ECON4 ECONOMICS:

THE NATIONAL AND INTERNATIONAL ECONOMY

BEAL HIGH SCHOOL ECONOMICS REVISION GUIDE 2014

3.4.1 MACROECONOMIC INDICATORS

THE ECONOMIC CYCLE AND ECONOMIC GROWTH

Candidates should be able to analyse and evaluate the causes of changes in the various phases of the economic cycle, including demand-side and supply-side shocks.

Candidates should be able to analyse and evaluate the supply-side factors that are likely to determine the long-run trend rate of growth, such as investment, technology, education and training.

Candidates should be able to analyse and evaluate the various costs and benefits of economic growth. There should be the ability to discuss whether or not economic growth is sustainable and to evaluate the impact of growth on individuals, the economy and the environment.

KEY TERMS

Demand-side Shocks - A sudden surprise event that temporarily increases or decreases demand for goods or services. A positive demand shock increases demand, while a negative demand shock decreases demand

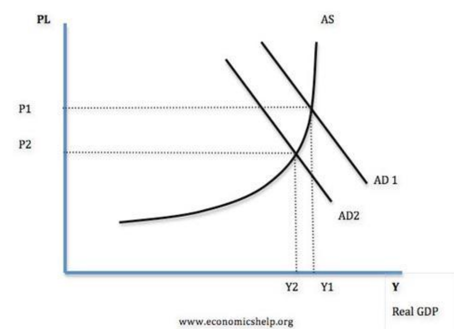
Supply-side shocks - An unexpected event that changes the supply of a product or commodity, resulting in a sudden change in its price. Supply shocks can be negative (decreased supply) or positive (increased supply)

Long-run trend rate of growth - the long run average rate for a country over a period of time

KEY ANALYSIS

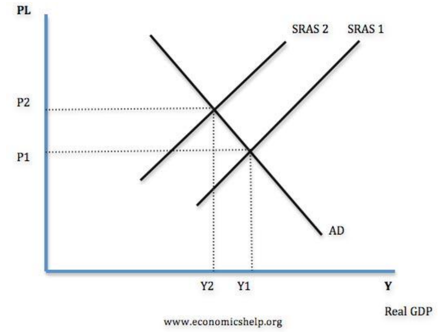
DEMAND SIDE SHOCK (CAUSES OF A RECESSION)

- Higher interest rates which reduce borrowing and investment
- Falling real wages
- Falling consumer confidence
- Credit crunch which causes a decline in bank lending
- A period of deflation, often encourage people to delay spending.
- Appreciation in exchange rate which makes exports expensive and reduces demand for exports.

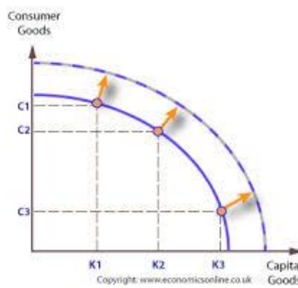


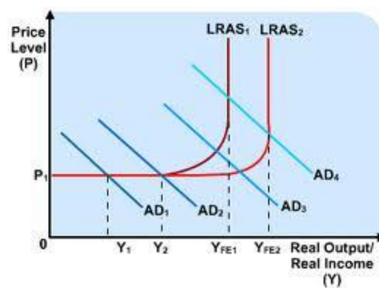
SUPPLY SIDE SHOCK (CAUSES OF A RECESSION)

- Higher oil prices would increase the cost of production and causes the short run aggregate supply curve to shift to the left.



INCREASE IN THE LONG RUN TREND RATE OF GROWTH





- Technology policy
- Human capital development
- Reducing red-tape and de-regulation
- Providing incentives
- Tax reform
- Increasing competitiveness and contestability
- New markets
- Infrastructure

BENEFITS OF ECONOMIC GROWTH

- Improvements in living standards
- More jobs
- The accelerator effect of growth on capital investment:
- Greater business confidence
- The "fiscal dividend.
- Potential environmental benefits

COSTS OF ECONOMIC GROWTH

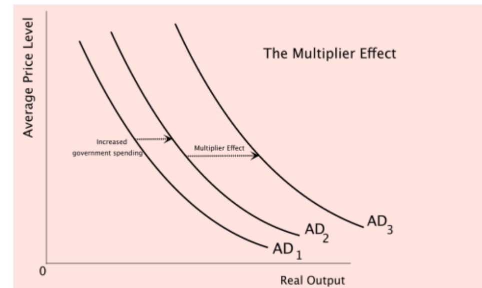
- Inflation risk
- Environmental concerns
- Income and Wealth Inequality

ACCLERATOR PRINCIPLE

- It is a concept in economics that explains the link between output and capital investment. It states that an increase or decrease in the demand for consumer goods will cause a greater increase or decrease in the demand for machines required to make those goods. In other words, there is a direct relationship between the rate of output of an economy and the level of investment in capital goods.

NATIONAL INCOME MULTIPLIER

- The National Income Multiplier says that an initial increase in spending can have a much greater final impact on the level of equilibrium national income. It comes about because injections of demand into the circular flow of income stimulate further rounds of spending – in other words "one person's spending is another's income" – and this can lead to a much bigger effect on equilibrium output and employment.



- Government increase wages of nurses by £2 billion => +£2 billion to GDP
- Nurses spend part of their extra wage => +£1 billion to GDP
- The final increase in National Income = £3 billion
- Multiplier effect = 1.5

Multiplier Formula

- 1/1-MPC or 1/MPS
- With the MPC being the 'Marginal Propensity to Consume' and MPS being the 'Marginal Propensity to Save'.
- Example
- If there is an MPC of 0.8
- Then the Multiplier would be 1/0.2 = 5
- The higher the MPC the stronger the multiplier effect
- If there is an MPC of 0.9
- Then the Multiplier would be 1/0.1 = 10

USES OF NATIONAL INCOME DATA

Candidates should be able to discuss the use and limitations of national income data to draw conclusions on living standards. They should be able to interpret different types of economic data, such as the Human Development Index, and use them to compare the living standards of the residents of different countries. They should be able to discuss the limitations of using such data to arrive at conclusions.

KEY TERMS

Gross National Product An economic statistic that includes GDP, plus any income earned by residents from overseas investments, minus income earned within the domestic economy by overseas residents.

Nominal GDP. This is the simplest measure and shows the actual final market value of GDP produced in the economy.

GDP in Purchasing Power Parity (PPP). This takes into account the different costs of living in countries. For example, a country like India will have a higher PPP GDP because although GDP is low, official exchange rates don't reflect the lower living costs. You can see a comparison here GDP at PPP v GDP in nominal terms

Real GDP per capita. This gives an impression of average incomes in a country. Clearly, the countries with the most people will have high GDP (e.g. India, China). But, GDP per capita will be relatively lower. It can involve Nominal GDP per capita or GDP per capita PPP.

Human Development Index - A tool developed by the United Nations to measure and rank countries' levels of social and economic development based on four criteria: Life expectancy at birth, mean years of schooling, expected years of schooling and gross national income per capita.

KEY ANALYSIS

LIMITATIONS OF NATIONAL INCOME DATA

- Differences in the distribution of income
- Differences in hours worked
- International price differences
- Difficulty of assessing true values, such as merit goods
- Hidden economies
- Currency conversion

HUMAN DEVELOPMENT INDEX (HDI)

HDI is a tool developed by the United Nations. It measure and rank countries' levels of social and economic development based on four criteria: Life expectancy at birth, mean years of schooling, expected years of schooling and gross national income per capita. It is a standard means of measuring well-being. The HDI makes it possible to track changes in development levels over time and to compare development levels in different countries.

INDEX OF SUSTAINABLE ECONOMIC WELFARE (ISEW)

The ISEW is an economic indicator intended to replace the GDP. Rather than simply adding together all expenditures like the gross domestic product, consumer expenditure is balanced by such factors as income distribution and cost associated with pollution and other unsustainable costs.

ISEW = personal consumption + public non-defensive expenditures - private defensive expenditures + capital formation + services from domestic labour - costs of environmental degradation - depreciation of natural capital

UNEMPLOYMENT

Candidates should be able to analyse and evaluate the causes of unemployment and the consequences for individuals and the performance of the economy.

They should understand the concept of, and the factors which determine, the natural rate of unemployment and both the short-run and long-run Phillips curves, and be able to discuss the implications of these for economic policy.

KEY TERMS

Natural rate of unemployment - The Natural Rate of Unemployment is the rate of Unemployment when the labour market is in equilibrium. It is the difference between those who would like a job at the current wage rate and those who are willing and able to take a job. The Natural Rate of Unemployment will therefore include frictional unemployment and structural unemployment

Short-run Phillips Curve - The Phillips curve depicts the inverse relationship between inflation and unemployment rates.

Long-run Phillips Curve – A straight line showing that any rate of inflation is consistent with the Natural Rate of Unemployment. In the long run, there is no trade-off between inflation and unemployment as is in the short run Phillips Curve.

Non-Accelerating Inflation Rate of Unemployment (NAIRU) is the specific level of unemployment that exists in an economy that does not cause inflation to increase. The non-accelerating rate of unemployment (NAIRU) often represents equilibrium between the state of the economy and the labour market. NAIRU is also sometimes referred as a "long-run Phillips curve".

Rational expectations is an economic idea that the people in the economy make choices based on their rational outlook, available information and past experiences. The theory suggests that the current expectations in the economy are equivalent to what the future state of the economy will be.

Full Employment - A situation where the labour market has reached a state of equilibrium - i.e. when those in the active labour force who are willing and able to work at going wage rates are able to find work. At this point the remaining unemployment would essentially be frictional.

Frictional Unemployment - Frictional unemployment is transitional unemployment due to people moving between jobs.

Voluntary Unemployment - Defined as a situation when workers choose not to work at the current equilibrium wage rate. There are several reasons for the existence of voluntary unemployment including excessively generous welfare benefits and high rates of income tax.

Keynesian Unemployment - Cyclical unemployment is involuntary unemployment due to a lack of demand for goods and services. This is also known as Keynesian unemployment or demand-deficient unemployment.

Natural Rate of Unemployment - The natural rate of unemployment is defined as the equilibrium rate of unemployment (see below) i.e. the rate of unemployment where real wages have found their free market level and where the aggregate supply of labour is in balance with the aggregate demand for labour.

Equilibrium Unemployment - The equilibrium unemployment level is the difference between those who are employed at a given wage rate and those who can work. In other words, there is equilibrium with respect to the demand and supply of labour, however, unemployment still exists because a proportion of the labour force are not willing to work at that time and that wage rate.

Replacement Ratio - The ratio of the total resources received when unemployed to those received when in employment.

Classical Unemployment/Real wage unemployment occurs when real wages for jobs are forced above the market clearing level. Traditionally, trade unions and wages councils are seen as the institutions causing this type of unemployment. Classical unemployment is thought to be the result of real wages being above their market clearing level leading to an excess supply of labour. Some economists believe that the introduction of the national minimum wage may create some classical unemployment

KEY ANALYSIS

CAUSES OF UNEMPLOYMENT

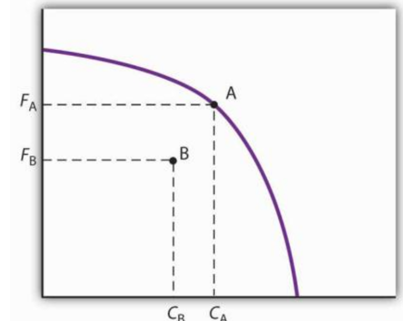
- Real wage unemployment
- Demand deficient unemployment
- Frictional unemployment
- Structural unemployment

CONSEQUENCES OF UNEMPLOYMENT FOR AN INDIVIDUAL AND THE ECONOMY

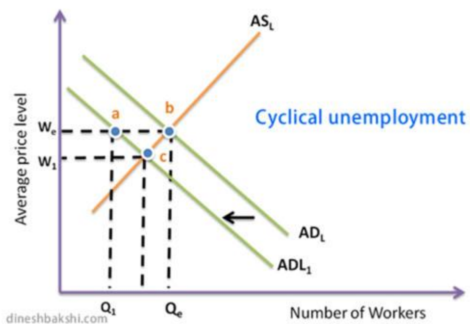
- Loss of earnings
- Those who are unemployed will find it more difficult to get work in the future (this is known as the hysteresis effect)
- Stress and Health problems
- Increased govt borrowing (PSNCR).
- Lower GDP for the economy,
- Increase in social problems.

FULL EMPLOYMENT ON THE PPF

Point A all the resources in terms of employment are fully used, whereas point B shows not full employment in the economy meaning that he resources aren't being fully used.

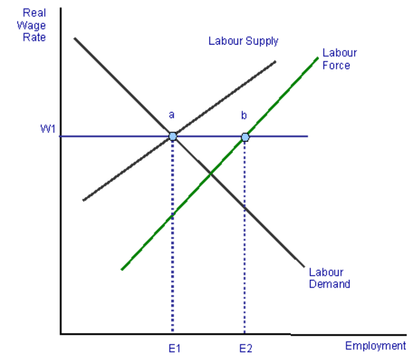


CYCLICAL UNEMPLOYMENT



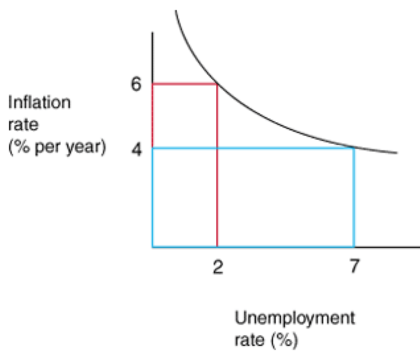
NATURAL RATE OF UNEMPLOYMENT/ EQUILIBRIUM UNEMPLOYMENT

The natural rate of unemployment = AB

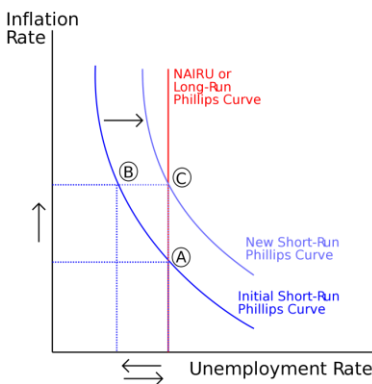


At the natural rate, all those wanting to work at the prevailing real wage rate have found employment and thus there is assumed to be no involuntary unemployment. There remains some voluntary unemployment as some people remain out of a job searching for work offering higher real wages or better conditions.

PHILLIPS CURVE



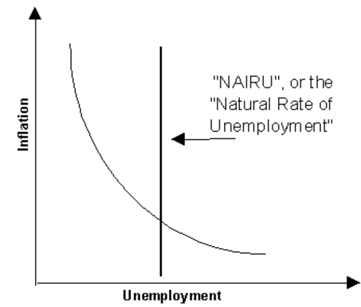
LONG RUN/AUGMENTED PHILLIPS CURVE



Friedman argued that the Phillips curve relationship was only a short-run phenomenon. In the long-run, workers and employers will take inflation into account, resulting in employment contracts that increase pay at rates near anticipated inflation. Unemployment would then begin to rise back to its previous level, but now with higher inflation rates. This result implies that over the longer-run there is no trade-off between inflation and unemployment.

1) When unemployment at the long-run Philips Curve (red line), inflation is stable.
2) In the short run, policy makers can reduce unemployment from A to B with expansionary policy.
3) Exploiting short run trade off raise inflation expectations (shifting the curve from B to C).
4) Reduction in unemployment below the natural rate is temporary, and lead to inflation in long run.

NAIRU- MONETARIST EXPLANATION OF THE NAIRU (ECONOMICSHELP.ORG)

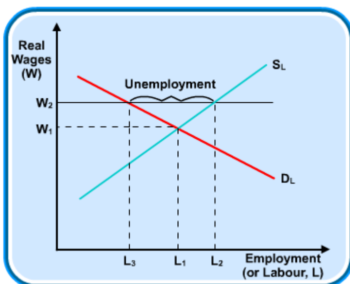


- If there is an increase in AD, firms pay higher wages to workers in order to increase in output; this increase in nominal wages encourage workers to supply more labour and therefore unemployment falls.
- However, the increase in AD also causes inflation to increase, and therefore real wages do not actually increase but remain the same.
- Later workers realise that the increase in wages was only nominal and not a real increase. Therefore they no longer work overtime.
- Therefore, the supply of labour falls and unemployment returns to its original or Natural rate of unemployment.
- It is only possible to reduce unemployment by causing an increase in the rate of inflation. Therefore, the natural rate is also known as the NAIRU (non accelerating rate of unemployment.

REPLACEMENT RATIO

$$\text{Replacement Ratio} = \frac{\text{Amount of Income when employed}}{\text{Amount of benefit received}}$$

CLASSICAL UNEMPLOYMENT



INFLATION AND DEFLATION

Candidates should have an understanding of how index numbers are calculated and used to measure changes in the price level. Although a detailed technical knowledge is not expected of indices such as the Retail Price Index (RPI) and Consumer Price Index (CPI), candidates should have an awareness of the underlying features, for example, the Family Expenditure Survey, the concept of the 'average family', the basket of goods and services, and weighting.

Candidates should be able to analyse and evaluate the causes of changes in the price level and the consequences for both individuals and the performance of the economy, including the potential impact of a rising or falling price level.

There should be an understanding of Fisher's equation of exchange and the Quantity Theory of Money in relation to the monetarist model. The possible relevance of expectations to changes in the price level should be understood.

KEY TERMS

Index Numbers - An index starts in a given year, the base year, at an index number of 100. In subsequent years, percentage increases push the index number above 100, and percentage decreases push the figure below 100. An index number of 102 means a 2% rise from the base year, and an index number of 98 means a 2% fall.

Retail Price Index (RPI) - Like CPI, it looks at the prices of items we spend money on, but it includes housing costs - such as council tax - and mortgage interest payments.

Consumer Price Index (CPI) - CPI forms the basis for the Government's inflation target that the Bank of England's Monetary Policy Committee is required to achieve. It is an internationally comparable measure of inflation, published in the UK until December 2003 as the Harmonised Index of Consumer Prices (HICP). Like RPI, the CPI looks at the prices of hundreds of items we spend money on, such as food and cinema tickets, but excludes housing costs and mortgage interest payments.

Family Expenditure Survey – Now called the 'Living Costs and Food Survey'. The survey monitors changes and patterns in Britain's spending and food consumption since the 1950s. The survey continues to be primarily used to provide information for the Retail Prices Index; National Accounts estimates of household expenditure. (ONS)

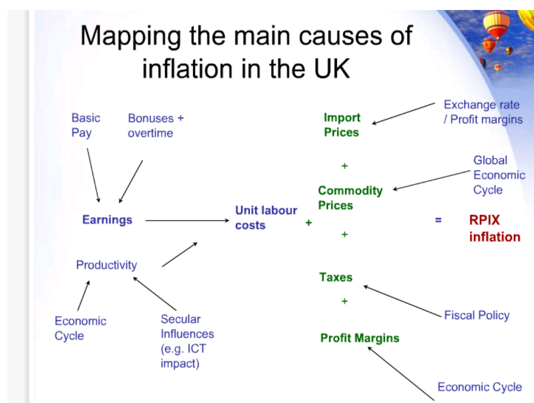
Basket of goods - a 'shopping basket' containing those goods and services on which people typically spend their money. As the prices of the various items in the basket change over time, so does the total cost of the basket. Movements in the CPI and RPI represent the changing cost of this representative shopping basket. In practice, both the CPI and RPI are calculated by collecting a sample of prices for a selection of representative goods and services in a range of UK retail locations. Currently, around 180,000 separate price quotations are used every month in compiling the indices, covering approaching 700 representative consumer goods and services for which prices are collected in around 150 areas throughout the UK. (ONS)

Fisher's equation of exchange – Fisher's equation of exchange states MV = PT. M is the money supply; V is the velocity of circulation; P is average prices and T is the number of transactions.

Quantity Theory of Money states that there is a direct relationship between the quantity of money in an economy and the level of prices of goods and services sold.

KEY ANALYSIS

CAUSES OF CHANGES IN THE PRICE LEVEL (TUTOR2U)



CONSEQUENCES OF INFLATION

- Greater uncertainty
- High rate of inflation will affect people who have constant incomes, such as retired people, students, and dependents.
- Rise in prices of essential commodities (food & clothing) will affect the poor segment of the society as they spend a major part of their income on these good.
- Less saving
- Damage to export competitiveness
- Social unrest
- Increased interest rates:
- Menu cost is the cost to a firm resulting from changing its prices

CONSEQUENCES OF DEFLATION

- Cyclical unemployment: Deflation usually happens to due to a fall in Aggregate Demand in the economy. This will lead to businesses cutting the output levels which will result in retrenchment/laying off of workers.
- Consumers delay spending in anticipation of falling prices economic activity falls, unemployment increases.
- Bankruptcies: As the value of money is increasing, it becomes difficult for debtors to repay the load.
- A rise in the real value of debt.
- Monetary policy can prove ineffective when interest rates (nominal) are already low.

QUANTITY THEORY OF MONEY

M V = P T

- **M** represents the money supply
- **V** represents the velocity of money (assumed to be constant)
- **P** represents the average price level (constant in short term)
- **T** represents the volume of transactions in the economy (constant in long term)

3.4.2 MANAGING THE NATIONAL ECONOMY

MACROECONOMIC MODELS AND POLICIES

Candidates should be able to use macroeconomic models, including the AD/ AS model, to analyse the causes of possible conflicts between policy objectives in the short run and long run. They should be able to discuss approaches to reconciling these conflicts and the monetarist/supply-side view that the major macroeconomic objectives are compatible in the long run.

There should be an awareness of the changes in monetary and fiscal policy which have occurred in the last ten years or so.

KEY TERMS

Policy Objectives - the aims or goals of government policy

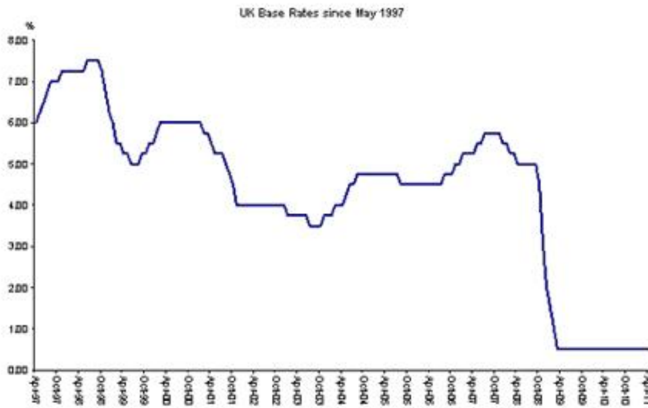
Supply-side economics is a school of macroeconomics that argues that economic growth can be most effectively created by lowering barriers for people to produce goods and services as well as invest in capital. According to supply-side economics, consumers will then benefit from a greater supply of goods and services at lower prices; furthermore, the investment and expansion of businesses will increase the demand for employees. Typical policy recommendations of supply-side economists are lower marginal tax rates and less regulation.

KEY ANALYSIS

POSSIBLE CONFLICTS BETWEEN POLICY OBJECTIVES

- Full employment vs low inflation
- Economic growth vs stable prices
- Economic growth vs a balance of payments
- Economic growth vs negative externalities
- Economic growth vs equity

10 YEARS OF MONETARY POLICY



Forward guidance

2%

Forward guidance is one of the tools the Bank of England's Monetary Policy Committee (MPC) can use to **hit the Government's 2% inflation target.**

It's designed to help people understand how the MPC sets interest rates.

This means households and businesses can plan their spending and investment with more confidence.

Forward guidance was first used in August 2013.

The MPC said it would leave interest rates unchanged at 0.5% at least until the unemployment rate had fallen to 7%, provided there weren't risks to inflation or financial stability.

Forward guidance can evolve.

By February 2014, unemployment had fallen close to 7%. The MPC said there remained room for growth in the economy before raising interest rates.

And, when they come, increases in interest rates are likely to be gradual and limited.

www.bankofengland.co.uk

Quantitative Easing (QE) – injecting money into the economy

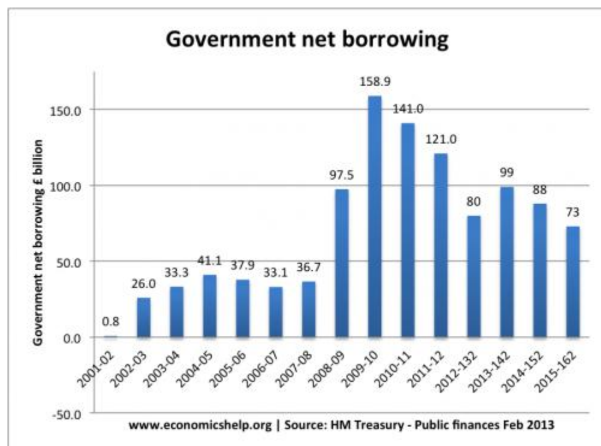
If interest rates are very low and the Bank's Monetary Policy Committee expects inflation to fall below the Government's 2% target, it can inject money directly into the economy to boost spending. This is **quantitative easing**.

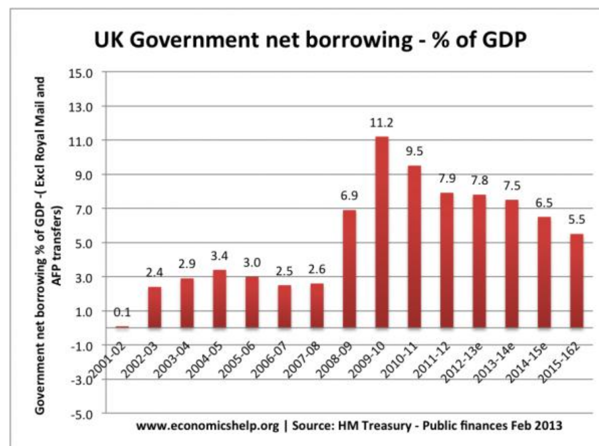
The Bank of England creates **new money** electronically to buy financial assets like government bonds. This cash injection lowers the cost of borrowing and boosts asset prices to support spending and get inflation back to target.

If inflation looks like being too high, the Bank of England can **sell these assets** to reduce the amount of money and spending in the economy.

The Monetary Policy Committee continues to set interest rates each month, and the objective of monetary policy is unchanged – to meet the Government's **2% inflation target**. Quantitative easing was first used in the UK in March 2009.

10 YEARS OF FISCAL POLICY





FISCAL POLICY

Candidates should be able to discuss the issue of the budget balance and be able to evaluate the possible economic consequences of a budget deficit or budget surplus and the possible corrective measures.

They should be able to assess the economic significance of changes in the level and distribution of public expenditure.

They should be able to analyse and evaluate the microeconomic significance of taxation and the various roles and relative merits of the different UK taxes.

There should be an awareness of the taxation principles which are likely to underlie a taxation system, such as the ability to pay and the impact on incentives.

There should be an awareness of the introduction of fiscal rules such as the Stability and Growth Pact within the euro area.

Candidates should be able to assess the economic significance of changes in the level of the national debt.

Note: given the requirements of this Unit and those of Unit 2, it is expected that candidates will have an understanding of both the potential demand-side and supply-side effects of fiscal policy, including its microeconomic role and the influence over the pattern of economic activity.

KEY TERMS

Budget deficit - The budget deficit is the annual amount the government has to borrow to meet the shortfall between current receipts (tax) and government spending.

Budget surplus – When tax receipts exceed government spending

Crowding out - Where increased public sector spending replaces, or drives down, private sector spending. Crowding out refers to when government must finance its spending with taxes and/or with deficit spending, leaving businesses with less money and effectively "crowding them out." One explanation of why crowding out occurs is government financing of projects with deficit spending through the use of borrowed money. Because the government borrows such large amounts of capital, its activities can increase interest rates. Higher interest rates discourage individuals and businesses from borrowing money, which reduces their spending and investment activities.

Demand side fiscal policy - government intervention to shift aggregate demand in or out depending on whether unemployment, GDP or inflation is the most pressing issue.

Expansionary fiscal policy - tax cuts and increased government spending also known as a fiscal stimulus.

Contractionary fiscal policy - tax increases and cuts in government spending (austerity).

Progressive tax - A tax that takes a larger percentage from the income of high-income earners than it does from low-income individuals.

Regressive tax - the average rate of tax falls as incomes rise

Proportional/flat tax - A tax system that requires the same percentage of income from all taxpayers, regardless of their earnings.

Direct taxation - levied on income, wealth and profit, such as income and corporation tax

Indirect taxes - taxes on spending – such as excise duties on fuel, cigarettes and alcohol and Value Added Tax (VAT)

Marginal Rate of Tax - the percentage of extra income received that must be paid in taxes. For an individual, it can be determined by increasing or decreasing the income earned or spent and calculating the change in taxes payable. An individual's tax bracket is the range of income for which a given marginal tax rate applies.

Laffer Curve - supposes that there is an optimal income tax level to maximize tax revenues for a given economy. If the income tax level is set below this level, raising taxes will increase tax revenue. And if the income tax level is set above this level, then lowering taxes will increase tax revenue. The theory claims that there is a single maximum and that the further you move in either direction from this point the lower the revenues will be. In reality this is only an approximation.

EU Stability and Growth Pact – is a rule-based framework for the coordination of national fiscal policies in the European Union. It was established to safeguard sound public finances, based on the principle that economic policies are a matter of shared concern for all Member States.States that the deficit must not exceed 3% of GDP and public debt must not exceed 60% of GDP

National Debt - Total outstandingborrowings of a central government comprising of internal (owing to national creditors) and external (owing to foreign creditors) debt incurred in financing its expenditure.

Supply- side fiscal policy – Government spending and taxation to help the supply side of the economy, such as income tax, infrastructure spending, and training

KEY ANALYSIS

THE POSSIBLE ECONOMIC CONSEQUENCES OF A BUDGET DEFICIT

- Increased borrowing
- Higher debt interest payments
- Increased AD
- Higher Taxes and lower spending
- Increased Interest rates
- Crowding Out
- Inflation

THE POSSIBLE ECONOMIC CONSEQUENCES OF A BUDGET SURPLUS

- Use surplus funds to retire the debt
- Refund the surplus funds to taxpayers
- More government spending
- Putting surplus by ready for next downturn

POSSIBLE CORRECTIVE MEASURES UK GOVERNMENT PLANS 2013.

"We are taking the following actions to reduce the deficit:

- the Chancellor has set out tax and spending plans to 2015 to 2016, including action to drive out further efficiencies and to ensure that welfare remains affordable
- Spending Round 2013 announced how £11.5 billion of savings will be made from day-to-day departmental spending in 2015 to 2016
- at Autumn Statement 2013, we announced that government departmental budgets for 2014 to 2015 and 2015 to 2016 will be reduced by an additional 1.1%, not including protected departments, local government, security and intelligence agencies and HMRC
- by 2015 to 2016, the cost of running Whitehall departments will have been reduced by around 40 per cent compared to 2010
- at Autumn Statement 2013 we announced a review into the way the government manages its debt including using surpluses in good years to help reduce it

To rebalance the economy:

- we have developed a National Infrastructure Plan, with investment in critical infrastructure projects as well as steps to attract major new private sector investment to the UK
- we have set out a pipeline of infrastructure projects in Investing in Britain's Future worth £100 billion over the next Parliament
- we are implementing most of the recommendations of Lord Heseltine's Review, including the creation of a Single Local Growth Fund

REASONS FOR CHANGES IN THE LEVEL OF PUBLIC EXPENDITURE

- Cyclical factors, such as automatic stabilisers, counter recessions, initiate a multiplier effect
- Increased provision of merit goods
- Increased provision of public goods
- To influence the distribution of income
- Reduce poverty
- Underpin key sectors of the economy, e.g. financial services, the car industry

REASONS FOR CHANGES IN THE DISTRIBUTION OF PUBLIC EXPENDITURE

- Changing economic circumstances forcing a redistribution
- the changed priorities of a new government
- the impact of an ageing population
- Greater interest payments on debt

MICROECONOMIC SIGNIFICANCE OF TAXATION

- Taxation and work incentives:
- Taxation and the Pattern of Demand
- Taxation and labour productivity

DIFFERENT UK TAXES

- Income tax
- National Insurance contributions
- Value added tax (VAT)
- Other indirect taxes
- Capital taxes
- Corporation tax
- Bank levy
- Council tax
- Business rates

ICAEW TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

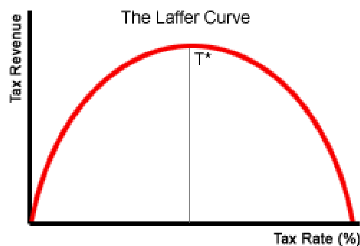
1. **Statutory**
2. **Certain**
3. **Simple**
4. **Easy to collect and to calculate**
5. **Properly targeted**
6. **Constant**
7. **Subject to proper consultation**
8. **Regularly reviewed**
9. **Fair and reasonable**
10. **Competitive**

MARGINAL RATE OF TAX

- Let m be the marginal tax rate.
- Let t be the tax liability.
- Let i be the taxable income.

$$m = \frac{\Delta t}{\Delta i}$$

LAFFER CURVE



THE ECONOMIC SIGNIFICANCE OF CHANGES IN THE LEVEL OF THE NATIONAL DEBT.

- Higher Interest Payments
- Higher Taxes / lower spending in the future.
- Crowding out of private sector investment / spending.
- Potential negative impact on exchange rate
- Potential of rising interest rates as markets become more reluctant to lend to the UK government.

DEMAND SIDE FISCAL POLICY

- Fiscal and Monetary Policies designed to influence Aggregate Demand in the economy
- Discretionary fiscal policy which can be expansionary or Contractionary

SUPPLY SIDE FISCAL POLICIES

- Lower starting rate of income tax for lower income earners.
- Changes to the tax and benefit system seek to reduce the risk of the poverty trap
- Tax and benefit reforms to improve work incentives and lead to an increase in the labour supply, this will help to reduce further the equilibrium rate of unemployment (the NAIRU) and thereby increase the economy's non-inflationary growth rate.
- Cutting the top rate of income tax from 50%
- Increased government subsidies to industry
- Governments spending on infrastructure

SUPPLY-SIDE POLICIES

Candidates should develop a more sophisticated understanding of supply-side policies using A2 concepts such as progressive taxation and the natural rate of unemployment. They should understand the contribution of supply-side policies to the management of the economy and to achieving particular macroeconomic policy objectives.

They should also appreciate that supply-side policies, such as tax changes, privatisation and labour market reforms, can have microeconomic as well as macroeconomic effects.

KEY TERMS

Progressive tax - A tax that takes a larger percentage from the income of high-income earners than it does from low-income individuals.

Natural Rate of Unemployment - The natural rate of unemployment is defined as the equilibrium rate of unemployment i.e. the rate of unemployment where real wages have found their free market level and where the aggregate supply of labour is in balance with the aggregate demand for labour.

Deregulation - The reduction or elimination of government power in a particular industry, usually enacted to create more competition within the industry.

Red Tape - refers to excessive regulation that hinders or prevents action or decision-making. It is usually applied to governments, corporations, and other large organizations.

KEY ANALYSIS

SUPPLY SIDE POLICES

- Privatisation.
- Deregulation
- Reducing Income Taxes
- Increased education and training
- Reducing the power of Trades Unions
- Reducing State Welfare Benefits
- Providing better information about jobs
- Removing unnecessary red tape and bureaucracy
- Improving Transport and infrastructure
- Deregulate Labour Markets

MONETARY POLICY, THE MONEY SUPPLY AND INTEREST RATES

Candidates should be able to build on their knowledge of the role of the Monetary Policy Committee (MPC) of the Bank of England from Unit 2 and be able to discuss how the Bank can influence the money supply (including quantitative easing) and the rate of interest. In particular, they should be aware of the objectives of monetary policy. They should be able to identify and explain the instruments of policy which are currently employed by the Bank of England to achieve the inflation target set by the government.

Candidates should understand how the demand for, and supply of, funds in different markets affect interest rates. Candidates should have an understanding of the factors considered by the MPC when setting interest rates. Note: knowledge of the credit multiplier and liquidity preference theory is not expected.

KEY TERMS

Money Supply - The entire stock of currency and other liquid instruments in a country's economy as of a particular time. The money supply can include cash, coins and balances held in checking and savings accounts.

Quantitative Easing - An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.

Transmission Mechanism - is the way in which interest rate changes affect economic activity and inflation. The main impact is through the level of aggregate demand.

LIBOR - The London Interbank Offered Rate is the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another

Forward Guidance - The MPC said it would leave interest rates unchanged at 0.5% at least until the unemployment rate had fallen to 7%, provided there weren't risks to inflation or financial stability. Amended to include, 'whilst there remained room for growth in the economy before raising interest rates'.

Macroprudential Monetary Policy - the approach to financial regulation aimed to mitigate the risk of the financial system

KEY ANALYSIS

THE OBJECTIVES OF MONETARY POLICY

- The Bank of England's monetary policy objective is to deliver price stability – low inflation – and, subject to that, to support the Government's economic objectives including those for growth and employment. Price stability is defined by the Government's inflation target of 2%

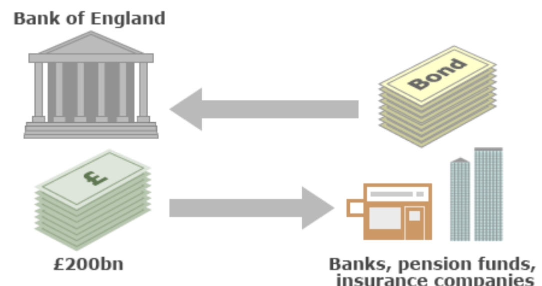
INSTRUMENTS OF POLICY WHICH ARE CURRENTLY EMPLOYED BY THE BANK OF ENGLAND

- Interest rates
- Money supply/Quantitative easing
- Exchange rates

FACTORS CONSIDERED BY THE MPC WHEN SETTING INTEREST RATES. (FROM MINUTES OF APRIL 2014 MEETING)

- Financial markets (bond yields, shares, short-term interest rates, exchange rates)
- The international economy
- Money, credit, demand and output (GDP, output, retail sales, household and business spending, credit)
- Supply, costs and prices (employment, expectations, earnings)

QUANTITATIVE EASING



- Quantitative Easing (QE) is a form of monetary policy used by central banks to increase the supply of money in an economy when the bank interest rate is close to zero. A central bank does this by first crediting its own account with money it has created out of nothing. It then increases the money supply by buying government securities or other securities from the market.
- Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity. It also has the advantages of lowering bond yields, thus making borrowing cheaper. Lastly, it has contributed to a lower exchange rate which has benefited UK exports
- The major risk of quantitative easing is that, although more money is floating around, there is still a fixed amount of goods for sale. This will eventually lead inflation.

LIBOR

- Libor (London Interbank Offered Rate) is the average interest rate that leading banks in London charge when lending to other banks. Banks borrow money for one day, one month, two months, six months, one year, etc., and they pay interest to their lenders based on certain rates. The LIBOR is derived from a filtered average of the world's most creditworthy banks' interbank deposit rates for larger loans. The LIBOR is the world's most widely used benchmark for short-term interest rates.

EXCHANGE RATE POLICY

Candidates should understand the relationship between interest rates and the exchange rate and how the exchange rate might be an influence on policy objectives such as price stability and unemployment.

KEY TERMS

Exchange rates - The price of a nation's currency in terms of another currency

Hot money - Money that flows regularly between financial markets as investors attempt to ensure they get the highest short-term interest rates possible. Hot money will flow from low interest rate yielding countries into higher interest rates countries by investors looking to make the highest return.

Currency appreciation - An increase in the value of one currency in terms of another. Currencies appreciate against each other for various reasons, including capital inflows and the state of a country's current account.

Currency depreciation - A decrease in the level of a currency in a floating exchange rate system due to market forces. Currency depreciation can occur due to any number of reasons – economic fundamentals, interest rate differentials, political instability, risk aversion among investors and so on.

KEY ANALYSIS

THE RELATIONSHIP BETWEEN INTEREST RATES AND THE EXCHANGE RATE

- A rise in interest rates compared to those in other countries is likely to result in an increase in the quantity of funds flowing into the UK, as investors are attracted to the higher sterling rates of interest. This ends in an appreciation of the exchange rate compared to other currencies.
-

3.4.3 THE INTERNATIONAL ECONOMY

GLOBALISATION

Candidates should have an understanding of the causes of globalisation, its main characteristics, and the different consequences for developing and for developed countries. There should be some understanding of the role of multinational corporations in the development of globalisation.

KEY TERMS

Globalisation - the process of increased integration and co-operation of different national economies. It involves national economies becoming increasingly inter-related and integrated.

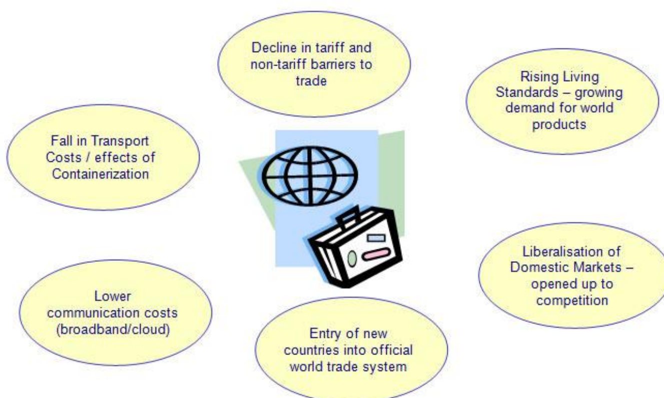
Developing countries - is a nation with a lower living standard, underdeveloped industrial base, and low Human Development Index (HDI) relative to other countries

Developed countries - is a sovereign state that has a highly developed economy and advanced technological infrastructure relative to other less industrialized nations.

Multinational Corporation - is a corporation that is registered in more than one country or that has operations in more than one country. It is a large corporation which both produces and sells goods or services in various countries

KEY ANALYSIS

CAUSES



BENEFITS OF GLOBALISATION

- **Free Trade** - Free trade is a way for countries to exchange goods and resources. This means countries can specialise in producing goods where they have a comparative advantage (this means they can produce goods at a lower opportunity cost). When countries specialise there will be several gains from trade
- **Free Movement of Labour** - Increased labour migration gives advantages to both workers and recipient countries. If a country experiences high unemployment, there are increased opportunities to look for work elsewhere. This process of labour migration also helps reduce geographical inequality. This has been quite effective in the EU, with many Eastern European workers migrating west.
- **Increased Economies of Scale** - Production is increasingly specialised. Globalisation enables goods to be produced in different parts of the world. This greater specialisation enables lower average costs and lower prices for consumers.
- **Greater Competition -** Domestic monopolies used to be protected by lack of competition. However, globalisation means that firms face greater competition from foreign firms.
- **Increased Investment -** Globalisation has also enabled increased levels of investment. It has made it easier for countries to attract short term and long term investment. Investment by multinational companies can play a big role in improving the economies of developing countries.

COSTS OF GLOBALISATION

- **Free Trade can Harm Developing Economies -** Developing countries often struggle to compete with developed countries, therefore it is argued free trade benefits developed countries more. There is an infant industry argument which says industries in developing countries need protection from free trade to be able to develop. However, developing countries are often harmed by tariff protection Western economies have on agriculture.

- **Environmental Costs -** One problem of globalisation is that it has increased the use of non renewable resources. It has also contributed to increased pollution and global warming. Firms can also outsource production to where environmental standards are less strict. However, arguably the problem is not so much globalisation as a failure to set satisfactory environmental standards.

- **Labour Drain -** Globalisation enables workers to move more freely. Therefore, some countries find it difficult to hold onto their best skilled workers, who are attracted by higher wages elsewhere.

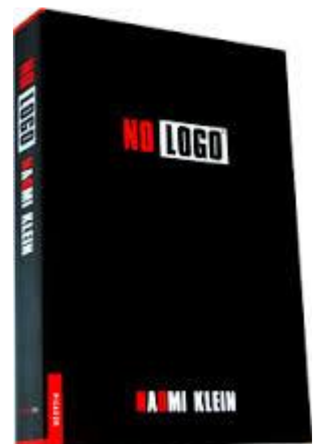
- **Less Cultural Diversity** - Globalisation has led to increased economic and cultural hegemony. With globalisation there is arguably less cultural diversity, however it is also led to more options for some people.

- **Tax Competition and Tax avoidance**. - Multinational companies like Amazon and Google, can set up offices in countries like Bermuda and Luxembourg with very low rates of corporation tax and then funnel their profits through these subsidiaries. This means they pay very little tax in the countries where they do most of their business. This means governments have to increase taxes on VAT and income tax. It is also seen as unfair competition for domestic firms who don't use same tax avoidance measures.

THE ROLE OF MNCS – 10 LARGEST COMPANIES IN THE WORLD BY MARKET CAPITILISATION

Company name	Nationality	Industry	Rank +/-	31-mar-13 Rank	31-mar-13 Market Cap $bn	31-mar-08 Rank	31-mar-08 Market Cap $bn
Search...	All	All					
APPLE	United States	Technology	40	1	416	41	126
EXXON MOBIL	United States	Oil & Gas	-1	2	404	1	453
GOOGLE	United States	Technology	33	3	263	36	138
BERKSHIRE HATHAWAY	United States	Financials	9	4	257	13	207
PETROCHINA	China	Oil & Gas	-3	5	255	2	424
WAL-MART STORES	United States	Consumer Services	5	6	246	11	208
GENERAL ELECTRIC	United States	Industrials	-4	7	240	3	369
MICROSOFT	United States	Technology	-1	8	240	7	264
IBM	United States	Technology	18	9	238	27	159
NESTLE	Switzerland	Consumer Goods	4	10	233	14	197

BOOK TO REFERENCE – NO LOGO NAOMI KLEIN



The book comprises four sections: "No Space", "No Choice", "No Jobs", and "No Logo". The first three deal with the negative effects of brand-oriented corporate activity, while the fourth discusses various methods people have taken in order to fight back.

"NO SPACE"

The book discusses how brand names such as Nike or Pepsi expanded beyond the mere products which bore their names, and how these names and logos began to appear everywhere.

"NO CHOICE"

In the second section, Klein discusses how brands use their size and clout to limit the number of choices available to the public – whether through market dominance (Wal-Mart) or through aggressive invasion of a region (Starbucks). Klein argues that the goal of each company is to become the dominant force in its respective field. Meanwhile, other corporations, such as Sony or Disney, simply open their own chains of stores, preventing the competition from even putting their products on the shelves.

"NO JOBS"

This section looks at the way in which manufacturing jobs move from local factories to foreign countries, and particularly to places known as export processing zones. Such zones have no labor laws, leading to dire working conditions. All of this is set against a backdrop of massive profits and wealth being produced within the corporate sector. The result is a new generation of employees who have come to resent the success of the companies they work for. This resentment, along with rising unemployment, labour abuses abroad, disregard for the environment and the ever-increasing presence of advertising breeds a new disdain for corporations.

"NO LOGO"

The final section of the book discusses various movements that have sprung up during the 1990s. These include Adbusters magazine and the culture-jamming movement, as well as Reclaim the Streets and the McLibel trial. Less radical protests are also discussed, such as the various movements aimed at putting an end to sweatshop labour.

TRADE

Candidates should understand the model of comparative advantage, the distinction between comparative and absolute advantage, and be able to use a simple numerical example to illustrate this distinction. They should be able to evaluate the importance and limitations of these concepts as well as discuss the costs and benefits of trade generally.

There should be an understanding of the reasons for changes in the pattern of trade between the UK and the rest of the world, as well as the potential costs and benefits of trade for an economy. Candidates should also be able to discuss the nature and importance of trade between developed and developing countries for both parties.

There should be an awareness of the extent of progress towards free trade in recent years, especially through the role of the World Trade Organisation (WTO). Equally, candidates should understand the causes and consequences of protectionist policies such as tariffs, quotas and export subsidies.

KEY TERMS

Comparative advantage - when one country can produce a good or service at a lower opportunity cost than another. This means a country can produce a good relatively cheaper than other countries

Absolute advantage - that an economy can produce a good for lower costs than another. It means that less resources are needed to produce the same amount of goods.

Free trade - The unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, duties and quotas

World Trade Organisation (WTO) - intergovernmental organisation set up in 1995 to negotiate and administer trade agreements, handle trade disputes and monitor national trade policies.

Protectionism - Government actions and policies that restrict or restrain international trade, often done with the intent of protecting local businesses

Customs Union - a group of states that have agreed to charge the same import duties as each other and usually to allow free trade between themselves.

KEY ANALYSIS

MODEL OF COMPARATIVE ADVANTAGE

Comparative Advantage is situation in which a country, individual, company or region can produce a good at a lower opportunity cost than a competitor. Even if one country is more efficient in the production of all goods (absolute advantage in all goods) than the other, both countries will still gain by trading with each other, as long as they have different relative efficiencies.

Example:

Country A – 6 shoes per hour, 6 shirts per hour (opportunity cost: 1 shoe for 1 shirt)

Country B – 2 shoes per hour, 4 shirts per hour (opportunity cost: 1 shoe for 2 shirts)

Both countries can benefit as their internal tradeoffs are different. If country A switches its production to shoes and country B switches its production to shirts. By trading, the tradeoff can be reduced to as low as 1:1/2 and 1:1 respectably. Both countries gain from the trade.

PROBLEMS OF COMPARATIVE ADVANTAGE

- Transport costs may outweigh any comparative advantage
- Increased specialisation may lead to diseconomies of scale
- Governments may restrict trade
- Comparative advantage measures static advantage but not any dynamic advantage for example in the future India could become good at producing books if it made the necessary investment

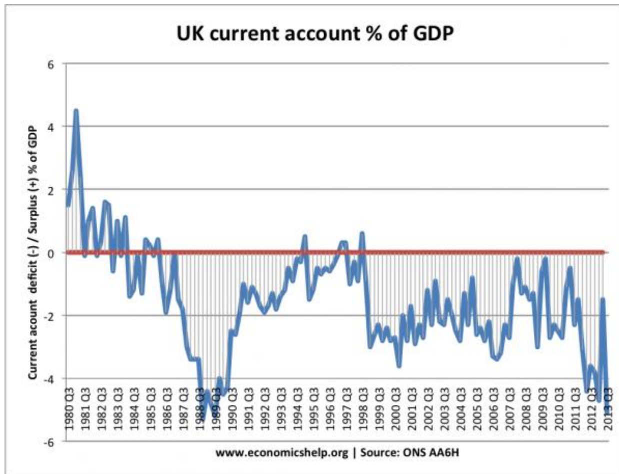
BENEFITS OF FREE TRADE

- The theory of comparative advantage
- Increased Exports.
- Economies of Scale.
- Increased Competition and lower prices
- Trade is an engine of growth.

COSTS OF FREE TRADE

- Infant Industry Argument.
- The Senile industry argument.
- To diversify the economy
- Help the Balance of Payments
- Protection against dumping

THE PATTERN OF TRADE BETWEEN THE UK AND THE REST OF THE WORLD

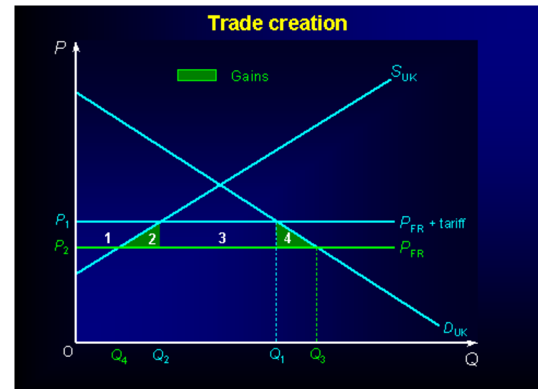


PROTECTIONISM

- Tariffs – This is a tax on imports.
- Quotas – This is a physical limits on the quantity of imports
- Embargoes – This is a total ban on a good, this may be done to stop dangerous substances
- Subsidies - If a government subsidises domestic production this gives them an unfair advantage over competitors.
- Administrative barriers – Making it more difficult to trade, e.g. imposing minimum environmental standards.

WELFARE GAINS AND LOSSES

- Welfare Gains occurs when consumption shifts from a high cost producer to a low cost producer. If we assume that France is the most efficient producer of wine. After joining the EC it is now possible to import wine from France without paying the tariff. This will lead to an efficiency gain to UK consumers. The diagram below shows that before joining the EC the UK had to pay the French price plus the tariff, P1. At P1 the UK produced Q2, consumed Q1, and therefore imported Q1 – Q2. With the removal of the tariff the price falls to P2. Consumption increases to Q3 and domestic production falls to Q4. Imports have therefore increased to Q3 - Q4. Trade has been created.



The gain in welfare from the removal of the tariff can also be demonstrated in the diagram above. There has been an increase in consumer surplus of areas 1 + 2 + 3 + 4. On the other hand there has been a reduction in the producer surplus of UK wine producers of area 1 and a loss in government tariff revenues of area 3. This means there will always be a net gain of 2 + 4 when trade creation occurs as a result of a country joining a trading bloc.

BALANCE OF PAYMENTS

Candidates should know the difference between the current and capital and financial accounts on the UK balance of payments.

*Note: candidates will be aware of the composition of the current account from Unit 2; a detailed knowledge of the remainder of the accounts is **not** required, but the nature and significance of both short-term and long-term international capital flows should be understood.*

An understanding of the importance of the City of London to the trade in financial services should be conveyed to candidates.

Candidates should understand the possible significance of deficits and surpluses for an individual economy. They should also understand the possible implications for the global economy of a major economy or economies with imbalances deciding to take corrective action. Candidates should also be able to analyse and evaluate measures which may be taken to deal with balance of payments deficits or surpluses.

KEY TERMS

The Balance of Payments - is the record of a country's transactions / trade with the rest of the world.

Current Account - trade in goods, services + investment incomes + transfers

Capital Account/Financial Account - capital and financial flows, net investment, portfolio investment

International capital flows - is the movement of money for the purpose of investment, trade or business production. Capital flows occur within corporations in the form of investment capital and capital spending on operations and research & development.

KEY ANALYSIS

THE DIFFERENCE BETWEEN THE CURRENT AND CAPITAL AND FINANCIAL ACCOUNTS ON THE UK BALANCE OF PAYMENTS.

A Summary of balance of payments
Balances (net transactions)

£ million

		2011	2012	2011 Q3	2011 Q4	2012 Q1	2012 Q2	2012 Q3	2012 Q4	2013 Q1	2013 Q2	2013 Q3
Seasonally adjusted												
Current account												
Trade in goods and services												
Trade in goods	**BOKI**	- 100 092	- 108 700	- 27 814	- 24 814	- 26 203	- 28 105	- 26 265	- 28 127	- 26 268	- 25 368	- 29 418
Trade in services	**IKBD**	76 832	75 060	19 622	19 489	17 475	18 180	19 791	19 614	19 681	20 349	19 400
Total trade	**IKBJ**	- 23 260	- 33 640	- 8 192	- 5 325	- 8 728	- 9 925	- 6 474	- 8 513	- 6 587	- 5 019	- 10 018
Income												
Compensation of employees	**IJAJ**	- 172	- 148	- 5	- 53	- 10	- 28	- 42	- 68	- 84	- 66	- 72
Investment income	**HBOM**	22 666	- 1 697	4 562	5 527	1 990	- 1 766	- 1 765	- 156	- 5 839	6 114	- 3 631
Total income	**HBOJ**	22 494	- 1 845	4 557	5 474	1 980	- 1 794	- 1 807	- 224	- 5 923	6 048	- 3 703
Current transfers												
General government	**FNSV**	- 16 258	- 16 264	- 4 537	- 4 095	- 3 898	- 3 752	- 4 070	- 4 544	- 4 407	- 5 247	- 5 146
Other sectors	**FNTC**	- 5 451	- 6 717	- 1 220	- 1 568	- 1 553	- 1 754	- 1 693	- 1 717	- 1 888	- 1 938	- 1 854
Total current transfers	**IKBP**	- 21 709	- 22 981	- 5 757	- 5 663	- 5 451	- 5 506	- 5 763	- 6 261	- 6 295	- 7 185	- 7 000
Current balance	**HBOP**	**- 22 475**	**- 58 466**	**- 9 392**	**- 5 514**	**- 12 199**	**- 17 225**	**- 14 044**	**- 14 998**	**- 18 805**	**- 6 156**	**- 20 721**
Capital balance	**FNVQ**	**4 020**	**3 788**	**1 326**	**1 049**	**937**	**944**	**979**	**928**	**989**	**1 510**	**1 126**
Not seasonally adjusted												
Current account												
Trade in goods and services												
Trade in goods	**LQCT**	- 100 092	- 108 700	- 28 273	- 24 534	- 26 216	- 27 771	- 27 005	- 27 708	- 26 113	- 25 170	- 30 382
Trade in services	**KTMS**	76 832	75 060	18 331	19 741	19 138	18 208	18 037	19 677	18 643	18 931	16 487
Total trade	**KTMY**	- 23 260	- 33 640	- 9 942	- 4 793	- 7 078	- 9 563	- 8 968	- 8 031	- 7 470	- 6 239	- 13 895
Income												
Compensation of employees	**KTMP**	- 172	- 148	- 16	- 43	- 31	- 10	- 50	- 57	- 111	- 44	- 84
Investment income	**HMBM**	22 666	- 1 697	3 318	5 936	2 758	- 2 595	- 3 690	1 830	- 4 961	6 269	- 6 694
Total income	**HMBP**	22 494	- 1 845	3 302	5 893	2 727	- 2 605	- 3 740	1 773	- 5 072	6 225	- 6 778
Current transfers												
General government	**FJUQ**	- 16 258	- 16 264	- 3 873	- 4 358	- 5 211	- 2 932	- 3 464	- 4 657	- 6 152	- 3 991	- 4 536
Other sectors	**FJUR**	- 5 451	- 6 717	- 1 223	- 1 507	- 1 790	- 1 537	- 1 651	- 1 739	- 2 123	- 1 738	- 1 807
Total current transfers	**KTNF**	- 21 709	- 22 981	- 5 096	- 5 865	- 7 001	- 4 469	- 5 115	- 6 396	- 8 275	- 5 729	- 6 343
Current balance	**HBOG**	**- 22 475**	**- 58 466**	**- 11 736**	**- 4 765**	**- 11 352**	**- 16 637**	**- 17 823**	**- 12 654**	**- 20 817**	**- 5 743**	**- 27 016**
Capital balance	**FKMJ**	**4 020**	**3 788**	**1 350**	**1 014**	**929**	**967**	**1 001**	**891**	**986**	**1 530**	**1 147**
Financial account												
Direct investment	**HJYV**	- 34 662	- 9 490	- 5 724	1 281	- 4 011	- 960	- 6 780	2 261	38 828	- 2 667	- 552
Portfolio investment	**HHZD**	- 27 162	- 195 314	23 853	- 3 889	- 53 864	11 043	- 135 887	- 16 606	34 280	5 662	- 44 358
Financial derivatives (net)	**ZPNN**	- 2 911	30 122	- 13 806	- 14 816	34 212	17 867	- 17 411	- 4 546	- 28 007	- 41 695	77 835
Other investment	**HHYR**	81 160	243 550	- 731	26 329	27 337	- 522	174 567	42 168	- 33 257	39 092	- 2 199
Reserve assets	**LTCV**	- 4 948	- 7 642	959	- 1 157	- 612	- 2 730	- 2 493	- 1 807	- 1 541	- 2 161	- 766
Net financial transactions	**HBNT**	**11 477**	**61 226**	**4 551**	**7 748**	**3 062**	**24 698**	**11 996**	**21 470**	**10 303**	**- 1 769**	**29 960**
Net errors and omissions [1]	**HHDH**	6 978	- 6 548	5 835	- 3 997	7 361	- 9 028	4 826	- 9 707	9 528	5 982	- 4 091

THE IMPORTANCE OF THE CITY OF LONDON

- The City of London's contribution to the national income is estimated at 3.7% of the total, while financial services represent 22.1% of total income (or gross value added) in the whole of London. The financial services sector accounts for 9.7% of the total national income of Great Britain.
- London as a whole made a net contribution of £10bn to the UK Exchequer in the tax year to the end of March 2012, representing 18.8% of total UK taxes.

Source: Oxford

DOES A CURRENT ACCOUNT DEFICIT MATTER?

Yes, we should worry

- It is a sign of uncompetitiveness, which will lead to lower economic growth and poorer prospects in the long run.
- If capital / financial flows dry up, it could lead to depreciation in the exchange rate and a fall in living standards
- It is a sign of an unbalanced economy.

No, we shouldn't be concerned

- The UK has had a persistent deficit since the mid 1980s.
- In era of globalisation, financial flows are easier to attract
- If the current account was too large, there should be a depreciation in the exchange rate to restore the balance.

REASONS FOR A CURRENT ACCOUNT DEFICIT

- 1. Overvalued exchange rates
- 2. High Consumer Spending
- 3. Unbalanced Economy**.**
- 4. Competitiveness.

POLICIES TO REDUCE A CURRENT ACCOUNT DEFICIT

- Reduce consumer spending
- Supply side policies to improve competitiveness.
- Devaluation of the exchange rate. (see below for evaluation
- Protectionism

WILL A DEVALUATION WORK - MARSHALL-LERNER CONDITION

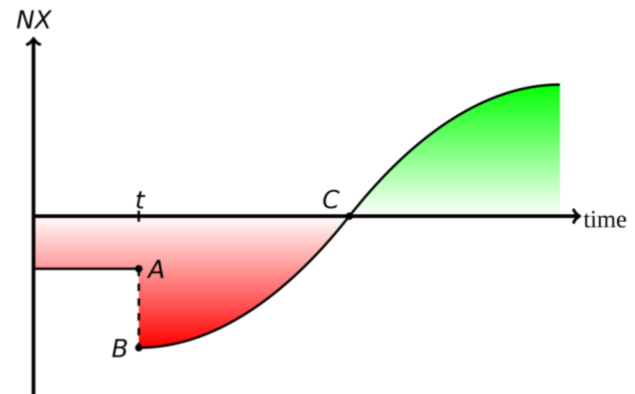
- The Marshall–Lerner condition is a technical reason why devaluation of a nation's currency will not immediately improve its balance of payments. The condition states that, for a currency devaluation to have a positive impact on trade balance, the sum of price elasticity of exports and imports must be greater than 1.

  Devaluation = Reduction in the price of exports = Increases exports

  Devaluation = Rise in the price of imports = Decreases imports
- The net effect on the trade balance will depend on price elasticity. If goods exported are elastic to price, their quantity demanded will increase proportionately more than the decrease in price, and total export revenue will increase. Similarly, if goods imported are elastic, total import expenditure will decrease. Both will improve the trade balance.

THE J-CURVE

In economics, the 'J curve' refers to the trend of a country's trade balance following devaluation under a certain set of assumptions. A devalued currency means imports are more expensive, and on the assumption that the volume of imports and exports change little immediately. Goods tend to be inelastic in the short term, as it takes time to change consuming patterns. Thus, the Marshall–Lerner condition is not met, and devaluation is likely to worsen the trade balance initially. In the long term, consumers will adjust to the new prices, and trade balance will improve.



EXCHANGE RATE SYSTEMS

Candidates should understand how exchange rates are determined in both fixed and floating exchange rate systems (whether completely free or managed periodically by the authorities). Candidates should be able to evaluate these exchange rate systems and have an understanding of their implications for the management of the domestic economy.

KEY TERMS

Fixed exchange rate - A country's exchange rate regime under which the government or central bank ties the official exchange rate to another country's currency (or the price of gold), also known as 'Pegged'

Floating exchange rates - type of exchange rate regime wherein a currency's value is allowed to fluctuate according to the foreign exchange market.

Dirty Float or managed float - is a floating currency exchange rate system which is not controlled entirely by the market forces of demand and supply. Instead, it is at least partially controlled by government intervention that limits appreciation or depreciation of the currency within a range. Central banks attempt to influence their countries' exchange rates by buying and selling currencies.

KEY ANALYSIS

ADVANTAGES OF FIXED EXCHANGE RATES

- **Avoid Currency Fluctuation**s. If the value of currencies fluctuate significantly this can cause problems for firms engaged in trade.
- **Stability encourages investment**. The uncertainty of exchange rate fluctuations can reduce the incentive for firms to invest in export capacity.
- **Keep inflation Low**. Governments who allow their exchange rate to devalue may cause inflationary pressures to occur. This is because AD increases, import prices increase and firms have less incentive to cut costs.

DISADVANTAGE OF FIXED EXCHANGE RATES

- **Conflict with other objectives.** To maintain a fixed level of the exchange rate may conflict with other macroeconomic objectives. The most effective way to increase the value of a currency is to raise interest rates. This will increase hot money flows and also reduce inflationary pressures.
- **Less Flexibility.** It is difficult to respond to temporary shocks. For example an oil importer may face a balance of payments deficit if oil price increases, but in a fixed exchange rate there is little chance to devalue.
- **Join at the Wrong Rate**. It is difficult to know the right rate to join at. If the rate is too high, it will make exports uncompetitive. If it is too low, it could cause inflation.
- **Current Account Imbalances.** Fixed exchange rates can lead to current account imbalances. For example, an overvalued exchange rate could cause a current account deficit.

ARGUMENTS IN FAVOUR OF A FLOATING EXCHANGE RATE

- **Automatic balance of payments adjustment -** For example, if a country has a balance of payments deficit then the currency should depreciate. This is because imports will be greater than exports meaning the supply of sterling on the foreign exchanges will be increasing as importers sell pounds to pay for the imports. This will drive the value of the pound down. The effect of the depreciation should be to make your exports cheaper and imports more expensive, thus increasing demand for your goods abroad and reducing demand for foreign goods in your own country, therefore dealing with the balance of payments problem.
- **Freeing internal policy-** With a floating exchange rate, balance of payments disequilibrium should be rectified by a change in the external price of the currency. However, with a fixed rate, curing a deficit could involve a general deflationary policy resulting in unpleasant consequences
- **Absence of crises -** Fixed rates are often characterised by crises as pressure mounts on a currency to devalue or revalue**.**
- **Lower foreign exchange reserves** - A country with a fixed rate usually has to hold large amounts of foreign currency in order to prepare for a time when they have to defend that fixed rate.

DISADVANTAGES OF THE FLOATING RATE

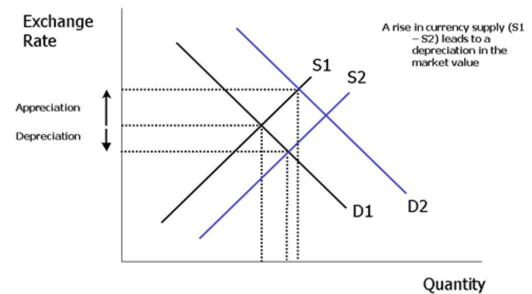
- **Uncertainty**
- **Speculation**
- **Does a floating rate automatically remedy a deficit**? - UK experience indicates that a floating exchange rate probably does not automatically cure a balance of payments deficit. Much depends on the price elasticity of demand for imports and exports. The Marshall-Lerner condition says that a depreciation in the exchange rate will help improve the balance of payments if the sum of the price elasticity's for imports and exports is greater than one.
- **Inflation**

MANAGING AN EXCHANGE RATE

Example:

Due in increased demand of export from India, the demand for the Indian Rupee increases (shift from D1 to D2). This results in appreciation of Indian Rupee.

Under a managed float system, the Indian government would keep the exchange rate low to manage a low price advantage.



The Indian government then buys US Dollar from the FX market and supply Indian Rupee in to the market. It increases supply of Indian Rupee (shift from S1 to S2) and causes depreciation of Rupee.

THE EUROPEAN UNION

Candidates should have an elementary understanding of the institutional structure of the EU, notably the role of the European Commission and the European Central Bank.

Note: a detailed knowledge of these institutions is ***not*** *expected.*

Candidates should be able to discuss the main features of customs unions and understand the significance of the EU as a customs union. The EU as a customs union should be considered in relation to the Single European Market (SEM).

Candidates should have an appreciation of the potential impact on the UK economy of EU enlargement. They should be able to evaluate Economic and Monetary Union (EMU) and the single European currency in the context of the debate over UK membership.

KEY TERMS

European Commission - The European Commission is the executive body of the European Union responsible for proposing legislation, implementing decisions, upholding the Union's treaties and day-to-day running of the EU. The Commission operates as a cabinet government, with 28 members of the Commission.

European Central Bank - The central bank responsible for the monetary system of the European Union (EU) and the euro currency. The bank was formed in Germany in June 1998 and works with the other national banks of each of the EU members to formulate monetary policy that helps maintain price stability in the European Union.

Customs union - Agreement between two or more (usually neighbouring) countries to remove trade barriers, and reduce or eliminate customs duty on mutual trade. A customs union (unlike a free trade area) generally imposes a common external-tariff (CTF) on imports from non-member countries and (unlike a common market) generally does not allow free movement of capital and labour among member countries.

Single European Market (SEM). The European Union's (EU) internal market (sometimes known as the single market, formerly the common market) seeks to guarantee the free movement of goods, capital, services, and people – the EU's "four freedoms" – within the EU's 28 member states. The internal market is intended to be conducive to increased competition, increased specialisation, larger economies of scale, allowing goods and factors of production to move to the area where they are most valued, thus improving the efficiency of the allocation of resources.

Economic and Monetary Union (EMU) - is an umbrella term for the group of policies aimed at converging the economies of all member states of the European Union at three stages. Both the 18 Eurozone states and the 10 non-euro states are EMU members.

The single European currency (Euro) - The euro (sign: €; code: EUR) is the currency used by the Institutions of the European Union and is the official currency of the Eurozone, which consists of 18 of the 28 member states of the European Union: Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

Optimal Currency Area - is a geographical region in which it would maximize economic efficiency to have the entire region share a single currency.

KEY ANALYSIS

BENEFITS OF A SINGLE MARKET

- Trade Creation.
- Reduction in the direct costs of barriers
- Economies of scale from specialization
- Greater competition

COSTS OF A SINGLE MARKET

- Structural Change due to increased specialization
- Adverse Regional multiplier effects.
- Development of Monopoly/ Oligopoly power
- Trade Diversion. If external barriers remain high countries could lose out

BENEFITS OF EUROPEAN UNION

- Peace amongst nations
- Economic development of countries like Portugal, Ireland and Spain.
- Free trade and removal of non-tariff barriers
- Environmental treaties
- Free movement of labour and capital have helped create a more flexible economy.
- Social Charter enshrines protection for workers such as maximum working week, right to collective bargaining and fair pay for employment. (UK opted out).
- Countries in the EU, are amongst the highest positions in the Human Development Index(HDI)

CRITICISM OF EUROPEAN UNION EU

- Common Agricultural Policy CAP
- Regulated Labour Markets
- Anti Inflation Bias
- Euro has Created Lower Economic Growth.

CONVERGENCE CRITERIA – JOINING THE EURO

- Inflation - Average inflation over previous year must not exceed by more than 1.5% that of the three lowest inflation countries
- Government Finances - Budget deficit must not exceed 3% of GDP
- Gross government debt - must not exceed 60% of GDP
- Interest Rates - Average yield on govt bonds must not exceed by more than 2% bond yields of three lowest inflation countries
- Exchange Rate Stability - Currency must have adhered to fluctuation margins of the ERM II in two previous years without severe tension

Benefits of the Euro

(1) Potential Gains for consumers

- Lower prices because of increased competition/ greater price transparency
- Reduction in the transactions costs of travelling within Europe (e.g. costs of currency exchange)
- Easier to live and work in different EU countries

(2) Potential gains for businesses

- Invoicing can be done with one currency
- Lower transactions costs
- Gains for the tourist industry in attracting overseas visitors
- Businesses might be able to fund their capital investment at lower real interest rates

Problems of the Euro

- Menu Costs and Installation of new payments systems
- Customer confusion (imperfect information)
- Higher prices
- A “one-size fits all” monetary policy may work against a country if their cycle is not convergent with Euro Zone
- Lose the option of making an exchange rate adjustment
- Meeting the EU Growth and Fiscal Stability Pact

USEFUL CURRENT KNOWLEDGE

ECONOMIC RE-BALANCING (ARTICLE FROM TUTOR2U)

- Re-balancing away from consumption and imports towards exports and business investment
- Re-balancing away from dependence on the housing market towards manufacturing industry
- Re-balancing away from dependence on financial services towards a greater role for manufacturing and a range of emerging potentially fast-growth industries such as life sciences and creative services
- Improving the level of regional balance i.e. encouraging more investment and jobs in areas / regions of the economy with persistently higher unemployment and lower incomes
- Re-balancing the economy away from high levels of government spending, taxation and borrowing towards a great share of national output and income flowing from the private sector

LSE GROWTH COMMISSION REPORT

Investments in Human capital

- Improving teacher quality through expanding the intake of teachers and engaging in more rigorous selection.
- Creating a 'flexible ecology' of schools, by which we mean, more autonomous primary and secondary schools, greater parental choice and easier growth for successful schools and their sponsors.
- Linking targets, inspections and rewards more effectively to hold schools to account for the outcomes of disadvantaged pupils

Investment in infrastructure.

- •An Infrastructure Strategy Board to provide independent expert advice to parliament to guide strategic priorities.
- An Infrastructure Planning Commission to support the implementation of those priorities with more powers to share the gains from infrastructure investment by more generously and compensating those who stand to lose from new developments.
- An Infrastructure Bank to facilitate the provision of finance, to bring in expertise and to work with the private sector to share, reduces and manages risk.

Private investment and innovation

- Increasing competition in retail banking.
- Having the proposed Business Bank make young and innovative firms its top priority.
- Encouraging a long-term investment perspective through regulatory changes (for example, over equity voting rights) and tax reforms (for example, reducing the bias towards debt finance).

POSSIBLE CONTEXT CASE STUDIES FOR YOUR EXAM (STORIES FROM 18 MONTHS AGO)

Roger Bootle – The Telegraph

- Euro's effects on our woes haven't died, they're just resting - 9 Dec 2012
- Issue of our EU membership is too important to be left to the Americans - 13 Jan 2013

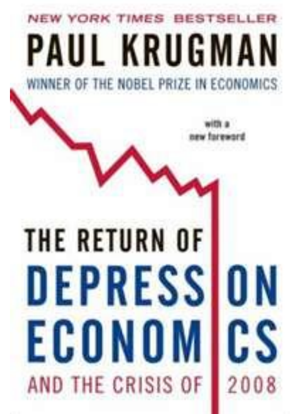
Paul Krugman – New York Times

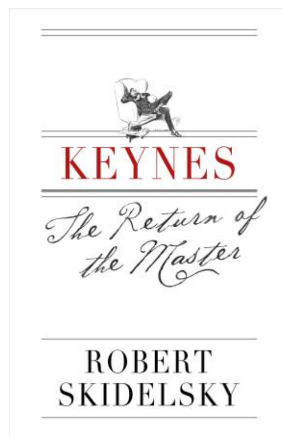
- The Forgotten Millions - The "fiscal cliff" has everyone talking about a fiscal crisis. But what we should be talking about is a very real job crisis – 7 Dec 2012
- That Terrible Trillion - Now, for a little perspective on the scary deficit - December 17, 2012

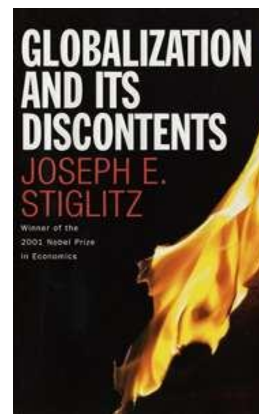
Larry Elliot – The Guardian

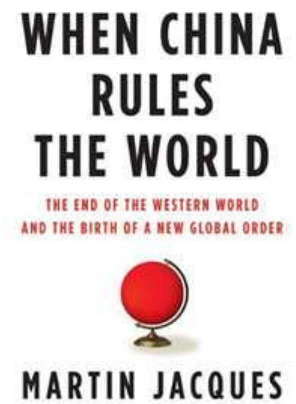
- George Osborne needs positive forecasts to avoid triple-dip recession – 7 December 2012
- Why the world economy needs America to avoid the fiscal cliff – 21 December 2012

BOOKS TO NAME CHECK









REVISION GUIDE SOURCES – AMONGST OTHERS

Investopedia

Economicshelp.org

Tutor2u.net