **peak** of activity and ends as the economy reaches its **trough** (decline in total production and total employment)
- Between trough and peak, the economy is in an **expansion** (increase in total production and total employment).
- A severe contraction, in which real GDP decreases for at least two quarters, is called a **recession.**

recession or depression!

- **ALL downturns or periods or decreasing economic activity are contractions, only some of these are depressions and recessions.**

- A contraction is defined as a recession if economic output has declined (negative growth) for two or more quarters.

- A depression is a prolonged period of declining economic output. So, not all contractions are necessarily a recession or depression

An Australian Business Cycle

- During the GFC in 2007–2008, Bangladesh had been in a trough.
- After recession Bangladesh economy might be in an ‘upswing’ situation
- This might be due to high import costs and current account deficit

2. Why is GDP an imperfect measure of economic well-being?

- GDP (Gross Domestic Product) is the market value of all final goods and services produced in an economy during a given period of time.
- GDP includes only the market value of the current production of final goods and services.
- GDP tends to be used as a measure of wellbeing – the idea here is the more goods and services people have the better off they will be. More goods and services produced, more income is generated will result in people being better off.

GDP Components

Components of GDP include:

$$Y = C + I + G + NX$$

- Consumption (C)
- Investment (I)
- Govt. Expenditure (G)
- Net Exports (NX) or (X-M)

GDP has many shortcomings as a measure of total production and a measure of wellbeing:

1. The ***distribution of GDP*** is not captured in GDP measures. GDP does not inform us on how the GDP/ income is allocated or shared amongst the population.

2. The value of Non-market production is not included in GDP:

- **Household production:** Goods and services people produce for themselves. Examples: Home cooking, cleaning, child care, gardening.
- **The *'black market':*** Buying and selling of goods and services that is concealed from the government to avoid taxes or regulations or because the goods and services are illegal.
- **Value of leisure**: In Economics (advanced) we may divide people's scarce time into working hours and leisure (non-working hours).

Shortcomings of GDP as a measure of wellbeing

3. Quantity and quality of healthcare and education – Healthcare and education are linked to well-being. An economy can produce a lot of goods and services and observe increases in GDP but what if availability/access to healthcare and education is low or too expensive. What if production of these is low quality?The level, quality of, and access to ***health care & education*** is not measured in GDP.
4. Negative production externality - Negative effects of productionGDP is not adjusted for **Externalities** or other negative effects of production.
5. GDP is not adjusted for changes in ***crime*** and other social problems.

Thus GDP may over estimate well-being

- *Ranking by Real GDP per person:*

Country	Real GDP per person	HDI
Norway	$37,670	0.963
United States	37,562	0.944
Australia	29,632	0.955
Singapore	24,481	0.907
United Arab Emirates	22,420	0.849
Greece	19,954	0.912
South Korea	17,971	0.901
Iran	6,995	0.736
China	5,003	0.755

- *Ranking by HDI:*

Country	Real GDP per person	HDI
Norway	37,670	0.963
Australia	29,632	0.955
United States	37,562	0.944
Greece	19,954	0.912
Singapore	24,481	0.907
South Korea	17,971	0.901
United Arab Emirates	22,420	0.849
China	5,003	0.755
Iran	6,995	0.736

3. Find the latest economic indicators for Australia and rate Australia's performance in terms of economic objectives (refer to (http://www.abs.gov.au/) and search for the Key Economic Indicators) :

i. rate of GDP growth (quarterly & annual)
ii. unemployment rate
iii. inflation rate (headline/underlying) (see RBA website for the underlying inflation rate, that is the 'trimmed mean' rate, (http://www.rba.gov.au/)

i. rate of GDP growth (quarterly & annual)

The "ideal rate" would be 0.9% for a qtr. and between 3.5 and 4% for an annual rate. Less than 3% annual is sluggish, but given state of world economy, Australian growth rate (2.5% March 2013) is ok.

ii. unemployment rate

6% May 2014 (trend) – given full employment is around 4.75% (with no cyclical unemployment). The current rate of U is okay, especially given the global environment. Unemployment has been slowly falling as economy recovers in 2008-2011, but rising a little bit in recent years.

iii. inflation rate (headline/underlying)

2.9% headline (March qtr. 2014) – includes all goods
2.6% underlying – excludes food and energy (subject to variation).
Target: between 2 and 3%. Inflation likely to rise when the economy gathers strength, tight labour market will increase wages, high oil prices will have an impact as well.

4. Describe the effects of the Business Cycle on the Unemployment and Inflation rate

- During expansions as GDP increases, unemployment falls while inflation (demand) increases (opposite during contractions). Full employment is reached at the peak of the cycle – referred to as the natural rate of unemployment.
- Australia's natural rate of unemployment currently estimated at 4.75%, according to Treasury.
- During contractions as GDP decreases, unemployment increases, while inflation (demand) decreases. Business confidence also declines
- When the economy begins to recover, the **unemployment rate** usually continues to rise for several months or even more than a year because:
  - Discouraged workers re-enter the workforce.
  - Some firms wait until conditions improve before hiring new workers.

5. Explain the economic costs of unemployment

Unemployment refers to those people who are willing to work, and have made an effort to find work but don't have jobs.

<u>Costs to Economy:</u>

- Loss of Gross Domestic Product / Income.
- Human capital may deteriorate because of idleness or lower skills.
- Retraining costs
- Unemployment benefit payments are a net drain on federal budget. Opportunity cost in terms of increased government expenditure (unemployment benefits) and decreased government revenue
- Loss of tax revenue – personal income tax, company tax, GST and excise taxes
- Unemployment is also linked to poverty and inequity in society
- Loss of self esteem.
- Unemployment may contribute to family break-ups, health problems, mental illness (e.g. depression), crime and political unrest (e.g. Spain and Greece in 2012-2013)

6. What is Inflation? Why is it a potential problem?

- Inflation is an increase in the *general price level* of goods and services in the economy over a period of time.
- It is a persistent, sustained and appreciable rise in the “price level” (average prices of goods and services) in the economy, not the price of just one commodity.
- Inflation is measured by the CPI (consumer price index) which measures changes in the average prices of consumer goods and services.

Causes of Inflation

- **Demand-pull inflation** is a rise in the general price level resulting from an excess of demand for all goods and services over supply.
- Prices are 'pulled up' by the pressure from buyers' total expenditures.
- Demand-pull inflation tends to occur when the economy is operating close to full employment – boom conditions

Causes of Inflation

- **Cost-push inflation** is a rise in the general price level resulting from an increase in the cost of production, irrespective of demand conditions.
- This could be caused by cost increases for labor, raw materials e.g. oil, construction, equipment, borrowing (interest rates) etc.

Does inflation impose costs on the economy?

- In general, wages rise with inflation, but they tend to rise AFTER prices.
- Inflation can, however, affect the distribution of income.
- The extent of redistribution depends, in part, on the degree to which inflation was *anticipated* or *unanticipated.*

- Cost of anticipated inflation:

(a) Menu cost: the cost of a firm changing its price

(b) Purchasing power of money declines

(c) Adverse tax implications

(d) Cost of capital for business increase

Does inflation impose costs on the economy?

– The problem with unanticipated inflation:

  – There are winners and losers, depending on whether inflation is higher or lower than anticipated.
  – For example: landlords who do not put rent up, will lose if inflation is higher than anticipated.
  – Borrowers may gain and lenders lose when inflation is higher than anticipated due to lower interest rates.

Does inflation impose costs on the economy?

- It ***redistribute income*** in arbitrary ways
- It ***diverts resources*** from productive activities to inflation forecasting.
- It increases ***uncertainty*** & reduces investment
- It decreases our international ***competitiveness***
- Eliminating inflation is costly because it brings a period of greater than average ***unemployment***.

	Winner	Loser	Explain
Pensioners and government	Govt.	Pensioner	Pensioner has to pay for goods and services at higher prices from a pension that remains the same. The government wins (sort of). It receives revenues at higher prices but pays expenses (pensions) at a fixed level.
Worker and firm	Firm	Worker	The firm is happy as it receives revenues (PxQ) at higher prices but its labour costs havent changed despite price increase.
Fixed rate contract Borrower and Lender	Borrower	Lender	The borrower pays a lower real interest rate. Lender receives a lower real interest rate. Real interest rate = nominal interest rate – inf rate. The real interest rate is interest earned on a lump sum of money offsetting its decline in purchasing power. Interest repayments have less value.
Investor and firm	Firm	Investor	Investor receives a return that is the same irrespective of price rises. Therefore the purchasing power of this return on investment is lower. The firm is happy. It is paying a rate of return percentage that is fixed even though it is adjusting prices by a higher percentage.