Unit 3: The National and international economy: Examiners comments and tips

Analysing data: Here are a few useful hints:

- What has happened *overall*? Compare the data at the start to the data at the end to state the *trend*.
- Is there a pattern in the data? i.e is it *fluctuating*, *cyclical* or *constant*?
- Is the data always *positive*/*negative*?
- Are there years/months that are *exceptions* to the trend?
- *To what extent* have things changed? i.e. an *evaluative* comment is needed.
- What influences on the variable might have altered over the period concerned?
- With two sets of figures a *comparative* comment is needed (e.g. one is rising, one is falling).

Performance of an economy

If asked to comment on this, look at Inflation, Unemployment, Balance of Payments and Economic growth data.

Balance of payments

A record of all financial transactions between a country and the rest of the world.

Exchange rate: The external value of a currency in terms of another currency, e.g. £ against €.

Policies to improve the Balance of Payments position of a country

- Deflation of the economy (to decrease imports).
- Devaluation of the currency to make exports cheaper and imports more expensive.
- Import controls to decrease imports.
- Supply side policies to increase UK competitiveness and so increase exports.

Problems with these policies

- Time lags before effects take place.
- Impact on UK competitiveness .
- Impact on other government macro-objectives.
- Limitations on government ability to implement them (e.g. WTO).
- The cause, size and duration of deficit will influence how successful the policy will be.

Economic growth

The aim is to achieve steady, sustainable growth; i.e. growth which minimises the negative consequences of growth

Measured by changes in *real GDP* (i.e. real output).

Real: Adjusted for inflation.
At constant prices.

GDP is total output/income/expenditure in an economy in a given period of time.

Costs of Economic Growth:

- Opportunity cost of consumption goods forgone (if the economy is at full capacity on the PPC) as the economy builds up its stock of capital
- Increase stress/deterioration in quality of life.
- Depletion of natural resources/damage to the environment.
- The need to retrain workers whose jobs become obsolete/outdated

Benefits of Economic Growth:

- Higher living standards as there is an increase in the quantity/quality of goods/services
- Higher life expectancy,
- Decrease in poverty if the benefits of growth are spread evenly
- The possibility of improved public services as government tax revenue increases
- Improved status of nation.
- Improved business/consumer confidence and the resulting future planning

A recession is: A period of decline in output/real GDP over two consecutive quarters or more.
When the economy is shrinking.
When Economic Growth is Negative.

Production is measured by *output*.

Productivity is measured by *output per worker*: It is an indicator of the *efficiency* of an economy.

Inflation:

- A sustained rise in the general level of prices over a period of time
- A fall in the purchasing power of money over a period of time.
  i.e There is an inverse relationship between inflation and the purchasing power of money

A fall in inflation rate means that

- Prices rising more slowly.

Or

- Purchasing power of money is falling at a slower rate.

It does ***not*** mean that prices are falling

Inflation is measured by changes in the **RPI:** This is a measure of the change in consumer prices based on a basket of goods and services (i.e. a range of products are monitored). Items in the basket are allocated weights based on expenditure patterns gathered from the family expenditure survey. Weights show the relative importance of different goods. The greater the % of income spent on the product, the higher the weight allocated. Changes in the prices of the items in the basket are measured monthly and then multiplied by the weight and averaged out to provide the overall increase.

Problems with the RPI:

- What to include in the basket of goods.
- Weights are out of date; they show what people spent money on in the past.
- It takes no account of improvements in the quality of goods/services
- It takes no account of special offers

Advantages of low inflation:

- Improved international competitiveness.
- Low menu costs.
- Low shoe leather costs.
- Low administrative costs.
- Encourages I → Increased economic growth → decrease in U.
- Consumer confidence ("feel good" factor).

Disadvantages of high inflation:

- Administration; shoe leather and menu costs all increase.
- Fiscal drag.
- Problems in planning.
- Negative effect on our international competitiveness.
- Negative effect on BoP, Economic growth and Unemployment.
- Anticipated or unanticipated?: The effects should be less if it is anticipated.

What happens if UK inflation is higher than that of our competitors?

- A negative effect on exports which become less competitive (but the extent of the effect will depend upon changes in the exchange rate and the PED for our exports)
- Imports become more competitive and so home produced goods become less competitive
- The overall effect of the two will be a worsening of the Balance of Payments

Unemployment

- Willing and able to work but unable to find a job; people actively seeking employment.
- ILO survey defines unemployment as 'out of work, but seeking employment'. It is based on a survey (i.e. a sample).
- Claimant count defines unemployment as the number claiming job seekers allowance. It is usually thought to *understate* the level of unemployment (as people are unemployed but not eligible for benefit) but can also overstate it (due to people working in the black economy signing on

Benefits for the economy of a decrease in Unemployment

- Increase in output in the economy.
- Increase in tax revenue for government.
- Decrease in G on jobseekers allowance and associated benefits.
- Decrease in crime levels.
- Decrease in health problems related to stress and low incomes.
- Increase in incomes leads to an increase in consumption, so leading to an increase in AD.

The opportunity cost of unemployment

- Lost output
- Alternatives that government expenditure on benefits could have been spent on

The link between GDP and Unemployment

The relationship is an inverse one

- Increase in real GDP → increase in D for goods and services → Increase in demand for labour to produce them: Unemployment decreases.
- Multiplier effect →a larger decrease in U.
- But, there may be a time lag before the effect on U is seen.
- How strong is the link? Has automation of manufacturing reduced the link?
- NB: GDP can increase with no decrease in U if productivity in the economy increases.

Circular flow of income

- Injections are I, G and X
- Leakages/Withdrawls are S, T and M

Aggregate Demand

Aggregate Demand = C + I + G + (X – M);

X - M is sometimes referred to as *net exports*.

AD measures the total value of goods and services produced within the boundaries of a country in a given time period; or; the total value of spending on domestic output at a given price level in a given time period.

Investment: Spending on capital goods by business/government.
If asked to define Investment, *give an example*.
Net investment increases productive capacity.
Investment is a component of AD and the circular flow model.

Why Investment in an economy increases:

- Decrease in the interest rates.
- Increase in Y.
- Increase in consumer D for products.
- Decrease in cost of capital goods.
- Decrease in corporation tax.
- Technological advances mean that firms needs to update their equipment.
- Increase in confidence/expectations by firms.
- Decrease in x-rate meaning exports become more competitive.
- Low and stable inflation.

How to stimulate Aggregate Demand

- Decrease in interest rates/Increase in Money Supply.
- Decrease in tax rates.
- Increase in government spending.
- Incentives to increase exporter.
- Devalue your currency.
- Incentives for firms to increase Investment .
- Protectionism to decrease imports.

Macro-economic policies the Government can use

Demand side

- Fiscal Policy
- Monetary (interest rate) policy

Supply side

Monetary (interest rate) policy

Monetary policy: Manipulation of the economy using *interest rates* and/or *money supply*.

Why increase interest rates?

- Decrease inflationary pressure.
- Encourage Savings.
- Increase the exchange rate.
- Discourage C.

Effectiveness of Monetary (interest rate) policy

You will need to know

- How money supply/interest rates effect AD.
- How money supply/interest rates effects the exchange rate and so AD.

Advantages of monetary/interest rate policy:

- Quicker than fiscal policy.
- Free from political control as interest rates are set by the Bank of England.

Limitations in monetary/interest rate policy:

- Some time lag
- Can't be too out of step with other countries interest rates.
- Offsetting factors e.g. lack of consumer/business confidence would mean there could be little effect on C and I.

Effect of a decrease in *interest rates* on:

C

↓

Increase in consumption due to…

↓

Via multiplier

↓

Increase in AD

I

↓

Increase in investment due to…

↓

Via multiplier

↓

Increase in AD

G

↓

Not a lot as this mainly depends on political decisions.

But cost of government borrowing will decrease so there may be an increase in G as government has more money to spend.

Or:

Decrease in G due to less interest payments on national debt. A further decrease due to decreased spending on

(X-M)

Due to a decrease in x-rate.

↓

Decrease in X prices → Increase in X.

Increase in M prices → Decrease in M.

↓

Improved BoP and so increase in injections and decrease in leakages.

↓

Via multiplier

↓

Increase in AD

But: Decrease in Roi → increase in disposeable income → increase in M so:

BoP may worsen and AD may fall so whether AD increases or decreases overall depends on the relative size of the two effects.

Fiscal Policy

Fiscal policy: Manipulation of the economy using *taxation* and *government spending*.

Expansionary fiscal policy is a policy to increase AD in the economy (as opposed to a contractionary policy which is designed to decrease AD in the economy).

How? Increase G and/or decrease T.
The increase in G or decrease in T should: Increase AD → Increase output → Decrease in U (if not at full employment) or an increase in inflation and a worsening of the BoP (if the economy is at full employment).

Effectiveness of fiscal policies

How changes in tax rates effects AD.
How changes in G effects AD.
} Via the components of AD (i.e. C, I, G, X and M).

In evaluating, refer to:

- Time lags; effects on other macro-economic objectives.
- Difficulty of changing G (types of spending).
- Political problems with changes to taxes.

Supply side policies

- Long term policies
- Policies designed to increase Aggregate Supply and shift the AS curve to the right (or move the PPC outwards in a micro-economic context).
- Designed to increase the efficiency of markets.
- Designed to increase the quality/quantity of a nations resources.
- Designed to improve the price and quality competitiveness of the UK:

Typical S-side policies involve:

- Education.
- Training.
- Tax incentives for individuals and firms.
- Changes to the benefit system
- Privatisation.
- Deregulation.
- Trade union reform.
- Subsidies for firms.
- Regional policy.
- Labour market reforms

Drawbacks:

1. Long time delay between implementation and effect.
2. Uncertainty over the scale of the final effect.

Using the AS and AD model

Learn the diagram: label curves, axes, arrows for shifts, learn what causes which curve to shift:

State and show on the diagram what happens to the equilibrium as a result:

- On the vertical (real price) axis.
- On the horizontal (real GDP, i.e. output) axis.

You *must* explain the diagram and its changes.

An increase in demand for exports would have effects on:

Inflation

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Increase in AD may lead to demand pull inflation.

Balance of payments

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Increase in exports → improvement in BoP

↓

Unless the increase in D may not be met if the economy is at or near full employment.

Unemployment

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Increase in output → Decrease in U

↓

But the size of the decrease in unemployment depends on the type of products produced (e.g. capital intensive production or labour intensive?)

Economic Growth

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Increased output → Economic growth

↓

But could be offset by a larger decrease in another component of AD.

Possible policies to decrease Unemployment:

Fiscal

↓

Decrease in T.
Increase in G.

↓

Increase in AD.

↓

Decrease in unemployment.

Monetary

↓

Decrease in interest rates

↓

Increase in I

Decrease in x-rate

↓

Increase in C and decrease in S

Increase in X and decrease in M

↓

Increase in AD

↓

Decrease in unemployment

Supply-side

↓

- Abolish minimum wage.
- Education.
- Training.
- Tax incentives.
- Decrease jobseekers allowance.
- Decrease trade union powers

↓

Decrease in unemployment.

Aggregate Supply

- Total supply/total output of the domestic economy at a given price level.
- Labour – policies aim to increase both the quantity and quality of labour, but particularly quality.
- Changes in aggregate supply can be caused by:
    - Improved technology.
    - Improved education.
    - Improved training.
    - Net investment (= Gross investment – depreciation) so increasing productive capacity.
    - Changes in tax/benefit policies.
    - Size of the working population (i.e. migration, 16/9 education, retirement age)

Protection of domestic industry

Arguments for:

- Protect infant industries.
- Protect declining industries.
- Prevent dumping.
- Improve the Balance of Payments
- Help domestic industry compete against low wage economies and prevent exploitation of labour in developing countries.
- Protect domestic employment.
- Protect strategic industries.
- Raise government revenue.
- Benefits of specialisation and trade.
    - Increase in choice.
    - More X and M.
    - Increase in world output.
    - Increase in specialisation.
    - Increase in efficiency.
    - Increase in competition.
    - Decrease in prices.

Against:

- You loose the benefits of specialisation and trade.
- Retaliation may occur.
- Reduced world economic efficiency.
- Reduced consumer choice.

Policies used for protection:

- Tariffs
- Quotas
- Embargoes
- Subsidise home producers
- Subsidise exporters
- Voluntary export restraint.
- Exchange controls.
- Import deposit scheme.
- Product standard regulations, complex customs procedures.

Tariffs

- Leads to an increase in the price of M.
- The decrease in the volume of imports depends on the *size* of the tariff imposed.
- The size of the decrease in demand for M depends on Price Elasticity of Demand for M: The more ELASTIC the demand, the GREATER the effect
- The effect of the tariff can be more than offset by:
  e.g. Increase in real incomes.
  Increase in exchange rate (which makes M cheaper).
- Risk retaliation from countries effected by the tariff
- Leads to less trade and so you lose the advantages of free trade).

Evaluative comments on macro policies:

You could consider:

- Trade offs (e.g. between inflation and unemployment).
- Time lags (i.e. how long before the policy takes effect).
- Limited policy choices (e.g. due to international rules ruling out some options).
- Skills shortages and how they may reduce the impact of the policy.
- Lack of incentives to work (e.g. due to increasing taxes).
- The motivating/demotivating effect of increased/decreased benefits.
- Offsetting factors (e.g. Increase/decrease in the exchange rate).
- Multiplier effects
- The *type* of G as some expenditure by government is more effective in increasing AD than others (e.g. meals on wheels employees vs. missile purchase).