WHAT YOU NEED TO KNOW ABOUT ECONOMICS

GEORGE BUCKLEY & SUMEET DESAI

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CONTENTS


INTRODUCTION

Have you ever wondered what makes an economy tick, and why recessions happen? Or why prices rise and fall? Why do governments borrow money, and why does it matter if they borrow too much? What causes unemployment? Why are house prices so important for the economy? And what is it that causes our savings rates and the cost of borrowing to move up and down?

If you have, then you're already interested in economics.

These are the sort of issues that we hear about every day in the newspapers and on the television news. There's always been a certain fascination with what's going on in the economy. This has been particularly true since the global credit crisis, with the recession that followed having had such as large impact on economies and businesses worldwide.

Never has it been more important to understand what's going on in the world of economics. The last few years have shown us that we can't always rely on strong economic growth and a rate of inflation that remains stable from one year to the next. Sometimes things go wrong, and when they do the economy is rarely out of the news.

To the uninitiated, understanding economics can be a daunting prospect. Sometimes news stories assume that the reader, viewer or listener knows more about economics than is actually the case. But you don't need a degree to understand economics. In fact, economics is a very

logical subject and the basics can be grasped very easily. It is no coincidence that the eighteenth century economist Adam Smith – dubbed the Father of Economics – began his career at Glasgow University as Professor of Logic.

What this book aims to do is to provide a basic introduction to the subject of economics. Understanding economics is one of the cornerstones of running any business. So having a feel for what's going on in the economy will give you a much better idea of the factors that are driving your business – both now and in the future.

Whether you're in business and want to have a better feel for the economic forces that are affecting your bottom line, or you're just looking to improve your general awareness of how the economy works, then this book provides a simple introduction to the subject. It explains key economic ideas in simple terms, and we hope it will whet your appetite for reading more about the subject of economics in the future.

So, in summary, if you're after an introduction to the broad field of economics then you need look no further than this book. Economics is a fascinating subject, one which is becoming ever more popular within schools and universities up and down the country. Take a look in your local bookshop and you'll see how much interest there is by the number of books on popular economics and, in particular, the recent credit crisis.

This book gives you the resources you need to get a clearer picture of how the economy works, what economic developments mean for you and your business, and an ability to better understand the economic analysis and discussion you read in the newspapers and see on television every day.

CHAPTER 1

GROWTH

WHAT IT'S ALL ABOUT

- How to measure the size of the economy and how fast it's growing
- How flows of money move around the economy
- How people's incomes affect their decisions about spending or saving
- How activity moves up and down but generally rises over time
- Why a rise in spending can have a magnified effect on the economy
- What recessions are and why they happen

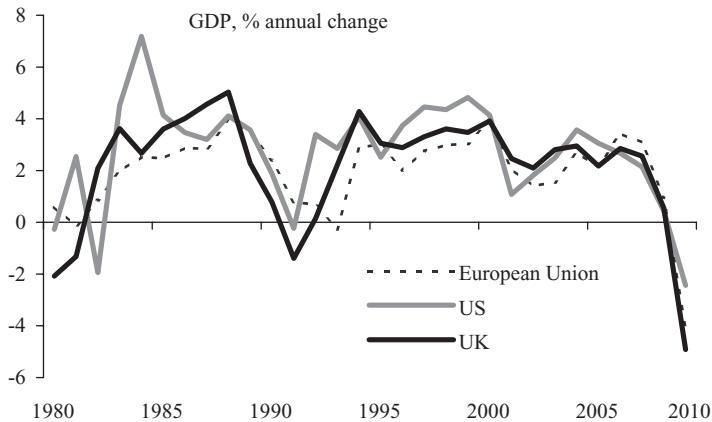
WHAT IS ECONOMIC GROWTH?

We hear regularly on the TV and radio news, and in newspapers and online, about how quickly the economy is expanding or – as has been the case during the financial crisis – contracting. But what exactly is this thing we call 'the economy', and how do we measure its size and rate of growth?

The size of the economy is often referred to as GDP – which stands for 'Gross Domestic Product'. One way to measure the size of the economy is to add up the total amount (Gross) in a country (Domestic) of all the goods & services made (Product). This is called the *output* measure of GDP, but there are two other ways we can get to this number. We can add up the total amount that we *spend* on goods & services. Or we can measure economic activity by looking at the total amount of *income* that has been earned.

We usually measure economic activity over a period of three months – a 'quarter' – or over an entire year. The rate of economic growth is then simply the percentage change in GDP from one quarter to the next (the quarterly growth rate), or from one quarter to the same period a year later (annual growth). Sometimes, the quarterly growth rate is shown as an 'annualised' figure – in other words, how quickly the economy would grow over an entire year if it continued at the rate achieved during that one quarter.

Growth in the US and Europe over the past 30 years



THREE MEASURES OF ACTIVITY

The three measures of GDP, or economic activity, outlined above should be identical, in theory at least, because any *income* earned is then *spent* on the goods & services that have been *produced*. In practice, however, it is difficult to measure economic activity precisely so getting the three measures to equal one another can be difficult. Let's take a closer look at these different ways of working out the size of economy.

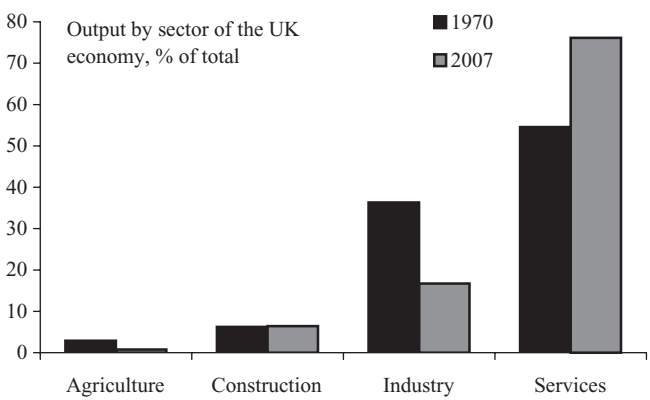
1. Output

The output measure adds up the value of all goods & services produced in the economy. This includes

the output of manufacturing, mining and energy supply companies – collectively called 'industrial production' – as well as construction and agricultural output.

It also includes the output of the service industries, even though they do not make physical products like manufacturers do. These include transport and telecommunications firms, restaurants, hotels, banks, accountants and estate agents to name but a few – all of which provide valuable services to the economy. In developed economies such as the UK, US and Europe, the service sector has become much more important in recent years, while the manufacturing base has become ever smaller.

Shifts in the structure of the UK economy



2. Income

We can measure GDP by adding together how much is earned across the economy. This means adding together wages paid to workers, rent paid to land owners and profits paid to the owners of firms. You may sometimes hear these three key inputs – labour, land and capital – referred to as the 'factors of production'. This is because they are the three basic components, combined together with technological know-how, required when we produce goods & services.

3. Spending

Most importantly, let's turn to the spending measure of GDP. If we were to measure the size of the economy by looking at everyone's outgoings we would need to think not just about how much we spend as individuals, but spending by other groups too. Investment spending by firms, for example, must be included. We often think of investment as the purchase by a firm of buildings and machines, but we must not forget that when firms change their stocks (or inventories) that is also a type of investment because they can be stored and sold at a later date. Governments spend money on goods & services – both current expenditure and for investment purposes – which is also a part of GDP. It is worth noting that we do not include benefit payments like jobseekers' allowance – these will already be included in how much *individuals*

receive from the government which they may then go on to spend, so to include it would be double counting. Finally, we also add in how much is spent by people abroad on our exports, less the amount we spend on imports from abroad (as the latter represents an outflow of money from the economy).

So, in summary total spending in the economy is made up of:

- how much households spend;
- investment by firms (including stock-building);
- spending by the government;
- spending on exports (less imports).

HOW IT ALL FITS TOGETHER

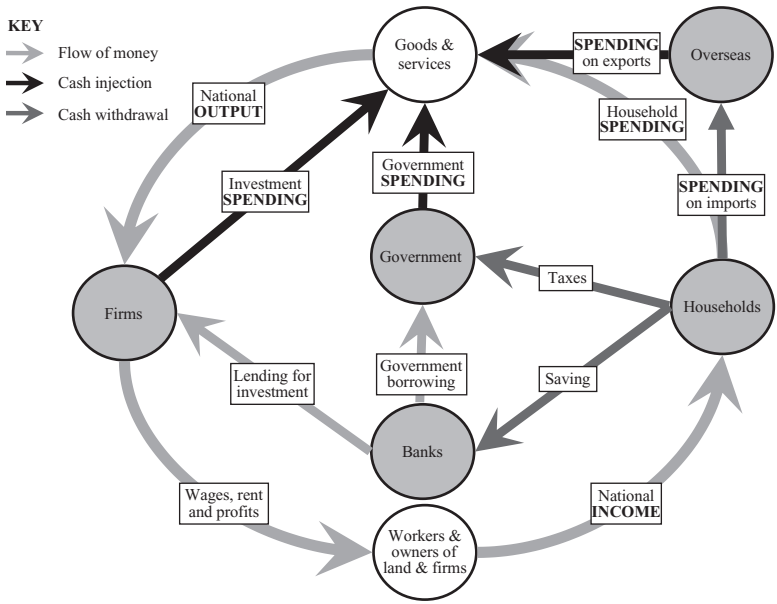
The interaction between these groups – households, firms, the government and the international sector – in an economy is called the 'circular flow of income', and getting a flavour of this helps us understand how economies work. Put simply, firms produce goods & services and pay their employees an income for doing so. Firms also pay rent to landowners while the profits go to the firms' owners. Households then use some of that income up by spending it on the goods & services produced by firms – which is why it is called the *circular* flow of income. The best way to show all of this is in the diagram on page 12.

As you can see, it is not *quite* as simple as that. As income moves round this circular system, some money is removed, but at the same time some money is injected back in. Money can be removed in three ways: (i) by spending on imports (as the money goes abroad), (ii) paying taxes to the government, and (iii) saving money in banks and other financial institutions. Additions of money come about in similar but conceptually opposite ways: (i) people abroad spending money on our exports, (ii) the government spending taxpayers' money on public services, and (iii) firms borrowing people's savings from banks to invest.

When the amount of cash that leaves the circular flow (imports, taxes, savings) is the same as the cash that enters the system (exports, government spending and investment) then we have some sort of happy balance – or, as economists call it, 'equilibrium'. When they don't match up this can cause either the economy to run too fast (additions higher than withdrawals) or alternatively too slow (withdrawals higher than additions).

In the diagram overleaf, the grey circles are the various groups or 'sectors' in the economy, while the white circles show the markets for jobs as well as goods & services. The arrows refer to money flows – the red ones represent money removed from the system, the blue ones money added back in. Take some time to look at this diagram and it should become clear how it all fits together. In particular, it helps to explain why the output, income and spending measures of GDP should all be the same – because they are just measuring the flow of money at

The circular flow of income



WHO SAID IT

An individual is "led by an invisible hand to promote an end which was no part of his intention … By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it."

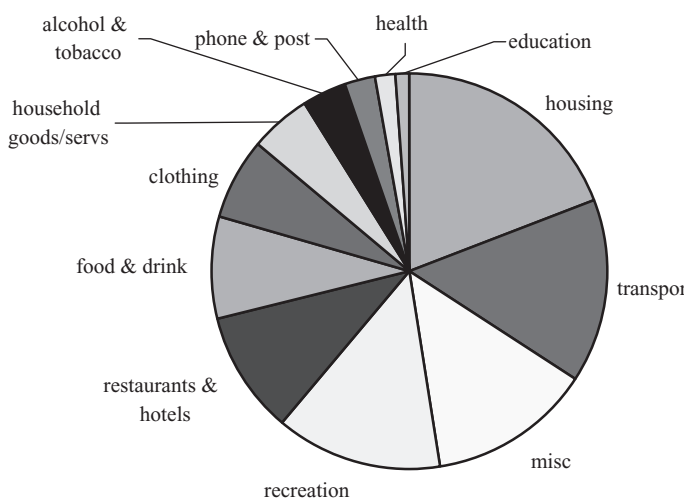
– Adam Smith

different points in the circle (the three measures are shown in capital letters in the diagram above to make them easier to spot).

FOCUS ON HOUSEHOLD SPENDING AND INVESTMENT BY FIRMS

Let's think about the spending measure of GDP. We take a more detailed look at government spending and international trade (exports and imports) later on in the book, so for now let's focus on the main factors influencing spending by households and firms.

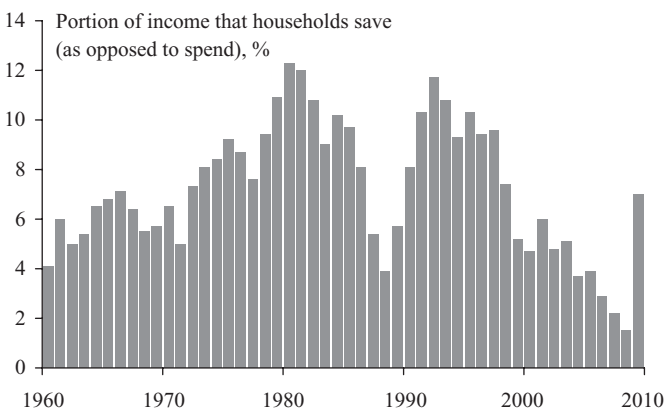
What UK households spend money on



Household spending is one of the most important components of total expenditure because it is worth such a large portion of the economy. In fact, in many advanced economies around two thirds of all spending is done by households. The previous chart shows what we spend our money on in the UK. Close to half of it goes on what we might term necessities – things like housing, transport, food and drink, health and education – which probably does not change that much from one year to the next.

When we choose what portion of our income to spend, we must also make a simultaneous decision about what portion of income we want to save. This is called the household saving ratio and is shown in the chart below for the UK.

Movements in the UK household saving ratio over time



Over the years there has been a lot of important work done to investigate how households decide how much to spend and save at any point in time. There are lots of things that will affect this decision, including interest rates, for example (higher rates dissuade spending because it is more costly to borrow, and encourage saving because of higher returns). Even the value of our homes or the shares we might own could affect how much we spend – the more wealthy we feel, the more likely we are to buy things. This is called the 'wealth effect'.

Leaving these influences aside, one of the biggest debates among economists in the past has been about how the *level of income* affects spending. Back in the 1930s, John Maynard Keynes – one of the most important economists of all time – argued that the amount of money people spend would depend mainly on how much they *currently* earn in their job.

While that might sound reasonable, it seemed too crude to Milton Friedman, an American Nobel Prize winning economist who looked into these issues back in the 1950s and 1960s. He argued that how much people will spend depends not only on their current earnings, but also on how much they think they will earn in the future – something he called 'permanent income'.

This is an important conclusion for two reasons. Firstly, because it means that people will *smooth* their spending over time. In years where a person's earnings have been especially good they may squirrel more of it away, so they

WHO YOU NEED TO KNOW

John Maynard Keynes

John Maynard Keynes was one of the most influential economic thinkers of the twentieth century. Keynes devoted his time looking at a branch of economics called *macroeconomics* – the study of how the economy operates as a whole. In his work published between the two world wars (the most important of which was *The General Theory of Employment, Interest and Money*, 1936) he looked at the factors that determined key economic variables such as interest rates, inflation, output and unemployment.

He argued a key driver of economic activity was the difference between how much people want to save and how much firms want to invest. Unlike the views of his predecessors (the 'classical' economists such as Adam Smith), Keynes believed interest rates would not always be at a level that would equilibrate the two. Too *much* saving would mean not enough spending, which in turn could cause recession. While too *little* saving could cause a boom in consumer spending and in turn lead to higher inflation.

Keynes was a firm believer in intervention by the central bank and the government. Leaving the economy to its own devices (a policy known as 'laissez faire') may mean a prolonged period of too much or too little activity. By changing interest rates and public spending/taxes, economic activity and inflation could be managed by the authorities over a shorter period. He even went as far as to say that if total, or 'aggregate' as economists call it, demand in the economy was too low (and unemployment too high), governments could help by burying banknotes in bottles which people would then dig up and spend! To be a 'Keynesian', therefore, means to support government intervention in the economy through a process of 'demand management'.

can draw upon it in bad years when their income may be lower. Someone who is worried about losing their job, for example, might opt to save more now so that they have savings to see them through their period of expected unemployment. Secondly, it means that government intervention – such as tax cuts – may not have the desired effect to support the economy. The reason is that people may not spend all of their extra disposable income if they think the government will only end up raising taxes again in the future.

The economic data shows this smoothing of consumer spending to be true – the amount households spend is not only one of the largest but also one of the *least variable* components of total spending in the economy. Economists call the proportion of income that people spend – as opposed to save – the 'propensity to consume', which for both individuals and society as a whole will depend on income distribution. For example, people who are less well off tend to spend a greater portion of their income than richer people do.

The relative stability we see in consumption is not the case when we look at how much businesses invest, however. Investment is usually a smaller part of total spending than consumption, but it can change quite quickly. Keynes said this was due to the 'animal spirits' of investors. As a result, investment swings can have a large effect on the rate at which the overall economy grows – both on the upside during the boom and on the downside during recessions.

How do firms decide how much to invest? If firms can't keep up with the amount of demand there is for their product, then they probably need to invest so they can produce more. On the other hand, if they are producing too much relative to what is required then they may need to invest less – or even retire some of their existing plant or machinery. In this case we say the firm has 'spare' or 'excess' capacity.

The cost of increasing the workforce must be accounted for, because more machinery will likely mean more people required to operate it. And the price of what the firm sells compared with the cost of investing – the interest rate – will be an important consideration too. Unlike Keynes, classical economists believed that interest rates in the market should, without intervention, eventually move to a level whereby households will want save as much as firms desire to invest.

VOLUMES, VALUES AND THE SEASONS

Before we begin to look at economic cycles, there are two more things that are important to know about GDP.

First, this may sound obvious but the size of the economy will vary depending on the time of year. For example, economic activity is usually higher from October to December than it is during any other quarter

of the year as production, spending, and income are all raised for Christmas. Distortions such as this can make it difficult to analyse the underlying trend in the economy, so we usually adjust GDP for such seasonal influences. That way, if adjusted output rises strongly towards the end of the year we can be sure it is because of something else other than the usual Christmas effect.

The second issue relates to prices. So far, you might have assumed that we've been talking about GDP in cash, or 'nominal', terms – in other words, the *value* of output produced or bought, or income earned. But normally when we hear about economic activity it is in 'real' terms – the *number* of goods produced or bought, or how many can be bought with the income we earn.

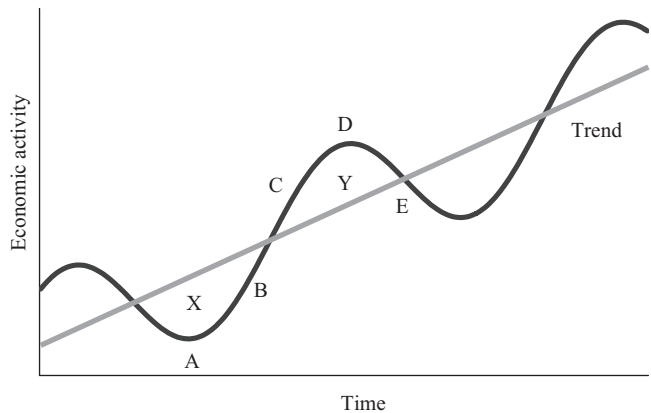
Consider the following example. Imagine the economy only produces handbags, and 100 are sold in the first year at a price of £10 each. In the following year, let's say the same number is sold, but the price has risen to £15 each. *Nominal GDP* in this case would have risen by 50% from £1000 to £1500 between the two years, but *real GDP* – the amount physically produced in the economy – would be unchanged.

There will be occasions when we prefer to look at nominal instead of real activity, but generally speaking when we talk about the growth rate of an economy we are referring to the volume of (or real) GDP.

BUSINESS CYCLES AND TREND GROWTH

As we have seen, the rate at which the economy grows can vary considerably over time. Sometimes activity growth is strong, sometimes it is weak, and on occasion activity actually contracts, as it did sharply in many developed countries during the recent financial crisis. This process of ups and downs in GDP around a generally rising trend is referred to by economists as the 'business cycle'.

The business cycle



Let's examine the phases of a normal business cycle using the graph above, starting at point A. This is pretty much where many advanced economies stood

immediately after the recession of 2008–09. Activity in most countries had stabilised after falling sharply during the banking sector crisis, reflected in the line flattening out.

Following a recession, the next stage of a typical economic cycle is recovery, indicated by points B and C. Economic activity at first begins to increase slowly before speeding up (point B) as it bounds back from its recession-lows (it's worth just reminding ourselves here that the line in the graph above shows the *level* of activity – so the steeper the line, the faster the rate of growth).

As the economy continues to grow, probably supported by the central bank and the government (interest rates and taxes will likely have been lowered, while government spending should be higher too), activity eventually moves back above its trend level (point C). The growth rate here is becoming faster – probably because of something known as the 'accelerator theory'. As GDP recovers so too do firms' profits, in turn leading to greater investment, employment and incomes. Some of that income is then spent on goods & services, which feeds back into greater profits and the process continues.

A good way to understand the accelerator is to think about a football team. As the team's performance improves it moves into a higher league. The team then receives more money which can be spent on better players. That improves performance, resulting in a higher league position, more money and (once again) better players.