

Leiden University

Political Science

PRINCIPLES OF ECONOMICS

COURSE INFORMATION GUIDE

2012

**Class schedule:** Weekly lecture (2 hours) on Mondays, weekly seminar (2 hours), and weekly Q&A session (1 hour) on Wednesdays. Please do see the e-guide for times and places

**Time slot:** February 6 till March. 21

**Final exam:** Mach 28: 9.00-12.00 USC; retake exam June 6, 9.00-12.00 USC

**Course Code:** 6441PEC05

**Credits:** 5 EC

**Contact:** For individual questions students can always contact the instructor by e-mail. If necessary, an individual appointment can be made

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*Research interests:* General economics; Law and economics especially constitutional economics; History of economic thought especially Austrian economics.

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## Course Information

### 1. Introduction

Economics is the social science of satisfying unlimited wants with scarce resources. Principles of Economics refers to the basic methods and concepts economists use when doing economics, hence to economic analysis. In this view the term "economics" refers to the discipline, not to the economy. We will discuss consumer and producer behavior, markets, business cycles, economic growth, money and the financial system. We will also discuss fiscal and monetary policy and policy issues such as unemployment, inflation, and balance of payments surpluses and deficits.

### 2. Why Study Economics?

Economics combines the virtues of politics and science. It is, truly, a social science. Its subject matter is society--how people choose to lead their lives and how they interact with one another. But it approaches its subject with the dispassion of a science. By bringing the methods of science to the questions of politics, economics tries to make progress on the (global) challenges that all societies face. To introduce students to the economist's view of the world, we summarize ten "principles of economics" (by N. Gregory Mankiw).

#### *How People Make Decisions*

1. **People Face Tradeoffs.** To get one thing, you have to give up something else. Making decisions requires trading off one goal against another.
2. **The Cost of Something is What You Give Up to Get It.** Decision-makers have to consider both the obvious and implicit costs of their actions.
3. **Rational People Think at the Margin.** A rational decision-maker takes action if and only if the marginal benefit of the action exceeds the marginal cost.
4. **People Respond to Incentives.** Behavior changes when costs or benefits change.

#### *How the Economy Works as A Whole*

5. **Trade Can Make Everyone Better Off.** Trade allows each person to specialize in the activities he or she does best. By trading with others, people can buy a greater variety of goods or services.
6. **Markets Are Usually a Good Way to Organize Economic Activity.** Households and firms that interact in market economies act as if they are guided by an "invisible hand" that leads the market to allocate resources efficiently. The opposite of this is economic activity that is organized by a central planner within the government.
7. **Governments Can Sometimes Improve Market Outcomes.** When a market fails to allocate resources efficiently, the government can change the outcome through public policy. Examples are regulations against monopolies and pollution.

#### *How People Interact*

8. **A Country's Standard of Living Depends on Its Ability to Produce Goods and Services.** Countries whose workers produce a large quantity of goods and services per unit of time enjoy a high standard of living. Similarly, as a nation's productivity grows, so does its average income.

9. **Prices Rise When the Government Prints Too Much Money.** When a government creates large quantities of the nation's money, the value of the money falls. As a result, prices increase, requiring more of the same money to buy goods and services.
10. **Society Faces a Short-Run Tradeoff Between Inflation and Unemployment.** Reducing inflation often causes a temporary rise in unemployment. This tradeoff is crucial for understanding the short-run effects of changes in taxes, government spending and monetary policy.

### **3. General Objectives of the Course**

In this course, the student will gain a thorough acquaintance with the principles of economics. He will understand the economic motives of consumers and producers, the market processes in macro economic developments, as well as the interdependencies between economic processes and the main features of public economic policy.

### **4. Learning Outcomes**

At the end of the course, students should be able to:

- describe the main principles of economics;
- understand how the main mechanism in economics work;
- identify some (global) economic problems in every day news, to relate them to economic concepts and to discuss these problems based on economic theory.

### **5. Teaching Methods**

Seven weeks course. Each week consists of one lecture (2 hrs), one seminar (2 hrs), and one Q&A session (1 hr):

- During the lecture, the main issues in the required reading will be identified and discussed. Based on an interactive setting, the focus will be on understanding the concepts and theories in micro and macro economics.
- In weekly seminars, students will apply their knowledge. Each week, the homework consists of preparing study problems. In class, students will discuss their solutions for the problems. Applying the concepts and theories, and explaining this to each other increases the knowledge and understanding of economics. Furthermore, it also provides a good preparation for the final exam.
- Every week students do have the opportunity to ask (individual) questions at the course instructor in a special Q&A hour directly after the seminar.

### **6. Literature and Course Materials**

#### *Compulsory Literature*

- Stanley L. Brue, Campbell R. McConnell and Sean M. Flynn (2010), Essentials of Economics, 2<sup>nd</sup> edition, International Student Edition, Boston etc.: McGraw-Hill/Irwin (ISBN 978-0-07-

01 7266-1).

- Additional information in the workbook (please do see below).

#### *Recommended Literature & Other Sources*

We link this course directly to a website to indicate that additional content on a subject can be found online, as interactive graphs, self-grading quizzes, web-based questions, origin of the idea sections, and learning objectives. Website: [www.brue2e.com](http://www.brue2e.com)

#### *Background and Further Reading:*

- For the most recent economic news about the European Union, for instance with respect to economic growth, unemployment, inflation and government debts, see the website of Eurostat, the official statistics agency of the European Union.

Website: [www.ec.europa.eu/eurostat](http://www.ec.europa.eu/eurostat)

- The website of the Organization for Economic Co-operation and Development. The OECD is an international economic organization of 34 countries founded in 1961 to stimulate economic progress and world trade. It defines itself as a forum of countries committed to democracy and the market economy, providing a platform to compare policy experiences, seeking answers to common problems, identifying good practices, and co-ordinating domestic and international policies of its members. For example, The global crisis has left the OECD area with a legacy of lower potential output, high unemployment and a high government debt burden. More on this via:

Website: [www.oecd.org/home](http://www.oecd.org/home) and [www.stats.oecd.org/index.aspx](http://www.stats.oecd.org/index.aspx)

- The Netherlands Bureau for Economic Policy Analysis (in Dutch “Centraal Planbureau”) provides sophisticated analyses of policy issues such as the ageing of the population, health care costs, the telecommunications liberalization and the housing market.

Website: [www.cpb.nl/en/node/](http://www.cpb.nl/en/node/)

## **7. Weekly Overview**

### **Nb. We do skip all the appendices**

1. Introduction: scarcity, choice, opportunity cost, markets, circular flow model. Chapters 1-2
2. Demand and Supply: demand, supply, market equilibrium, elasticities, public goods, externalities. Chapters 3-5
3. The Ideal Market: business, costs, pure competition. Chapters 6-7
4. Imperfect Competition: monopoly, monopolistic competition, oligopoly, antitrust policy. Chapters 8-9
5. Resources and Domestic Product: labor market, income inequality, poverty, gross domestic product. Chapters 10-12
6. Macroeconomics: business cycles, unemployment, inflation, aggregate demand and supply, fiscal policy, debt and deficits. Chapters 13-15
7. Monetary and International Economics: money, banking, money demand and supply, interest rates, monetary policy, international trade and exchange rates. Chapters 16-18

## 8. Assessment & Grading

The assessment of this course is based on a final written exam of ten open questions. Each question gets an equal weight in the total score for the exam. The questions will be based on the literature and the material which is discussed in class. Previous exams will be posted on blackboard.

### Weekly Overview

#### Week 1: Introduction

##### Central Concepts and Guiding Questions

This week, we will introduce the central concepts of economics, such as *scarcity*, *choice*, *opportunity cost*, *utility*, *factors of production*, *markets*, *marginal analysis*, *circular flow model*, *invisible hand*.

The main questions that we will discuss this week are:

- What is the object of study of economics?
- Why do people have to make choices?
- What is the difference between microeconomics and macroeconomics?
- What is a market system and how does this differ from a command system?

### Reading & Preparation

#### Lecture

- Reading: Textbook chapters 1 and 2.

#### Seminar

Prepare the *open study questions* from the textbook to discuss in class.

- Chapter 1 (p. 24-25): 1, 2, 3, 4, 5, 6 and 7.
- Chapter 2 (p. 54-55): 1, 2, 3, 4, 5, 6, 10 and 11

### Additional information week 1

#### *Grote getallen*

In de macro-economie wordt vanzelfsprekend gewerkt met grote getallen. Helaas komen de Nederlandstalige en de Engelstalige benamingen niet helemaal overeen. Tabel 5.1 zet de termen op een rij.

Tabel 5.1 Grote getallen

Nederlandstalig	Engelstalig	Aantal nullen	Voluit	Ofwel
1 miljoen (mln)	1 million	6	1.000.000	$10^6$
1 miljard (mld)	1 billion	9	1.000.000.000	$10^9$

1 biljoen (bln)	1 trillion	12	1.000.000.000.000	10 <sup>12</sup>
1 biljard (bld)	1 quadrillion	15	1.000.000.000.000.000	10 <sup>15</sup>

Dus: een miljonair is in het Engels gewoon een millionaire, maar een *miljardair* (zoals Bill Gates) is in het Engels een *billionaire*.

### *Notatie van getallen*

In de Engelstalige literatuur worden duizendtallen met een komma aangegeven, en decimalen met een punt. In Nederland doen we dat precies andersom. Een voorbeeld:

	<u>Engelstalig</u>	<u>Nederlandstalig</u>
• Vierentwintigduizend	24,000	24.000
• Twaalf-viertiende	12.4	12,4

## **Week 2: Demand and Supply, Markets and Public Goods**

### **Central Concepts and Guiding Questions**

Why is the price of a toothbrush 2 euro but the price of a car 20,000 euro? Why has the price of oil been rising over the last decade? To answer this type of questions, economists analyze markets to understand what quantities of goods are bought and sold for what prices. Quantities and prices depend on the demand from buyers and the supply from sellers. Markets for all types of goods are analyzed, for jeans, oil, rice and also for labor. Markets are one of the most important object of study in the field of economics. Not all types of products and services are suitable to be provided by the market. There may be good reasons to provide these products publicly, by the government. In economics, these products are called *public goods*. This week, we study which goods are typically provided by the government and for what reasons.

Central concepts: *demand, supply, elasticity, market failure, public good, Coase theorem, externality, productive efficiency and allocative efficiency*.

Guiding questions:

- How do demand and supply influence the prices and quantities of goods sold?
- How do quantities of goods demanded and supplied respond to price changes?
- Why are some goods provided on private markets and other goods by governments?

### **Reading & Preparation**

#### Lecture

- Reading: Textbook chapters 3, 4 and 5.

#### Seminar

Prepare the *open study questions* from the textbook to discuss in class.

- Chapter 3 (p. 78-79): 1, 2, 3, 4, 5, 6 and 7.
- Chapter 4 (p. 100-101) : 1, 2, 3, 4, 7, 9 and 11.
- Chapter 5 (p. 123-124): 1, 2 and 9.

### Week 3: The Ideal Market

#### Central Concepts and Guiding Questions

Every day, firms make decisions about how much output to produce, how much labor to hire and how much capital to invest. These decisions are based on expectations about how much profit they will make. Profits depend on the prices and quantities of the goods sold on the one hand and the production costs on the other. This week, we start with analyzing the production costs of firms. Subsequently, we will analyze the market structures, since the type of market determines the behavior of firms. The first market structure to be analyzed is *pure competition*.

Central concepts: *implicit costs, normal profit, law of diminishing returns, pure competition*

Guiding questions:

- Why do economics costs include both implicit and explicit costs?
- Why declines the marginal product when additional resources are added to a production process?
- Why do long-run and short-run cost curves differ?
- What are the characteristics of the market structure *pure competition*?
- What are the characteristics of a long-run equilibrium of a competitive firm?

#### Reading & Preparation

##### Lecture

- Reading: Textbook chapters 6 and 7.

##### Seminar

Prepare the *open study questions* from the textbook to discuss in class.

- Chapter 6 (p. 151-152) : 3, 4, 7, 8 and 9.
- Chapter 7 (p. 178-179) : 1, 2, 4, 5 and 7.

### Week 4: Imperfect Competition

#### Central Concepts and Guiding Questions

In most markets, there is no perfect competition. This may due to several reasons: the number of sellers is limited, there is no standardized product, or it is relatively difficult for new firms to enter the market. As a results, the market structure differs from the situation of perfect competition and so does the behavior of firms in terms of quantities of goods supplied and equilibrium prices. The goal of this week is to understand the functioning of the market structures *pure monopoly, oligopoly, monopolistic competition*. Furthermore, the economic effects of these market structures will be discussed. Based on these economic effects, students will be able to assess the desirability of different market structures.

Central concepts: *pure monopoly, oligopoly, monopolistic competition*.

Guiding questions:

- What are the main characteristics of the market structures *pure monopoly, oligopoly* and *monopolistic competition*?
- How and why do the profit-maximizing prices and outputs of these market structures differ from the profit-maximizing price and output on a market of pure competition?
- What are the economic effects of a monopoly for a society as a whole?
- Why may monopolies sometimes be socially justifiable?

## Reading & Preparation

### Lecture

- Reading: Textbook chapters 8 and 9 (not pp. 214-216).

### Seminar

Prepare the *open study questions* from the textbook to discuss in class.

- Chapter 8 (p. 201-202): t.b.a.
- Chapter 9 (p. 228-229): t.b.a.

## Week 5: Resources and Domestic Product

### Central Concepts and Guiding Questions

In the previous weeks, we focused on final goods and services markets. In order to produce these goods and services, firms need *resources* or *production factors*. Hence, this week we analyze the resource markets and in particular the labor market. In line with the circular flow model, that was introduced in Week 1, firms are buyers instead of sellers on these markets. Another interesting difference between the labor market and the goods markets as discussed in the previous weeks is the role of labor unions in reaching the equilibrium on the market. On resource markets, incomes are earned. Based on market outcomes, incomes may be distributed unequally among people and households. Subsequently, all incomes in an economy can be taken together in order to get an impression of an economy as a whole. Economists use the total market value of all final goods and services produced in order to calculate for instance the growth rate of an economy. This week, we focus on the definition and measurement of the gross domestic product.

Central concepts: *monopsony, substitution effect, income inequality, poverty rate, equality-efficiency trade-off, gross domestic product (GDP)*.

Guiding questions:

- How are wages determined?
- What are the causes of income inequality?
- What are the economic arguments for and against income inequality and income redistribution?
- How do we measure the overall production and income of an economy as a whole?

## Reading & Preparation

### Lecture

- Reading: Textbook chapters 10-12.

### Seminar

Prepare the *open study questions* from the textbook to discuss in class.

- Chapter 10 (p. 255-257): t.b.a
- Chapter 11 (p. 278-279): t.b.a
- Chapter 12 (p. 309-310) : t.b.a

## Week 6: Macroeconomics

### Central Concepts and Guiding Questions

A recession is an important phenomenon, not only from an academic perspective, but also in daily life. Especially unemployment receives a lot of attention in politics, the media and also in academia, because it hurts people. Governments usually try to combat unemployment with fiscal policy. These policies do not come without any costs. They create budget deficits in the short run and state debts in the long run. The goal of this week is to understand how recessions work, how fiscal policies may influence production levels and how inflation is related to the business cycle.

Central concepts: *business cycle, unemployment, inflation, fiscal policy, multiplier, budget deficit, built-in stabilizer.*

Guiding questions:

- What are the causes of unemployment?
- How do economists measure inflation?
- Where does economic growth come from?
- What can governments do in times of recessions?

### Reading & Preparation

#### Lecture

- Reading: Textbook chapters 13-15.
- Additional information week 6.

#### Seminar

Prepare the *open study questions* from the textbook to discuss in class.

- Chapter 13 (p. 330): t.b.a
- Chapter 14 (p. 356-357): t.b.a
- Chapter 15 (p. 382-383): t.b.a

### Additional information week 6

#### Unemployment

Three types of unemployment can be distinguished:

- Structural unemployment
- Frictional unemployment
- Cyclical unemployment

Structural and frictional unemployment are jointly referred to as *normal unemployment*. There will always be people unemployed due to frictional or structural unemployment. On top, there is cyclical unemployment, depending on the phase of the business cycle. In downturn of the business cycle, actual unemployment rate is higher than normal unemployment rate. In a recovery stage of the business cycle, cyclical unemployment may disappear or the actual unemployment rate may even become lower than natural rate of unemployment. In the latter case, the cyclical unemployment rate is negative: employees will work in overtime, unemployed

people will be employed on temporarily basis, part-time employees will temporarily work more hours than they used to do, etcetera.

### Inflation

Overspending may cause inflation - *demand-pull inflation*. Increasing price levels (wages, raw materials, etcetera) can cause inflation as well - *cost-push inflation*. These two types of inflation can occur at the same time. Then the economy has entered a phase of expansion, while at the same time the costs of one or more resources have risen strongly. A combination of a recession, i.e. stagnation, and (cost-push) inflation is labeled as *stagflation*.

Inflation is capable of taking monstrous forms - *hyperinflation*. Figure 6.1 shows some examples of hyperinflation. Hyperinflation emerge under exceptional unstable (economic) circumstances, for example in or just after a war (Hungary, Yugoslavia, Germany) or under dictatorial misgovernment (Zimbabwe). Hyperinflation hampers trade, i.e. to buy and sell with money. Production and employment collapses and people fall back to barter and/or exchange with foreign currency. For example, in Israel local currency price tags on products were replaced by foreign currency price tags (U.S. dollars) during the first half of the 1980s, while inflation amounted to hundreds of per cent a year.

Figure 6.1 Hyperinflation

Country	Month	Inflation <i>per month</i>	Inflation <i>per day</i>	Time required for prices to double:
Hungary*	July 1946	41,900,000,000,000 %	207 %	15 hours
Zimbabwe**	November 2008	79,600,000,000 %	98 %	24,7 hours
Yugoslavia***	January 1994	313,000,000 %	64.6 %	1,4 days
Germany	October 1923	29,500 %	20.9 %	3,7 days
Comparative: annual inflation 5 %		0.407 %	0.014 %	14 years
Comparative: annual inflation 1 %		0.083 %	0.003 %	70 years

\* This is 41.9 quadrillion per cent!

\*\* This is 79.6 billion per cent. \*\*\* Federal Republic of Yugoslavia (without Slovenia and Bosnia and Herzegovina).

### Fiscal Policy - Europe

#### The Stability and Growth Pact

The Stability and Growth Pact is a series of agreements between countries of the Economic and Monetary Union to guarantee stability of the single currency (euro). The Stability and Growth Pact was established in 1997. The idea is that countries' public finances should be in control: high deficits generate inflation and high interest rates, and therefore weaken the single currency due to higher inflation. Over-indebtedness in extreme cases could lead to the bankruptcy of governments. This may seem unthinkable for Europe, but cost of aging of the population would generate higher expenditures and growing debts. Governments agreed upon a maximum deficit of 3% of GDP and a maximum debt of 60% of GDP in the Maastricht Treaty.

The Stability and Growth Pact is a permanent commitment to budgetary stability, and made it possible for penalties to be imposed on any country in the euro area whose budget deficit exceeded 3% of GDP. The Pact was subsequently judged to be too strict and was reformed in March 2005.

Country that reaches the boundary of 3 percent GDP will have problems during a recession. Their automatic stabilization (see book page 362 - 363) then automatically cause that the deficit

will increase above the 3 percent. EMU countries are then forced to cut spending or to raise taxes, but that will have a counterproductive effect on their economic activity at that stage. In order to prevent such a pro-cyclical fiscal policy, Member States agreed upon to control their budgets 'close to balance or in surplus'. If a country, under normal economic circumstances, does not have a deficit, then the automatic stabilization can do their job. During a recession deficits will increase up to some percent of the GDP, but it has to remain below the boundary of 3 percent. In a period of economic recovery a surplus arises - debts can be diminished.

## Euro

On 1 January 1999, 11 European countries adopted the euro. Euro became the common currency of Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. (Greece joined them on 1 January 2001). From this point onwards, the European Central Bank became responsible for monetary policy.

Euro notes and coins were introduced on 1 January 2002 in these 12 euro-area countries.

National currencies were withdrawn from circulation two months later.

## Convergence criteria

Each EU country must meet five convergence criteria in order to join the Euro area:

- price stability: the rate of inflation may not exceed the average rates of inflation of the three member states with the lowest inflation by more than 1.5%;
- inflation: long-term interest rates may not vary by more than 2% in relation to the average interest rates of the three member states with the lowest inflation;
- deficits: national budget deficits must be below 3% of GDP;
- public debt: this may not exceed 60% of GDP;
- exchange rate stability: exchange rates must have remained within the authorized margin of fluctuation for the previous two years.

## Week 7: Monetary and International Economics

### Central Concepts and Guiding Questions

In the final week, two themes will be discussed. The first theme is monetary economics. Scholars of monetary economics study the role of money in the economy. They focus in particular on the money markets and on the players on these markets, mainly the financial institutions. An exceptional role on the money market is played by central banks. With monetary policy, central banks can influence the money market, but also the real economy.

The second theme of this week is the international side of economics. Countries import and export goods and services from and to other countries. This is called international trade. We will start with the question why countries actually trade internationally. Related to import and export is that firms have to pay firms in other countries with foreign currencies. Hence, students will analyze how exchange rates are determined. Finally, we pay attention to trade interventions by governments, called *protectionism*, and to organizations which promote international trade liberalization such as the World Trade Organization.

Central concepts: *commercial bank, central bank, monetary policy, demand for money, exchange rate, comparative advantage.*

Guiding questions:

- What is the function of money?
- How is the interest rate determined?

- How effective is monetary policy?
- Why do countries trade with each other?
- How are exchange rates determined?

## Reading & Preparation

### Lecture

- Reading: Textbook chapters 16-18.
- Additional information week 7

### Seminar

Prepare the *open study questions* from the textbook to discuss in class.

- Chapter 16 (p. 413-414 ): t.b.a
- Chapter 17 (p. 437): t.b.a
- Chapter 18 (p. 465-467): t.b.a

## Additional information week 7

### Monetary Policy in the EMU

The Economic and Monetary Union (EMU) has been in effect since 1 January, 1999. The then 11 member states (Austria, Belgium, Germany, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain) linked their own currencies at a fixed ratio to each other and to the new common currency: the Euro. As from that moment, trade on financial markets took only place in euros. Euro coins and banknotes were introduced on January, 1st, 2002. In the meantime, the number of EMU-members has increased to 17. Greece joined the EMU in 2001, Slovenia in 2007, Cyprus and Malta in 2008, and Slovakia in 2009.

The European System of Central Banks (ESCB) is responsible for the monetary policy in the EMU. The ESCB comprises of:

- The European Central Bank (ECB);
- The national central banks.

The ECB is fully independent of the member states and it is therefore able to set monetary policy independently from the influence of any of the member states (for example to stimulate the economy). It is explicitly forbidden for the ECB to seek or receive instructions from anyone. The ECB has an Executive Board that consists of six members, of which the President (currently Mario Draghi from Italy) is well-known. Members of the Executive Board are appointed by the member states.

The Board of Directors of the ECB, or in other words: the ECB's Governing Council, takes the monetary policy decisions. The Governing Council comprises the six members of the ECB Executive Board plus the 17 governors of the national central banks of the Euro-area countries. The national central banks are partly tasked with implementing European monetary policy, and - besides - perform their own, non-ESCB tasks as well. The main non-ESCB task is the supervision on national banks, insurance companies and pension funds.

The primary objective of the monetary policy is to maintain price stability. In addition, it aims to support the general-economic policy (aimed at economic growth and full employment) of the

EU, as far as the primary goal of price stability is not jeopardized. This is the main difference between European and U.S. monetary policy. The main goal of the European monetary policy is to maintain price stability, whereas in the U.S. price stability on the one hand and full employment and economic growth on the other are equally important goals of monetary policy.