1.2. Economic issues (1): The 2007 financial crisis

WHAT HAPPENED?

1. LENDERS GIVE SUBPRIME MORTGAGES

- **subprime mortgage** ➔ those given to questionable borrowers

why lend?
increase in house prices

why borrow?
low interest rates

2. MORTGAGE COMPANIES SELL BONDS TO OTHER FINANCIAL INSTITUTIONS

- bonds = group of subprime mortgages

3. BORROWERS DEFAULT ➔ MORE HOUSES ➔ DROP IN PRICE

- this causes subprime mortgages to lose their value!

4. CREDIT CRUNCH OCCURS

- banks don't want to lend to borrowers and to each other

5. THIS DECREASES ECONOMIC ACTIVITY

- closing down of firms, cutting jobs, decrease in consumer confidence

THE EFFECTS OF THE CRISIS

1. WHAT TO PRODUCE

- **less:** houses, expensive and non-essential goods (such as cars)
- **more:** R&D (research and development), software

2. HOW TO PRODUCE

- **less:** employment
- **more:** unemployment

} **reallocation of input resources**

3. FOR WHOM TO PRODUCE

- **less:** middle and low income households
- **more:** rich people, first-time buyers, discounts on sales

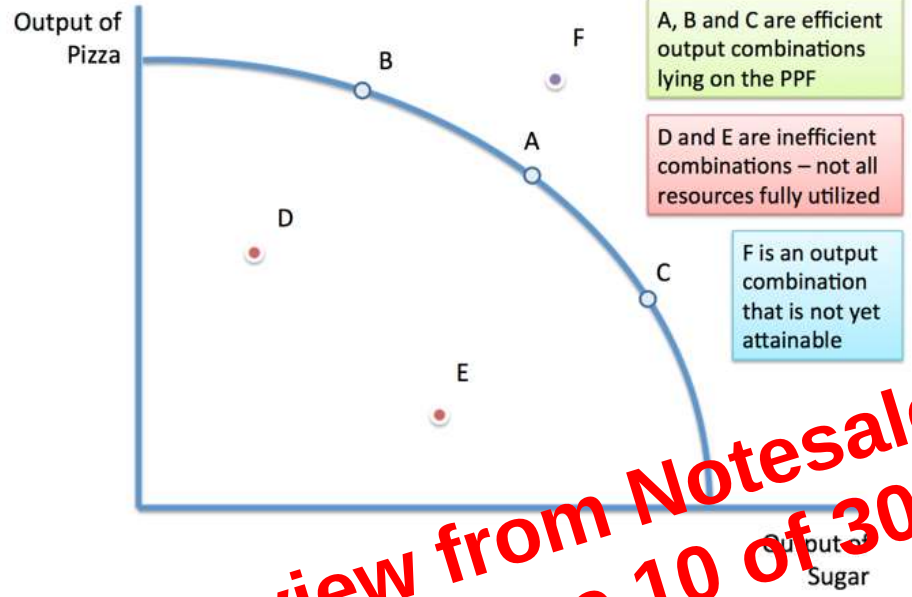
❖ **RECESSION ➔ period of time when the amount of goods and services declines**

1.3. Scarcity and the competing use of resources

ASSUMPTIONS

- **FULL EMPLOYMENT**
  - all workers have jobs
- **WORKERS ARE A SCARCE RESOURCE**

Production Possibility Frontier (PPF)



PPF shows the max combination of outputs an economy can produce with all current resources

THE SLOPE OF PPF

- **it represents the OPPORTUNITY COST of a good**
  - how much of one good needs to be sacrifised to make more of another good
- **it is increasing because of LAW OF DIMINISHING MARGINAL RETURNS**
  - each extra workers adds less output than the previous extra worker
  - **applies** when one input is variable, and others are fixed

WHAT IS **PRODUCTION EFFICIENCY?**

- **more output of one good can only be obtained by sacrificing output of other goods**
  - ➢ this basically answers the question WHAT and HOW TO PRODUCE (not for whom)
  - ➢ this is decided by **government** or **markets**

2.1. Economic data

1) TIME-SERIES DATA

- **sequence of measurements of the same variable at different points in time**
- how variable changes over time

PRESENTATION	INTERPRETATION

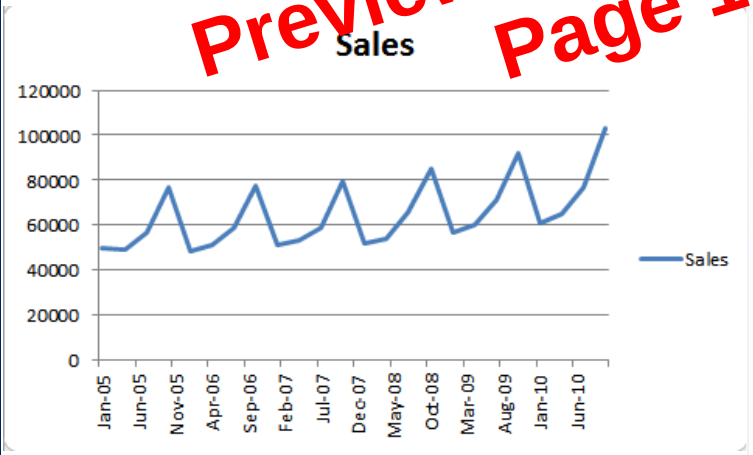
• **tables**
• **charts**
	• **can be easily manipulated**
	  ○ e.g. in advertising, politics
	• **best way:**
	  ○ averages over a month, quarter or a year

2) CROSS-SECTION DATA

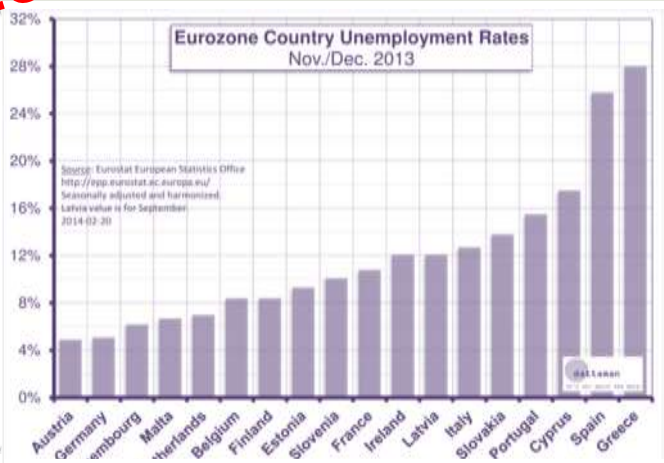
- **record how economic variable differs across (groups of) individuals at a point in time**
- how variable changes across different individuals or groups of individuals

3) PANEL (LONGITUDINAL) DATA (mix ☺)

- **record how economic variable differs across (groups of) individuals over time**
- how variable changes over time and across different individuals or groups of individuals



1) Time-series data



2) Cross-section data

Table 2.3 Unemployment by country, 2006–09 (% of labour force)

	US	Japan	Germany	France	UK
2006	4.6	4.1	9.8	9.2	5.4
2007	4.6	3.9	8.4	8.4	5.3
2008	5.8	4.0	7.4	7.9	5.7
2009	9.3	5.4	8.1	9.5	7.7

Sources: OECD and IMF.

3) Panel data

2.2. Index Numbers

INDEX NUMBERS

- **express data relative to a given base value**
- application: comparing numbers without emphasizing units of measurement

WEIGHTS

- **reflect the purpose for which the index is constructed**
- example: relative use of aluminium and copper as industrial inputs
  - (**0.2** x 150) + (**0.8** x 242) = 224

TO REMEMBER:

- they always add up to 1

WEIGHTED AVERAGE

- **index number constructed by combining multiple individual indices**
- shows the group relative change
- example:
  - (0.2 x 150) + (0.8 x 242) = **224**

TO REMEMBER:

- it is always between individual indices
- weights determine which it is closer to

- POPULAR INDICES -

CPI (CONSUMER PRICE INDEX)

- **DOES IT WHAT MEASURE?**
  - **changes in the cost of living** by looking at the cost of standard 'shopping basket' of goods
- **STEPS OF CONSTRUCTION:**
  - **individual indices** of goods groups
  - **weighted average** of them
- **IT DOES NOT INCLUDE:**
  - mortgage interest payments

❖ **WAS measurement of inflation target in UK**

RPI (RETAIL PRICE INDEX)

- **WHAT DOES IT MEASURE?**
  - **changes in the cost of living** by looking at the cost of standard 'shopping basket' of goods
- **STEPS OF CONSTRUCTION:**
  - **individual indices** of goods groups
  - **weighted average** of them
- **IT DOES INCLUDE:**
  - mortgage interest payments

❖ **IS measurement of inflation target in UK+EU**

◆ **drawbacks: they overstate the cost of living because they inaccurately measures Δquality**

2.7. Theories and evidence

THREE STAGES OF ECONOMIC ANALYSIS

- **CONTEMPLATION AND PROBLEM FORMULATION**
  - e.g. armchair thinking = we decide tube fares has something to do with tube revenues
- **MODEL DEVELOPMENT → SO TO CAPTURE ESSENCE OF PROBLEM**
  - e.g. thinking about what influences tube usage and tube revenue
- **MODEL TESTING → BY CONFRONTING IT WITH ECONOMIC DATA**
  - we use econometric examination to quantify the things model identifies
    - **model and data compatible** → we don't reject the model (but be careful!)
    - **model and data incompatible** → we reject the model, start again

ECONOMIC LAWS

- **models that we have become very confident about**

2.8. Some popular criticisms of economics and economists

POPULAR CRITICISMS

- **NO TWO ECONOMISTS EVER AGREE**
  - this applies both to normative and positive economics
  - **but…** → this happens also in physics, chemistry!
- **MODELS ARE TOO SIMPLE AND UNREALISTIC**
  - **but…** → a good model helps us see the essentials of the problem
- **ECONOMISTS THINK ONLY ECONOMIC INCENTIVES MATTER**
  - **but…** → it's not true as they also care about OTHER THINGS EQUAL
- **ACTIONS OF HUMANS CANNOT BE REDUCED TO SCIENTIFIC LAWS**
  - **but…** → in average, for humans as a whole science can predict the behaviour ☺