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2.2. JOHN MAYNARD KEYNES: CONSUMPTION – SAVINGS – BASIC INCOME

The British economist John Maynard Keynes developed the idea of consumption further. According to him each individual has to consume to survive no matter if an income is available or not. The consumption which is absolutely necessary to survive he called "autonomous consumption". He also assumed that individuals do not use their whole income for consumption but only a part of it. His own surveys showed him that British people use 80% of their income for consumption of goods and services. Of every additional money unit earned, 80% are consumed, so the **marginal propensity to consume** is 0.8. Taken these two assumptions into account he set up the following function:

	C(Y) = consumption		
$C(Y) = C_a + cY$	C _a = autonomous consumption		
	c = marginal propensity to consume		
	Y = income		

Keynes further assumed, that the **basic income** (equilibrium income) matches consumption: Y = C(Y) or $Y = C_a + c \times Y$

If we transform this function we get:

Y- c x Y = C_a or
Y x (1-c) = C_a or
Y = C_a
$$\div$$
 (1 - c) or 1 \div (1-c) x C_a

As already mentioned Keynes found out that the marginal propensity to consume is 80% of the income. We further assume that the autonomous consumption is 200 money units.

This leads us to the following consumption function: $C(Y) = 200 + 0.8 \times Y$

For incomes from 0 to 1600 money units we can set up the following table:

Y	Ca	схҮ	C(Y)	Y – C
0	200	0	200	-200
200	200	160	360	-160
400	200	320	520	-120
600	200	480	680	-80
800	200	640	840	-40
1,000	200	800	1,000	0
1,200	200	960	1,160	40
1,400	200	1,120	1,320	80
1,600	200	1,280	1,480	120

2.6. THE DEVELOPMENT TOWARDS THE NEW EQUILIBRIUM INCOME EXPLAINED USING KEYNES' IDEAS.

How do these ideas translate to the diagrams Keynes developed?

An increase of investment causes a parallel upward shift of the total spending curve. The shift is equal to the increase in investment. The vertical intercept goes up by 100 MU.



At the basic income of 1,000 MU total spending (consumption + investment) exceeds the level of output by the injection of 100 MU. But this investment translates into income of those involved in building it. This income makes households increase their consumption spending 100 x 0.8 = 80 MU. The increasing demand triggers more output and more income leading to even more demand. As the households consume according to their marginal propensity to consume they always spend 80% of their additional income, the generated demand becomes smaller and smaller. In the diagram the development towards the new equilibrium looks like a squeezed staircase. Injection and generated income = 100 MU \rightarrow consumption = 80 MU \rightarrow generated output and income = 80 MU \rightarrow consumption 64 MU \rightarrow generated output and income = 64 MU \rightarrow consumption 51.2 MU \rightarrow generated output and income = 51.2 MU \rightarrow consumption 40.96 MU......this process will continue until the new equilibrium income of 1,500 MU is reached. When comparing the new equilibrium income with the basic income it becomes clear that the increase in the equilibrium income is much greater than the initial investment. How much the value changes, depends on the marginal propensity to consume (c). So c determines the value of the multiplier. In our case the multiplier is

$$\frac{1}{1-c} = \frac{1}{s} = \frac{1}{0.2} = 5$$

For every MU invested 5 MU additional income is generated. The change in our equilibrium level of income is therefore the multiplier multiplied by the additional investment: $100 \text{ MU} \times 5 = 500 \text{ MU}$.

In the new equilibrium income has increased by 500 MU consisting of additional consumption of 400 MU (= 80%) and additional savings of 100 MU (= 20%). The increase in savings exactly matches the original investment \rightarrow the investment spending has created its own savings.

Assignment 7

The consumption function is described by C=207+0.77*Y. The planned investment equals 138.

- 7.1 Find the equilibrium income (arithmetically and graphically)
- 7.2 Plot the new equilibrium and show the development towards it.
- 7.3 After the new equilibrium income has been reached investment is reduced by 69 MU.
 - Calculate the new equilibrium income.
- 7.4 Plot the new equilibrium and show the development towards it.
- 7.5 Explain the development towards the new equilibrium in both cases.

WULUS YOU SHOULU KHOW	Words	vou	should	know
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injection	Zuführung, Injektion
leakage	Verlust, Leck
withdrawal	Entzug, Wegnahme
counterpart	Gegenstück

2.8. CRITICISM OF KEYNESIAN ECONOMICS

2.8.1. DEFICIT SPENDING

The main criticism on Keynes is deficit spending which means that governments should take on debt in crisis and reduce debt when the economy flourishes. Running into debt has never been a problem whereas the reduction of debt has proved to be almost impossible in democracies. Every four years the representatives are elected by the people who tend to vote for those who give and tend to get rid of politicians who want to increase tax or reduce social benefits.

This dilemma becomes obvious when we compare the objective of the European Union to the actual debt of its member states.

Every country which wants to become a member of the European Union has to fulfill the so-called convergence criteria which are laid down in Article 126 of the Maastricht Treaty:

Article 126¹ of the Maastricht Treaty determines the excessive deficit procedure. According to Article 126(2) and (3), the European Commission prepares a report if an EU member state does not fulfill the requirements for fiscal discipline, in particular if: 1. the ratio of the planned or actual government deficit to GDP exceeds a reference value

(defined in the Protocol on the excessive deficit procedure as 3% of GDP), unless:

- 1.1. either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively,
- 1.2. the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

2. the ratio of government debt to GDP exceeds a reference value (defined in the Protocol on

the excessive deficit procedure as 60% of GDP), unless the ratio is sufficiently diminishing

and approaching the reference value at a satisfactory pace.

Assignment 12: Read Article 126 carefully and summarize the convergence criteria

Words you should know

convergence criteria	Konvergenzkriterien		
excessive deficit procedure	Defizitverfahren		
reference value	Referenzwert		
exceptional	ausnahmsweise		
to diminish	abnehmen		
pace	Geschwindigkeit		

¹ <u>https://www.ecb.europa.eu/ecb/orga/escb/html/convergence-criteria.en.html</u> (July 2017)

3. MACROECONOMIC OBJECTIVES

3.1. THE GERMAN LAW OF STABILITY AND GROWTH

Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft

§ 1

Bund und Länder haben bei ihren wirtschafts- und finanzpolitischen Maßnahmen die Erfordernisse des gesamtwirtschaftlichen Gleichgewichts zu beachten. Die Maßnahmen sind so zu treffen, dass sie im Rahmen der marktwirtschaftlichen Ordnung gleichzeitig zur Stabilität des Preisniveaus, zu einem hohen Beschäftigungsstand und außenwirtschaftlichem Gleichgewicht bei stetigem und angemessenem Wirtschaftswachstum beitragen.

14.Please translate §1 of the German law of stability and growth into good English

3.2 THE MAGIC RECTANGLE OR THE UNEASY QUADRANGLE

The four macroeconomic objectives are also called the magic rectangle or the uneasy quadrangle. Price stability, high employment, balance of trade and steady growth are the main macroeconomic objectives of Germany. The rectangle is called magic because it is almost impossible to reach all objectives at the same time.



Assignment 25 – case study

25.1. Please fill in the table using the information of the website "The World Factbook". Work together with at least one partner to increase speed and efficiency.

2016						
Search item	Germany	UK	Greece	EU	USA	China
GDP (in trillion \$)						
GDP Growth rate					0	
GDP/capita					XO	
GDP by sector						
agriculture					•	
industry						
services						
GDP by expenditure						
household consumption						
government consumption			2			
investment in fixed capital						
investment in inventories						
export of goods and services						
import of goods and services						

Use the information from the table to consider the following tasks:

- 25.2 Why is the GDP/capita a useful information, what does it tell you about the respective country?
- 25.3. For each country set up the GDP (product method and expenditure method)
- 25.4. Write a comparison of the GDPs of Germany, the UK and Greece and give reasons for differences you find especially important or striking. You can use your background from the subject politics to support your comparison.

25.5. Compare the EU, the USA and China. Find explanations and reasons for differences.

3.7.1. MORE INCOME EQUALITY

It was quite surprising for me to find more articles and information about income inequality than about income equality. This is why I just picked some articles I find helpful and ask you to read them carefully and conclude why more income equality is a macroeconomic objective.

30 The Price of Inequality: How Today's Divided Society Endangers Our Future² By Joseph E. Stiglitz

"There are two visions of America a half century from now. One is of a society more divided between the haves and the have-nots, a country in which the rich live in gated communities, send their children to expensive schools, and have access to first-rate medical care. Meanwhile, the rest live in a world marked by insecurity, at best mediocre education, and in effect rationed health care—they hope and pray they don't get seriously sick. At the bottom are millions of young people alienated and without hope. I have seen that picture in many developing countries; economists have given it a name, a dual economy, two societies living side by side, but hardly knowing each other, hardly imagining what life is like for the other. Whether we will fall to the depths of some countries, where the gates grow higher and the societies split farther and farther apart, I do not know. It is, however, the nightmare towards which we are slowly marching."

"The other vision is of a society where the gap between the haves and the have-nots has been narrowed, where there is a sense of shared destiny, a common commitment to opportunity and fairness, where the words "liberty and justice for all" actually mean what they seem to mean, where we take seriously the Universal Declaration of Human Rights, which emphasizes the importance not just of civil rights but of economic rights, and not just the rights of property but the economic rights of ordinary citizens. In this vision, we have an increasingly vibrant political system far different from the one in which 80 percent of the young are so alienated that they don't even bother to vote. I believe that this second vision is the only one that is consistent with our heritage and our values. In it the well-being of our citizens—and even our economic growth, especially if properly measured—will be much higher than what we can achieve if our society remains deeply divided. I believe it is still not too late for this country to change course, and to recover the fundamental principles of fairness and opportunity on which it was founded. Time, however, may be running out.

30.1. Summarize both visions

30.2. Discuss what governments could do to make sure that the first vision is prevented.

Words you should know			
gated community	bewachte Wohnanlage		
mediocre	zweitklassig		
To alienate so	jmd. ausgrenzen		

² <u>https://www.goodreads.com/work/quotes/19319742-the-price-of-inequality-how-today-s-divided-society-endangers-our-future</u> (July 2017)

5. DEMAND-SIDE ECONOMICS VERSUS SUPPLY-SIDE ECONOMICS

5.1. DEMAND-SIDE ECONOMICS

Demand-side economics is based on the assumption that the main force affecting overall economic activity and causing short-term fluctuations is consumer demand for goods and services. This is why it is often called "Keynesian economics". Keynes developed demand-side economics in response to the Great Depression when the measures of classic economics failed to adequately explain why the mechanisms of the free market were obviously unable to get the economy back towards the equilibrium.

In opposition to classical theories of economics which firmly believe that economic activity is self-regulating, so government should not interfere directly by applying anticyclical policies, demand-side economics claims that economic activity is best boosted by increasing the buying power of the lower and middle classes, thus increasing the demand for goods and services.

Demand-side economists support government spending during a recession to overcome the short-term low aggregate demand. Raising the market's aggregate demand will reduce unemployment and encourage economic activity, according to this theory. Government increases demand through spending on public goods (investing in the infrastructure, building schools and hospitals) and services. Demand-side economics can also work through its control of the money supply through altering interest rates or open market operation (monetary policy is within the responsibility of the ECB).

5.2. SUPPLY-SIDE ECONOMICS

Supply-side economics consists of any policy that improves an economy's <u>productive</u> <u>potential</u> and its ability to produce. There are several individual actions that a government can take to improve supply-side performance.

Supply-side economics is often called "**Reaganomics**," or the "trickle-down" policy. It was supported by 40th U.S. President Ronald Reagan. He supported the controversial idea that greater tax cuts for investors and <u>entrepreneurs</u> are incentives to invest and produce economic benefits that trickle down into the overall economy.

Improving the Productivity of Factors

There are a number of measures to improve factor productivity: