24 The role of government

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Local role

- The central or federal government collects taxes + fund local services using taxes
    - e.g. rubbish collection, street lighting, libraries, schools, hospitals and public parks
- Central government gives local government funding to spend on these public and merit goods in the local area

National role

- The central government makes decisions about how to achieve its macroeconomic aims
    - Economic growth
    - Stable price
    - Low unemployment
    - Healthy balance of payments
    - Redistribution of income
- Achieving macroeconomic aims by using appropriate macroeconomic policies
    - e.g. fiscal policy, monetary policy, supply-side policy, policies to protect the environment

International role

- Modern economies need to trade with other countries
- An economy may be part of a trading bloc
    - = a free trade area which promotes the free movement of factors of production between member countries.
    - e.g. the European Union
- There will be some countries with which the country does not have free trade → tariffs and quotas may be imposed on goods traded

25 The macroeconomic aims of government

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Five macroeconomic aims

- Economic growth
- Full employment / low unemployment
- Stable prices / low inflation
- Balance of payments stability
- Redistribution of income

Economic growth

- Definition
  - The annual increase in the level of national output i.e. annual percentage change of GDP
- Refer to an increase in a country's real GDP over time
- Sustained economic growth is important because it is the most practical measure of SoL in a country
  - Increases confidence, consumption, investment, employment, government budget
- Economic growth represents a long-term expansion in the productive capacity of the economy
  - PPC of the country shifts outward in economic growth

Full employment / low unemployment

- Unemployment definition
  - Occurs when people are willing and able to work, and actively seeking employment, but are unable to find work
- Low unemployment complements economic growth
  - Higher employment tends to lead to higher GDP
- Low unemployment hence tends to increase the SoL in an economy
- Represents greater efficiency in the use of economy's resources

Stable prices / low inflation

- Inflation definition
  - The sustained rise in the general price level in an economy
  - Most governments set a target inflation rate to control economic activity
- Typically measured by using a Consumer Price Index (CPI)
  - This weighted index measures the changes in prices of a representative basket of goods and services consumed by the average households in the economy

Balance of payments stability

- Balance of payment definition
  - A financial record of a country's transactions with the rest of the world for a given time period, usually one year
- Includes the country's trade in goods and services with other countries
  - Credit items = all payments received from other countries
  - Debit items = all payments made to other nations
- A large and persistent balance of payments deficit suggests that the country is uncompetitive in international markets
  - Can have negative effects such as job losses → less economic growth and SoL

Redistribution of income

- Definition
  - Refers to the macroeconomic aim of achieving greater equality in the distribution of income in an economy
- Achieve greater equality through redistribution of income
  - Economies face unequitable distribution of income naturally due to unequal ownership of factors of production in a free market economy

- Help the relatively low income ones by methods such as progressive taxation, subsidies and welfare benefits

Possible conflicts

- Full employment vs. stable prices
  - When there is economic growth and more employment there tends to be more inflationary pressure
  - People have more money to spend as more are employed
    - Demand-pull inflation may occur as demand increases faster than supply
  - Cost-push inflation can occur
    - Full employment makes it harder for firms to attract skilled workers
    - Can lead to wage inflation and higher general prices
- Economic growth vs. balance of payment stability
  - If economic growth is caused by higher consumption expenditure there might be a deficit in the country's balance of payments
    - As consumption rises there tends to be higher expenditure on imports
    - More impact if economic growth caused inflation so the country's exports are less competitive
- Full employment vs. balance of payment stability
  - As employment level rises people have more money to spend and buy more imports
    - Therefore it can lead to an deficit in the balance of payment
  - Wages tend to rise as the economy reaches the level of national income where there is full employment
    - More cost-push inflation so the exports are less competitive
- Economic growth vs. stable prices
  - Stimulating economic growth by reducing tax rate / reducing interest rate / increasing money supply can cause inflation
  - A cut in interest rate means people with existing loans and mortgages have more disposable income to spend
  - Borrowing is also cheaper so firms can raise their investment expenditure
  - This can cause demand-pull inflation as there is more consumption and investment so more demand

26 Fiscal policy

2023年10月8日 23:04

Government budget

- Definition
  - Refers to the government's financial plans in terms of planned revenues and expenditure
  - Revenues = mainly tax revenues
  - Expenditure = healthcare, education and welfare payments
- Government try to balance their budgets in the long run
  - Increasing tax is unpopular
  - Government borrowing to fund budget is expensive due to interest
- Balanced revenue and spending = budget balance
- Spends more than revenue = budget deficit
- More revenue than spending = budget surplus

Reasons for government spending

- Essential services
  - e.g. state education, housing, healthcare, postal services
- Redistribute income and wealth
  - e.g. welfare benefits such as state pension
- Correct market failures by intervening
  - e.g. providing subsidies for merit goods

Reasons for taxation

- Tax definition
  - A government levy on income or expenditure
- Fund government expenditure
  - Before the government can spend money on the economy it must first take the money from taxpayers
- Areas spent
  - Social security
  - Education
  - Healthcare
  - Transport
  - Infrastructure
  - National defence
- Examples
  - Taxes on salaries and profits raises government revenue to help redistribution of income or wealth
  - Taxes on goods and services to raise cost of production and therefore lower the output of demerit goods
  - Taxes imposed on foreign goods and services help to protect domestic firms from oversea rivals

Types of taxes

Tax	Explanation
Income tax	• A direct tax levied on personal incomes — wages, interest, rent and dividends • In most countries this is the main source of tax revenues
Corporation tax	• A direct tax on the profits of businesses
Sales tax	• An indirect tax charged on an individual’s spending, such as VAT
Excise duties	• Indirect inland taxes imposed on certain goods and services • e.g. alcohol, tobacco, petrol, soft drinks and gambling

Customs duties	• Indirect cross-border taxes on foreign imports
Capital gains tax	• A direct tax on the earnings made from investments such as buying shares and private property
Inheritance tax	• A direct tax on the transfer of income and wealth such as property when passed on to another person
Stamp duty	• A direct progressive tax paid on the sale of commercial or residential property
Carbon tax	• An indirect tax imposed on vehicle manufacturers or firms that produce excessive carbon emissions
Windfall tax	• A tax charged on individuals and firms that gain an unexpected one-off amount of money • Such as a person winning the lottery or a firm gaining from a takeover bid

Direct / indirect taxation

- Direct taxation
    - Paid from the income, wealth or profit of individuals or firms
    - e.g. income tax, inheritance tax
- Indirect taxation
    - Expenditure taxes imposed on spending on goods and services
    - e.g. GST (goods and services tax) / VAT

Progressive / regressive / proportional taxation

- Progressive taxation
    - Those with a higher ability to pay are charged a higher rate of tax
    - As the income / wealth / profit of the taxpayer rises a higher rate of tax is imposed
    - e.g. income tax, capital gains tax, stamp duty
- Regressive taxation
    - Those with a higher ability to pay are charged a lower rate of tax
    - The higher the income the lower the tax rate
    - e.g. airport tax and television license
        - Everyone pay the same amount but takes up a smaller proportion of income for the wealthier ones
- Proportional taxation
    - The percentage paid stays the same, irrespective of the taxpayer's level of income / wealth / profit
    - e.g. 20% VAT

Principles of taxation

- Equitable (fair)
    - Taxes should be based on the taxpayer's ability to pay
    - Justify progressive taxation as the rich have a greater ability to pay
- Economical
    - The tax should be easy and cheap to collect
    - Maximum the yield relative to the cost of collection
- Convenience
    - Method of payment should be convenient to the taxpayer → encourage payment
- Certainty
    - The taxpayer should know what, when, where and how to pay the tax
- Efficiency
    - The tax system should attempt to achieve its aims without any undesirable side effects
    - e.g. higher tax rate can result in a disincentive to work → slow down economic growth
- Flexibility
    - Taxes need to be flexible enough to adapt to a change in the economic environment without rewiriting the tax legislation

Impact of tax on price and quantity

- Imposing sales tax shifts the supply curve of the product to the left due to higher unit cost of production
- Increase in equilibrium price, decrease in equilibrium quantity → higher price charged, less sold and produced
- Can reduce the amount of tax revenue charged, depending on PED
    - Elastic = demand drops more than raise in price → revenue fall

Impact of tax on economic growth

- Taxation reduce incentive to work and produce → negative impact on economic growth
- Tax cut increase domestic spending due to higher disposable income
    - Create more job opportunities
    - Benefit individuals and businesses
- Tax revenue fund government spending which also fuels economic growth

Impact of tax on inflation

- Higher taxation reduce the spending ability of individuals (lower disposable income) and profits of firms
    - Reduce the inflation by reducing market demand (less demand-pull inflation)
- Lower taxation = more inflation
    - Higher disposable income for households and firms
    - More market demand → more inflation

Impact of tax on business location

- High corporation tax rates discourages multinational businesses to locate in the country
    - Less foreign direct investment
- Easier to attract workers with low income tax rates
- (vice versa)

Impact of tax on social behaviour

- Reduce the consumption of demerit goods by imposing tax on them
- Protect the natural environment by charging those who pollute or damage it
    - e.g. carbon emission tax

Impact of tax on tax avoidance and tax evasion

- Tax avoidance
    - The legal act of minimising payment of taxes
    - e.g. avoid spending on items with a large sales tax
- Tax evasion
    - The illegal act of not paying the correct amount of tax
    - e.g. firms under-declaring its profits
- High level of taxation tends to encourage both
- Lower tax rates create less incentives for doing so

Impact of tax on redistribution of wealth

- Wealthier people pay more tax
    - More income tax, sales tax, stamp duty, etc.
    - Progressive taxation = wealthier ones pay a higher proportion of income
- Poor people pay less tax
- Funds can be used by the government for education, healthcare and social benefits for less wealthy ones

Fiscal policy

- Definition
    - The use of taxes and government spending to influence level of economic activity and achieve macroeconomic objectives

- Expansionary fiscal policy
    - Increase the level of economic activity
    - Increase government spending and lowering taxes
        - Increase spending in the economy + money supply in the economy
        - e.g. increasing wages for public sector workers
    - Reduce the effects of an economic recession by boosting GDP and reducing unemployment
- Contractionary fiscal policy
    - Reduce the level of economic activity
    - Decrease government spending and raising taxes
        - e.g. using property taxes to slow down escalating house prices
    - Used to reduce inflationary pressure during an economic boom
- Expansionary fiscal policy reduce government revenue in the short term but as economy improve in the long run less government expenditure is needed to boost the economy as people earn and spend more money and there will be more revenue (vice versa for contractionary fiscal policies)

? **<u>Effects of fiscal policy on government macroeconomic aims</u>**

- Economic growth
    - Government capital expenditure on infrastructure helps to boost investment in the economy
    - Lower rate of corporation tax help to attract foreign direct investment into the economy → higher potential output
- Low inflation
    - Lower taxes boost the productive capacity of the economy in the long run
        - Keeps the general price level relatively low so reduces inflation
        - (May increase due to increased spending and market demand)
    - Contractionary fiscal policy also reduce inflation
- Employment
    - Cut in income tax can incentivise people to seek employment and work harder
    - Support for business start-ups through subsidies or tax cut to incentivise entrepreneurs / increase local spending
        - Create more job opportunities
- Healthy balance of payments
    - Relatively low rates of taxation help to keep domestic firms competitive
        - Benefit exporters
    - Subsidise domestic industries to improve their international competitiveness
    - Benefit the country's balance of payments as there are more exports
- Redistribution of income
    - The government use progressive taxation and government spending (welfare, education, healthcare)

27 Monetary policy

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Money supply

- Refers to the amount of money in the economy at a particular point in time
- e.g. coins, banknotes, bank deposits and central bank reserves

Monetary policy

- Definition
  - The use of interest rates, exchange rates and the money supply to control macroeconomic objectives and to affect the level of economic activity
- Most government rely on interest rate policy as it is difficult to directly control the money supply or manipulate exchange rate
  - Money supply difficulty
    - Definition of money is quite loose
    - Banks can create credit easily
  - Manipulation of exchange rate difficulty
    - Reliance on international trade
    - Compliance with regulations of the World Trade Organisation

Monetary policy measures

- Change in interest rates
  - The main monetary policy
  - Higher interest rate will make borrowing more expensive and people with existing loans or mortgages have less to spend
    - Creates more incentive to save
    - Reduce overall spending in the economy
- Changes in money supply
  - Allowing commercial banks to lend more money (lower cash reserve ratio) increases the money supply
    - Can boost consumption and investment expenditure in the economy
- Changes in foreign exchange rates
  - Foreign exchange market has a direct impact on the domestic money supply
  - e.g. domestic customers need to purchase foreign currency in order to buy import → less domestic money supply

Expansionary / contractionary monetary policy

- Expansionary (loose) monetary policy
  - Boost economic activity by expanding the money supply
  - Mainly by lowering interest rates
    - Makes borrowing more attractive to households and firms because the cost of borrowing is lower
    - People with existing loans and mortgages have more disposable income
    - Households and firms have more money to spend
- Contractionary (tight) monetary policy
  - Slow down economic activity
  - Increase in interest rate tends to reduce overspending and limit investment in the economy
  - Used to reduce inflation although it can harm economic growth and cause job losses in the long run

Effects of monetary policy measures on macroeconomic aims

	Effect on economic growth	Effect on inflation	Effect on unemployment	Effect on balance of payments
Higher interest rates	Lower — via reduced consumption and investment	Lower due to less demand-pull pressure	Higher due to lower spending leading to rising cyclical unemployment	Improved — less spending on imports as consumption falls
		Lower due to exchange rate rises leading to less cost-push pressure		
Reduced money supply	Less borrowing and less spending, so lower growth	Less spending in economy, so lower demand-pull inflation	Higher due to lower spending and less lending by banks on business activities (such as start-ups and expansion)	Lower imports due to less money being available to spend on imports
Rise in exchange rate	Lower due to fall in exports	Lower as imports are cheaper, which reduces cost-push pressure	Higher due to decline in export industries' output	Worsened as exports fall and imports may rise due to being cheaper

- (not fully explained)

<u>Limitations of monetary policy</u>

- There are time lags in the reaction to interest rate changes in the economy'
    - Reduce the effectiveness of policies and may destabilise the economy
- Economic activity is not only dependent on interest rates
    - Other factors e.g. consumer and business confidence levels impact GDP as well
- Higher interest rates can be counterproductive
    - It restricts economic activity and discourage foreign direct investment firms due to high cost of borrowing
    - Less profits, job creation, R&D expenditure and innovation
    - Can conflict with other macroeconomic objectives, especially economic growth and low unemployment

28 Supply-side policy

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Supply side policy

- Long term measures to increase the productive capacity of the economy, leading to an outward shift of the PPC, by improving the quality and/or quantity of production

Types of supply side policy

- Education and training
- Labour market reforms
- Lower direct taxes
- Deregulation
- Incentives to work
- Incentives to invest
- Privatisation

Education and training

- Improved education and training in the economy = better skills, productivity, flexibility and mobility of the workforce
- Hence increased spending on education and training is likely to eventually improve the productive capacity of the economy
- However, there is often under-provision of educational services in a market economic system (merit good) so there is often a need for government intervention
- The government can spend money directly on providing education and training or provide incentives for private firms to supply these services
- Cost a lot of money → high tax needed

Labour market reforms

- Reform by reducing or removing
  - The power of trade unions
  - Unemployment benefits
  - Minimum wages
- Labour market reforms help to promote greater competition by increasing flexibility → higher efficiency and productivity
  - e.g. less excessive and complex employment legislation and the threat of strike action from trade unions, which hinder efficiency in labour markets
- In the long run, such supply-side policies should reduce unemployment as labour markets become more internationally competitive

Lower direct taxes

- Create incentives for work, especially for people on low wage rates
  - They get a higher disposable
- Over time higher disposable income provides a boost to consumption expenditure and hence an increase in GDP

Deregulation

- Refers to the reduction or removal of barriers of entry in order to make markets more competitive
  - e.g. allowing new firms to enter an industry previously dominated by a monopolist
- Increased competition in an industry tends to lead to lower prices and better-quality output of goods and services
- The expected benefits of deregulation only materialise after new firms have entered and competed in the market
  - Could take a long time to happen

Incentives to work

- Direct tax cuts encourage people to find work or to work harder
- In general countries that impose lower rates of income tax will tend to create greater incentives to work
- Lower rates of indirect taxes can create incentives for households and individuals to spend
- The government could also reduce welfare benefits to the unemployed → creating more incentive for them to seek employment

Incentives to invest

- Lower corporation tax rate
  - Countries that impose lower rates of corporate tax will tend to create greater incentives for firms to invest so they can maximise their returns → more FDI
  - High corporate tax rates in countries can reduce incentives to invest in these nations
- Enterprise zones
  - Give firms an incentive to invest in enterprise zones by providing subsidies
  - These are locations with relatively high rates of unemployment where the government creates financial incentives for firms to relocate
    - Such incentives include tax rebates and reduced regulations in order to attract private sector investments.
- Supply-side policies focus on the importance of investment in research and development (R&D), new product development, new technologies and infrastructure, thus contributing to growth of the economy
- Capital increases the productive capacity and productivity of the economy in the long run

Privatisation

- This is the policy of selling off state-owned assets / businesses to the private sector so they can be run more efficiently
- Private sector firms are motivated by profit, so they can develop better products and deliver better services
- Private sector firms become more productive and efficient due to competitions thus helping to boost the productive capacity of the economy

The effects of supply-side policy measures on macroeconomic aims

- Economic growth
  - Supply-side policy measures can be used to achieve sustainable economic growth by increasing the productive capacity of the economy
  - e.g. investment in education and cuts in corporate taxes can help to boost economic growth in the long run
- Full employment/low unemployment
  - An increase in the economy's productive capacity will tend to increase national output, thereby creating jobs in the economy in the long term
  - Supply-side policies such as investment in training can help to reduce both frictional and structural unemployment
- Stable prices/low inflation
  - As supply-side policies increase the productive potential of the economy, they help to prevent the general price level from rising beyond control
  - A limitation of using fiscal and monetary policies (demand-side policies) to achieve economic growth is that they stimulate demand-pull inflation
  - Supply-side-policy measures increase the productive capacity of the economy → resulting in economic growth without price rising
- Balance of payments stability
  - Supply-side policies can improve productivity and national output without inflation → improves the international competitiveness of the country
  - This helps to boost the economy's export earnings → improved balance of payments
- Redistribution of income
  - Supply-side policies such as greater investment in education and training / greater incentives to work tend to benefit low income earners more than high income earners

29 Economic growth

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Economic growth

- The annual increase in the level of national output i.e. the annual percentage change in GDP
- Increases the long term productive capacity of the economy → outward shift of PPC
- Increases in income level
- Measurements
  - Increased in GDP, GNP or NNP (Net National Product) over a period of time in real terms

Components of nominal GDP

- $GDP = C + I + G + (X - M)$
- Nominal GDP
  - Measures the monetary value of goods and services produced within a country during a given period of time (usually 1 year)
- Consumption expenditure
  - The total spending on goods and services by individuals and households in an economy
- Investment expenditure
  - The sum of capital spending by all businesses within a country
  - Capital spending is used to increase production and to expand the country's productive capacity
- Government spending
  - The total consumption and investment expenditures of the government
    - e.g. spending on infrastructure and on the construction of new schools or hospitals
  - Ignores payments made to others without producing any corresponding output
    - e.g. unemployment benefits
- Net exports
  - The monetary value of the difference between a nation's export earnings and its import expenditure
    - = $(X - M)$
  - Export earnings
    - The monetary value of all exports sold to foreign buyers
  - Import expenditure
    - The monetary value of all payments for imports
    - The money spent leaves the economy so this must be deducted in GDP calculations

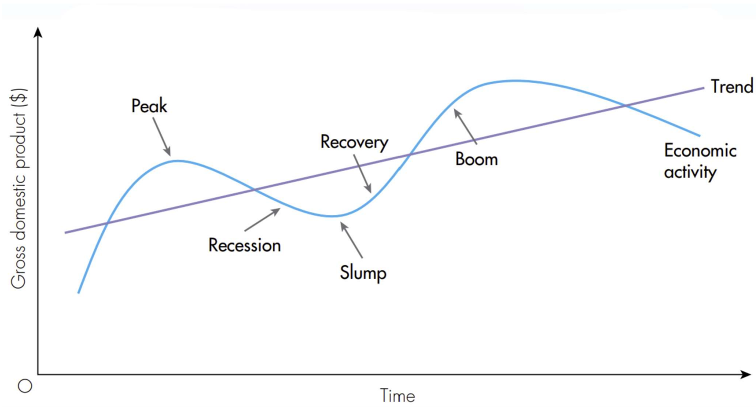
Real GDP

- Refers to the value of national income that is adjusted for inflation
- Reflects the true value of goods and services produced in a given year as inflation raises the value of a country's output

GDP per capita / GDP per head

- Measures the GDP of a country divided by its population size
- A key measure for a country's economic growth and SoL
  - GDP per capita indicates the mean national income per person

The business cycle / trade cycle

- 

- Business cycle definition
  - Describes the fluctuations in the economic activity of a country over time, creating a long-term trend of economic growth in the economy
- Peak
  - Economic activity is at its highest level. Unemployment is low, while consumer and business confidence levels are high
- Recession
  - Occurs in the business cycle when there is a fall in GDP for two consecutive quarters
  - * Below trend line
- Slump
  - At the bottom of a recession in the business cycle
  - There will be high unemployment while consumption, investment and net export earnings will be low
  - Many businesses will have collapsed and consumers have little confidence in the economy
  - Hence, government spending may be needed to help the economy to recover from the recession
- Recovery
  - Occurs when the level of GDP starts to rise, thus recovering from the slump
  - The levels of consumption, investment and net exports gradually rise
    - Leading to employment opportunities in the long run
- Boom
  - The level of economic activity rises
    - Caused by any combination of an increase in consumption, investment, government spending and net export earnings
  - Economic growth occurs when GDP increases for two consecutive quarters

<u>Causes of recession</u>

- A higher level of unemployment
- Higher interest rates, which discourages investment but raises demand for savings
- Greater uncertainty in the economy
- Lower rates of disposable income, causing a fall in consumer spending
- Lower levels of government expenditure
- A decline in the demand for exports
- Lower levels of consumer and business confidence

<u>Causes of economic growth</u>

- Factor endowments
  - e.g. Saudi Arabia is endowed in the supply of oil
  - Refers to the quantity and quality of a country's factors of production
  - Countries endowed in a factor of production can therefore specialise production on a large scale
    - Benefit from economies of scale
    - Export their lower price products in overseas markets
  - Countries that lack natural resources, land and productive labour tend to struggle to achieve economic growth

- The labour force
  - Large labour force, highly skilled workers, higher geographical + occupational mobility of labour = higher economic growth
    - e.g. Large labour force in India, highly skilled workers in Germany
- Labour productivity / productive use of labour
  - This refers to the amount of goods and services that workers produce in a given time period
    - Often referred to as output per worker expressed as a monetary value $\left(\frac{\text{GDP}}{\text{The country's labour force}}\right)$
  - It depends on the qualifications, experience, training, motivation, etc. of the labour force
  - Technological advances can also enhance labour productivity
  - An increase in the labour productivity of a country helps to improve its international competitiveness and hence economic growth
- Investment expenditure
  - Investment is a component of overall demand in the economy, so ↑ investment = ↑ GDP
  - Investment helps to boost the country's productive capacity in the long run
  - Investment expenditure on physical capital can also help to improve labour productivity
    - e.g. using computers in production
  - In order to remain competitive in the long run, countries must invest in capital resources

<u>**Positive consequences of economic growth**</u>

- Improved standards of living
  - Economic growth tends to lead to higher income levels in the country
  - Higher income levels in a country enable people to spend more money to meet their needs and want
  - Higher income helps to eliminate absolute poverty in the country
- Employment
  - Economic growth = higher employment
  - This helps to raise consumption + market demand and encourages further investment in capital, helping to sustain economic growth
- Tax revenues
  - Economic growth is associated with higher levels of spending in the economy
  - This generates more tax revenues for the government
    - e.g. more sales taxes (from higher consumption), corporate tax (on the profits of firms) and import taxes
    - Hence there are more funds for the government to use to further sustain the growth of the economy or improve social welfare

<u>**Negative consequences of economic growth**</u>

- Environmental consequences
  - High rates of economic growth can create external costs (demerit goods) such as pollution, congestion, climate change and land erosion
  - Such environmental impacts can damage people's wellbeing and quality of life in the long run
- Risk of inflation
  - If the economy grows due to excessive demand, there is the danger of demand-pull inflation
    - Demand increasing faster than supply
  - This can lead to prices of goods and services rising to unstable levels
  - Negative consequences for the economy e.g. a decline in the country's international competitiveness
- Inequalities in income and wealth
  - Economic growth often creates greater disparities in the distribution of income and wealth
    - Rich people benefit more than the poor
    - Wider gap between rich and poor
- Resource depletion
  - Economic growth often involves using up the world's scarce resources at unsustainable rates
  - e.g. deforestation and overfishing have led to problems in the ecosystem

Policies to promote economic growth (check chapter 26-28)

- Fiscal policy
    - Involves the use of taxation / government spending to control the level of economic activity in the economy
    - If demand in the economy is too low, the government may choose to stimulate economic growth by cutting taxes and/or increasing its own expenditure in order to boost the level of economic activity → higher consumption = economic growth
    - This should also have a positive impact on employment in the economy.
- Monetary policy
    - Involves the central bank changing interest rates / changing money supply / changing exchange rates in order to control the level of demand and hence economic activity
    - To promote economic growth lower interest rates can be used to cut the costs of borrowing to consumers and firms
        - Help to fund consumer expenditure and business investments → boosting economic growth
- Supply-side policy
    - Used to increase the economy's productive capacity
    - These policies seek to increase competition, productivity and innovation in order to promote economic growth
        - e.g. government funding to encourage education and training
    - A reduction in corporate taxes can also encourage risk taking and foreign direct investment in the economy
    - In the long run, supply-side policies increase the productive capacity of the economy, thereby promoting economic growth

30 Employment and unemployment

2023年11月20日 17:31

Definitions

- Employment
  - Refers to the economic use of labour as a factor of production
- Unemployment
  - Occurs when people of working age are both willing and able to work but cannot find employment
- Full employment
  - Means that everyone in a country who is willing and able to work has a job

Importance of employment (explain with previous knowledges)

- High employment raises standards of living for the average person in the country
- It promotes economic growth ← key macroeconomic objective
- It increases tax revenues (due to higher levels of income and spending in the economy) → finance government spending
- It reduces the financial burden and opportunity cost to the government as spending on welfare benefits falls
- It prevents 'brain drain' from the economy
  - This can occur during periods of high unemployment when highly skilled workers leave the country in search of job opportunities elsewhere
- It reduces income and wealth inequalities
  - Poorer people are more affected by unemployment as they lack savings and wealth

Why employment patterns change

- Employment sector
  - As a country develops, less people is employed in the primary sector and more is employed in the tertiary sector
- Delayed entry to the workforce
  - As more people study to university level, the average age of employees entering the workforce rises
    - e.g. around 25 when completing master degree
  - More females and mature students have also entered university
  - Limiting the size of the economy's workforce
- Ageing population
  - This occurs when the average age of the population rises
    - Partly due to lower birth rates and longer life spans in developed economies
  - The lower labour supply means that firms are more willing to employ older employees and hire people beyond their retirement age
- Formal sector employment
  - As an economy develops, there is a higher proportion of workers employed in the formal economy and a lower proportion who work in the informal sector
  - Employment = formal
    - Workers pay income taxes and contribute to the country's official GDP
- Female participation rates
  - As a country grows and develops, there tends to be a greater proportion of women active in the labour force
  - This is due to changes in social attitudes towards women in the economy
  - In economically developed countries, women are choosing to have fewer children and at a later age
    - High costs of raising children
    - More women opt to pursue a professional career
- Public sector employment

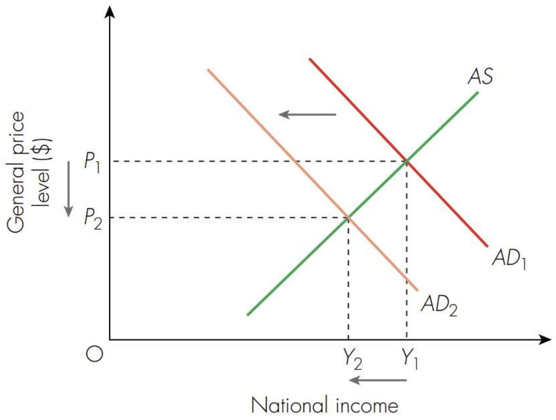
    - More countries around the world move towards a market economy with less direct government intervention → decline in the proportion of people employed in the public sector
- Flexible working patterns
    - Changes in the world economy means that firms need to be more flexible in order to compete internationally
        - e.g. hiring more part-time staff, allowing employees to work from home, introducing flexible working hours and outsourcing non-core functions (such as accounting, cleaning, security and ICT) to other service providers

Measuring unemployment

- Claimant count
    - Measures the number of people who are out of work and claiming unemployment benefits
    - To qualify for benefits they must prove they are actively seeking employment
    - Disadvantages
        - Underestimates the true level of unemployment, because many people are not eligible for unemployment benefits
            - e.g. those who are only seeking part-time work or people on job retraining schemes
- Labour force survey (LFS)
    - Uses the ILO's standardised household-based survey to collect work-related statistics
        - e.g. employment status, education and training opportunities
    - Produced by the ILO (International Labours Organization)
        - Used by all member states of the European Union and other countries too
    - Questionnaires are collected face-to-face or completed over the telephone
    - The ILO measures a country's unemployment based on the number of people who are
        - Willing to work, but unable to find it
        - Actively looking for work (they have looked for a job in the last 4 weeks)
        - Able to start work within the next 2 weeks
        - Waiting to start a new job within the next 2 weeks
- Unemployment rate
    - A measure of the percentage of a country's workforce that is unemployed
    - Unemployment rate = $\frac{\text{Number of unemployed}}{\text{Workforce}} \times 100$
    - Unemployment rate = $\frac{\text{Number of unemployed}}{\text{Number of unemployed+employed+self-employed}} \times 100$

Types of unemployment and their causes

- Frictional unemployment
    - Transitional unemployment which occurs when people change jobs due to the time delay between leaving a job and finding + starting a new one
    - Always exists in the economy because it takes time for the labour market to match available jobs with the people looking for jobs
- Structural unemployment
    - Occurs when the demand for products produced in a particular industry continually falls, often due to foreign competition
    - The industry therefore suffers from structural and long-term fall in demand for its products so people become unemployed in these industries
    - Those who have become unemployed after working in such industries usually find it quite difficult to find a new job so retraining is needed
- Cyclical unemployment / demand-deficient unemployment
    - Is the most severe type of unemployment as it can affect every industry in the economy
    - It is caused by a lack of demand which causes a fall in national income.
    - Experienced during an recession and slump

- 

Consequences of unemployment

- Physical and mental health problems
  - The individuals who are unemployed may suffer from stress, depression, other health problems, low self-esteem, a lack of dignity and homelessness
  - In extreme cases unemployment can lead to suicides.
- Family and friends may also suffer from lower incomes as a result of unemployment
  - This often leads to arguments and even separation or divorce
- The local community can suffer if there is mass unemployment
  - Causing poverty, falling house prices and hence asset values, and increased crime rates
- Firms lose out as there are lower levels of consumer spending, investment and profits
  - Business failures and bankruptcies are therefore more likely to occur
- The government may face higher expenditure on welfare benefits and healthcare for the unemployed
  - Can lead to increased government debts
- Taxpayers negatively affected by the opportunity costs of unemployment
  - Increased reliance on taxpayer's money to finance unemployment and welfare benefits
- The economy as a whole suffers from being less internationally competitive due to falling levels of spending and national output

Policies to reduce unemployment (check previous chapters)

- Fiscal policy
  - This is the use of taxation and government spending policies to influence the level of economic activity
  - It can be used to tackle unemployment caused by demand-side issues (e.g. cyclical and structural unemployment)
  - The use of expansionary fiscal policy (such as tax cuts and increased government spending) boosts the level of consumption and investment in the economy
  - This causes an increase in real GDP, which brings about more employment opportunities
- Monetary policy
  - This refers to the use of interest rates to affect the level of economic activity
  - Tackles demand-side causes of unemployment
  - When interest rates are lowered, the cost of borrowing falls, thus encouraging households and firms to spend and invest
  - Results in higher employment
  - The resulting rise in real wage rates also helps to attract more labour
- Protectionist measures
  - Such as tariffs and quotas
  - Can be used to safeguard domestic jobs from the threat of international competition
- Supply-side policies
  - These government strategies are used to deal with imperfections in the labour market and to reduce unemployment caused by supply-side factors
  - These policies are aimed at addressing frictional and voluntary unemployment
    - They can also be used to help reduce structural and cyclical unemployment
  - Policies

- Investment in education and training
  - Helps unemployed people to gain new skills so they can find employment
  - Education and training expenditure should also help future generations to become more skilled and employable
- A reduction in trade union powers
  - Labour unions are not in such a strong bargaining position to obtain higher wages
  - Strong trade unions have often been able to demand annual pay rises in excess of inflation
  - Hence government intervention to reduce the influence and power of trade unions can help to reduce unemployment
- Incentives can be offered to firms for training and hiring the long-term unemployed
  - e.g. tax allowances / subsidies to reduce the costs of training and hiring workers
  - Special economic zones could be set up in areas of high unemployment to create jobs
    - Firms might be reluctant to do this because of the lower productivity and greater risks of hiring the long-term unemployed
- Reducing welfare benefits
  - Give unemployed people an incentive to find a job rather than to rely on state welfare benefits
  - If it is made more difficult for people to claim unemployment benefits, they become more proactive in searching for jobs

31 Inflation and deflation

2023年11月28日 19:40

Inflation

- The sustained rise in the general level of prices of goods and services over time, as measured by a consumer price index
- Reduces the value of money and the spending power of individuals, governments and firms
- Hyperinflation
  - Very high rates of inflation that are out of control, causing average prices in the economy to rise very rapidly

Deflation

- The sustained fall in the general price level in an economy over time, i.e. the inflation rate is negative
- Benign deflation
  - Caused by higher levels of supply of goods and services
  - Increasing the productive capacity of the economy
  - Decreases the general price level of goods and services and increases national income in the long run
  - Non-threatening deflation
- Malign deflation
  - Caused by lower levels of demand in the economy
  - Decreases the general price level of goods and services due to excess capacity in the economy
  - Harmful to the economy as it is associated with a decline in national income and standards of living

Measuring inflation and deflation

- Consumer price index (CPI)
  - A weighted index of consumer prices in the economy over time
  - It is used to measure the cost of living for an average household
  - It measures price changes of a representative basket of goods and services consumed by an average household in the country
  - Different statistical weights are applied to reflect different good and services' relative importance of the average household's expenditure
    - Weights are based on the proportion of an average household's spending on the items in the representative basket
  - Used for international comparisons of inflation rates
    - Uses a wide sample of the population to calculate the statistical weights
- Calculating CPI
  - Base year
    - The starting year when calculating a price index

Causes of inflation

- Cost-push inflation
  - Caused by higher costs of production e.g. higher wage, higher raw material costs
  - Firms raise their prices in order to maintain their profit margins
  - Reduce real national income due to decreased economic activity caused by higher prices
- Demand-pull inflation
  - Caused by higher levels of total demand in the economy
  - Increasing the general price level of goods and services
  - Increase real national income due to increased economic activity caused by higher demand
- Monetary causes
  - Increases in the money supply and easier access to credit (e.g. loans / credit cards)
- Imported inflation
  - Occurs due to higher import prices

- Forcing up costs of production and therefore causing domestic inflation

<u>Consequences of inflation</u>

- Menu costs
  - Inflation impacts on the prices charged by firms
  - Catalogues, price lists and menus have to be updated regularly and this is costly to businesses
    - Workers have to be paid for their time to reprice goods and services
- Consumers
  - As the cost of living increases consumers need more money to buy the same amount of goods and services
  - The purchasing power of consumers goes down as there is a fall in real income
- Shoe leather costs
  - Inflation causes fluctuations in price levels so customers spend more time searching for the best deals
    - e.g. visiting different firms to find the cheapest supplier or searching online
  - = opportunity costs for consumers
- Savers
  - Loss from inflation if there is no change in interest rates
  - Lose money if inflation rate is greater than interest rate → negative real incentive to save
  - Inflation = disincentive to save
  - Fewer funds being made available for investment in the economy
- Lenders
  - Loss from inflation because the money lent out to borrowers worths less than before due to inflation
- Borrowers
  - Tend to gain from inflation
  - The money they need to repay is worth less than when they initially borrowed it
- Fixed income earners
  - Fall in real income
  - Lower SoL than before as the purchasing power of their fixed income declines with higher prices
  - Even if employees receive a pay rise, the rate of inflation reduces the real value of this
- Low income earners
  - Inflation harms low incomes earners more than high income earners
  - Low income earners tend to have a higher PED for goods and services (price is a greater proportion of their income)
  - People with high income and accumulated wealth are less affected by higher prices
- Exporters
  - The international competitiveness of a country will tend to fall when there is domestic inflation
  - In the long run, higher prices make exporters less price-competitive, thus causing a drop in profits
  - This leads to a fall in export earnings, lower economic growth and higher unemployment
- Importers
  - Imports become more expensive for individuals, firms and governments due to lower purchasing power of money
  - Essential imports e.g. food can cause imported inflation
  - Inflation can cause problems for countries without many natural resources
- Employers
  - Workers / trade unions are likely to demand a pay rise during times of inflation in order to maintain their real income level
  - Higher labour cost → lower profit margin
  - Employees in highly skilled profession is in a strong bargaining position as there is a high labour demand + low labour supply for them
  - Can cause wage price spiral
    - Occurs when trade unions negotiate higher wages to keep income in line with inflation
    - This simply causes more inflation as firms raise prices to maintain their profit margins

(cost-push inflation)

- Business confidence levels
    - Inflation causes uncertainty
    - Uncertainty + lower than expected real rates of return on investment (due to higher costs of production) → less amount of planned investment in the economy

Consequences of deflation

- Unemployment
    - Deflation usually occurs due to a fall in demand for goods and services in the economy
    - Causes a fall in the derived demand for labour
- Bankruptcies
    - During deflation consumers spend less so firms tend to have lower sales revenues and profits
    - This makes it more difficult for firms to repay their costs and liabilities → can cause a large number of bankruptcies in the economy
- Wealth effect
    - As the profits of firms fall their valuations (share prices) also fall
    - Dividends and the capital returns on holding shares fall
    - Reducing the wealth of shareholders
- Debt effect
    - The real cost of borrowing increases when there is deflation
    - Real interest rates rise when the price level falls
    - Both consumer and business confidence levels fall → even less demand / spending
- Government debt
    - With more bankruptcies, unemployment and lower levels of economic activity, tax revenues fall whilst the amount of government spending rises (stimulate economic activity / unemployment benefits)
    - This creates a budget deficit for the government → it needs to borrow money even though the real cost of borrowing rises
- Consumer confidence
    - Deflation usually causes a fall in consumer confidence levels as consumers fear things will get worse for the economy
    - They may postpone their spending, as they expect prices to fall even further in the future / wait until the economy improves → causing a downwards deflationary spiral

Policies to control inflation and deflation

- Fiscal policy
    - Fiscal policy involves the use of taxation and/or government spending to control the level of economic activity in the economy
    - If the general level of demand in the economy is too high → causing demand-pull inflation
        - Contractionary fiscal policy
        - Raising taxes and/or reducing its own expenditure in order to reduce the level of economic activity
    - During times of deflation
        - Expansionary fiscal policy
        - Break out of a downward deflationary spiral require a significant boost to demand in the economy
        - Cut direct taxes, leading to an increase in real incomes and thus greater levels of demand
        - Higher levels of economic activity, which has a positive effect on employment and economic growth
    - Controls inflation and deflation in the short run
- Monetary policy
    - Involves the central bank changing interest rates in order to control the level of economic activity
    - Higher interest rate
        - Reduce consumer and investment expenditure as the cost of borrowing rises + more reward for saving → less inflation

    - Lower interest rate
        - Reduces the exchange rate because foreign investors receive a lower return on their investments
        - Resulting a fall in the price of imports and hence an increase in the demand for exports
        - People + firms have more money to spend and can borrow more due to lower cost of borrowing→ more spending + investment
        - Reduces deflation
    - Controls inflation and deflation in the short run
- Supply-side policy
    - Used to increase the economy's productive capacity
    - Increase competition, productivity and innovation in order to maintain lower prices → lower inflation
    - A reduction in corporate tax rates can also encourage risk-taking and greater investment
    - Supply-side policies boost the productive capacity of the economy in the long run
        - Giving the economy flexibility to grow without suffering from the costs of inflation

32 Living standards

2024年1月16日 19:39

Standards of living

- Definition = refers to the social and economic wellbeing of individuals in a country at a particular point in time
- Measured by the level of economic growth of a country
- Main measures = GDP per capita / Human Development Index (HDI)

Real GDP per capita

- Good indicator of SoL
- Real GDP is relatively easy for economists to calculate
- Higher real GDP = people have more to spend on goods and services
- Problem of using GDP to measure SoL = size of the population is ignored, might have a larger GDP because there is a larger population
    - GDP per capita is better for indication SoL
- Inflation = erodes the value of GDP because the value of money falls if there is inflation so the productive capacity might not have actually increased
    - Real GDP and real GDP per capita need to be used to adjust the value of GDP for price changes

HDI

- Definition = the United Nations' composite indicator of living standards in a country, comprising three dimensions of human development: healthcare, education and income
- Healthcare: measures life expectancy at birth
- Education: measures the mean years of schooling and the expected years of schooling in the country
- Income levels: poor countries tend to have low HDI while wealthy countries tend to have a high HDI

HDI pros and cons

- Advantages
    - Composite index so it considers several key indicators of SoL rather than a single one
        - Improvements in education and healthcare are more likely than real GDP to indicate a country's level of social wellbeing
        - Especially if income is not distributed evenly in the economy
- Disadvantages
    - Qualitative factors affecting living standards ignored e.g. gender inequalities and human rights
    - Does not take account of the inequitable distribution of income in the economy, lacks accuracy as an indicator of living standards for average people
    - Ignores environmental issues and resource depletion resulting from economic growth
    - Ignores cultural variations and different interpretations of the meaning of standards of living

Factors affecting standards of living and income distribution

- Productivity levels
    - Higher skill and experience → higher productivity → higher labour demand + lower labour supply → higher salaries → higher SoL
    - Lower productivity = lower earning and lower SoL
- Role of governments
    - Use direct taxes (esp. progressive taxation) to redistribute income
    - More likely in mixed economy than market economy
    - A fairer distribution of income and wealth can help to raise living standards for the majority of a population
- Size of population
    - Densely populated cities tend to have higher rents due to limited space and high demand, as well as congestion, pollution and higher living costs
    - Lower social wellbeing + less purchase power = lower standard of living

- Distribution of national income
  - Although national income may be high, it may not be distributed in a socially desirable way
  - Normally huge wealth gaps in most societies so there is the need to redistribute national income
  - Composition of GDP
    - GDP increases because of higher government spending on the military $\neq$ better living standards for the majority of the population
- Regional differences
  - Regional income and wealth disparities within countries
- General price level
  - Increase in the general price level e.g. inflation tends to have a negative impact on standards of living as people can afford less goods and services
- Level of education (productivity)
  - Positive correlation between educational attainment and earnings
  - The more educated and well qualified a person is, the higher their earning potential tends to be = higher living standards
- Level of freedom
  - Measures of SoL includes consideration of civil liberties, political rights, religious freedom and economic rights
  - More freedom = tend to have higher SoL

33 Poverty

2024年2月20日 23:12

Poverty

- A condition that exists when people lack adequate income and wealth to sustain a basic standard of living
- Problems caused by poverty
  - Hunger and malnutrition
  - Ill health and mortality from illness
  - Limited or lack of access to education and other basic services
  - Homelessness and inadequate housing
  - Unsafe environments
  - Social discrimination and exclusion

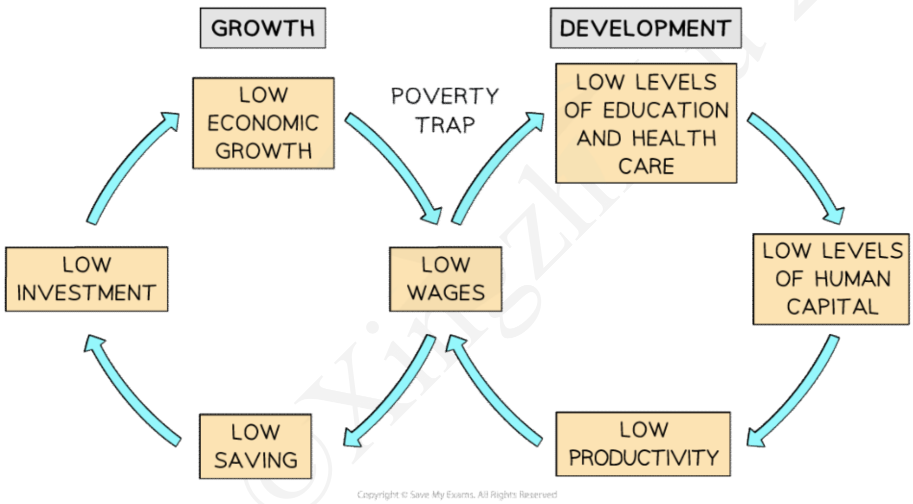
Types of poverty

- Absolute poverty
  - Exists when there is extreme outright poverty, i.e. income equal to or less than $1.25 per day
  - Income entirely spent on basic human needs for survival: minimal amounts of food, clothing and shelter
  - The most common method to measure absolute poverty is to calculate the number of individuals living below a poverty line
- Relative poverty
  - A comparative measure of poverty, referring to those who have a lower standard of living in comparison to the average member of society
  - Measures the extent to which a person's financial resources fall below the average income for the country's population

Causes of poverty

- Unemployment
  - Unemployed people have to go without income for a long time
  - May end up having to sell their possessions, consume less and go and into poverty.
- Low wages
  - Low GDP per capita → low wages in the economy
  - This tends to be the case in countries with a high proportion of unskilled workers
  - This limits consumption and investment in the economy, and so can cause poverty
- Poor healthcare
  - People find it harder to stay well or recover from illness
  - People miss out work when ill → less productive and earns less
  - Firms are less willing to employ people with poor health
- Poor education
  - Low-income countries have insufficient investment in education and training, so their literacy rates tend to be low
  - People are unskilled and cannot find better jobs
  - Results in low GDP per capita
- Age
  - Older people are likely to have more health problems and be less suitable for further employment → poverty
  - Young people are still employable and may find ways to earn an income
- High population growth
  - Poorer countries tend to have high population growth rates
    - A lack of family planning and sex education
    - Poor access to contraception
    - Cultural norms
  - Sharing a limited amount of resources among a growing population hinders the country's

ability to lift itself out of poverty

- Poor infrastructure
    - Poor transportation of foods and difficult to communicate with others
    - Difficult to carry out economic activity
    - Lower GDP and hence lower national income
- Low FDI
    - Poor countries do not attract FDI due to the expected high risks and low financial returns → kept in poverty
    - Lack of capital resources = ability of creating income and wealth limited
- High public debt
    - Low-income countries are far more likely to borrow money to finance their public sector expenditure
    - The government will need to repay its loans + interests rather than using the funds for investment in the economy / provision of essential services
    - LEDCs tend to pay more for financing their public debts
        - High interest rates imposed + a fall in the value of their currency
- Reliance on primary sector output
    - These tend to have low prices and profit margins in comparison to manufactured products and tertiary sector services
- Corruption and instability
    - Huge opportunity costs of civil war, dishonest government officials, fraudulent behaviour and the purchase of arms and weapons
    - Hinder economic development, result in greater inequalities in income distribution, and create poverty
- 

<u>Policies to alleviate poverty and redistribute income</u>

- Promoting economic growth and reducing unemployment
    - Expansionary policy such as lower taxes or lower interest rates can encourage consumer spending and investment expenditure in the economy
    - In the long run, this can help to create more jobs and alleviate the problems of poverty
    - Lower exchange rates can encourage export sales as the price for foreign buyers is lower
    - Higher export earnings help to boost GDP + create more jobs and wealth in the economy over time
    - Sustained economic growth helps to create more income and wealth for the country which can then be redistributed to the deprived and underprivileged members of society
- Improving education
    - Narrows the gap between the rich and the poor
    - Higher level of education = higher earnings and earning potential
    - Improve the human capital and productive capacity of the country, thereby creating economic growth and lowering poverty
- Providing more generous state benefits
    - Gives financial assistance to enable the unemployed and disadvantaged to meet their basic

needs
    - e.g. unemployment benefit, state pension, and child benefit
    - State benefits help to redistribute income and alleviate poverty by ensuring every citizen has access to basic necessities
- Using progressive taxation
    - Reduce the gap between the rich and poor members of a country as higher-income groups pay a higher percentage of their incomes in tax
    - Tax collected can be used by the government to support lower-income groups or those without any income
        - e.g. improve the provision of services or state benefits
- Introducing a national minimum wage / imposing a higher minimum wage rate
    - Can improve the standard of living for low-income households → alleviate poverty

34 Population

2024年2月20日 23:13

Population

- Population refers to the total number of inhabitants of a particular country

Population growth

- Population growth refers to the rate of change in the size of a country's population

Factors that affect population growth

- Birth rate
    - Measures the number of live births per thousand of the population in a year
    - The higher a country's birth rate, the greater its population growth will tend to be
    - Fertility rate
        - Measures the average number of children born per woman
        - Indicates the potential for population change in a country
    - Replacement fertility rate
        - The number of children that the average woman must have to maintain a stable population size
- Death rate
    - Measures the number of deaths per thousand of the population in a year
    - The lower a country's death rate, the greater its population growth will tend to be
- Net migration rate
    - Measures the difference between immigration and emigration rates for a country, thus indicating the physical movement of people into and out of a country
    - Immigration occurs when people enter a country to live and work
    - Emigration occurs when people leave a country to live and work abroad
    - Net migration rate = immigration — emigration
    - More people enter a country than leave in the year = net immigration
    - More people leave a country than enter the country = net emigration

Reasons for different birth rates

- Living standards
    - Improved quality and availability of food, housing, clean water and medical care result in fewer babies dying → birth rate
    - Countries where children often die due to poor living standards have higher birth rates as people have more children fearing that some of their children might die
    - In LEDCs people have more children as they can work to produce food and earn incomes
- Contraception
    - Increased use of contraception and legalisation of abortion have reduced birth rates in developed countries.
- Customs and religion
    - Many religious beliefs don't allow the use of contraceptive pills, so birth rates in those communities rise
    - In developed economies it is now less fashionable to have large families so birth rates have fallen
- Changes in female employment
    - More females in developed countries entering the labour force
    - Resulted in falling birth rates since they do not want motherhood to affect their careers
- Marriage
    - In developed countries, people are tending to marry later in life, so birth rates have reduced.

Reasons for differing death rates in different economies

- Living standards

- Death rates tend to be very high in less-developed economies due to lack of good-quality food, shelter and medical care
    - In developed countries, the major causes of death include lifestyle diseases, mostly caused by unhealthy diets
- Medical advances and heath care
    - Lack of medical care and infrastructure in less-developed countries continue to be a cause for high death rates
- Natural disasters and wars
    - Hurricanes, floods, earthquakes and famine due to lack of rain and poor harvests, and wars and civil conflicts increase death rates

<u>Reasons for differing net migration in different economies</u>
- Living standards
    - People move to countries where living standards are high which they can benefit from.
- Employment/wages
    - People migrate mainly to seek better job opportunities
    - Widespread unemployment and low wages in the home country will cause people to move to countries with better employment opportunities and higher wages
- Climate
    - Very cold or very warm countries will face more emigration than other countries

<u>Optimum population</u>
- Exists when the output of goods and services per head of the population is maximised

<u>Under and over population</u>
- Under-population
    - The country does not have sufficient labour to make the best use of its resources
    - GDP per head of the population could be increased if there were more human resources
    - Fertility rates below the replacement level can lead to under-population, causing potential economic decline
    - The government could introduce measures to increase the population size, such as encouraging immigration to reach the optimum population
- Over-population
    - The population is too large given the available resources of the country
    - Negative economic consequences such as famine, housing shortages, energy shortages and diseases
    - Fertility rates above the replacement level can lead to potential over-population which causes a fall in GDP per capita as there are insufficient resources to sustain the population
    - To reach the optimum population the government could introduce measures either to reduce the population size or to boost investment and productivity in the economy

<u>Population distribution</u>
- Refers to the composition and structure of a country’s population

<u>Demographics</u>
- The study of population distribution and trends

<u>Population pyramids</u>
- A graphical representation of the age and gender distribution of a country’s population

<u>Gender distribution</u>
- This refers to the number of males compared to the number of females in the population
- Consequences of changes in the gender distribution
    - Having more females will encourage birth rates to rise and increase population growth
    - More females in employment will increase productivity
    - More females in education and employment will increase living standards
    - A more balanced gender distribution can aid better social equality as social attitudes towards

women in education and employment become progressive

Age distribution

- This refers to the number of people in different age groups in the population.
- Consequences of an ageing population
  - The workforce will decline and there will be much dependence on the tax-paying population to fund the welfare of old people / retirement age need to increase
  - Increase in demand for products for old people including healthcare
  - The government will have to spend more on housing, pension etc
  - Old people are less mobile and so the economy will be slow to adapt to new technologies

Dependency ratio

- A comparison of the number of people who are not in the labour force with the number of people in active paid employment
- Dependency ratio = dependent population ÷ working population
- The working population
  - Refers to the people aged 15–65, those who are willing and able to work
  - This consists of those in paid employment, the self-employed and the unemployed
- Reasons for increase in dependency ratio
  - Higher birth rates, which mainly occur in less economically developed countries
  - A higher compulsory school leaving age, raising the number of people classified as part of the dependent population
  - Social changes such as workers entering the labour force at a later stage due to greater demand for higher education, or more people choosing early retirement (thus reducing the size of the working population)

Effects of increasing population size

- Increases size of the home market and thus potential for increase in aggregate demand in the long-run
- Higher demand and incomes will lead to more economic growth and expansion
- Increased supply of labour
- Puts more pressure on already scarce resources, especially land
- Shift of employment and output from the primary sector towards the services sector because land for primary activities is fixed, but want for services is practically infinite as population grows + the emergence of mechanisation and technologies will force people out of the primary sector
- As population and incomes rise, people will move to cities and towns which will become crowded causing congestion in urban centres. There will be need for heavy transport, communications, housing, waste management infrastructure spending
- More natural resources used and more pollution

35 Differences in economic development between different countries

2024年2月20日 23:17

Economic development

- An intangible concept that considers both quantitative and qualitative variables in raising the standard of living within a country

36 International specialisation

2024年3月3日 13:32

International specialisation

- Occurs when countries concentrate on the production of certain goods or services due to cost advantages, perhaps due to their abundance of resources

Advantages of specialisation at a national level

- Economies of scale and efficiency
  - Countries can specialise in what they do best, make better use of scarce resources
  - Leads to efficiency and economies of scale
  - Increase output while reducing costs
- Labour productivity
  - Workers become more skilled in the jobs they do because they are able to concentrate on what they do best
  - Improves labour productivity and enables better-quality products to be produced
- Increased productive capacity
  - Specialisation can help to shift the production possibility curve of a country outwards due to its increased productive capacity, as shown in Figure 36.1. Thus, specialisation leads to increased national output.
- Improved competitiveness
  - Allow firms to sell their products to international markets
  - Build international brands and increase market shares and profits
  - Competitive prices also improve the international competitiveness of a country, thereby boosting its economic growth

Disadvantages of specialisation at a national level

- Overspecialisation
  - Can cause regional and structural unemployment if the industry decline
  - Countries that overspecialise also suffer the most during an economic downturn as they do not have a variety of goods and services that they can rely on to survive.
- Lack of variety for consumers
  - Specialisation often leads to standardised, mass-produced goods
  - Domestic customers may look at alternative imported products from foreign suppliers, thereby reducing the competitiveness of domestic firms that overspecialise
- High labour turnover
  - This occurs if lots of workers choose to leave their jobs in search of more challenging and less boring ones
  - The higher the turnover rate, the more expensive it is for the economy as firms have to continually hire and train workers
  - Industries that suffer from high labour turnover tend to pay low wages to low-skilled workers
- Low labour mobility
  - Low-skilled and poorly paid workers tend to receive little training, so may not develop the necessary skills to find alternative jobs
  - Can lead to structural unemployment in the economy
  - Highly skilled and specialised workers, can also find it extremely difficult to change to alternative professions and careers
  - Inefficient use of factors of production
- Higher labour costs
  - Firms that employ workers with highly specialised skills tend to face very high salary demands
  - High labour costs can have a negative impact on the profits of firms and potentially reduce their competitiveness

37 Globalisation

2024年3月3日 13:32

Globalisation

- The process by which the world's economies become increasingly interdependent and interconnected.

Multinational corporation (MNC)

- An organisation that operates in two or more countries.

Advantages to home country

- MNCs create opportunities for marketing the products produced in the home country throughout the world.
- They create employment opportunities to the people of home country, both at home and abroad.
- It aids and encourages the economic growth and development of the home country.
- MNCs help to maintain favourable balance of payments of the home country in the long run as they export their products abroad

Advantages to host country

- Provides significant employment and training to the labour force in the host country.
- Transfers of skills and expertise, helping to develop the quality of the host labour force.
- MNCs add to the host country's GDP through their spending, for example with local suppliers and through capital investment.
- Competition from MNCs acts as an incentive for domestic firms in the host country to improve their competitiveness and efficiency.
- MNCs extend consumer and business choice in the host country.
- MNCs bring with them efficient business practices, technologies and standards from across the world, which can influence the industries in the home country.
- Profitable MNCs are a source of significant tax revenues for the host economy (for example on profits earned as well as payroll and sales-related taxes)

Disadvantages to home country

- MNCs transfer capital from the home country to various host countries causing unfavourable balance of payments.
- MNCs may not create employment opportunities to the people of home country if it employs labour from other countries, perhaps due to lower costs or better skills.
- As investments in foreign countries is more profitable, MNCs may neglect the home country's industrial and economic development

Disadvantages to host country

- Domestic businesses may not be able to compete with MNC's efficiency, low costs, low prices and brand image, and may be forced to close shop.
- Unethical and cost-cutting practices e.g. poor working conditions and low wages for workers in low-income countries
- Overreliance on MNCs in low-income countries means that there are major consequences if a MNC choose to relocate its operations to another country e.g. major job losses
- Profits earned by MNCs may be remitted back to the MNC's home country rather than being reinvested in the host economy
- MNCs may make use of transfer pricing and other tax avoidance measures to reduce the profits on which they pay tax to the government in the host country

Advantages to the MNC

- Exploit economies of scale because MNCs operate on a very large skill so consumers can enjoy lower prices

- Generate more profits by having a larger customer base and their home country is also repatriated
- Spread risks by operating in various markets, poor sale in one market can be covered up by others
- Avoid trade restrictions e.g. tariff by producing in a foreign country
- Reduce transportation costs by producing the goods in the market directly
- Move or expand to foreign countries to take the benefit of lower rate of corporation tax, and create tax revenue in the countries operating

<u>Disadvantages to the MNC</u>

- MNCs face an array of issues as a result of operating in different countries, such as different legal systems, tax regulations and environmental guidelines. The lack of local knowledge can also cause major problems for an MNC.
- The sheer size and geographic spread of an MNC's operations makes it harder to manage the overall business. Effective communication can also be an issue if workers are located in countries with different languages, national cultures and time zones.
- MNCs may be unsuccessful if they offer goods and services that do not appeal to local tastes and customs

<u>International trade</u>

- Refers to the exchange of goods and services beyond national borders

<u>Free trade</u>

- International trade takes place without protectionist measures (barriers to international trade).

<u>Benefits of free trade</u>

- Access to resources
    - International trade enables producers and consumers to gain access to goods and services that they cannot produce themselves
- Lower prices
    - Free trade reduces the costs of trading
- Economies of scale
    - Firms are operating on a larger scale in global markets
    - These cost savings can be passed on to consumers in the form of lower prices or kept by the producers in the form of higher profits
- Greater choice
    - Free trade enables consumers and firms to access a larger variety of goods and services from different producers around the world
- Increased market size
    - International trade enables fi rms to earn higher revenues and profi ts. For example, American fi rms can sell products to a domestic market of 322 million people, whereas they can reach a market of more than 2.7 billion potential customers by selling their products to China and India
- Efficiency gains
    - Free trade forces domestic producers to focus on improving the quality of their output + efficiency of production due to foreign competition → lower price + better quality goods
- Allows countries to benefit from specialisation
    - The country can specialise in a few industries and import other goods and services

<u>Disadvantages of free trade</u>

- May reduce opportunities for growth in less-developed economies and threaten jobs in developed economies
    - Small businesses in developing countries may not be able to compete with larger foreign firms
    - Established businesses in developed countries may lose market share as new firms keep entering the market
- Environmental damage
    - Causes rapid resource depletion and climate change as more resources are used up by firms
- Exploitation of workers and the environment
    - Free trade has allowed firms to relocate to countries with lower costs + less regulations, where

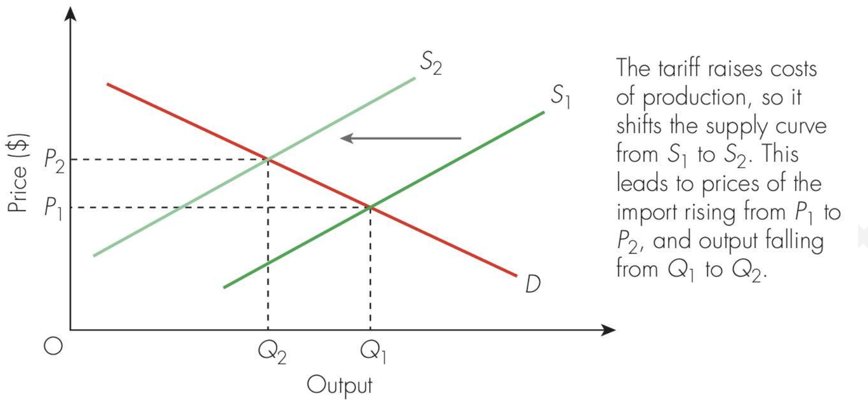
workers and the environment can be exploited

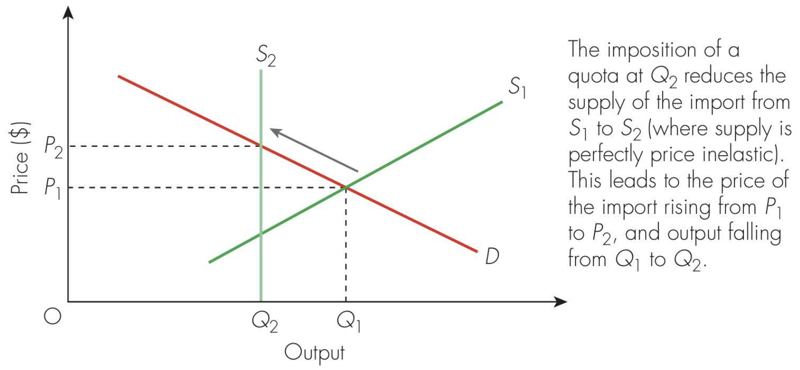
- Income inequality worsens
  - Multinational firms and consumers have dominated the international supply and demand
  - This means that the rich keep getting richer (by buying and selling more products) while the poor lose out on products and resources

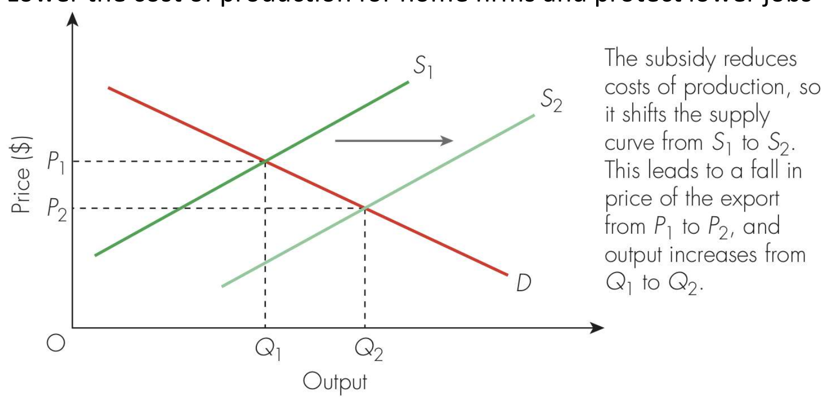
Protection

- Refers to the use of trade barriers to restrain foreign trade, thereby limiting overseas competition.

Protectionist measures

- Tariffs
  - These are indirect taxes on imported (or exported) goods that make them more expensive
  - Imposed in order to discourage domestic consumers from buying them
  - 

- Import quota
  - Sets a quantitative limit on the sale of a foreign good in a country
  - Restricting supply will push up their market prices and discourage consumption of those imports
  - 

- Subsidies
  - A form of government financial assistance to help cut production costs of domestic fi rms, enabling them to compete against foreign producers
  - Lower the cost of production for home firms and protect lower jobs
  - 

- Embargo
  - A ban on trade with a certain country
  - Rarely benefits local consumers who suffer from a lack of choice and higher prices

- Rules and regulations
  - Countries often use bureaucratic rules and regulations as a form of protection
  - These rules and regulations consume a lot of time and increase the costs for overseas firms while also helping to protect domestic consumers

Arguments for protection

- Safeguard infant industries
  - Safeguard domestic jobs
  - Preventing foreign firms from dumping their goods in the domestic economy
    - Dumping occurs when foreign firms sell their products in large quantities at prices deliberately below those charged by domestic firms, often even below the cost of production.
- Protection can be a source of government revenue
  - Tariffs collected
- Protection can help to overcome a balance of payments deficit
  - If a country's expenditure on imports exceeds the revenue earned from its exports, the country will experience problems as it spends more than it earns
  - Protectionist measures to restrict imports would help to deal with this imbalance by reducing demand for imports + encouraging the sale of domestically produced goods
- To protect strategic industries
  - e.g. transport, energy, defence etc.
  - Governments will want to protect these so they are not dependent on supplies from overseas
  - If foreign firms supplied these, they would restrict output and raise prices
- Protection can safeguard the country from being too dependent on goods and services from other countries
  - e.g. subsidising agriculture to ensure a safe food supply

Arguments against protection

- Government intervention distort market signals
  - Domestic consumers may not be able to purchase lower-priced imports which are of higher quality than those produced domestically
  - Protected firms and industries can become too reliant on the government and thus become inefficient.
- Protection can lead to increased costs of production
  - Lack of competition and incentives to be innovative
- Inflation
  - High levels of import tariffs and quotas will increase the costs of production at home and drive up prices due to higher import prices, causing imported inflation.
- Other countries are likely to react by retaliating and imposing their own trade barriers
  - Such actions may hinder global economic growth and prosperity
  - Relations between countries will worsen

38 Foreign exchange rates

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Exchange rate

- The price of one currency measured in terms of other currencies

A foreign exchange market

- The marketplace where different currencies can be bought and sold

Floating exchange rate system

- The currency is allowed to fluctuate against other currencies according to market forces, without any government intervention

Advantages + disadvantages of a floating exchange rate system

- Advantages
  - Automatic Stabilisation
    - Any disequilibrium in the balance of payments would be automatically corrected by a change in the exchange rate
    - e.g. if a country suffers from a deficit in the balance of payments, then the country's currency should depreciate → import demand fall and export demand to rise → the balance of payments equilibrium would therefore be restored
    - Similarly, a surplus would be eliminated as the currency appreciates
  - Frees up internal policy
    - A floating exchange rate allows a government to pursue internal policy objectives such as full employment and growth, not having to worry about balance of payments imbalances as they will be automatically adjusted
  - Insulated from external changes
    - A floating exchange rate helps to insulate a country from inflation elsewhere
    - If a country were on a fixed exchange rate then it would 'import' inflation through higher import prices
    - A floating exchange rate would automatically adjust demand and supply in the economy and avoid such external disturbances
  - Don't need too much foreign reserves
    - Under a floating exchange rate system, there is no need to maintain reserves to deliberately change the exchange rate
    - These reserves can therefore be used to import capital goods in order to promote faster economic growth
- Disadvantages
  - Uncertainty
    - Since currency values fluctuate constantly, businesses, investors and consumers will be uncertain about the economy and its future
    - They may lose confidence in the economy if it fluctuates too rapidly
  - Lack of Investment
    - The uncertainty introduced by floating exchange rates may discourage direct foreign investment
    - They will prefer to invest in countries with fixed exchange rate systems where they can effectively predict economic conditions and act accordingly
  - Speculation
    - The day-to-day fluctuations in exchange rates may encourage speculative movements of 'hot money' from country to another, thereby causing more exchange rate fluctuations
  - Lack of Discipline
    - The need to maintain an exchange rate imposes a discipline upon the national economy, which is absent in a floating exchange rate regime
    - With a floating exchange rate, short-run problems such as domestic inflation may be

ignored until they lead to a crisis

A fixed exchange rate system

- Exists when the central bank (or monetary authority) buys and sells foreign currencies to ensure the value of its currency stays at the pegged value

Advantages + disadvantages of a fixed exchange rate system

- Advantage
  - Certainty
    - More predictable currency removes uncertainties for international trade, allowing domestic and international firms to be more certain about prices
  - Stability encourages investment
    - A fixed exchange rate provides greater certainty and encourages firms to invest
  - Keep inflation low
    - Depreciation of a currency can cause inflation as demand, prices and costs (esp. imported goods) for firms rise
    - On a fixed exchange rate, firms have an incentive to keep cutting costs to remain competitive
  - Balance of Payments stability
    - Since the exchange rate is not determined by market forces, sudden changes in the balance of payments will be eliminated, keeping it stable instead
- Disadvantage
  - Opportunity costs
    - Huge opportunity costs of using large amount of foreign exchange reserves to maintain a fixed exchange rate
    - Could have been used to improve the economy / buying key imports
  - Conflict with other macroeconomic objectives
    - The goal to maintain a fixed exchange rate may conflict with other macroeconomic objectives when the government intervenes with its policies
    - e.g. if it raises interest rates to remove the pressure of the currency to fall, economic growth might be adversely affected
  - Less flexibility
    - In a fixed exchange rate, it is difficult to respond to temporary shocks e.g. rise in price of a key import → worse balance of payments
    - Removes flexibility around monetary policy (e.g. cannot necessarily change interest rates without impacting demand for currency)
  - Risk of overvaluation or undervaluation
    - It is difficult to know the optimum rate to fix the exchange rate at
    - If the rate is too high, it will make exports uncompetitive
    - If it is too low, it could cause inflation

Change in interest rates

- In floating exchange rate system
  - Appreciation: occurs when there is an increase in its value relative to another currency operating in a floating exchange rate system
  - Depreciation: occurs when there is a fall in its value relative to another currency operating in a floating exchange rate system.
- In fixed system
  - Revaluation: occurs when the price of a currency operating in a fixed exchange rate system is officially and deliberately increased
  - Devaluation: occurs when the price of a currency operating in a fixed exchange rate system is officially and deliberately lowered

Causes of exchange rate fluctuations

- Changes in the demand for exports and imports
  - Increase in the demand for exports e.g. due to improved quality or successful advertising = increase the demand for the country's currency so the exchange rate rises

    - Increase in the demand for imports e.g. due to an increase in the competitiveness of foreign firms = raise the value of the foreign currency in order to facilitate the purchase of foreign goods and services
- Inflation
    - Increase in the price of goods and services caused by domestic inflation will tend to decrease the demand for exports
    - Currency demand fall → exchange rate fall
    - More supply as of the currency as people buy more foreign goods so the exchange rate further fall
- Changes in interest rate
    - If a country's interest rate rises, overseas residents may be keen to save or invest money in that country
    - The demand for the currency will rise, and the exchange rate will rise
    - If interest rates fall below that of other countries, the currency will fall in value as overseas demand falls
- FDI
    - Investment in overseas production plants requires the use of foreign currencies
    - Inward FDI will boost the demand for a currency and increase its foreign exchange value
    - Outward FDI will increase the supply of a currency and cause its foreign exchange rate to fall
- Speculation
    - Foreign exchange traders and investment companies move money around the world to take advantage of higher interest rates and variations in exchange rates to earn a profit
    - As huge sums of money are involved (known as 'hot money'), this can cause exchange rate fluctuations (at least in short run)
    - If speculators lack confidence in the economy they will withdraw their investments in that country, thereby causing a fall in the value of the currency
    - High confidence in the economy will invite investments and raise the foreign exchange value of the currency
- Government intervention (used in fixed exchange rate systems)
    - Government can sell their reserves of domestic currency in the foreign exchange market to increase its supply and cause a fall in its value / buy more domestic currency to increase exchange rate

<u>**Consequences of exchange rate fluctuations**</u>

- Customers
    - Greater purchasing power when the exchange rate increases
- Exporters
    - Face more difficult trading conditions when the exchange rate increases
    - This is because their goods and services will become more expensive for foreign customers so demand for exports fall
- Importers
    - Potentially gain from a higher exchange rate
    - It is cheaper for firms to import raw materials, components and finished goods from abroad when exchange rate is high
- Balance of payments
    - If a currency appreciation has a larger impact on exports than imports then the balance of payments will worsen
    - This is because a strong currency will make it more difficult for exporters to sell their goods and services in overseas markets
- Employment
    - A fall in net exports and deteriorating profits will, in the long run, cause job losses in export-oriented businesses
    - This will therefore cause unemployment in the economy.
- Inflation
    - Lower levels of spending in the economy caused by higher unemployment will tend to reduce the rate of inflation
    - If the country relies heavily on certain imports, such as oil or food supplies, then the higher

exchange rate will help to reduce the general price level even further

- Economic growth
    - Likely to fall due to the combination of lower export sales and higher unemployment.

Coping with a strong exchange rate

- Cutting export prices to maintain their price competitiveness against foreign rivals, although this means the domestic firms will have to accept lower profit margins
- Seeking alternative overseas suppliers of cheaper raw materials and components
- Improving productivity (efficiency) to keep average labour costs under control
- Focusing on supplying more price inelastic and income inelastic products because customers will then become less sensitive to exchange rate fluctuations
- Focusing on non-price factors that are important to overseas customers, such as brand awareness and social responsibility
- Relocating production processes overseas, where costs of production are relatively low and where operations are less exposed to exchange rate fluctuations

39 Current account of balance payments

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Balance of payments

- A financial record of a country's transactions with the rest of the world for a given time period, usually one year

Current account

- The largest component of the balance of payments
- It records all exports and imports of goods and services between a country and its trading partners, plus net income transfers from abroad

Parts of current account

- Largest part = balance of trade
  - Balance of trade = visible balance + invisible balance
  - Visible balance: a record of the exports and imports of physical goods
  - Invisible balance: a record of the export and import of services
- Net primary income
  - Received or made in payment for the use of factors of production (rent, wage, profit, interest)
  - Earned from investments abroad
- Net secondary income
  - Income transfer between residents and non-residents
  - Payments between governments for international co-operation and other transactions that involve payments for non-productive activities

Current account deficit / surplus

- A current account deficit occurs when a country spends more money than it earns, i.e. imports exceed exports
- A current account surplus exists if a country exports more than it imports

Causes of current account deficits

- Higher exchange rate
  - Imports will be cheaper and therefore there will be a higher quantity of imports
  - Exports will become more expensive and therefore there will be a fall in the quantity of exports
- Economic growth
  - If there is an increase in aggregate demand and national income increases, people will have more disposable income to consume goods
  - If producers cannot meet the domestic demand, consumers will have to imports goods from abroad
- Decline in competitiveness
  - If export industries are in decline and cannot compete with foreign countries, the exports fall
  - (This is a major reason for many countries today experiencing current account deficits)
- Inflation
  - This makes exports less competitive and imports more competitive (cheaper)

Consequences of current account deficits

- Low growth
  - A deficit means that there are less demand on domestically produced goods
  - Leads to lower aggregate demand and therefore slower growth
- Unemployment
  - Deficit can lead to loss of jobs in domestic industries as demand for exports is low and demand for imports is high
  - Derived demand of labour fall as demand for goods produced fall

    - Can cause cyclical unemployment
- Lowers standard of living
    - Negative balance of net incomes = capital outflows exceed capital inflows for the country
    - Less income = likely to suffer from lower standards of living
- Capital outflow
    - Currency weakness can lead to investors losing confidence in the economy and taking capital away.
- Loss of foreign currency reserves
    - Countries may run short of vital foreign currency reserves as more foreign currency is being spent on imports and foreign currency revenues from exports is falling
- Increased borrowing
    - Countries need to borrow money or attract foreign investment in order to rectify their current account deficits
    - In addition, there is an opportunity cost of debt repayment (interest), as the government cannot use this money to stimulate economic growth.
- Lower exchange rate
    - A fall in demand for exports and/or a rise in the demand for imports reduces the exchange rate
    - Exports becoming more price-competitive + essential imports will become more expensive
    - This can lead to imported inflation

<u>Causes of current account surpluses</u>

- Improved competitiveness
    - Exports may have become more price-competitive in the international market, due to better labour productivity or lower prices
- Change in foreign countries
    - Export demand may have risen due to trading partners experiencing growth and higher incomes
    - Inflation in overseas market make imports more expensive so demand for imports fall
- High foreign direct investment
    - Strong export growth can be the result of a high level of foreign direct investment.
- Depreciation
    - Less demand for imports as they become more expensive
    - More demand for exports as they become cheaper
- High domestic savings rates
    - High levels of domestic savings and low domestic consumption of goods and services cause more products to be exported and imports to fall
- Closed economy
    - Some countries have a low share of national income taken up by imports, perhaps because of a range of tariff and non-tariff barriers

<u>Consequences of current account surpluses</u>

- Economic growth
    - Net exports is a component of GDP, so a rise in exports and incomes will cause economic growth directly
    - Higher demand for exports help to create job opportunities
- Appreciation
    - As exports increase, the demand for the currency increases and therefore the value of the currency increases, which will make exports more expensive and cause its demand to fall
- Better standards of living
    - The country receives a higher income because domestic firms have a competitive advantage in the products they export
- Inflation
    - Higher demand for exports can lead to demand-pull inflation
    - This can diminish the international competitiveness of the country over time as the price of exports rises due to inflation

Policies to achieve balance of payments stability

- Do nothing
    - A floating exchange rate should correct it
    - If there is a trade deficit, a depreciation will occur as more currency is being spent than received
    - Depreciation will make imports more expensive and exports cheaper
    - As a result, domestic demand for imports will fall and foreign demand for exports will rise, reducing the deficit
- Fiscal / monetary policy
    - Contractionary = reduce deficit (reduce demand for imports)
    - Expansionary = reduce surplus (increase demand for imports)
- Protectionist measures
    - Deficit = impose
    - Surplus = remove
- Supply-side policy
    - Raise productive capacity - reduce trade deficit
- Reduce outward income flow
    - Stop primary output: stop inward FDI (stricter regulations) / increase outward FDI
    - Secondary: almost impossible to prevent