

John Sloman • Alison Wride • Dean Garratt

ECONOMICS

Ninth Edition



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ECONOMICS

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About the authors



John Sloman is Visiting Fellow at the University of Bristol and Associate of the Economics Network (www.economicnetwork.ac.uk) a UK-wide organisation, where, until his retirement in 2012, he was Director. The Economics Network is based at the University of Bristol and provides a range of services designed to promote and share good practice

in learning and teaching economics. The Network is supported by grants from the Royal Economic Society, the Scottish Economic Society and university economic departments and units from across the UK.

John is also Visiting Professor at the University of the West of England, Bristol, where, from 1992 to 1999, he was Head of School of Economics. He taught at UWE until 2007.

John has taught a range of courses, including economic principles on social science and business studies degrees, development economics, comparative economic systems, intermediate macroeconomics and managerial economics. He has also taught economics on various professional courses.

John is the co-author with Dean Garratt of *Essentials of Economics* (Pearson Education, 6th edition 2013) and, with Kevin Hinde from the University of Durham and Dean

Garratt, of *Economics for Business* (Pearson Education, 6th edition 2013) and with Elizabeth Jones of the University of Warwick of *Essential Economics for Business* (Pearson Education, 4th edition 2014). Translations or editions of the various books are available for a number of different countries with the help of co-authors around the world.

John is very interested in promoting new methods of teaching economics, including group exercises, experiments, role playing, computer-aided learning and use of audience response systems and podcasting in teaching. He has organised and spoken at conferences for both lecturers and students of economics throughout the UK and in many other countries.

As part of his work with the Economics Network he has contributed to its two sites for students and prospective students of economics: Study Economics (www.study.economics.org) and Why Study Economics? (www.whystudyeconomics.ac.uk).

From March to June 1997, John was a visiting lecturer at the University of Western Australia. In July and August 2000, he was again a visiting lecturer at the University of Western Australia and also at Murdoch University in Perth.

In 2007, John received a Lifetime Achievement Award as 'outstanding teacher and ambassador of economics' presented jointly by the Higher Education Academy, the Government Economic Service and the Scottish Economic Society.



Alison Wride is Provost of GSM London and a Professor of Economics. Prior to her appointment at GSM London she was Head of the College of Business, Economics and Law at Swansea University, and before that she spent her early career at the University of Exeter. Her areas of

interest include the student experience and the relationship between skills, employability and education. She is acknowledged as having expertise in understanding the factors that influence student satisfaction and has always endeavoured to bring a sense of engagement to her teaching. In 2006 Alison received the Student Nominated Award

for Teaching Excellence from the Economics Network of the UK Higher Education Academy. This was followed by the University of Exeter Vice Chancellor's Award for Excellence in 2007, in recognition of both her role in leading the transformation of the student experience in the Business School and her own teaching. In 2009 Alison was awarded a National Teaching Fellowship.

Alison believes that 'good' teaching depends on great communication. She sees that her job, as a teacher and author, is to take relatively complex ideas and to explain them in a way that is accessible and that inspires the reader, leaving them wanting to know more. She has taught economics to A level students, undergraduates and to those who are already out in the world of work. Her teaching ethos is based on enthusing students, bringing economics

to life and setting the theory in context. She still believes that ‘the best decision I ever made – in terms of my career – was choosing to take A-level economics. I fell in love with the subject within an hour and that was entirely due to the excellence and enthusiasm of my teacher.’

Alison’s external interests include work with the Treasury and Government Economic Service on economics training



Dean Garratt is a Principal Teaching Fellow in the Department of Economics at the University of Warwick. Prior to joining Warwick in 2014, Dean was a principal lecturer and course leader of the undergraduate economics portfolio at Nottingham Business School. Dean teaches economics at a variety of levels, both to students

on economics courses and to those taking economics on other degree courses.

Earlier in his career Dean worked as an economic assistant at both HM Treasury and at the Council of Mortgage Lenders. While at these institutions Dean was researching and briefing on a variety of issues relating to the household sector and to the housing and mortgage markets.

His time as an economic assistant has significantly influenced Dean’s approach towards the teaching of economics. This has seen Dean frequently adopt a problem or issues-based approach in his teaching of economics. Dean believes that a deeper understanding of what it means to

for non-economists working in government; she is currently involved in a similar initiative with the Department for Business, Innovation and Skills. This work focuses on furnishing those at the cutting edge of developing policy with the tools and economic understanding to ensure that both the formulation of aims and the choice of methods result in coherent strategies that enhance efficiency and equity.

think like an economist is achieved when students are encouraged to see the relevance and application of economic ideas and principles.

In 2006 Dean received an Outstanding Teaching Award from the Economics Network of the Higher Education Academy. The award is given to an academic who demonstrates excellence in course structure, delivery, student response, student performance and peer recognition.

Subsequently, Dean became an Associate of the Economics Network helping to promote quality teaching practices through presentations and workshops. Dean has been involved in projects to develop problem-based learning and teaching resources for economists, including resources for use on level 1 quantitative methods and data analysis modules.

Dean is an academic assessor for the Government Economic Service (GES). In this role he helps to assess potential recruits to the GES with particular focus on the ability of candidates to articulate their understanding of economics and its applications.

Outside of work, Dean is an avid watcher of most sports. He is a season ticket holder at both Leicester City Football Club and Leicestershire County Cricket Club.

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Supporting Resources

You can use the power of MyEconLab to accelerate your learning. You need both an access card and a course ID to access MyEconLab. Students, is your lecturer using MyEconLab? If so, ask your lecturer for your course ID.

Has an access card been included with the book? Check the inside back cover of the book.

If you have a course ID but no access card, go to: www.myeconlab.com to buy access to this interactive study programme.

MyEconLab



MyEconLab for *Economics*, 9th edition enables you to assess your learning and provides you with a personalised Study Plan, which identifies areas you need to concentrate on to improve your grades. Specific tools are provided to direct your study in the most efficient way.

You can register at www.MyEconLab.com to find essential learning material such as:

- a personalised Study Plan, with extensive self-testing material and homework that can be set by your tutor;
- a complete online workbook for use alongside the textbook as you learn;
- multiple-choice questions to test your learning;
- extra case studies with questions per chapter;
- maths cases with exercises, related to the Looking at the Maths boxes in the book;
- answers to all in-chapter questions;
- an economics news blog updated several times per month – (each news item has an introduction, links to a range of news articles, questions and references to the relevant chapter of the book);
- animations of all key models with audio explanations, which can be downloaded to your iPod, iPad, iPhone or MP4 player;
- extensive annotated Hotlinks to relevant sites on the Internet, regularly updated;
- an online glossary to explain key terms with flashcards to test your knowledge;

MyEconLab for lecturers

- MyEconLab's gradebook which automatically records each student's time spent and performance on the tests and Study Plan and generates reports you can use to monitor your students' progress;
- using MyEconLab to build your own tests, assessments and homework assignments from the question base provided;
- questions generated algorithmically so that they use different values each time they are used;
- creation, if desired, of your own exercises by using the econ exercise builder.

For lecturers wanting more information about the MyEconLab product, please contact your local Pearson sales representative at www.pearsoned.co.uk/replocator or visit www.myeconlab.com.

Additional lecturer resources:

- tutor guide to using chapters and discussion of learning/teaching issues;
- customisable lecture plans in PowerPoint with questions for use in lectures with or without an audience response system;
- key models animated as full-colour PowerPoint slide shows;
- downloadable PowerPoint slides of all figures and tables from the book;
- a range of teaching and learning case studies;
- workshops with answers;
- answers to end-of-chapter questions;
- answers to the case studies found in MyEconLab.

These lecturer resources can be downloaded from the lecturer website at www.pearsoned.co.uk/sloman. Click on the *Economics*, 9th edition cover and select lecturer resources.

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Custom publishing allows academics to pick and choose content from one or more textbooks for their course and combine it into a definitive course text.

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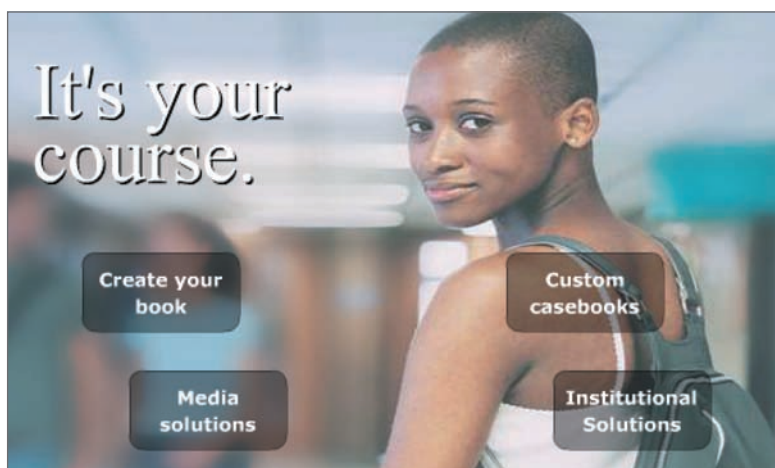
If you are teaching a first year Economics course you may have a large teaching team with different lecturers teaching the micro and macroeconomics sections. Do you find that it can be difficult to agree on one textbook? If you do, you might find combining the macro and micro halves from different Pearson textbooks a useful solution. You may teach a mixed ability class and would like to be able to provide some advanced material from Sloman's larger economics text or perhaps you take more of a business focus where chapters from Sloman's *Essential Economics for Business* might be useful.

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If, once you have had time to review this title, you feel Custom publishing might benefit you and your course, please do get in contact. However minor, or major the change – we can help you out.

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Preface

A NOTE TO THE STUDENT FROM THE AUTHORS

Economics affects all our lives. As consumers we try to make the best of our limited incomes. As workers – or future workers – we take our place in the job market. As citizens of a country our lives are affected by the decisions of our government and other policy-makers: decisions over taxes, decisions over spending on health and education, decisions on interest rates, decisions that affect unemployment, inflation and growth. As dwellers on the planet Earth we are affected by the economic decisions of each other: the air we breathe, the water we drink and the environment we leave to our children are all affected by the economic decisions taken by the human race.

Economics thus deals with some of the most challenging issues we face. It is this that still excites us about economics after many years of teaching the subject. We hope that some of this excitement rubs off on you.

The first eight editions of *Economics* have been widely used in the UK and throughout the world. Like them, this new edition is suitable for all students of economics at first-year degree level, A-level or on various professional courses where a broad grounding in both principles and applications is required. It is structured to be easily understood by those of you who are new to the subject, with various sections and boxes that can be left out on first reading or on shorter courses; yet it also has sufficient depth to challenge those of you who have studied the subject before, with starred sections (appearing on a grey background) and starred case studies that will provide much that is new. There are also optional short mathematical sections for those of you studying a more quantitatively-focused course.

The book gives a self-contained introduction to the world of economics and is thus ideal for those who will not study the subject beyond introductory level. But by carefully laying a comprehensive foundation and by the inclusion of certain materials in starred sections that bridge the gap between introductory and second-level economics, it provides the necessary coverage for those of you going on to specialise in economics.

The book looks at the world of the early twenty-first century. Despite huge advances in technology and despite

the comfortable lives led by many people in the industrialised world, we still suffer from unemployment, poverty and inequality, and in many countries (the UK included) the gap between rich and poor has grown much wider; our environment is polluted; our economy still goes through periodic recessions; conflict and disagreement often dominate over peace and harmony.

What is more, the world order has been changing. With a growing interdependence of the economies of the world; with an inexorable process of ‘globalisation’, which links us all through a web of telecommunications and international trade into a world of Coca-Cola, Nike trainers, Microsoft, football and American TV shows; with repeated bouts of turmoil on international financial markets culminating in the banking crisis of 2008–9, the effects of which are still being felt today; with evidence that economic problems spread like a contagion around the world, tying domestic economic growth to global events; with Chinese economic growth increasingly becoming the powerhouse of the global economy; with the move away from the ideological simplicity of a ‘free-market’ solution to all economic problems; with a powerful but economically sluggish eurozone; with concerns over levels of indebtedness and financial resilience in the public and private sectors in many economies; and with an ever-deepening crisis for many of the poorest developing countries, often ravaged by disease, conflict and famine; so there are many new economic challenges that face us. Economists are called on to offer solutions.

But despite our changing environment, there are certain economic fundamentals that do not change. Despite disagreements among economists – and there are plenty – there is a wide measure of agreement on how to analyse these fundamentals.

We hope that this book will give you an enjoyable introduction to the economist’s world and that it will equip you with the tools to understand and criticise the economic policies that others pursue.

Good luck and have fun.

John, Alison and Dean

TO LECTURERS AND TUTORS

In the light of the financial crisis, there has been much soul searching amongst economists about the appropriateness of the models we use and what should be taught to our students. These concerns were debated at an international conference at the Bank of England in 2012. One outcome of this was the publication of a book, *What's the Use of Economics*¹. This considers how undergraduate courses could be reformed to meet the needs of employers and how economic models and syllabuses could be revised to reflect the real world and to provide a foundation for devising effective economic policy.

We attempted to address these concerns in the eighth edition of this book and have gone further in this new edition. In particular, we have incorporated recent developments in macroeconomics, including stressing the importance of balance sheets and systemic risk. We have also given much more weight to behavioural economics and to the importance of institutional structures and culture.

In addition we show how many of the theories have developed to explain the problems that existed at the time. We have thus continued to emphasise the link between the history of economic thought and economic history.

This new edition also retains many of the popular features of the previous edition:

- A style that is direct and to the point, with the aim all the time to provide maximum clarity. There are numerous examples to aid comprehension.
- All economic terms highlighted in the text where they first appear and defined at the foot of that page. Each term is also highlighted in the index, so that the student can simply look up a given definition as required. By defining them on the page where they appear, the student can also see the terms used in context in the text.
- Key ideas highlighted and explained when they first appear. There are 39 of these ideas, which are fundamental to the study of economics. Students can see them recurring throughout the book, and an icon appears in the margin to refer back to the page where the idea first appears.
- Fifteen 'threshold concepts'. Understanding and being able to relate and apply these core economic concepts helps students to 'think like an economist' and to relate the different parts of the subject to each other. Again, an icon appears in the margin wherever the concept recurs.
- A wealth of applied material in boxes (185 in all), making learning more interesting for students and, by relating economics to the real world, bringing the subject alive. The boxes allow the book to be comprehensive without the text becoming daunting and allow more advanced material to be introduced where appropriate. Many of

the boxes can be used as class exercises and virtually all have questions at the end.

- Full-page chapter introductions. These set the scene for the chapter by introducing the students to the topics covered and relating them to the everyday world. The introductions also include a 'chapter map'. This provides a detailed contents listing, helping students to see how the chapter is structured and how the various topics relate to each other.
- A consistent use of colour in graphs and diagrams, with explanations in panels where appropriate. These features make them easier to comprehend and more appealing.
- Starred sections and boxes for more advanced material (appearing with a grey background). These can be omitted without interrupting the flow of the argument. This allows the book to be used by students with different abilities and experience, and on courses of different levels of difficulty.
- 'Looking at the maths' sections. These short sections express a topic mathematically. Some use calculus; some do not. They are designed to be used on more quantitatively-focused courses and go further than other textbooks at introductory level in meeting the needs of students on such courses. Most refer students to worked examples in Maths Cases in MyEconLab. Some of these use simultaneous equations; some use simple unconstrained optimisation techniques; others use constrained optimisation, using both substitution and Lagrange multipliers. The 'Looking at the maths' sections are short and can be omitted by students on non-mathematical courses without any loss of continuity.
- An open learning approach, with questions incorporated into the text so as to test and reinforce students' understanding as they progress. This makes learning a much more active process.
- End-of-chapter questions. These can be set as work for students to do in class or at home. Alternatively, students can simply use them to check their comprehension at the end of a topic.
- Summaries given at the end of each section, thus providing a point for reflection and checking on comprehension at reasonably frequent intervals.
- An even micro/macro split.
- The book is divided into seven parts. This makes the structure transparent and makes it easier for the student to navigate.
- Despite retaining these popular features, there have been many changes to this eighth edition.

Extensive revision

Economics (9th edition) uses a lot of applied material, both to illustrate theory and policy, and to bring the subject

¹ Diane Coyle (ed.), *What's the Use of Economics?* (London Publishing Partnership, 2012).

alive for students by relating it to contemporary issues. This has meant that, as with the previous edition, much of the book has had to be rewritten to reflect contemporary issues. Specifically this means that:

- Many of the boxes are new or extensively revised.
- There are many new examples given in the text.
- Theoretical coverage has been strengthened at various points in the book. This includes:
 - an increased emphasis on the role of borrowing, debt, balance sheets and risk at the government, corporate and household levels;
 - the development of macroeconomic models, including the interaction between the *IS/MP* model and the *ADI/ASI* model;
 - increased emphasis on behavioural economics.
- The text provides extensive coverage of the recent developments in money and banking and their impact on economies.

- All policy sections reflect the changes that have taken place since the last edition, including changes to the regulation of businesses and the protection of the environment, and international responses to the financial crisis and policies adopted in various countries to reduce levels of public-sector deficits and debt. The text enables students to see how they can apply fundamental economic concepts to gain a better understanding of these important issues and, as a result, analyse the actual responses of policy makers as well as the alternatives that could perhaps have been pursued.
- All tables and charts have been updated, as have factual references in the text.
- Most importantly, every single section and every single sentence of the book have been carefully considered, and if necessary redrafted, to ensure both maximum clarity and contemporary relevance. The result, we hope, is a text that your students will find exciting and relevant to today's world.

SUGGESTIONS FOR SHORTER OR LESS ADVANCED COURSES

The book is designed to be used on a number of different types of course. Because of its comprehensive nature, the inclusion of a lot of optional material and the self-contained nature of many of the chapters and sections, it can be used very flexibly.

It is suitable for one-year principles courses at first-year degree level, two-year economics courses on non-economics degrees, A-level, HND and professional courses. It is also highly suitable for single-semester courses, either with a micro or a macro focus, or giving a broad outline of the subject.

The following suggests chapters which are appropriate to different types of course and gives some guidance on chapters that can be omitted while retaining continuity:

Alternative 1: Less advanced but comprehensive courses

Omit all starred sections, starred sub-sections and starred boxes.

Example of a comprehensive course, omitting some of these chapters: Chapters 1–7, 9, 11–13, 14, 15, 17–22, 24–25.

Alternative 2: Economics for Business courses

Chapters 1–3, 5–9, 12–15, 18, 21, 23–26.

Example of an Economics for Business course, omitting some of these chapters: Chapters 1–3, 5–9, 13, 14, 15, 18, 21, 24–25.

Alternative 3: Introduction to microeconomics

Chapters 1–13, 24. The level of difficulty can be varied by including or omitting starred sections and boxes from these chapters.

Example of an Introduction to Microeconomics course, omitting some of these chapters: Chapters 1–7, 9, 11–13, 24.

Alternative 4: Introduction to macroeconomics

Chapters 1, 2, 14–26. The level of difficulty can be varied by including or omitting starred sections and boxes from these chapters.

Example of an Introduction to Macroeconomics course, omitting some of these chapters: Chapters 1, 2 (if microeconomics has not previously been covered), 14, 15, 17–23, 25.

Alternative 5: Outline courses

Chapters 1, 2, 5, 6, 14, 15, 17, 18, 24, 25 (section 25.1). Omit boxes at will.

Alternative 6: Courses with a theory bias

Chapters 1, 2, 4–9, 11, 14–19, 20, 22, 24, 25. The level of difficulty can be varied by including or omitting starred sections and boxes from these chapters.

Alternative 7: Courses with a policy bias (and only basic theory)

Chapters 1–3, 5, 6, 10–15, (17), 21, 23–26.

COMPANION RESOURCES

MyEconLab (for students)

MyEconLab is a comprehensive set of online resources developed for the 9th edition of *Economics*.

It provides a variety of tools to enable students to assess their own learning, including exercises, quizzes and tests, arranged chapter by chapter. There are many new questions in this edition and each question has been carefully considered to reflect the learning objectives of the chapter. A personalised Study Plan identifies areas to concentrate on to improve grades, and specific tools are provided to each student to direct their studies in the most efficient way.

In addition, a large range of other resources are available in MyEconLab, including:

- Animations of key models with audio explanations. These can be watched online or downloaded to a computer, MP4 player, smart phone, etc.
- A news blog with news items added several times each month.
- A comprehensive glossary with flashcards to check students' knowledge.
- 193 case studies with questions for self-study, ordered chapter by chapter and referred to in the text.
- Maths cases with exercises, related to the 'Looking at the Maths' sections in the book.
- Updated list of over 290 hotlinks to sites of use for economics.
- Answers to all in-chapter questions.
- Learning objectives for each chapter written in 'student-friendly' language.

Note that the news blog and hotlinks can also be accessed directly from www.pearsoned.co.uk/sloman.

MyEconLab (for lecturers)

You can register online at www.myeconlab.com to use MyEconLab, which is a complete virtual learning environment for your course or embedded into Blackboard, WebCT or Moodle. You can customise its look and feel and its availability to students. You can use it to provide support to your students in the following ways:

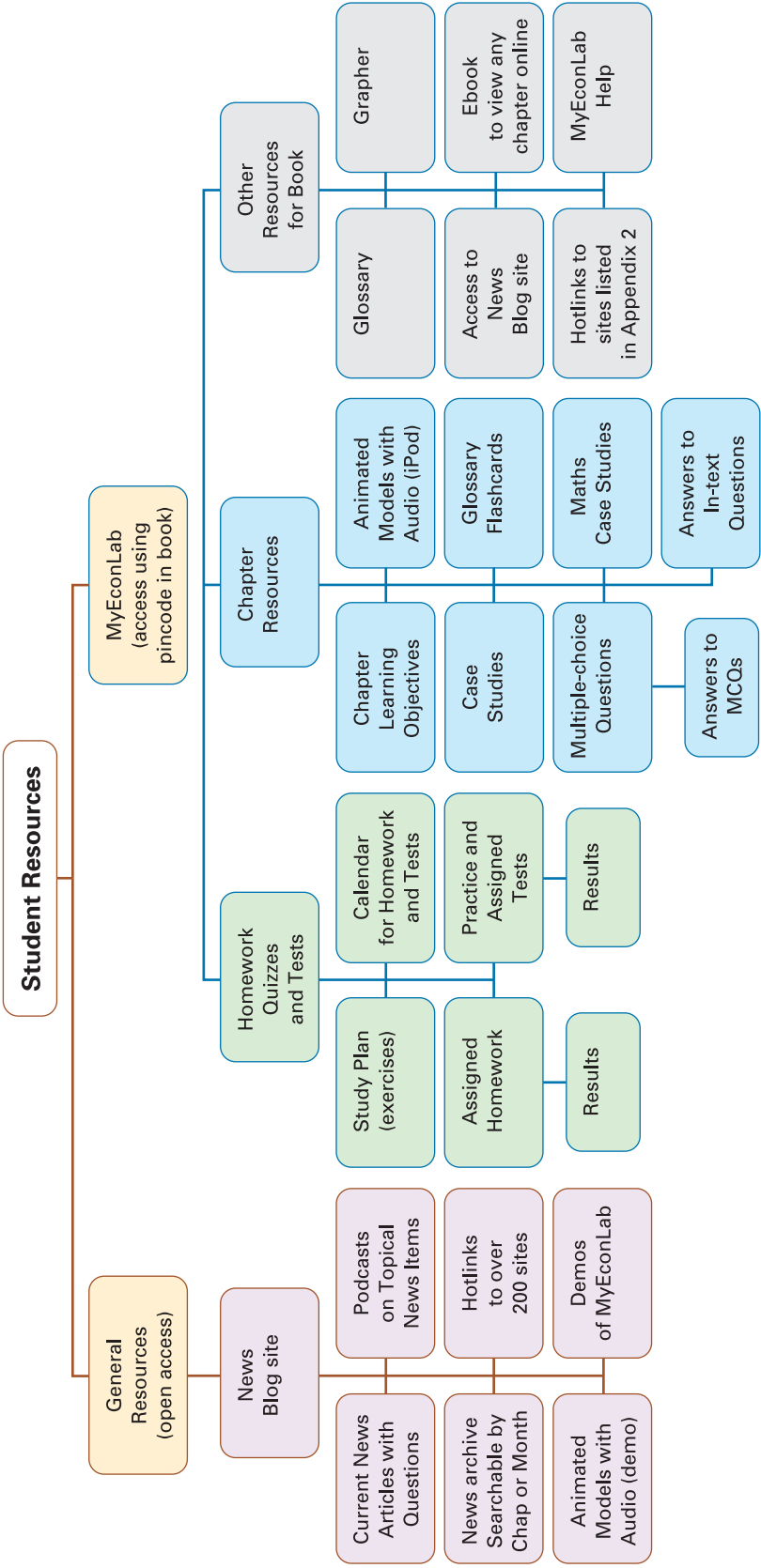
- MyEconLab's gradebook automatically records each student's time spent and performance on the tests and Study Plan. It also generates reports you can use to monitor your students' progress.
- You can use MyEconLab to build your own tests, quizzes and homework assignments from the question base provided to set for your students' assessment.
- Questions are generated algorithmically so that they use different values each time they are used.
- You can create your own exercises by using the econ exercise builder.

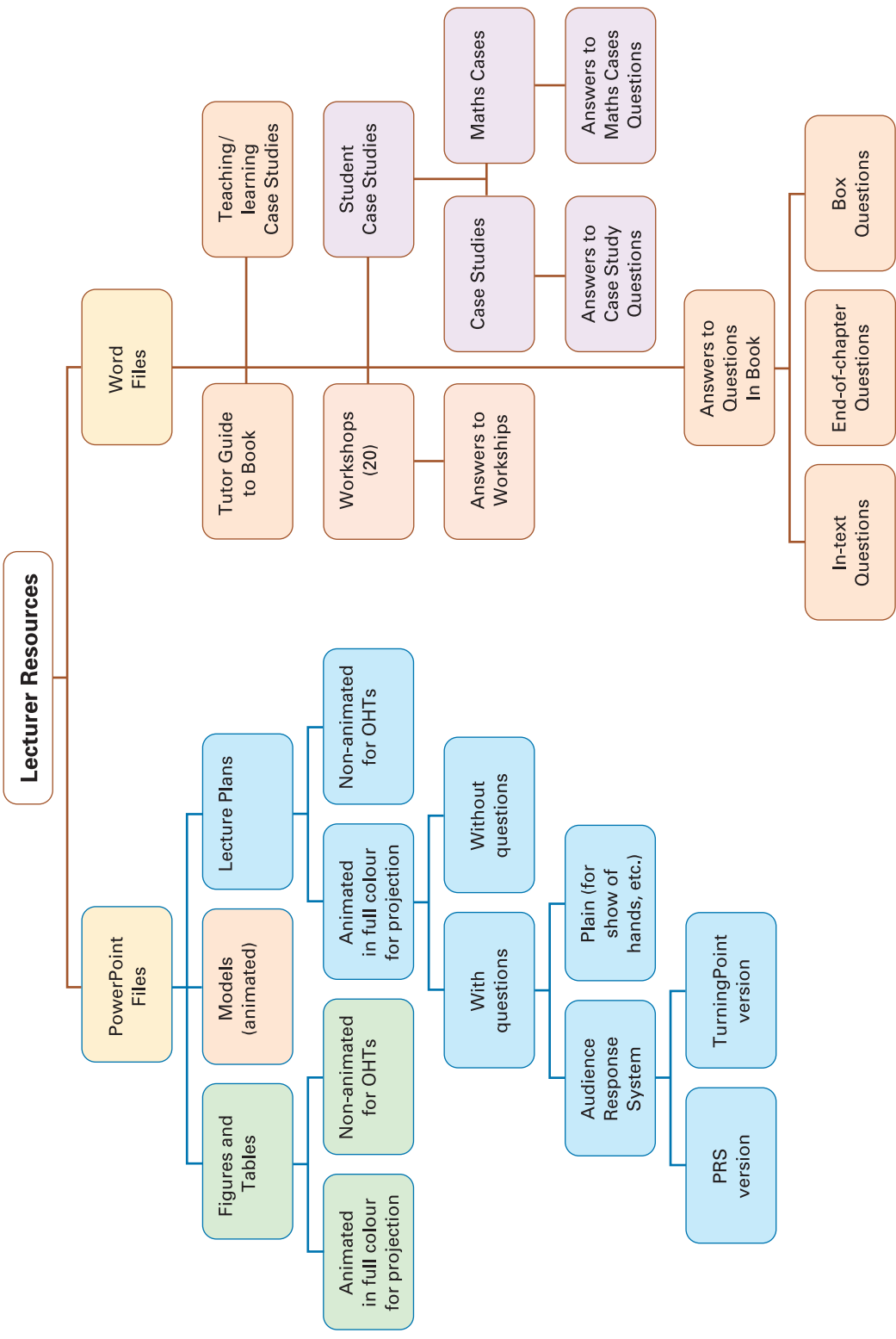
Additional resources for lecturers

There are also many additional resources for lecturers and tutors that can be downloaded from the lecturer section of MyEconLab. These have been thoroughly revised from the 8th edition. These include:

- PowerPoint® slideshows in full colour for use with a data projector in lectures and classes. These can also be made available to students by loading them on to a local network. Suggestions for use are given in an accompanying Word® file. There are several types of these slideshows:
 - All figures from the book and most of the tables. Each figure is built up in a logical sequence, thereby allowing them to be shown in lectures in an animated form. They are also available in a simple version suitable for printing onto acetate for OHPs.
 - A range of models. There are 37 files, each containing one of the key models from the book, developed in an animated sequence of between 20 and 80 screens.
 - Customisable lecture slideshows. These are a series of bullet-point screens. There is one for each chapter of the book. Each one can be easily edited, with points added, deleted or moved, so as to suit particular lectures. A consistent use of colour is made to show how the points tie together. They come in various versions:
 - o Lecture slideshows with integrated diagrams. These lecture plans include animated diagrams, charts and tables at the appropriate points.
 - o Lecture slideshows with integrated diagrams and questions. These include multiple-choice questions to allow lectures to become more interactive and can be used with or without an audience response system (ARS). ARS versions are available for InterWrite PRS® and for TurningPoint® and are ready to use with the appropriate 'clickers'.
 - o Lecture slideshows without the diagrams. These allow you to construct your own on the blackboard or whiteboard or use an OHP.
- Tutor's Guide in Word®. This contains suggestions on how to use the text. It also contains learning objectives that can be used for syllabus design and course planning.
- Answers to all questions in *Economics* (9th edition): i.e. questions embedded in the text, box questions and end-of-chapter questions. These can be edited as desired and distributed to students.
- Answers to the case studies and maths cases found in MyEconLab.
- Case studies. These 193 cases, also available to students in MyEconLab, can be reproduced and used for classroom exercises or for student assignments. Most cases have questions, to which answers are also provided (not available to students).
- Maths cases. These 27 maths cases with exercises, also available to students in MyEconLab, relate to the 'Looking at the Maths' sections in the book. Answers to the exercises are also provided (not available to students).
- Workshops. There are 20 of these (10 micro and 10 macro/international). They are in Word® and can be reproduced for use with large groups of students (up to 200). They can also be amended to suit your course. Suggestions for use are given in an accompanying file. Answers to all workshop questions are given in separate Word® files.
- Teaching/learning case studies. These 20 case studies examine various ways to improve student learning of introductory economics. They have been completely revised with new hyperlinks where appropriate.

The following two pages show in diagrammatic form all the student and lecturer resources.





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As with previous editions, we owe a debt to various people. The whole team from Pearson has, as always, been very helpful and supportive. Thanks in particular to Kate Brewin, the editor, who has been of tremendous help and support at every stage of revising the book, and to Tim Parker who has steered the book smoothly through production. Thanks also to Joan Dale Lace, who meticulously copy-edited the manuscript, Neville Hankins, proofreader, and Jane Ashley who prepared the Index.

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Figures

Figures on pages 236 and 237 after *World Investment Report 2014*, June, UNCTAD (2014) Annex Tables 9 and 11; Figure on page 264 from *Flexibility, Uncertainty and Manpower Management*, Institute of Manpower Studies (Atkinson, J. 1984) IMS Report No. 89, Institute for Employment Studies (IES); Figure 10.9 after *UK Personal Wealth Statistics* September 2012, HMRC (2012) Table 13.1, contains public sector information licensed under the Open Government Licence (OGL) v2.0. <http://www.nationalarchives.gov.uk/doc/open-government-licence>; Figure on page 356 from *Stern Review on the Economics of Climate Change*, Office of Climate Change (OCC), Stern Review, 2006 (Executive Summary, Figure 1, based on data drawn from World Resources Institute Climate Analysis Indicators Tool (CAIT) online database version 3.0), contains public sector information licensed under the Open Government Licence (OGL) v2.0. <http://www.nationalarchives.gov.uk/doc/open-government-licence>; Figure 12.4 adapted from *Family Spending 2012* National Statistics (2013) Table 3.2, Office for National Statistics licensed under the Open Government Licence v.2.0; Figure 12.5 adapted from *Statistical Pocketbook 2013* European Commission (2013) Table 2.6.2, © European Union, 1995–2014; Figure on page 394 from Electricity supply: re-organisation and privatisation, *The Economic Review*, March, Vol. 7, No. 4 (Green, R. 1991), Philip Allan Updates/Hodder Education, reproduced by permission of Hodder Education; Figures on pages 414 and 633 and Figure 14.6 after AMECO database, European Commission, DGECFIN, © European Union, 1995–2014; Figure on page 662 after *Inflation Report*, February, Bank of England (2014); Figure 24.8 from *The Competitive Advantage of Nations* The Free Press (Porter, M.E. 1998) p. 127, with the permission of The Free Press, a Division of Simon & Schuster, Inc. Copyright © 1998 by M.E. Porter. All rights reserved; Figure on page 822 from Building BRICs of growth, *The Economist*, © The Economist Newspaper Limited, London, 05/06/2008; Figure 27.2 after *World Economic Outlook* April 2014 database, International Monetary Fund.

Tables

Table A1.3 from *The Effects of Taxes and Benefits on Household Income, 2012/13* National Statistics (2014), Office for

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Text

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Introduction

Why Economics is Good for You 2

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This opening part of the book introduces you to economics – what it is, some of the fundamental concepts and, most of all, why it is a great subject to study. Economics is not a set of facts or theories to be memorised, it is both more interesting and more useful than that. Studying economics enables you to think about the world in a different way; it helps you to make sense of the decisions people make: decisions about what to buy or what job to do; decisions governments make about how much to tax or what to spend those taxes on; decisions businesses make about what to produce, what prices to charge and what wages to pay. This makes economics relevant for everyone, not only those who are going on to further study.

After studying economics you will be able to apply this ‘way of thinking’ to your life both now and in the future. You will be able to think more analytically and problem-solve more effectively; this helps explain why studying economics can lead to a better career. We start you off in Chapter 0, with some puzzling ideas that should make you think. By the time you have studied, you’ll be able to answer these and more.

Economics contains some simple core ideas which can be applied to a wide range of economic problems. We will start examining these ideas in Chapter 1. In ‘Why Economics is Good for You’ we start with a look at some interesting questions and puzzles that make the subject such a rich one.

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Welcome

Welcome to the **Sloman Economics News Site**. This blog contains links to topical stories in the news discussing key economic issues and concepts.

Each news item starts with an introduction to the issue. This is followed by several links to relevant news articles – some to videos or podcasts. The item finishes with discussion questions that can be used either for self-testing or for use in class.

Scroll down below to read the latest articles posted, or use the search facilities on the left-hand side to search the articles by date, keyword and your chosen textbook.



Why Economics is Good for You

CHAPTER MAP

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You may never have studied economics before, and yet when you open a newspaper what do you read? – a report from ‘our economics correspondent’. Turn on the television news and what do you see? – an item on the state of the economy. Talk to friends and often the topic will turn to the price of this or that product, or whether you have got enough money to afford to do this or that.

The fact is that economics affects our daily lives. We are continually being made aware of local, national and international economic issues, whether price increases, interest rate changes, fluctuations in exchange rates, unemployment, economic recessions or the effects of globalisation.

We are also continually faced with economic problems and decisions of our own. What should I buy for supper? Should I save up for a summer holiday, or spend more on day-to-day living? Should I go to university, or should I try to find a job now? If I go to university, should I work part time?

This ‘mini chapter’ is an easy read, to get you started on the road to thinking like an economist.

WHAT IS ECONOMICS?

If we told you that economics is a problem of maximisation subject to constraints, you'd probably stop reading and find something else to do. So let's put it a different way. Economics is a way of answering some of the most important questions societies face. It's also a way of answering much 'smaller' questions: ones that affect all of us. We are going to set out some of these questions, and start you off on your economics journey. But be warned – once you start thinking like an economist, you probably won't be able to stop.

An island economy

In Chapter 1 we will introduce various core economic concepts and some formal definitions of the economic problems faced by individuals and society. But let's start with a flight of fancy.

Let's suppose that we wake up tomorrow and find ourselves in charge of an island economy. Who is 'we' in this case? Well perhaps it is the authors, plus the reader. Or perhaps it is your economics tutorial group, or a group of random strangers. It really doesn't matter, since it *is* just an imaginary problem.

Once we got over the excitement of being in charge of a whole economy, we might begin to appreciate it's not going to be all palm trees and days by the pool. An economy has people who need to eat, be housed and will need access to health care. It may have other islands, nearby, who are friendly and want to trade – or who are not friendly and may want to invade.

Being in charge suddenly seems to involve quite a few decisions. What is this island going to produce so that people can live? Is it going to be self-sufficient, or to 'swap' goods with other countries? How are people going to know what to produce? How will the products be shared out? Will they be allocated to everyone, even those who do not work? What will we do if some people are too old to work and haven't got savings or families? What should we do if the island bank runs out of money? How can we be sure that we will have enough resources to support the people next year, as well as this?

At the end of the text (page 832) you will see a poem about people cast away on a desert island. Hopefully, after reading this text, you will understand their plight better. But you might find it interesting to read it now before embarking on your studies.

Of course, we are never actually going to be parachuted in to be in charge of an island, although some of you reading this text may aspire to go into politics. But the questions we have posed above are a reflection of the real challenges

countries face. We will look at the role of government throughout this text: decisions that need to be taken, different approaches, and what happens when governments need to work together.

Books and media

Economics has undergone something of a makeover in the past few years. There are two main reasons.

In 2007–8 there was a major financial crisis, which led to the collapse of banks across the world and a downturn in the global economy. It also led to a close scrutiny of why economists had not predicted the crisis. The outcome was a great deal more coverage of economics and economists than had been seen previously – an interesting example of the Oscar Wilde saying, 'There is only one thing worse than being talked about, and that is not being talked about.' Indeed, it stimulated a lot of interest in studying economics at university!

The second reason has less to do with actual economics and more to do with the way it has been written about. The first decade of the century saw the publication of a number of books which presented economics as a series of thought-provoking puzzles, rather than a purely academic subject. These included *The Undercover Economist*¹ by Tim Harford and the *Freakonomics*² titles, which resulted from collaboration between University of Chicago economist Steven Levitt and *New York Times* journalist Stephen J. Dubner.

Today, coverage of economics is widespread: in papers, on the Internet, in blogs and radio and television programmes. If you are reading this book because you are studying for a degree or other qualification, you may feel that you are just too busy to read more than the recommended reading list. But try to think more broadly than that. You will find that you can develop your 'economics' brain by spotting the issues. Whether you read papers, or look at news sites online, if you get into the habit of identifying economics issues and puzzles, you will be going a long way towards being an economist.

You could start by Googling the Sloman Economics News site.³ This not only gives you links to up-to-date articles and some analysis. It also links through to chapters in this book.

¹ Tim Harford, *The Undercover Economist* (Little, Brown Book Group, 2005).

² Steven D. Levitt and Stephen J. Dubner, *Freakonomics: A Rogue Economist Explores the Hidden Side of Everything* (William Morrow and Company, 2005).

³ www.pearsoned.co.uk/sloman

PUZZLES AND STORIES

Let's look at some examples of economic puzzles and ideas. The ones we discuss below are just a few that you might find interesting.

A pay-rise, how exciting

Do you work? By which we mean, do you work for money? If so, make a note of your hourly pay and how many hours you work per week.

Let's assume you are earning £7.50 per hour. Would you like a pay-rise to £15 per hour? You would? And what will you do with the extra money you earn? You might go on holiday, save more, or perhaps you'll simply go out for an extra evening per week, or buy nicer food when you go shopping.

But before we start talking about that, we need to go back to that note of yours. If your rate of pay doubled, how many hours would you work now? You might work the same number of hours; you might think it's worth working more hours; or you might decide that you can work fewer hours and have more time for other things. It's an interesting puzzle for you to think about. You could ask your friends how they might react in this situation. Perhaps you, or some of your friends, aren't working at the moment, but might do so if higher rates of pay were on offer.

We've thought about this from your point of view. Who else might be interested in the puzzle? Employers are obviously involved. If they want people to do more work, they might consider whether offering higher hourly rates will achieve that. Imagine how annoying it would be if instead people want to work fewer hours, not more. We will see in Chapter 9 that governments might be interested too.

Of course I want to know

One thing that economists spend a lot of time talking and thinking about is information. We will see in the rest of this text how important it is when making decisions. And as you've already seen, most of economics is about looking at decisions. How can you decide whether you work? You need to have all sorts of information: rates of pay, what hours are offered, what the job is actually like, what you'll have to wear. You can probably think of at least three or four other things just on this decision. If you are going to make a 'good' decision you need 'good' information. So if we can offer you some important information now, would you like it?

Of course, having information is going to affect your decision making: that's the whole point. So let's imagine you are trying to decide whether to see a film that's just been released. You can get information about the plot, the actors, the special effects, the rating, etc. You can also read opinions of critics and reviewers on the quality of the film. Hopefully all this information will help you decide whether

to spend money and time going to see it. Similarly, you can get information about many of the other goods and services you might want to buy, by talking to friends or family, researching on the Internet or browsing in shops.

What about a bigger piece of information? Suppose someone could tell you exactly how long you will live? Would that be a useful piece of information? How would it change your decisions every day? Would you behave differently right away? Does your answer depend on who gives the information? You might be more inclined to believe a scientist than an astrologer!

In practice, no one is going to be able to tell you your exact life expectancy (to the day). Accidents can happen and medicine moves on. So the best you could currently expect is an informed prediction based, usually, on statistical probability. But such informed predictions about life expectancy are crucial for insurance companies deciding on premiums.

Information is all around us – in fact, we are said to live in the information age. So the problem is often not one of a lack of information, but one of too much and what information is reliable. We hope, by reading this book, you will be better able to assess information and its usefulness for making economic decisions.

We need to save more; we need to spend more

Puzzles like the two above are looking at individual decisions and these are probably the easiest type to identify. But there are some which apply to a whole economy or country. The second half of this text (Chapters 14 onwards) looks at 'whole economy' economics, so let's identify an issue in that area.

How much do you save? The answer will depend on your income, your spending habits and probably on something that's hard to pin down, but really is about how 'good' you are at saving.

Now let's think about saving on a national basis. You may have heard people say that we need to save more. There are all sorts of reasons why saving is a 'good thing'. We are living longer and, unless we save more, we may not have enough to be comfortable in our old age. When we save, we have a buffer against emergencies. When we save, we are not (generally) borrowing, so we don't have to pay interest; instead we receive interest, so our income is higher.

All of these reasons can be scaled up to the whole economy. You have probably heard politicians say that the country needs to save for the future, especially if we all are going to live longer. The nation, they argue, needs to reduce its debts so that we can reduce the interest we have to pay, leaving more for the things people want, such as a better health service and better education. And if emergencies

arise (the financial crisis of 2007–8 is a really good example) the country will be in a better position if banks have plenty of money. It's also true that saving by individuals provides a source of funds for businesses that want and need to borrow for investment.

You might be wondering why this is a puzzle, since it seems pretty straightforward.

Let's think about the opposite of saving. If you don't save, what do you do with your money? You spend it and, hopefully, enjoy it. Imagine the opposite – that you saved a lot of your income, much more than you do now. Imagine that you only bought the barest of necessities, grew your own food, wore the same clothes for years and didn't buy

any new technology, or even have an occasional night out. You might have a pretty miserable life.

Now scale this up to the whole economy again. If no one is spending much, what will happen? Businesses will very quickly be in trouble. The banks will be full of our savings, but no one will be borrowing. Spending will therefore be low and firms won't be able to make profits. We will have lots of security in the form of future spending, but an economy that is in recession and very soon could be in crisis.

Of course this is an exaggerated example. But you can see the puzzle, can't you? Saving is good, but so is spending. What should we do? What should the government encourage us to do?

APPLYING THE PRINCIPLES

Thinking like an economist – a word of warning

As you go through the rest of this text, whether you study all of it or just some sections, try to spot the puzzles we have talked about above. And look out for others. You can do this outside formal study. Economics is about people and society. It isn't a dry subject; it is something that is all around us. Try to get into the habit of thinking like an economist on a daily basis. If there's a decision to be made, there's an economic way of thinking about it.

Where will this approach take you? It will make you more analytical, it will help you make better decisions.

There's evidence that it can get you a better job and it will certainly make you better at a job.

We'd like to offer one word of warning though. Once you're thinking like an economist, there's no turning back. It's a skill that will be with you for life. Just bear in mind that the non-economists around you may need convincing about the beauty of the subject. One of the authors of this book has a story to relate on this. On her wedding anniversary one year, she presented her (non-economist) husband with an analysis of the costs and benefits of both marriage in general, and anniversaries in particular. Luckily he saw the funny side.

Enjoy the book, but, more importantly, enjoy your journey through economics.

MyEconLab

This book can be supported by MyEconLab, which contains a range of additional resources, including an online homework and tutorial system designed to test and build your understanding.

You need both an access card and a course ID to access MyEconLab:

1. Is your lecturer using MyEconLab? Ask your lecturer for your course ID.
2. Has an access card been included with the book at a reduced cost? Check the inside back cover of the book.
3. If you have a course ID but no access card, go to: <http://www.myeconlab.com/> to buy access to this interactive study programme.

Economics and Economies

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In the introductory chapter we introduced some of the questions and puzzles that make economics such an interesting subject to study. Now we turn to explaining those ideas in a bit more detail. We also introduce some of the tools you will need to help you analyse the puzzles posed and answer the questions.

Economics contains some core ideas. These ideas are simple, but can be applied to a wide range of economic problems. We start examining these ideas in Chapter 1. We begin on the journey to help you to ‘think like an economist’ – a journey that we hope you will find fascinating and will give you a sound foundation for many possible future careers.

In the introductory chapter, we asked what economics is about. In this chapter we will attempt to answer this question and give you greater insight into the subject that you are studying. We will see how the subject is divided up and we will distinguish between the two major branches of economics: microeconomics and macroeconomics.

We will also look at the ways in which different types of economy operate, from the centrally planned economies of the former communist countries to the more free-market economies of most of the world today. We will ask just how ‘markets’ work.

1.1 WHAT DO ECONOMISTS STUDY?

Many people think that economics is about *money*. Well, to some extent this is true. Economics has a lot to do with money: with how much money people earn; how much they spend; what various items cost; how much money firms make; the total amount of money there is in the economy. But as we will see later in the book, money is only important because of what it allows us to do; money is a tool and economics is more than just the study of money.

It is concerned with the following:

- The **production** of goods and services: how much an economy produces, both in total and of individual items; how much each firm or person produces; what techniques of production are used; how many people are employed.
- The **consumption** of goods and services: how much people spend (and how much they save); how much people buy of particular items; what individuals choose to buy; how consumption is affected by prices, advertising, fashion and other factors.



Could production and consumption take place without money? If you think they could, give some examples.

But we still have not got to the bottom of what economics is about. Is there one crucial ingredient that makes a problem an economic one? The answer is that there is a central problem faced by all individuals and all countries, no matter how rich. It is the problem of scarcity; and scarcity underlies all other economic problems. For an economist, scarcity has a very specific definition.



Before reading on, how would you define 'scarcity'? Must goods be at least temporarily unattainable to be scarce?

The problem of scarcity

Ask people if they would like more money, and the vast majority would answer 'Yes'. But they don't want more money for its own sake. Rather they want to be able to

buy more goods and services, either today or in the future. These 'wants' will vary according to income levels and tastes. In a poor country 'wants' might include clean water, education and safe housing. In richer nations 'wants' might involve a second car, longer holidays and more time with friends and family. As countries get richer, human wants may change but they don't disappear. Wants are virtually unlimited.

Yet the means of fulfilling wants are limited. At any point the world can only produce a finite amount of goods and services because the world has a limited amount of *resources*. These resources, or **factors of production** as they are often called, are of three broad types:

- Human resources: **labour**. The labour force is limited in number, but also in skills. This limits the productivity of labour, the amount labour can produce.
- Natural resources: **land and raw materials**. The world's land area is limited, as are its raw materials.
- Manufactured resources: **capital**. Capital consists of all those inputs that have themselves had to be produced. The world has a limited stock of factories, machines, transportation and other equipment. The productivity of this capital is limited by the current state of technology.



Could each of these types of resources be increased in quantity or quality? Is there a time dimension to your answer?

So this is the fundamental economic problem: human wants are virtually unlimited, whereas the resources available to meet those wants are limited. We can thus define scarcity as follows:



Scarcity is the excess of human wants over what can actually be produced. Because of scarcity, various choices have to be made between alternatives.



If we would all like more money, why does the government not print a lot more? Could it not thereby solve the problem of scarcity 'at a stroke'?

Definitions

Production The transformation of inputs into outputs by firms in order to earn profit (or to meet some other objective).

Consumption The act of using goods and services to satisfy wants. This will normally involve purchasing the goods and services.

Factors of production (or resources) The inputs into the production of goods and services: labour, land and raw materials, and capital.

Labour All forms of human input, both physical and mental, into current production.

Land and raw materials Inputs into production that are provided by nature: e.g. unimproved land and mineral deposits in the ground.

Capital All inputs into production that have themselves been produced: e.g. factories, machines and tools.

BOX 1.1

WHAT'S THE LATEST ECONOMICS NEWS?

CASE STUDIES AND APPLICATIONS

- There are calls for access to the benefit system to be restricted for those arriving in the UK, from Romania and other EU countries.
- House prices are rising sharply in London and the South-East, with commentators expressing concern about the impact of the 'Help to Buy' scheme.
- Severe flooding hits parts of the UK for the third consecutive winter.
- There is widespread criticism of President Obama, as his proposed health care reforms stutter.
- Unemployment falls, leading to expectations of higher interest rates.
- The age at which UK workers can draw their state pension is raised further. Many predict that those currently under 30 will be working until at least the age of 70.
- The Chancellor of the Exchequer announces that undergraduate student numbers will no longer be capped in the UK higher education sector.
- A report suggests that the UK's energy security is at risk due to the slow pace of fracking.
- There is criticism following the privatisation of Royal Mail, as the share price rose strongly on the first day of trading.



1. What is it that makes each one of the above news items an economics item?
2. In each case identify two different individuals or groups who might be affected by the news item.

Of course, we do not all face the problem of *scarcity* to the same degree. A poor family who may not be able to afford enough to eat, or a decent place to live, will hardly see it as a 'problem' that a rich family cannot afford a second skiing holiday. But economists do not claim that we all face an equal problem of scarcity. In fact this is one of the major issues economists study: how resources are distributed, whether between different individuals, different regions of a country or different countries of the world.

This economic problem – limited resources but limitless wants – makes people, both rich and poor, behave in certain ways. Economics studies that behaviour. It studies people at work, producing goods that people want. It studies people as consumers, buying the goods that they want. It studies governments influencing the level and pattern of production and consumption. In short, it studies anything to do with the process of satisfying human wants.

Demand and supply

We have said that economics is concerned with consumption and production. Another way of looking at this is in terms of *demand* and *supply*. Demand and supply and the relationship between them lie at the very centre of economics. How does this relate to the problem of scarcity?

Demand is related to wants. If every good and service were free, people would simply demand whatever they wanted. In total such wants are likely to be virtually boundless, perhaps only limited by people's imagination. *Supply*,

on the other hand, is limited. It is related to resources. The amount that firms can supply depends on the resources and technology available.

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p7

Given the problem of scarcity – that human wants exceed what can actually be produced – *potential* demands will exceed *potential* supplies. Society has to find some way of dealing with this problem, to try to match demand with supply. This applies at the level of the economy overall: total or '*aggregate*' demand needs to be balanced against total or *aggregate* supply. In other words, total spending in the economy should balance total production. It also applies at the level of individual goods and services. The demand and supply of cabbages should balance, and so should the demand and supply of cars, houses, tablets and holidays.

But if potential demand exceeds potential supply, how are *actual* demand and supply made equal? Either demand has to be reduced, or supply has to be increased, or a combination of the two. Economics studies this process. It studies how demand adjusts to available supplies, and how supply adjusts to consumer demands.

Dividing up the subject

Economics is traditionally divided into two main branches – *macroeconomics* and *microeconomics*, where 'macro' means big and 'micro' means small.

Macroeconomics is concerned with the economy as a whole. It is concerned with *aggregate demand* and *aggregate supply*. By 'aggregate demand' we mean the total amount of

Definitions

Scarcity The excess of human wants over what can actually be produced to fulfil these wants.

Macroeconomics The branch of economics that studies economic aggregates (grand totals): e.g. the overall level of prices, output and employment in the economy.

Aggregate demand The total level of spending in the economy.

Aggregate supply The total amount of output in the economy.

spending in the economy, whether by consumers, by customers outside the country for our exports, by the government, or by firms when they buy capital equipment or stock up on raw materials. By ‘aggregate supply’ we mean the total national output of goods and services.

Microeconomics is concerned with the individual parts of the economy. It is concerned with the demand and supply of particular goods, services and resources such as cars, butter, clothes, haircuts, plumbers, accountants, blast furnaces, computers and oil.



Which of the following are macroeconomic issues, which are microeconomic ones and which could be either depending on the context?

- Inflation.
- Low wages in certain sectors.
- The rate of exchange between the pound and the euro.
- Why the price of cabbages fluctuates more than that of cars.
- The rate of economic growth this year compared with last year.
- The decline of traditional manufacturing industries.
- The influx of workers from eastern Europe.

Macroeconomics

Because scarcity exists, societies are concerned that their resources should be used *as fully as possible* and that over time their national output should grow.

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p7

Why should resources be used as fully as possible? If resources are ‘saved’ in one time period surely they can be used in the next time period? The answer is that not all resources can be saved. For example, if a worker doesn’t go to work one week then that resource is lost: labour can’t be saved up for the future.

Why do societies want growth? To understand this, think back to the discussion of endless wants: if our output grows, then more of our wants can be satisfied. Individuals and society can be made better off.

The achievement of growth and the full use of resources are not easy. This is demonstrated by periods of high unemployment and stagnation that have occurred from time to time throughout the world (e.g. in the 1930s, the early 1980s and the recent turndown that started in 2008). Furthermore, attempts by governments to stimulate growth and employment can result in inflation and rising imports. Economies have often experienced cycles where periods of growth alternate with periods of recession, such periods varying from a few months to a few years. This is known as the ‘business cycle’.

Macroeconomic problems are closely related to the balance between aggregate demand and aggregate supply.

If aggregate demand is too *high* relative to aggregate supply, inflation and trade deficits are likely to result.

- **Inflation** refers to a general rise in the level of prices throughout the economy. If aggregate demand rises substantially, firms are likely to respond by raising their prices. If demand is high, they can probably still sell as much as before (if not more) even at the higher prices,

and make higher profits. If firms in general put up their prices, inflation results.

- **Balance of trade** deficits are the excess of imports over exports. If aggregate demand rises, people are likely to buy more imports. So part of the extra spending will go on goods from overseas, such as Japanese TVs, Chinese computers, etc. Also, if inflation is high, home-produced goods will become uncompetitive with foreign goods. We are likely to buy more foreign imports and people abroad are likely to buy fewer of our exports. If aggregate demand is too low relative to aggregate supply, unemployment and recession may well result.
- **Recession** is where output in the economy declines: in other words, growth becomes negative. A recession is associated with a low level of consumer spending. If people spend less, shops are likely to find themselves with unsold stock. Then they will buy less from the manufacturers; they will cut down on production; and they will buy fewer capital goods such as machinery.
- **Unemployment** is likely to result from cutbacks in production. If firms are producing less, they will need to employ fewer people.

Macroeconomic policy, therefore, tends to focus on the balance of aggregate demand and aggregate supply. It can be **demand-side policy**, which seeks to influence the level of spending in the economy. This in turn will affect the level of production, prices and employment. Or it can be **supply-side policy**. This is designed to influence the level of production directly: for example, by trying to create more incentives for firms to innovate.

Definitions

Microeconomics The branch of economics that studies individual units: e.g. households, firms and industries. It studies the interrelationships between these units in determining the pattern of production and distribution of goods and services.

Rate of inflation The percentage increase in the level of prices over a 12-month period.

Balance of trade Exports of goods and services minus imports of goods and services. If exports exceed imports, there is a ‘balance of trade surplus’ (a positive figure). If imports exceed exports, there is a ‘balance of trade deficit’ (a negative figure).

Recession A period where national output falls for six months or more.

Unemployment The number of people who are actively looking for work but are currently without a job. (Note that there is much debate as to who should officially be counted as unemployed.)

Demand-side policy Government policy designed to alter the level of aggregate demand, and thereby the level of output, employment and prices.

Supply-side policy Government policy that attempts to alter the level of aggregate supply directly.