GDP shortcomings

- GDP has a number of shortcomings as a measure of economic welfare:
  - Non-market transactions
  - Distribution, kind and quality of products
  - Neglect of leisure time
  - The underground economy
  - Economic bads (overusing resources, pollution…).
- It is a quantitative, rather than qualitative, measure of output.

5. ***Compute the inflation rate***: The inflation rate is the percentage change in the price index from the preceding period.

The inflation rate is calculated as follows:

$$inflation\ rate\ in\ year\ 2 = \frac{CPI\ in\ year\ 2\ - CPI\ in\ year\ 1}{CPI\ in\ year\ 1} \times 100\%$$

Calculating the CPI and the inflation rate: An example

Step 4: Choose one year as a base year (2009) and calculate the consumer price index in each year	
Year	Consumer price index
2009	($14/$14) x 100 = 100
2010	($22/$14) x 100 = 157
2011	($32/$14) x 100 = 229

Step 5: Use the consumer price index to calculate the inflation rate from previous year	
Year	Inflation rate
2010	(157 - 100)/100 x 100 = 57%
2011	(229 - 157)/157 x 100 = 45%

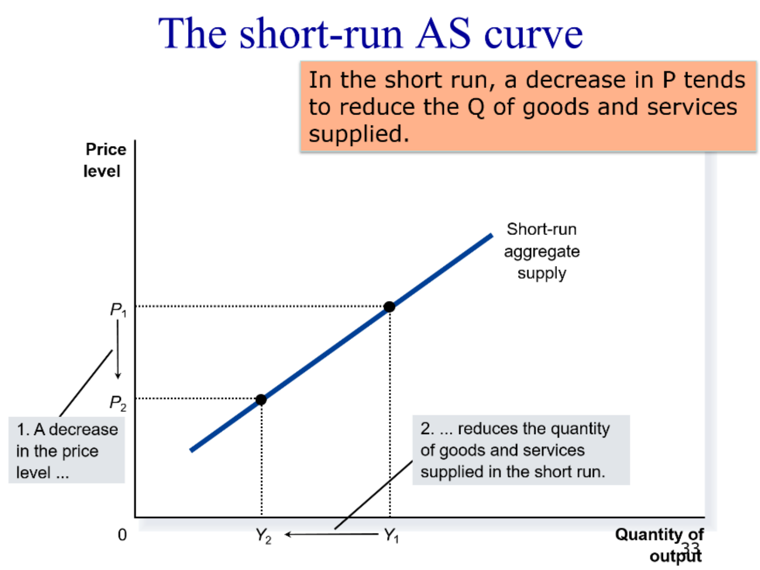
Problems in measuring the cost of living

- The CPI is an accurate measure of the selected goods that make up the typical bundle, but it is not a perfect measure of the cost of living.
  - ***<u>Fixed basket for several years</u>***
- *Substitution bias*
  - The basket does not change to reflect consumer reaction to changes in relative prices.
  - Consumers substitute toward goods that have become relatively less expensive.
  - The index overstates the increase in cost of living by not considering consumer substitution.
- *Introduction of new goods*
  - Fixed basket cannot reflect the introduction of new products timely.
  - New products result in greater variety, which in turn makes each dollar more valuable.
- *Unmeasured quality changes*
  - If the quality of a good rises from one year to the next, the value of a dollar rises, even if the price of the good stays the same.
  - If the quality of a good falls from one year to the next, the value of a dollar falls, even if the price of the good stays the same.

The substitution bias, introduction of new goods, and unmeasured quality changes cause the CPI to ***be an inaccurate measure for*** the true cost of living.

SRAS

- In the short run, the aggregate-supply curve is *upward-sloping.*



Why is it upward sloping?

- Always start from firm's profit.
- Profit = revenue - cost

1- The Keynesian sticky-wage theory

- Nominal wages are slow to adjust, or are 'sticky' in the short run.
  - Wages do not adjust immediately to a fall in the price level.
  - A lower price level makes employment and production less profitable.
  - This induces firms to reduce the quantity of goods and services supplied.

2- The New Keynesian sticky-price theory

- Prices of some goods and services adjust sluggishly in response to changing economic conditions.
- An unexpected fall in the price level leaves some firms with higher-than-desired prices.
- This depresses sales, which induces firms to reduce the quantity of goods and services they produce.

3- The new classical misperceptions theory

- Decreases in the overall price level temporarily mislead suppliers about what is happening in the markets in which they sell their output.
- A lower price level causes misperceptions about relative prices – supplier only notice his product is cheaper – profit is lower.
- These misperceptions induce suppliers to decrease the quantity of goods and services supplied

Shifts if SRAS

- Shifts arise due to:
  - Labour: An increase in minimum wage raises natural rate of unemployment rate
  - capital
  - natural resources
  - technology
  - *expected price level*
- An increase in the expected price level reduces the quantity of goods and services supplied and shifts the short-run aggregate supply curve to the left.
- *Predict price high → set wages high → production cost high → profit low → supply less*