# GLOSSARY

**absolute advantage** The advantage that one region or person is said to have over another in the production of a given good when an equal quantity of resources can produce more of that good in the first region than in the second. Compare *comparative advantage*.

***AD* curve** See *aggregate demand curve*.

**adverse selection** An example is the tendency for people most at risk to insure themselves, whilst people least at risk do not, so that the insurer gets a disproportionate number of high-risk clients. In general, it involves selection where quality is uncertain and care needs to be taken to avoid abnormally poor-quality goods or services.

**agent** Any person involved in economic decision-making.

**aggregate demand (AD)** The total desired purchases of the economy's final output at the current average price level.

**aggregate demand curve** A curve relating consumers' total desired output to the aggregate price level in the economy.

**aggregate demand shock** A shift in the *aggregate demand curve*, for example resulting from changes in consumer confidence or deliberate shifts in monetary or fiscal policy.

**aggregate supply** The total amount that will be produced and offered for sale at each aggregate price level.

**aggregate supply curve** A curve relating *aggregate supply* to the aggregate price level.

**aggregate supply shock** A shift in the *aggregate supply curve*, for example resulting from a shift in commodity prices or a technological change.

**appreciation** When a change in the *exchange rate* raises the value of the specified currency relative to others.

**AS curve** See *aggregate supply curve.*

**asymmetric information** A situation in which some economic agents have more information than others and this affects the outcome of a transaction between them.

**at the margin** Decisions taken at the margin are arrived at by considering whether a slight adjustment to the current situation would be an improvement. For example, firms can consider whether increasing (or decreasing) production by one unit would increase profits, and consumers can consider how much consuming one more unit of a particular product would increase their total utility.

**balance of payments accounts** A summary record of a country's transactions that involve payments and receipts of foreign exchange.

**balance of trade** The difference between the value of imports and exports of goods and services.

**barriers to entry** Anything that prevents new firms from entering an industry. These can be natural, such as substantial economies of scale, or created, such as a patent, or when firms engage in excessive advertising to make it difficult for a new firm to compete.

**behavioural economics** A field of economics which replaces simple assumed motives (in particular the assumption that consumers make rational choices designed to maximize their utility) with more complex motives and behaviours, often drawn from psychology.

**black market** A market in which goods are sold in violation of some legally imposed pricing or trading restriction.

**bond** A tradable debt contract carrying a legal obligation to pay interest and repay the principal at some stated future time.

**budget deficit** Usually refers to the *fiscal deficit* run by the government.

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**budget surplus** Usually refers to the *fiscal surplus* run by the government.

**cartel** A group of firms that agree amongst themselves to cooperate rather than compete, raising prices in order to increase their total profits.

**central bank** A bank that acts as banker to the commercial banking system and often to the government as well. In the modern world it is usually a government-owned institution that is the sole money-issuing authority and has a key role in setting and implementing *monetary policy*. The UK central bank is the Bank of England.

**central bank independence** The policy of allowing the central bank to implement monetary policy without direct government control. Typically the government sets a target level for inflation, but leaves the central bank free to set interest rates at whatever level it deems necessary to meet this target. The key aim of central bank independence is to increase the credibility of monetary policy and hence reduce expected inflation. The central banks of most developed economies are now independent.

**centrally planned economy** An economy in which the decisions of the government (as distinct from households and firms) exert the major influence over the allocation of resources and the distribution of income. Also called a command economy.

**classical economics** A term loosely used to refer to all mainstream economics up to the 1950s. This body of theory was criticized by Keynes.

**comparative advantage** The ability of one nation (or region or individual) to produce a good or service at a lower opportunity cost in terms of other products forgone than another nation (or region or individual). Compare *absolute advantage*.

**competition policy** Policy designed to prohibit the acquisition and exercise of excessive market power by firms. It is designed to prevent monopolies from arising, or abusing their power where they do exist, and also to prohibit non-competitive behaviour by oligopolistic firms.

**complementary goods (complements)** Two goods for which the quantity demanded of one is negatively related to the price of the other, typically because they need to be used together to meet one underlying need (e.g. cars and petrol are of little use separately, but together provide transport).

**consumer price index (CPI)** An index of the general price level based on the consumption pattern of typical consumers.

**consumer surplus** The difference between the value that consumers place on the total amount of a good or service that they consume, and the payment they must make to purchase this amount. The difference between what consumers actually pay and the maximum they would be willing to pay for this amount.

**cost-push inflation** The tendency for prices to rise throughout the economy as producers raise the prices of their products in order to protect their profit margins following an increase in raw material prices.

**creative destruction** Schumpeter's theory that high profits and wages earned by monopolistic or oligopolistic firms are the spur for others to invent cheaper or better substitute products and techniques that allow their suppliers to gain some of these profits thus eroding the previously existing market power.

**credibility** The extent to which agents in the private sector of the economy believe that the government will carry out the policy it promises. This is important because expectations of future government policy action can influence current behaviour.

**credit crunch** A general collapse of lending in which even borrowers who were previously considered reliable now find it impossible to borrow.

**current account deficit** When all international transactions between one country and the rest of the world related to goods and services, income payments, and receipts are totalled, a current account deficit is recorded if the payments exceed the receipts. The largest single component of the UK current account deficit has tended to be its *trade deficit*, as the value of imports into the UK exceeds the value of exports from it.

**demand** The amount of a good or service that an individual or group would be willing to buy at a specified price.

**demand curve** A graphical relation showing the quantity of some good or service that households would like to buy at each possible price.

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**demand management** See *demand side policies.*

**demand-pull inflation** The tendency for the general price level to rise when the economy is booming, typically because employees demand wage rises or producers attempt to increase their profit margins.

**demand shock** A change in demand for a good (or service) which results from something other than a change in the price of this product (e.g. a reduction in incomes or a change in the price of a substitute good). This change shifts the demand curve for the product.

**demand side policies** Policies designed to reduce unemployment by boosting demand. These include *fiscal policy, monetary policy*, and *quantitative easing.*

**depreciation** (1) The loss in value of an asset over time due to physical wear and tear and obsolescence. (2) A shift in the free-market exchange rate which reduces the value of the specified currency in terms of other currencies.

**developed economies** Usually refers to the rich industrial economies of North America, Western Europe, Japan, and Australasia.

**developing countries** The lower-income countries of the world, most of which are in Asia, Africa, and South and Central America. Also called emerging economies.

**development economics** The study of poorer (less-developed) economies, aiming in particular to identify the reasons why they have so far failed to catch up with more developed economies.

**diminishing marginal utility** The observation that the satisfaction (utility) that a consumer gains from consuming one more unit of a good or service tends to decline as the amount consumed increases. For example, I am likely to enjoy eating my first ice cream today more than my second, and far more than my twentieth!

**economies of scale** A situation in which unit costs fall as output increases, enabling large firms to produce at lower unit costs than small firms.

**efficiency wage** A wage rate above the market-clearing level that enables employers to attract the best workers as well as to provide their employees with an incentive to perform well so as to avoid being sacked.

**elastic** Where the percentage change in the quantity demanded or supplied is greater than the percentage change in the factor that caused it. This corresponds to a price or income elasticity greater than 1 in absolute value.

**elasticity of demand** See *price elasticity of demand.*

**elasticity of supply** See *price elasticity of supply.*

**EMU (Economic and Monetary Union)** Adoption by EU countries of a common currency (the euro) in place of their previous separate currencies.

**equities** Certificates (or electronic records) indicating part ownership of a joint-stock company. Also known as shares.

**ERM (Exchange Rate Mechanism)** System which attempted to keep exchange rates between European Union countries stable. Most currencies in the ERM have now joined the *EMU* instead.

**excess demand** The amount by which the quantity demanded exceeds the quantity supplied at a given price; negative *excess supply.*

**excess supply** The amount by which the quantity supplied exceeds the quantity demanded at a given price; negative *excess demand.*

**exchange rate** The price at which two national currencies can be exchanged for each other. The amount of one currency needed to buy one unit of the other currency.

**externality** A cost or benefit of a transaction that falls on agents not involved in the decision (e.g the effects of pollution on third parties).

**final goods and services** The outputs of the economy after eliminating all double counting, i.e. excluding all intermediate goods.

**fiscal deficit** A shortfall of current government revenue below current expenditure.

**fiscal policy** Policy designed to influence aggregate demand by altering government spending and/or taxes, thereby shifting the *AD curve.*

**fiscal surplus** The amount by which current government revenue exceeds current expenditure.

**fixed exchange rate** An exchange rate that is held within a narrow range around some pre-announced value. Typically the country's central bank intervenes by buying/selling its currency in the foreign-exchange market in order to keep it within the desired range.

**floating exchange rate** An exchange rate that is left free to be determined on the foreign-

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exchange market by the forces of demand and supply.

**foreign exchange (FX) market** The market where currencies are traded—at prices that are expressed by the *exchange rate*.

**framing** The exact way in which a problem is presented, or a question is asked. Studies in psychology and behavioural economics have demonstrated that people may make very different choices in a given situation, depending on exactly how the choices are presented.

**free riding** The problem that arises because people have a self-interest in not paying for a *public good* in the hope that others will pay for it.

**free trade** The absence of any form of government interference with the free flow of international trade.

**game theory** The study of *strategic* choices, applicable when the outcome for one person depends on the behaviour of others.

**GDP** See *gross domestic product*.

**GDP gap** The difference between actual GDP and potential GDP. Also called the output gap. Negative output gaps are sometimes called recessionary gaps; positive output gaps are sometimes called inflationary gaps.

**globalization** The increased worldwide interdependence of most economies. Integrated financial markets, the sourcing of components throughout the world, the growing importance of transnational firms, and the linking of many service activities through the new information and communications technologies are some of its many manifestations.

**goods** Tangible products, such as cars or shoes. Sometimes all goods and services are loosely referred to as goods.

**government failure** Where flawed government intervention imposes costs that would have been avoided if it had acted differently.

**gross domestic product (GDP)** The value of total output actually produced in the whole economy over some period (usually a year, although quarterly data are also available). Nominal GDP is in current money terms. Real GDP is a volume measure that removes the effects of inflation.

**groupthink** A term from behavioural economics referring to our tendency to hold the same opinions as those around us.

**household** All people living under one roof and taking joint financial decisions.

**human capital** The capitalized value of the productive capabilities of a person. Usually refers to value derived from expenditures on education, training, and health improvements.

**hyperinflation** Episodes of very rapid inflation.

**implicit contract** Details of what employee and employer can expect from each other (such as the scope for future promotion and pay rises) which, although important, are not included in the formal contract signed by these two parties.

**income elasticity (of demand)** The responsiveness of quantity demanded to a change in income. Measured as the percentage change in quantity demanded divided by the percentage change in income that brought about this change.

**indicators** Data that investors and policy-makers monitor for information about the state of the economy.

**inelastic** When the percentage change in quantity is less than the percentage change in price or income that brought it about (i.e. elasticity is less than 1 in absolute value).

**infant-industry argument** The argument that new domestic industries with potential economies of scale need to be protected from competition from established low-cost foreign producers so that they can grow large enough to achieve costs as low as those of foreign producers.

**inferior good** A good with a negative *income elasticity*, implying that demand for it diminishes when income increases. Compare *normal good*.

**inflation** A positive rate of increase in the general price level in the economy.

**injections** Additional spending flows which increase the circular flow of income between domestic households and firms. In a simple macro model the injections are government spending, exports, and investment.

**interest rate** The percentage of the amount borrowed which must be paid each year as interest on the loan.

**intermediate goods and services (intermediates)** All goods and services which, rather than being consumed directly, are used as inputs into the production of other goods and services.

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**internalizing the externality** A policy which gives decision-makers an incentive to take account of the *externalities* that they cause and take appropriate steps to reduce them (assuming that these externalities are harmful). Examples are carbon taxes and congestion charging.

**investment** The act of producing or purchasing goods that are not for immediate consumption. These are durable goods that will form part of the physical capital stock, housing, and additions to inventories of goods.

**Keynesian revolution** The adoption of the idea (first proposed by J. M. Keynes) that the government can use monetary and fiscal policy to control aggregate demand and thereby influence the level of GDP and unemployment.

**labour force** See *workforce*.

**long run** A period of time over which all inputs used by a firm may be varied but the basic technology of production is unchanged.

**long-run aggregate supply curve** A curve that relates the aggregate price level to equilibrium real GDP after all input costs, including wage rates, have been fully adjusted to eliminate any excess demand or supply.

**marginal cost** The increase in a firm's total costs as a result of raising the rate of production by one unit.

**marginal revenue** The change in total revenue resulting from selling one extra unit per period of time.

**marginal utility** The change in satisfaction resulting from consuming one more unit of a good or service.

**market** An area in either geographical or cyberspace in which buyers and sellers negotiate the exchange of a specified product.

**market economy** A society in which people meet most of their material wants through exchanges voluntarily agreed upon by the contracting parties, with limited intervention by the government. Often referred to as a free market economy.

**market failure** Any market performance that is less than the most efficient possible (the optimal) performance. Key reasons for market failure are natural monopoly, information problems, externalities, and public goods.

**market structure** The characteristics of a market that influence the behaviour and performance of firms that sell in the market. The four main market structures are *perfect competition*, *monopolistic competition*, *oligopoly*, and *monopoly*.

**monetarism** The theory that the money supply exerts a powerful influence over the economy and that control of the money supply is a potent means of affecting the economy's macroeconomic behaviour.

**monetary policy** Policy of seeking to control aggregate demand, and ultimately GDP and the inflation rate, by adjusting short-term interest rates, and more recently, by *quantitative easing*.

**money supply** The total amount of money circulating in the economy. Also called the supply of money or the money stock.

**monopolist** The sole seller of a product or service.

**monopolistic competition** A market structure in which there are many sellers and new firms are able to enter the industry, but in which each firm sells a slightly different version of the product and, as a result, faces a negatively sloped demand curve for its own product.

**monopoly** A market structure in which the industry contains only one producer.

**moral hazard** The change in behaviour which results from people being protected against risk, for example, starting to drive more carelessly when they have accident insurance.

**multiplier** The ratio of the change in GDP to the size of the change (e.g. a tax cut) which brought it about.

**NAIRU** The Non-Accelerating Inflation Rate of Unemployment'. The level of unemployment that is consistent with a constant rate of inflation.

**national debt** The total debt of the central government, arising as a result of previous *fiscal deficits*.

**natural monopoly** An industry for which a single producer is clearly more efficient than having competing firms, typically because of large *economies of scale*.

**negative sum game** An interaction in which some participants win and others lose, but in which the total losses made by the losers exceed the gains made by the winners. See also *positive sum game*, *zero sum game*.

**net exports** Total exports of goods and services minus total imports.

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**nominal GDP** Total output of the economy valued at current prices. This can rise due to either real GDP growth or inflation. Also known as 'money GDP'.

**normal good** A good or service for which demand increases when income increases. Compare *inferior good*.

**oligopoly** An industry that contains only a few firms that interact strategically. The outcome for each is affected by what the others do.

**OPEC** Organization of Petroleum Exporting Countries, a permanent, intergovernmental organization to regulate petroleum production, created in 1960.

**opportunity cost** Measurement of the cost of one choice in terms of the value of the alternatives forgone.

**perfectly competitive industry (perfect competition)** A market structure in which there is a large number of firms in an industry, more are free to enter, and all produce goods which consumers regard as identical. This extremely competitive environment means that each individual firm must sell at the same price as its competitors (setting a higher price would generate no sales, and a lower price is likely to be loss-making). Thus the demand curve for each individual firm appears flat, even though the demand curve for the industry as a whole slopes down.

**positive sum game** An interaction in which some participants win and others lose, but in which the total gains made by the winners exceed the total losses made by the losers. See also *negative sum game, zero sum game*.

**potential GDP (potential output)** The level of GDP which is consistent with unemployment being at the NAIRU, implying that inflation is stable—neither rising nor falling.

**price discrimination** Situation arising when firms sell different units of their output at different prices for reasons not associated with differences in costs.

**price elasticity of demand** The percentage change in quantity demanded divided by the percentage change in price that caused it. Usually just called elasticity of demand.

**price elasticity of supply** The percentage change in quantity supplied divided by the percentage change in price that caused it. Usually just called elasticity of supply.

**private sector** That portion of an economy in which production is owned and operated by private (non-government) bodies. Compare *public sector*.

**production possibility boundary** A curve that shows the alternative combinations of goods and services that can just be produced if all available productive resources in the economy are fully employed and used efficiently; the boundary between attainable and unattainable output combinations (see Figure 10.2).

**progressive tax** A system which charges richer people a higher proportion of their incomes as tax.

**public goods** Goods and services that, once produced, can be consumed by everyone, such as police protection and parks. Also called collective consumption goods.

**public sector** That portion of an economy in which production is owned and operated by the government or by bodies created and controlled by it, such as nationalized industries. Compare *private sector*.

**quantitative easing** The purchase of government and corporate bonds by the *central bank* on a large scale intended to raise the money supply, influence asset prices, and affect long-term interest rates. This policy has been used by central banks which wanted to stimulate *aggregate demand* but could not lower interest rates any further.

**real GDP** Total economic output valued at prices from a specified base year, for example, GDP at 1999 prices. It is a volume measure of real economic activity that removes the effects of inflation.

**recession** A sustained drop in the level of aggregate economic activity, officially defined to occur when real GDP drops for two successive quarters.

**regret** The emotional pain associated with realizing that we have made a bad decision. Studies in psychology and behavioural economics have found that this can have a substantial impact on our decision-making.

**relative price** Any price expressed as a ratio of another price or price index.

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**scarce** A resource is considered scarce if using more of it for one purpose necessitates using less of it for another purpose. By contrast, we can use more of a plentiful resource for a new purpose whilst continuing to use it as before for existing purposes.

**services** Intangible rather than physical products, for example, haircuts and medical services.

**shares** See *equities*.

**short run** The period of time over which firms cannot adjust some of their inputs, such as physical capital.

**specialization** When applied to countries, it refers to producing in the domestic economy products for which the country has a *comparative advantage* and importing those for which it has a comparative disadvantage. When applied to labour within a country, it refers to specialization in particular tasks rather than each person producing a wide range of products.

**stagflation** The simultaneous occurrence of a positive GDP gap (with its accompanying high unemployment) and rising inflation.

**stock exchange** The market in which investors can buy or sell *shares*. Most shares are now traded electronically.

**strategic behaviour** Decisions that take into account the reactions of others to one's own actions, e.g. when an oligopolistic firm takes into account how its competitors might react to a price cut.

**substitute** Two goods are substitutes if the quantity demanded of one is positively related to the price of the other, typically because they are alternative means of meeting an underlying need (e.g. train and air travel).

**sunk costs** Costs already committed to a project which cannot be recovered even if the project is now abandoned.

**supply** The amount of a good or service that an individual or group would be willing to sell at a specified price.

**supply curve** The graphical representation of the relation between the quantity of some good or service that producers wish to make and sell per period of time and its price, other relevant factors remaining unchanged.

**supply shock** A change in the supply of a good (or service) which results from something other than a change in the price of this product. This change shifts the supply curve for the product.

**supply side policies** Policies that seek to shift the *aggregate supply curve* to the right, by increasing the productive efficiency of the economy. Examples are policies aimed at equipping the workforce with skills that are currently in short supply, and policies aimed at increasing entrepreneurship or the degree of competition between firms.

**systemic risk** The risk of widespread financial disruption if the collapse of one financial institution leads to the collapse of others in a chain reaction.

**tacit collusion** When firms arrive at a cooperative solution (which increases their joint profit) even though they have not explicitly agreed to cooperate.

**trade deficit** Occurs when the value of exports from the economy is less than the value of imports into it.

**trade union** A union covering workers with a common set of skills, no matter where, or for whom, they work.

**utility** The total satisfaction derived from consuming some amount of a good or service.

**value added** The value of a firm's output minus the value of the inputs that it purchases from other firms.

**very long run** A period of time over which the technological possibilities open to a firm or the economy as a whole are subject to change.

**visible trade** Trade in physical products. Sometimes called merchandise trade.

**visibles** Tangible goods such as cars, aluminium, coffee, and iron ore, which we can see when traded across international borders.

**wage–price spiral** The tendency for inflation to remain high even after the conditions that initially caused it have passed. Employees may continue to demand wage rises to compensate for the effect of previous price rises (thus protecting their real wage), whilst employers continue to raise prices in order to pass on their increased wage bills.

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**withdrawals** Spending that leaves the domestic economy and does not create further incomes for domestic residents. Import spending, for example, creates incomes overseas. Also called leakages. The main withdrawals from the circular flow between households and firms are savings, taxes, and imports.

**workforce** The total of the employed, the self-employed, and the unemployed, i.e. those of working age who have a job plus those who are looking for work.

**zero sum game** An interaction in which some participants win and others lose, but in which the total gains made by the winners exactly balance the total losses made by the losers. See also *negative sum game, positive sum game*.

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