Case Studies on

Macroeconomics – Vol. I

Edited by

Mercy Mathew

Icfai Business School Case Development Centre

Icfai Books

71, Nagarjuna Hills, Punjagutta, Hyderabad – 500082

Icfai Books
71, Nagarjuna Hills,
Punjagutta, Hyderabad – 500082
Andhra Pradesh, INDIA
Phone: 91 - 40 - 23435387/91, Fax: 91 - 40 - 23435386
e-mail: icfaibooks@icfai.org, ibscdc@icfai.org
Website: www.icfaipress.org/books, www.ibscdc.org

© 2006 The Institute of Chartered Financial Analysts of India. All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means - electronic, mechanical, photocopying or otherwise – without prior permission in writing from The Institute of Chartered Financial Analysts of India.

While every care has been taken to avoid errors and omissions, this book is being sold on the condition and understanding that the information given in the book is merely for reference and must not be taken as having authority of or being binding in any way on the authors, editors, publisher or sellers.

Product or corporate names may be registered trademarks. These are used in the book only for the purpose of identification and explanation, without intent to infringe.

Case studies are intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation.

Copies of individual case studies are available for purchase from www.ibscdc.org

ISBN : 81-314-0490-0

Editorial Team: Sushma T. and Prabha Devi

Visualiser: Ch. Yugandhar Rao
Designer: A. Mrugasira

OVERVIEW

Macroeconomics is the study of the aggregate performance of the economy. It concentrates on economy-wide concepts such as national income, gross domestic product, rate of growth of the economy, changes in unemployment levels, inflation and price levels, which when analysed reveals the overall health of the economy. Since it is influenced by numerous factors, Macroeconomics is a complicated study when compared to Microeconomics, which concentrates more on individuals and how they make economic decisions. In other words, Macroeconomic studies help consumers, businesses and government to make better economic decisions by forecasting the economic trends.

Consumers would like to know how much it will cost them to buy goods and services, or how much it may cost to borrow money or how easy it will be to find work. Businesses use macroeconomic data to determine the demand, to find whether consumers have enough money to buy their products, or is it feasible to expand its production base in a particular country. And governments take major decisions on budgeting, taxation, interest rates and other economic policies based on the macroeconomic data.

Macroeconomic Analysis

The basic parameters employed to judge the health of an economy are national output, unemployment and inflation.

National Output or GDP: It refers to the total amount of goods and services produced in a country, and is commonly known as the gross domestic product (GDP). GDP can be calculated in terms of real GDP, which takes into account inflation, or in terms of nominal GDP, which reflects only changes in prices. The current GDP would always be an estimated one, deciphered from the historical figures. The GDP figures can be compared across economies to determine which countries are economically strong or weak. Apart from this, the analysis of the reasons for a robust GDP growth, such as government policy, consumer behaviour or international phenomena help business organisations in better decision-making.

Unemployment: The unemployment rate shows the percentage of people from the available pool of labour force who are without work. When an economy witnesses a high GDP growth rate, unemployment levels are relatively low. This is because, in order to sustain the greater levels of production during the period, more workforce is required.

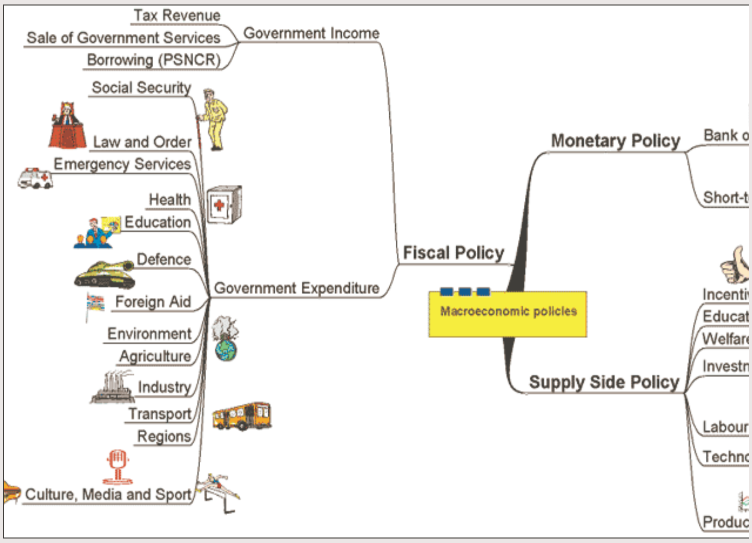
Inflation: Inflation rate is the indicator of the rate at which prices rise. Inflation can be measured in two ways: through the Consumer Price Index (CPI) and the GDP deflator. The CPI is based on the current price of a selected basket of goods and services, while the GDP deflator is the ratio of nominal GDP to real GDP.

Demand and Disposable Income: The growth of the economy is determined by demand for goods and services, which is linked to the consumers (consumption or savings), the government (spending on goods and services of federal employees), and the international trade (imports and exports). But demand alone cannot be depended upon to determine the output levels, because customers may not be able to afford what they demand. Hence in order to determine the actual demand, the customer's disposable income is also taken into consideration. This is the amount of money leftover after paying taxes, for spending and/ or investment.

Demand will determine the supply (production levels) of goods and services within the economy, but in order to meet the production levels money is required. To determine how much money is needed in the economy, the sum of all individual demands is taken into account. For this, the economists look at the nominal GDP, which measures the aggregate level of transactions. The Central Bank of the country then regulates the money supply accordingly. Though it is the consumers who ultimately determine the direction of the economy, governments also influence it through fiscal and monetary policy.

Macroeconomic Policies - Greasing the Engine of Economy

Microeconomic Policies – Mind Map



Source:http://www.bized.ac.uk/educators/16-19/economics/macro/presentation/policies_map.htm

Monetary Policy

Monetary policy is the central bank process of managing money supply to achieve specific goals, such as constraining inflation, maintaining an exchange rate, achieving full employment or economic growth. Monetary policy can involve changing interest rates, either directly or indirectly through open market operations, setting reserve requirements, or trading in foreign exchange markets.

Monetary Policies should take into account diverse factors like:

- Short-term interest rates
- Long-term interest rates
- Velocity of money through the economy
- Exchange rates
- Credit quality
- Bonds and equities (corporate ownership and debt)
- Government vs private sector spending/savings
- International capital flow on a large scale
- Financial derivatives such as options, swaps, futures contracts, etc.

Fiscal Policy

Fiscal Policies relate to the government's attempt to influence the economy by varying its purchases of goods and services and taxes to smoothen the fluctuations in aggregate expenditure. To conduct a fiscal contraction, the government can increase taxes or lower government spending. With the government spending less money and the high taxes, the disposable income with the consumers would decrease, resulting in decrease in overall demand as well as output. On the other hand, fiscal expansion by the government would mean that taxes are decreased, or the government spending is increased, or both.

Macroeconomics and Business

Business decisions involve huge parameters, both intrinsic as well as extrinsic. Most of the extrinsic factors are believed to be influenced by government's macroeconomic decisions. Successful businesses understand how macroeconomic variables, such as economic growth, earnings, unemployment and inflation, could affect the markets where they operate. With a large number of companies becoming global companies, global trade and international capital flows that drive the world economy and force reactive policies from governments, have a far reaching impact on the business operations.

This book, with its assortment of 22 case studies is aimed to provide a better perspective about the various macroeconomic issues across the globe, and also to appreciate the goals and conflicts in macroeconomic management such as sustainability of growth, low and stable inflation, full employment and a satisfactory external trade position.

Name of the Case Study	**Geographical Region**	**Core Concept**
Ageing Japan: Growing Problems	Japan	The economic impact of an ageing population
American Pension Fund's Fiasco: The Bailout	US	Pension fund reforms
Australia: Managing the Current Account Deficit	Australia	Managing current account deficits through monetary policies and tax reforms.
Caribbean Sugar: Implications of European Connection	Caribbean Islands	Implications of protectionism and globalisation on Caribbean sugar industry
Chilean Pension Model	Chile	A new pension system in p lace of 'pay-as-you-go' pension system, which has become a model for other countries to emulate
China: Importing Commodities and Inflation	China	Economic impact of China's fast-Exporting paced growth on the rest of the world
Deflation in Japan	Japan	Managing deflation
Dominican Republic: Leonel Fernandez's Turnaround Efforts	Dominican Republic	Managing foreign debt, a high inflation inflation rate and a depreciating currency
Drug Price Distortions – US and Canada	US and Canada	Drug price distortions, curbing imports of low-priced prescription drugs and also fulfilling the commitment towards the welfare of senior citizens
European Drug Pricing and its Implications	EU	Causes for drug price distortions and the implication of European drug pricing regulation on the long-term health of the European drug industry
Gas Taxes: USA's Dilemma	US	The economies and diseconomies of higher gas taxes
Gordon Brown's Fiscal Management	UK	Fiscal policy codes to achieve macroeconomic objectives of high employment, low inflation, growth and balance of payment/trade equilibrium
Heavily Indebted Poor Countries' Debt: Should it be Written off?	N/A	International debt management. IMF and World Bank's HIPC initiative for heavily indebted poor countries
Japan: Employing the Unemployed	Japan	Creating employment in the wake of increasing corporate restructuring
Monetary Policy – Hungary vs Poland	Hungary & Poland	Interrelationship between interest rates, inflation and currency value
Poland and the EU	EU	Potential economic benefits and repercussions of Poland's entry into the EU
		Contd...

Putin vs the Oligarchs: The Future of Russian Business	Russia	Russian privatisation programme and the country's attractiveness as an investment destination
Singapore: From Lee Kuan Yew to Lee Hsien Loong	Singapore	Singapore's development as one of the richest and fastest growing Asian country. Its economic and social problems
Tax Competition vs Tax Harmonization	EU	International taxation. Standardisation of tax rates among nations
The Economics of Hosting the Olympics	N/A	Long-term economic benefits vs colossal investments for nations hosting the Olympics
UK and the Euro	EU	UK's interests in joining Economic and Monetary Union (EMU) of the EU
US Fiscal Deficit	US	Controlling the spiralling budget deficit

Managing current account deficits through monetary fiscal policy reforms and the interrelationship between interest rates, taxes, inflation, employment, and currency value are showcased through the case studies *Australia: Managing the Current Account Deficit, Deflation in Japan, Dominican Republic: Leonel Fernandez's Turnaround Efforts, Gas Taxes: USA's Dilemma, Gordon Brown's Fiscal Management, Japan: Employing the Unemployed, Monetary Policy – Hungary vs Poland, Tax Competition vs Tax Harmonization, UK and the Euro*, and *US Fiscal Deficit.*

The case study *Aging Japan: Growing Problems* details the effect of an ageing population and a declining birth rate on the economy of Japan. Japan could face severe deficits, as funds are diverted from productive investment to meet pension liabilities. Case studies *American Pension Fund's Fiasco: The Bailout* and *Chilean Pension Model* highlight pension reforms.

Caribbean Sugar: Implications of European Connection elucidates the impact of protectionism of the Caribbean sugar industry by the European countries, which eventually rendered the industry inefficient to cope with globalisation. Implications of drug price distortions on the long-term health of the drug industry are discussed in the case studies *Drug Price Distortions – US and Canada*, and *European Drug Pricing and its Implications*.

The case studies *China: Importing Commodities and Exporting Inflation, Poland and the EU, Putin vs the Oligarchs: The Future of Russian Business,* and *Singapore: From Lee Kuan Yew to Lee Hsien Loong,* demonstrates the economic conditions in these countries and how they are dealing with the economic problems.

The world's 137 poorest nations spend on an average 25% of their national budget to repay debt. Should their debt be written off, to set the ball of sustainable development rolling in these countries, is the focus of the case study *Heavily Indebted Poor Countries' Debt: Should it be Written off?*

The Economics of Hosting the Olympics showcases the economic benefits of hosting the Olympics, as huge investments in infrastructure can translate into a growth pill for the struggling economy.