Chapter 1 Review Questions

1. Explain the difference between microeconomics and macroeconomics. How are the two related?

Microeconomics focuses on the decisions that households and firms make, usually to maximise utility or profits respectively. The outcome of these decisions explains how much household consume, firms produce, governments spend on public goods, etc.

Macroeconomics is concerned with looking at the economy as a whole. This is partly a case of aggregating from the micro-level, so macroeconomics has a strong micro-foundation. However, macroeconomics takes a general equilibrium approach, and acknowledges that the decisions taken at the individual level are linked by the circular flow of income. Therefore, the outcomes of an economy, and the design of policy need to acknowledge that the main players (households, firms, government, and financial institutions and the foreign sector) are interlinked and cannot be studied in isolation.

2. Why are economists interested in macroeconomic models?

The macroeconomy consists of a many linkages and interactions between the main players. Models are designed to simplify these, so the effects of shocks and policies can be predicted or analysed in a general equilibrium setting.

More advanced problem

3. 'Gross Domestic Product (GDP) is a good measure of a country's standard of living.' Discuss

Gross Domestic Product (GDP) is a measure of the gross output of a country in a given year. GDP per capita is this measure divided by the population, and gives a rough indication of average material living standards in a country. However, there are several arguments that this may be a poor measure of the actual 'standard of living'.

- Net national product (NNP) per capita
Part of the output of a country simply replaces capital stock that has worn out- this is referred to as depreciation- and therefore is not additional resources available for consumption. Also, part of domestic income will have been earned by foreign firms and workers and is repatriated abroad, whereas domestic households and firms will also have foreign earnings. The difference between these outflows and inflows is the net property income from abroad.

NNP = GDP - depreciation + net income from abroad

NNP if often referred to as national income, as it widely considered as a better measure of the resources available for consumption than GDP.

- Distribution of wealth
GDP per capita is an average measure of output per person; it does not describe how the output of a country is actually distributed. Two nations with very similar levels of GDP per capita could have vastly different inequalities in income.

- Freedoms and externalities
GDP is a materialistic measure, and therefore does not value the contribution to 'living standards' of more intangible commodities such as freedom and the environment. Externalities refer to items that are not valued in terms of market prices, but may have significant welfare effects. For example, an externality from industrial production may consist of pollution.

- Composition of output
Merit goods refer to items such as education and health that contribute to the welfare of society as well as the individual who consumes them. These might make a larger contribution to 'living standards' than say- military spending.

- Non-marketed output
Economies that have a high degree of subsistence agriculture, or unrecorded output due to black economies are likely to have higher living standards than official measured in GDP figures.

- PPP comparisons
To make international comparisons of living standards the GDP per capita of different countries needs to be converted into a common currency, usually US dollars. However, official exchange rates only reflect traded goods, and may not be a good measure of the actual purchasing power of $1 in each nation. Purchasing power parity (PPP) exchange rates take account of this and are therefore a better measure for making international comparisons.