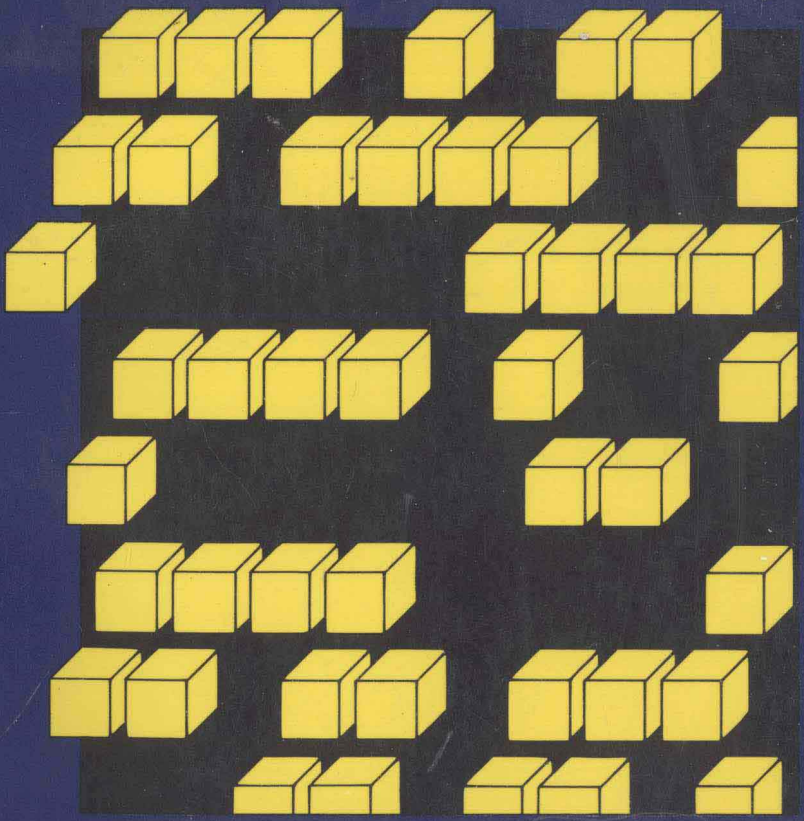
# UNDERSTANDING THE ECONOMY



Andrew Dunnett

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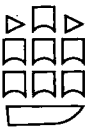
*Andrew Dunnett*



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# Preface

This book is directed towards first year students doing economics either as a single discipline or as part of a broader social science degree (such as business studies); at those students taking professional examinations (for example, in accountancy); and at students of A-level economics. My experience with students such as these over several years made me increasingly convinced that no suitable text existed, and indeed none has subsequently appeared. The problem with existing texts is that they are either too long-winded and weighty so that students miss the wood for the trees or too lightweight and descriptive with no strong analytical foundation. The applied texts which have appeared in recent years, though useful as supplementary texts, have no unifying structure running through them.

This book differs first in approach. It is non-mathematical since experience with my students has taught me that the effort involved in understanding the mathematics often stands in the way of an appreciation of the *economic* analysis. However, I take issue with those of my colleagues who equate the use of mathematical techniques with analytical rigour. The two never have been equivalent and I believe that this text is highly analytical, rather than descriptive, even though the mathematical techniques it uses are of the most rudimentary kind.

Second, the methodological approach of this book differs from that of existing texts, which tend to be naively empiricist, assuming that we can either prove or disprove a particular theory simply by looking at the data. Moreover, these texts tend to be complacent, in as much as they give the impression that economists understand the way the economy works – whereas, in fact, we do not. I have tried to integrate within this text a more sophisticated methodological position which should allow students to realize that economic theories are no more than *theories*. I have also tried to give students an appreciation of how these theories and ideas came to be developed, so that they can place them in their historical and political perspective.

Though I have pointed out the shortcomings of empiricism, I have, however, tried to encourage students to confront their

theories and prejudices with empirical data and to this end the book contains a fair amount of statistical material – enough, I hope, to whet the reader's appetite to seek out more for himself.

In addition to the difference in approach, the coverage of this book differs markedly from existing texts.

I place considerable emphasis on the open nature of the economy. This reflects my view that a book about the workings of a macroeconomy where one-third of output is exported (as it is in Britain) should not be the same as a book about an economy where less than 10 per cent is exported (as it is in the USA). Hence, I discuss the determination of the exchange rate and purchasing power parities in depth, and devote a chapter to international aspects of inflation.

There is a whole chapter devoted to economic growth and the post-war problems of the UK economy. I have spent some time discussing the current debates on, for example, Bacon and Eltis's contention that the public sector is too large, the de-industrialization debate, and the Cambridge Economic Policy Group's case for import controls.

I have also included a section on the Limits to Growth (which is only rarely included in macrotexts) and the recent work of Hirsch on the social limits to growth, which I think is quite important in establishing a perspective.

A whole chapter is devoted to an explanation of the relationship between the government's budget position, its borrowing requirement and the impact that this therefore has on the growth of the money supply and interest rates. This leads to a discussion of the merits of higher (or lower) public spending.

I have included a section on forecasting models. To some extent, this replaces the discussion of IS/LM analysis often found in macrotexts and is certainly easier to understand and probably of greater practical significance.

The labour market is discussed in rather more detail than one would normally expect to find in macrotexts. This reflects my view that it is a key area not just because of the inflationary forces therein but also because it is in the analysis of the labour market that the crucial differences between monetarists and Keynesians can best be seen.

Two related themes run through the book, helping to form a unified structure from the individual chapters. The first of these themes is to do with how prices are determined and therefore how inflation is caused (and by implication how it can be controlled). The second theme is the debate between the Keynesians and the monetarists and all that this entails, both in its economic and political aspects.

The over-riding consideration in deciding upon the form that

the book should take was the desire to give students a framework within which to analyse important contemporary policy issues. Whether I have been successful in this is something which the reader must judge for himself.

I would like to thank those of my colleagues who have given me help and support during that time at Ealing when this book was in preparation; in particular, John Crowley, Philip Wyatt, Carol Rees and David Glen. My thanks are due also to my wife, Jenefer, who typed the first draft of the book and to Gillian Hodges, who typed the final draft. My students did not help at all and yet somehow the whole exercise would have been pointless without them.

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# List of Abbreviations

| | |
|---|---|
| CCC | Competition and Credit Control |
| CSO | Central Statistical Office |
| GATT | General Agreement on Tariffs and Trade |
| GDP | Gross Domestic Product |
| GNP | Gross National Product |
| IMF | International Monetary Fund |
| IRR | International Rate of Return |
| MLR | Minimum Lending Rate |
| MPC | Marginal Propensity to Consume |
| MPS | Marginal Propensity to Save |
| NAFA | Net Aquisition of Financial Assets |
| NIESR | National Institute for Economic and Social Research |
| NNP | Net National Product |
| NPV | Net Present Value |
| OECD | Organisation for Economic Cooperation and Development |
| OPEC | Organisation of Petroleum Exporting Countries |
| PSBR | Public Sector Borrowing Requirement |
| PSFS | Public Sector Financial Surplus |
| RPI | Retail Price Index |

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# *Chapter 1*
# Models of the economy

## 1.1 A simple model of the macroeconomy

The purpose of this chapter is to present the reader with a number of models of the workings of the economy. For illustrative purposes, we shall first choose to talk about a desert island economy – one which is not subject to any outside influences. Suppose that there are just three people living on this island – doubtless the sole survivors from the shipwreck which left them stranded on this remote shore – and suppose further that each of these three individuals specializes in producing that in which he is most skilled. Individual A specializes in producing food, B specializes in making clothes and C specializes in making and repairing the crude dwellings in which they live. None of these three individuals is therefore self-sufficient, since each requires food, clothing and shelter to live, but by specializing and exchanging their surpluses, each of them is able to enjoy higher levels of consumption of food, clothing and shelter than if each person produced everything for himself. This island economy therefore possesses some of the features of a real world economy – people on the island act as individual economic units and there is specialization and exchange. There is one important feature which we have not mentioned, however. In the real world, exchange takes place by means of transactions involving the use of an acceptable medium of exchange, usually money. In the absence of any such medium of exchange, the alternative is to engage in barter transactions, that is, to swap goods for goods rather than goods for money. Let us make the rather unlikely assumption that on our desert island there is an acceptable medium of exchange and that therefore the inhabitants decide to engage in monetary transactions rather than in barter. Let us assume that the medium of exchange they choose is coins, no doubt salvaged from the shipwreck, and that the value of coins they managed to salvage totals £10. This therefore represents the money supply in our desert-island economy.

Let us further assume that the following chain of events takes place over a given period of time, say one month. Individual A,

who initially owns the £10, uses it to buy clothes from B. B, in turn, uses his income of £10 to pay C to repair his hut, and C, in turn, spends his income in buying food which A has produced. These transactions are illustrated diagrammatically in Fig. 1.1. We could therefore say that, in the month in question, total expenditure in our island economy was £30. This is equal to the total income of the three individuals and it is also equal to the value of the goods and services produced in the economy. Thus we could say, total expenditure = total income = value of total output of goods and services.

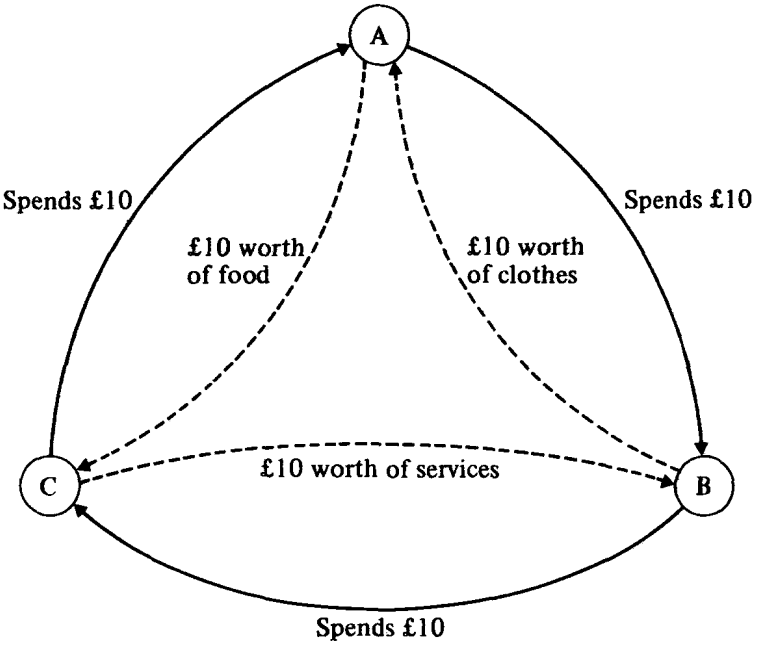


**Fig. 1.1**

What is true for our desert island economy is not necessarily true for our real world economy, but the equality between expenditure, income and output should be regarded by the student at this stage as something which is generally true.

It is important to note that total expenditure at £30 per month is financed by a money supply of only £10. The relationship between the flow of expenditure and the stock of money is given by the velocity of circulation of money. In our example this velocity is three times per month, that is, each pound changes hands three times in every month. In a year, therefore, money can

be expected to change hands $3 \times 12 = 36$ times, and we would therefore say that the velocity of circulation is thirty-six times per year.

If the events of this one month are repeated throughout the rest of the year, total expenditure will be $12 \times £30$ or £360 per year and this will be equal to total income and the annual value of output (or total product as it is usually known). If we consider our three individuals as comprising the whole of the national economy then we can say that, national expenditure = national income = national product = £360 per year.

Per capita income is therefore £120 per year, but this unfortunately tells us nothing about the standard of living of our three individuals. That is, we cannot say from this information how much food, clothing and shelter the inhabitants are able to consume. We know the value of total output but we do not know what volume of goods and services this represents. To emphasize this point, consider what would happen on our desert island if the stock of money were doubled to £20. If we assume that the velocity of circulation remained unchanged at 36 times per year, then the value of national product would be £720 per year. This may represent a real increase in the value of goods and services produced and sold, or it may simply reflect a fall in the value of money, such that the purchasing power of each pound is only half what it was previously. Thus we should be careful to distinguish between increases in the real value of national output and increases in the money value of national output.

In many ways our desert island economy is not a particularly realistic model of a real economy. It has no contact with other islands, so there is no foreign trade. There is also no government on the island so there is no such thing as taxation or public spending. A more subtle point, however, is that the standard of living of the inhabitants may well be much higher than our estimates of national product would have us believe. That is because if a statistician were preparing national income accounts for our island he would include only those goods and services which were the subject of money transactions. He would thus exclude all the food which A produced and consumed himself, all the clothes which B produced and consumed himself, and the value of all the work which C did on his own shelter. If all of the individuals on the island were self-sufficient and did not indulge in money trade with their fellows then conventional methods of measuring national output would value it at zero. This failure to take account of 'home production' (that is, the production of goods for one's own consumption) also occurs in real economies, but it is likely to be a more serious shortcoming in the national accounts of our desert island.

## 1.2 A model of production and consumption

Our second model of the macroeconomy contains not three individuals but two *sectors*, a household sector (H) and a firm sector (F). In order to simplify matters initially, we will make the following assumptions:

(i) The economy is 'closed', that is, there are no imports or exports in our model.
(ii) Households spend all their income. They spend it, of course, on the output of the firm sector.
(iii) The firm sector is able to sell all that it produces. That is, firms do not build up stocks or run down stocks.
(iv) The firm sector is ultimately owned by the household sector, because all the paid up share capital of firms is held by households.

The model, which is illustrated in Fig. 1.2, has a consumption side to it and a production side. The right-hand side illustrates the consumption aspect, where we have assumed that the flow of

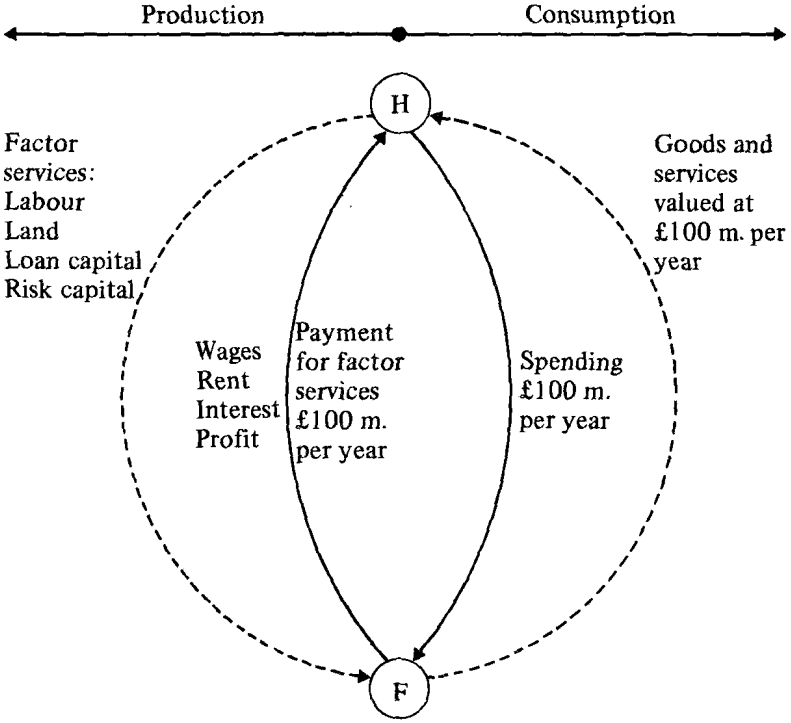


**Fig. 1.2**