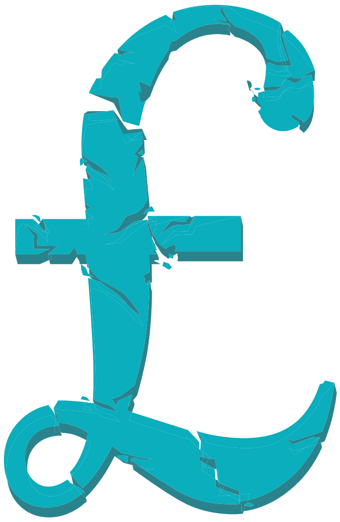
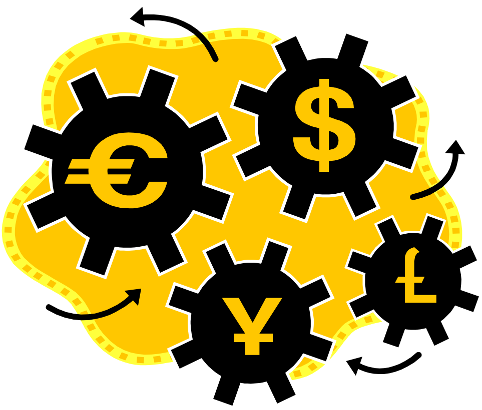
OCR

Unit 2



Economics Revision



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Economics Revision

$AD = C + I + G (X - M)$

KEY TERMS

- **Economic growth** - in the short run, an increase in real GDP, and in the long run, an increase in productive capacity, that is, in the maximum output that the economy can produce.

- **Unemployment** - a situation where people are out of work but are willing and able to work.

- **Inflation** - a sustained rise in the price level; the percentage increase in the price level over a period of time.

- **Gross domestic product (GDP)** - the total output of goods and services produced in a country

- **Aggregate demand (AD)** - the total demand for a country's goods and services at a given price level and in a given time period.

- **Aggregate demand (AS)** - the total amount that producers in an economy are willing and able to supply at a given price level in a given time period.

- **Multiplier effect** - the process by which any change in a component of aggregate demand results in a greater final change in real GDP.

- **Supply-side policies** - policies designed to increase aggregate supply by improving the efficiency of labour and product markets.

- **Monetary policy** - central bank and/or government decisions on the rate of interest, the money supply and the exchange rate.

- **Fiscal policy** - the taxation and spending decisions of a government.

Aggregate demand (AD)

The components of aggregate demand

- spending by households on goods and services
- Investment
- Spending on capital goods (machines, office buildings)
- Government spending
- Net exports add foreigner

Consumer expenditure - **real disposable income**, this is the main influence on consumer expenditure

- **Wealth**, the more people have (savings and shares) the more they tend to spend
- **Consumer confidence**, how optimistic consumers are about future economic prospects.

Investment - **Changes in real disposable income**, this may encourage firms to expand their capacity.

- **Capacity utilisation**, firms are also more likely to invest if they are currently operating close to full capacity.
- **Corporation tax**, a cut in corporation tax increases the amount of profit firms can keep and so can result in an increase in investment.
- **The rate of interest**, a rise in the rate of interest would be likely to reduce investment.
- **Advances in technology**, a firm may buy new capital equipment if it thinks that it will produce better quality products or produce products more cheaply.

Government spending - The governments view on the extent of market failure and its ability to correct it.

- The level of economic activity in the economy can influence government spending (level of unemployment in a certain area)

Net exports - **Real disposable income abroad**, a rise in income aboard is likely to result in more exports being sold.

- **Real disposable income at home**, a rise in income at home may result in a fall in exports.
- **The exchange rate**, the price of one currency in terms of another currency.

Shifts in AD	Shift right	Shift left
Changes in government policy	a fall in the interest rate	A rise in the interest rate
Changes in the exchange rate	Fall in exchange rate	A rise in exchange rate
Change in population	A rise in population	Fall in share prices on global markets
Changes in income tax	A cut in income tax	A rise in income tax

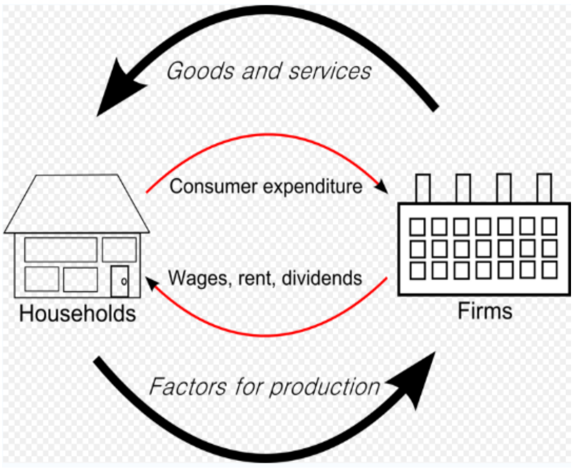
Aggregate Supply (AS)

Shifts in AS:

Short run (SRAS)	Long run (LRAS)
Changes in the costs of production	Changes in the quantity and quality of resources
Changes in the costs of raw materials	Improvements in education and training
Change in wages	Advance in technology
Changes to producer taxes	

The circular flow of income:

- Producers and consumers: household expenditure (consumption) flows to firms to pay for goods and services.
- Employers and employees: income (Y) flow from firms to households to pay for the services of factors of production(wages, interest, rent and profit pay for labour, capital, land and enterprise, respectively)
- Money entering the circular flow is known as a **withdrawal**:
  - Saving
  - Taxation
  - Import spending
- Money entering the circular flow is known as an **injection**:
  - Investment
  - Government spending
  - Export earnings



Objectives of government economic policy

Positive and stable Economic growth:

- increasing material living standards
- Trend growth, the expected increase in potential output over time. It is a measure of how fast the economy can grow without generating inflation.
- This means avoiding depleting non-renewable resources and damaging the environment, also to reduce pollution and searching for cleaner sources of energy.

High Employment and low unemployment:

- **High employment and low unemployment.**
- Full employment, a situation where those wanting and able to work can find employment at the going wage rate.
- Having a higher proportion of economically active people should raise the productive potential of the economy and reduce the cost of state benefits.

Low and stable Inflation:

- **Low and stable inflation**, this can also be referred to as price stability.
- Low level inflation enable firms to reduce their costs by not raising wages in line with inflation rather than by making some worked redundant

Favourable Balance of payments:

- Current account deficit, when money is leaving the country than entering it.
- A government is still likely to want to see increase in the international competitiveness of its producers, in order to keep aggregate demand and output high in the economy.

Economic stability:

- Governments want to avoid significant fluctuations in the economy. No “Boom and bust”

Economic Growth

- in the short run, an increase in real GDP, and in the long run, an increase in productive capacity, that is, in the maximum output that the economy can produce.

Measuring economic growth:

- measured by the annual percentage change in real GDP

The causes of economic growth:

- a fall in exchange rate

- a cut in income tax or a rise in consumer confidence
- The essential causes of long-run economic growth are increases in the quantity and/or quality of resources.
- And economy's resources may be increased as a result of the size of the labour force rising.
- The main cause is advances in technology and improvement in education and training.

$$\frac{\text{The unemployed}}{\text{Labour force}} \times 100\%$$

<u>The costs of economic growth:</u>

- The only way it can increase its output is to switch resources from making consumer goods to making capital goods.
- If economic growth is achieved in a way that is not sustainable, without regard to controls on pollution, there will be damage to the environment.
- There is also risk that economic growth may result in the depletion of non-renewable resources.
- Economic growth may reduce the quality of some people's lives.

<u>The benefits of economic growth:</u>

- A rise in peoples material standard of living,
- If real GDP per head rises, the population can enjoy more goods and services.
- Economic growth enables poverty within a country to be reduced.
- Higher output raises tax revenue without having to increase tax rates.
- Economic growth increases employment

<u>The sustainability of economic growth:</u>

- Sustainable economic growth, economic growth that can continue over time and does not endanger future generations.
- This means avoiding depleting non-renewable resources and damaging the environment, also to reduce pollution and searching for cleaner sources of energy.

<u>Unemployment</u>

A situation where people are out of work but are willing and able to work.

Measuring unemployment:

- Unemployment rate, the percentage of the labour who are out of work.
- The government's preferred measure is what is known as the Labour Force Survey (LFS), a measure of unemployment based o a survey using the ILO definition of unemployment.

Difficulties of measuring unemployment:

- Labour force survey(LFS), a measure of unemployment based on a survey using the ILO definition of unemployment.
- Some people can be actively seeking work but not entitled to claim unemployment-related benefits.
- LFS is more expensive to collect information than the claimant count.
- There is also a risk that it may be subject to sampling errors.
- Some people claiming benefits may not be actively seeking work.(false)
- Another difficulty of the claimant count is that it is not suitable for international comparisons.

The causes of unemployment:

- Cyclical unemployment, unemployment arising from a lack of AD.
- Unemployment can also arise due to problems with the supply labour.
- Structural unemployment, unemployment caused by the decline of certain industries and occupations due to changes on demand and supply.
- Technological unemployment, arises when workers lose their jobs because of advances in technology.
- International unemployment, occurs when jobs are lost because firms decide to carry out some of their work abroad.
- Frictional unemployment, short term unemployment occurring when workers are in-between jobs.

The consequences of unemployment:

- Lost output, having people who are willing and able to work without jobs is a waste of resources
- Lost tax revenue, if more people were in work, incomes, spending and possibly profits would be higher.
- Government spending on unemployment benefits, if unemployment rises, the government will have to spend more on unemployment related benefits.
- Pressure on other forms, when people are unemployed they are more likely to suffer health problems and even increase crime.
- Hysteresis, the longer people are out of work, the more difficult it can be for them to gain another job.

The benefits of unemployment:

- It may give them time to search for a more rewarding job.
- A high level of unemployment may discourage workers from seeking wage rises and may dissuade them from taking industrial action.

The significance of unemployment:

- How significant the consequences of unemployment are depends on how much unemployment there is, how long on average people are unemployed, the benefits provided to the unemployment, the type of employment and the distribution of unemployment.
- The higher the rate of unemployment, the more serious the costs are likely to be
- Generous unemployment benefits reduce the costs of unemployment but they have an opportunity cost for the economy.

Inflation

A sustained rise in price level; the percentage increase in the price level over a period of time.

Measuring inflation:

- Consumer price index (CPI), a measure of changes in the price of a representative basket of consumer goods and services.
- Retail price index (RPI), measure of inflation that is used for adjusting pensions and other benefits to take account of changes in inflation and frequently used in wage negotiations.

Difficulties of measuring inflation:

- Measures of inflation also tend to overstate inflation, as they measure the price of a fixed basket of products.
- The measures do not take into account people's ability to alter what they buy during the year.
- People usually move away from buying products that are becoming relatively more expensive towards those that are becoming relatively cheaper.

The causes of inflation:

- Demand-pull inflation, increases in the price level caused by increase in aggregate demand.
- Cost-push inflation, increases in the price level caused by increases in the costs of production.

The consequences of inflation:

- Fall the value of money, with the price level rising, each pound coin and other unit of the country's money will buy less.
- Menu costs, the costs of changing prices due to inflation.
- Shoeleather costs, costs in terms of the extra time and effort involved in reducing money holdings.

- Administrative costs, staff time may have to be devoted to adjusting accounts, assessing raw material costs, negotiating with unions about wage rises and estimating appropriate prices.
- Inflationary noise, the distortion of price signals caused by inflation.
- Random redistribution of income, inflation increases the cost of living, as people have to buy the same basket of goods and services
- Fiscal drag, people's income being dragged into higher tax bands as a result of tax brackets not being adjusted in line with inflation, reducing disposable income and increases tax revenue.
- Uncertainty, if firms are uncertain about what their costs will be and what prices they will receive from selling their products, they may be reluctant to invest.

The benefits of inflation:

- Workers also like rises in their pay, even if these are matched by higher prices.
- The ability that inflation gives firms too alter workers' real pay can help labour markets operate more efficiently and reduce unemployment.

DEFLATION - a sustained fall in the general price level.

The significance of inflation:

- *Cost-push inflation* tends to be more harmful for an economy than demand-pull inflation; cost-push is often accompanied by a fall in real GDP.
- *High inflation* may mean that prices are changing so often that firms cannot publish prices.
- ***Fluctuating inflation*** can be destabilising as, again, it creates inflationary noise and that it makes it difficult for the government, firms and households to plan ahead.
- ***Unanticipated inflation***, a situation where people are surprised by the inflation rate. Unanticipated inflation causes uncertainty and can result in a random redistribution of income.

Balance of payments

A record of money flows coming in and going out of a country.

Current account deficit: when more money is leaving the country than entering it, as result of sales of its exports, income and current transfers from abroad being less than imports and income and current transfers going abroad

The structure of the current account of the balance of payments:

- The main elements of the balance of payments are the current account, the capital and financial accounts and net errors and omissions.
- The current account includes trades in goods, trade in services, income and transfers. Trade in goods records the earnings from exports and the expenditure on imports of goods.
- The income part of the current account covers largely investment income.
- Transfers cover the transfer of money made and received by the government and individuals.
- The capital and financial accounts show the movement of direct investment.
- Net errors and omissions, is added to ensure that the balance of payments does balance.

The causes of a deficit on the current account:

- A deficit on the current occurs when the country's expenditure abroad exceeds its revenue from abroad.
- Main reasons why these happen, (1) because the country's inhabitants have spent more on goods and services from abroad than overseas. (2) Because there has been a net outflow of investment income.
- A rise in the exchange rate may also result in a deficit, as it will raise exports prices and lower import market.
- A deficit caused by changes in income.

The causes of a surplus on the current account:

- A surplus on the current account is experienced when a country's revenue from abroad is greater than it's expenditure
- The country is more likely to have a surplus if it's products are of a high quality, are produced at a low cost and reflect what households and firms at home and abroad to buy.

The consequences of a deficit and a surplus on the Current account of the balance of payments.

- A deficit means that a country is consuming more than it is producing.
- If deficit increase, it will reduce AD in the economy.
- A surplus means a country is consuming less than it is producing and is experiencing a net inflow of money and income.
- The increase in the money supply will mean that banks will have more money, which can increase bank leading.
- A rise in a surplus will mean that net exports are increasing. This will rise AD and be likely to push up the exchange rate.

The significance of a current account deficit.

- A deficit that forms a small percentage of real GDP or one that lasts a short time is unlikely to be very significant
- A deficit may indicate a growing and, indeed, healthy economy, or it may indicate an economy with structural problems.
- If the output of the economy is increasing, more foreign raw materials will be bought by firms and the higher income may result in more imports of finished goods.
- an economy with a high inflation rate and low productivity is also likely to have a deficit.

Supply-side policy

- Supply-side policies are policies designed to increase AS by improving the efficiency of labour and product markets.

Ranges of supply-side policies:

- These try to lower firms' costs of production and increase productive capacity by increasing the efficiency of labour and product markets.
- Supply-side policies often aim to raise macroeconomic performance by improving the performance of particular markets.

Examples of supply-side policies:

- Education and training, government investment in education and training and government encouragement to firms to increase their training should raise in the labour and labour productivity.
- Government to new firms, small firms provide employment, develop entrepreneurial skills and introduce new ideas.
- Reduction in direct taxes, lower direct taxes increases incentives to firms, workers and potential workers. E.g. a cut in corporation tax will increase both funds and investment and a cut in income tax.
- Reduction in unemployment benefits, a reduction in job seeker's allowance will widen the gap between income from employment and the benefit.
- Privatisation, transfer of assets from the public to the private sector. They believe that private sector firms are in the best position to make decisions about what to produce, how to produce and what to charge.
- Deregulation, is the removal of rules and regulations that affect firms in the belief that it will give the firms greater freedom to make their own decisions and to increase competition by making it easier for new firms.

The effectiveness of supply-side policies:

- Supply-side policies are selective, targeted at particular markets, and are designed to raise efficiency.
- Increasing AS enables AD to continue to rise over time without inflationary pressures building up.
- A higher quality of resources should also make domestic firms more price and quality completive.
- Increasing the productive potential of an economy on its own.

Monetary policy

Central bank and/or government decisions on the rate of interest, the money supply and the exchange rate. The main aim of monetary policy is to help keep macroeconomic stability in the economy and also to maintain the value of money.

- The main monetary policy instrument is the rate of interest.
- A higher interest rate tends to reduce consumption and lower firms' investment.
- This rise in demand for pounds will push up the value of the pound.
- A higher exchange rate will make exports more expensive and imports cheaper.
- A rise in the interest rate is likely to decrease AD by reducing consumption, investment and exports minus imports.
- Changes in the money supply can also be used to influence AD.
- An increase in the money supply is likely to increase AD.
- If the government prints more money or makes it easier for banks to lend more money. People will have more money to spend.
- A rise in the money supply, by increasing the amount that banks have to lend, reduced the interest rate.

The monetary policy committee:

The Monetary Policy Committee (MPC) of the bank of England sets the rate of interest with the main objective of achieving the government's target annual rate if inflation of 2%, as measured by the CPI.

The effectiveness of monetary policy:

- Monetary policy can be difficult to control.
- A central bank can seek to influence the exchange rate by buying and selling currency and by changing the interest rate.
- Interest rates offered to savers and charged to borrowers by commercial banks and other financial institutions do not always adjust quickly to reflect to change in base rate.
- A rise in interest rate may not cause to reduce their spending and firms to alter their investment if they are optimistic about the future.

- A central bank's ability to change its interest rate may be limited by the need for it to remain in line with other countries' interest rates.
- Another limit with using interest rate changes is that when the interest rate falls to very low levels, a further cut is likely to be ineffective in stimulating economic activity.
- The effectiveness of interest rate changes to stimulate economic activity can be limited by their very success in tackling inflation.
- The effects of monetary policy tend to be more concentrated on certain groups than do changes in income tax, for example.

Fiscal policy

The taxation and spending decisions of a government.

The nature of fiscal policy:

- A government may seek to influence AD and to ensure that it matches AS and so avoid both unemployment and inflation.
- Automatic stabilisers, forms of government spending and taxation that change automatically to offset fluctuations in economic activity.
- The government will receive more income tax revenue when GDP rises.
- Economic cycle, the tendency for economic activity to fluctuate outside its trend growth rate, moving from a high level of economic growth e.g. for instance, spending on child benefit is not linked to the economic cycle.
- One rule states that over the economic cycle the government should only borrow to pay for investment spending.

Types of taxes:

- Progressive tax, a tax that takes a higher percentage from the income of the rich.
- Regressive tax, a tax that takes a greater percentage from the income of the poor.

The effectiveness of fiscal policy:

- Advantages, a number of taxes and forms of government spending adjust automatically to offset fluctuations in real GDP.
- Changes in government spending directly affect the G component of AD while changes in taxation affect C and I by altering the disposable income of households and the post tax incomes of firms.
- Some forms of government spending and taxation, including cuts in corporation tax and training grants, increases both AD and AS,
- Disadvantages, changes in government spending and tax rates take time to have an effect on the economy.

- It can also take time to recognise the need for a change in policy and to gather the information on which to base the change.
- Then there is the time it takes to draw up and implement new tax codes and government spending plans.
- There is also a TIME LAG between introducing a fiscal policy instrument and that instrument having an impact on the economy.
- A number of forms of government spending are INFLEXIBLE.
  Households and firms may react in unexpected ways, a cut in income and corporation taxes may not lead to higher consumption and investment if households and firms lack confidence.
- A rise in income tax rates or an increase in state benefits may discourage some people from working.
- Higher corporation tax may discourage investment.
- A rise in taxation designed to reduce inflation may cut AD too far and cause a fall in real GDP and lowering unemployment.

International trade

International trade Involves the exchange of goods and services across national borders.

Advantages:

- It enables the country to specialise as the products it does not produce it can import.
- Consumer can benefit from the lower prices and higher quality those results from the higher level of competition that arises from countries trading internationally.
- They can also enjoy a greater variety of products.
- They will have access to larger markets in which to sell their products and from which to buy raw materials.

Disadvantages:

- Some countries restrict exports and most impose restrictions on imports.
- Competition
- Occupational immobility of labour, difficulty in moving from one type of job to another.

Methods of protection

- Protectionism, the protection of domestic industries from foreign competition.
- Tariffs, a tax on imports. They can be imposed with the intention of raising revenue and/or discouraging domestic consumers from buying imported products.

- Quotas, a limit on imports. The effect on quotas is to reduce supply. This is likely to push up price. Foreign firms would experience a reduction in the quantity they sell but they may benefit from the higher price if demand for their products is inelastic.
- Voluntary export restraint, this time the limit on imports arises from a voluntary agreement between the exporting and the importing country.
- Foreign exchange restrictions, a government may seek to reduce imports by limiting the amount of foreign exchange made available to those wishing to buy imported goods and services.
- Embargoes, is a ban on the exports or imports of a product and/or a ban on trade with a particular country.

OTHER POLICIES

Policies to reduce unemployment:

- Demand-side policies, unemployment nay be reduced by increases in AD. Using fiscal policy could increase its spending and/or cut tax rates in order to rise AD.
- Increases in the money supply or lower interest rates are also likely to rise AD.
- Economic stability and low inflation will make low unemployment more likely, by encouraging investment and maintaining or increasing international competitiveness.

Policies to control inflation:

- Cost-push inflation, if a government believes that inflation is caused by excessive increases in wage rates, it may try to restrict wage rises.
- A government may try to lower firms’ costs by reducing corporation tax.
- Demand-pull inflation, these are ones that seek to reduce inflation by decreasing AD
- A higher interest rate is likely to reduce AD by reducing consumption, investment and net exports.
- Inflation targeting, if people are convinced that a central bank has the determination, experience and ability to meet its target, they will act in a way that does not cause inflation.

- Long run, a government is likely to seek to reduce the possibility of inflationary pressure by increasing AS.

Policies to promote economic growth:

- Short run, increases in AD in the short run occur due to increases in AD if the economy is initially producing below full capacity.
- Long run, increases in the country's output can continue to be achieved only if the productive capacity of the economy increases. So for this to happen the quality and/or quantity of resources have to increase (supply-side polices try to do).
- Stable growth, most governments aim to stable growth. Governments try to avoid AD increasing faster than the trend growth rate permits.

Policies to improve the balance of payments:

- Short run, three main ways to try to raise export revenue and reduce import expenditure. A fall in the exchange rate, reducing demand for all products.
- Exchange rate adjustment, a country may seek to reduce the exchange rate if it believes that its current level is too high and as a result is causing its products to be uncompetitive against rival countries' products. lowering the exchange rate should increase AD and thereby raise aggregate output and employment in the short run.
- Deflationary demand management, to discourage expenditure on imports, a government may adopt deflationary fiscal and monetary policies.
- Import restrictions, a country may seek to reduce expenditure on imports by imposing import restrictions including tariffs and quotas.