

KEY TERMS

Key words or phrases appear in bold in the text at the first use and are then defined in the margin. They will help you to become familiar with the language of economics. Use the Key terms listing at the end of each chapter as a revision aid, to check your understanding. The terms and definitions are also repeated in the Glossary at the end of the book.

AUSTRALIAN DATA

Many figures and tables include Australian data, adding interest and relevance to the theory. See Figure 6.4, page 176.

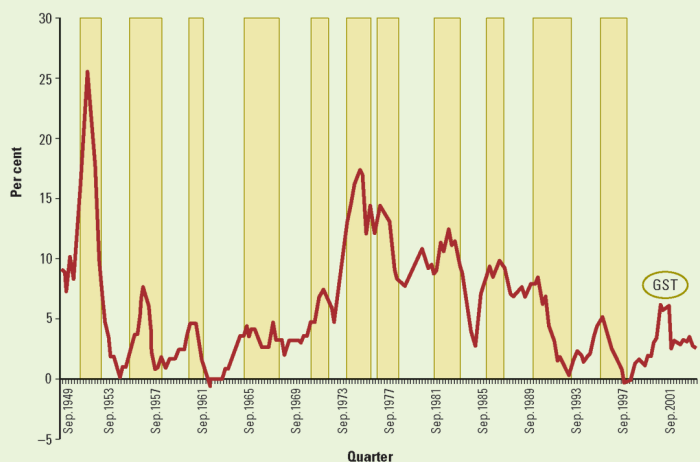
What is the relationship between an output gap and the amount of cyclical unemployment in the economy? By definition, cyclical unemployment is positive when the economy has a recessionary gap, negative when there is an expansionary gap, and zero when there is no output gap. A more quantitative relationship between cyclical unemployment and the output gap is given by a rule of thumb called *Okun's law*, after Arthur Okun, one of President Kennedy's chief economic advisers. According to **Okun's law**, each extra percentage point of cyclical unemployment is associated with about a 2-percentage point increase in the output gap, measured in relation to potential output. Okun's calculation related to the United States. For Australia, the figure is marginally lower—around 1.7. (This figure is based on our own calculations using data on real GDP and the unemployment rate over the period 1946 to 2003.) So, for example, if cyclical unemployment increases from 1 per cent to 2 per cent of the labour force, the recessionary gap will increase from 2 per cent to 3.7 per cent of potential GDP. (In symbols, Okun's law can be written as $\frac{Y - Y^*}{Y^*} = -\beta(u - u^*)$, where β , for the United States, is 2 and for Australia, it is 1.7.) Example 6.1 illustrates further.

Okun's law: Each extra percentage point of cyclical unemployment is associated with about a 1.7 percentage point increase in the output gap, measured in relation to potential output.

FIGURE 6.4

Inflation, 1948–2003.

Australian inflation since 1948 is measured by the percentage change in the CPI, and periods of recession are indicated by the shaded vertical bars.



Core economic principles

A few core principles do most of the work in economics and are essential building blocks for a deeper understanding of the subject. These principles are highlighted in green, with a 'Core economic principles' annotation in the margin, and are also listed at chapter ends. See Chapter 1, pages 4 and 33.

We call it the **scarcity principle**, because the simple fact of scarcity makes trade-offs necessary.



The scarcity principle: Although we have boundless needs and wants, the resources available to us are limited. So, having more of one good thing usually means having less of another.

Inherent in the idea of a trade-off is the fact that choice involves compromise between com-

CORE ECONOMIC PRINCIPLES

The scarcity principle (also called 'the no-free-lunch principle')

Although we have boundless needs and wants, the resources available to us are limited. So, having more of one good thing usually means having less of another.

The cost-benefit principle

An individual (or a firm, or a society) should take an action if, and only if, the extra benefits from taking the action are at least as great as the extra costs.

The principle of increasing opportunity cost (also called 'the low-hanging-fruit principle')

In expanding the production of any good, first employ those resources with the lowest opportunity cost, and only afterward turn to resources with higher opportunity costs.

The efficiency principle

Efficiency is an important social goal, because when the economic pie grows larger, everyone can have a larger slice.

