Zig Zag Education

Economics **A Level | AQA | 7136**

Course Companion

For A Level Year 2 AQA Economics: 4.2: The National and International Economy

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POD 8162

Contents

Teacher's Introduction

Overview

This resource is designed to supplement and enhance your teaching of the 2015 linear Economics A Level. It has been written to include every aspect of the AQA Year 2 Macroeconomics course as well as options for further research and study for keen and interested students. As up to 20% of the exam will be assessed on quantitative skills, this resource has ensured all the relevant maths is covered (however, it is assumed the students have a basic GCSE-level understanding).

Remember!
Always check the exam board website for new information, including changes to the specification and sample assessment material.

These notes can be given to students before a lesson, to allow them to read ahead in preparation, or after a lesson, as a revision tool to strengthen and build on current knowledge, or students and teachers can work through the resource in class to complement lessons. The Course Companion largely follows the syllabus but some parts have been reordered to follow a logical route that allows students to build on their understanding. However, because the resource has been written and structured to each specification topic, the notes can easily be reordered and distributed as and when the teacher wishes.

At the beginning of every section is a list of content that the students will cover. This is designed to prepare them for the lessons that follow, and it can also be used as a checklist, either after learning the section or during revision, to remind students of the content they have studied and ensure they have learnt the points on the specification. Review questions and exam-style questions are provided at the end of each section; these consolidate and develop students' learning. Answers can be found at the end of the resource. Also, towards the end of the resource there is an 'Exam Tips' section, which explains how each of the AQA Economics papers works and gives some general exam advice.

Each specification point has complete notes with all the relevant diagrams clearly explained and examples given where possible to help students relate their theoretical knowledge to real-life situations. Any key terms are defined either at the beginning of a topic or in key-term boxes throughout.

For all links go to **zzed.uk/8162**

4.2.1: The Measureme
Macroeconomic Perfor

By the end of this topic, you should understo
- ✓ **The main uses of national income / GDP d**
  - The limitations of these meas
  - mparing between countries

Uses of national income data

In Year 1, macroeconomics, one of the first economic indicators you will have lea
the total value of goods and services produced in an economy in a given time pe
to **national income**.

GDP is a useful way of comparing the growth of an economy over time as well as
economies. Using real GDP rather than nominal GDP facilitates comparisons of G
distortionary effect of inflation on GDP figures such that real GDP captures only '
growth. It is also useful in comparing GDP between countries. Imagine that one
79.8 billion % in one year (like Zimbabwe in 2008), while another country's price
mistake comparing *nominal* GDP for these countries because nominal GDP would
value brought about by inflation.

Another way that national income can be us
for population size (GDP per capita
of the population in a certai
to the conclusi
the average
The table below shows the ten richest economies in the world (using 2015 data)
per capita (in nominal terms):

Economy	GDP ($ trillion)	Economy
1. USA	17.4	1. Luxembourg
2. China	10.4	2. Norway
3. Japan	4.6	3. Qatar
4. Germany	3.9	4. Macao (part of C
5. UK	3.0	5. Switzerland
6. France	2.8	6. Australia
7. Brazil	2.4	7. Denmark
8. Italy	2.1	8. Sweden
9. India	2.0	9. Singapore
10. Russia	1.	10. USA

Source: **http://data.world**
icator/NY.GDP.PCAP.CD

How well d
measures accurately capture living standards? Critics would a
only a crude comparison of living standards between countries, and that many m
account before we can draw any concrete insights from the data.

Adjusting for costs of living

One important adjustment that can be made is to account for the cost of living in from the UK to, say, India, you would find that your money (once converted from lot more in India than it could in the UK– your purchasing power is greater. On th Norway where the cost of living is very high, your pounds wouldn't go as far.

So, when GDP figures are adjusted for this, the gap in living standards between m countries is not so large. The next table shows the actual rankings for countries living standards:

Economy	GDP, PPP ($ trillion)
1. China	18.0
2. USA	17.4
3. India	7.4
4. Japan	4.7
5. Germany	3.8
6. Russia	3.4
7. Brazil	3.3
8. Indonesia	2.7
9. France	2.6
10. UK	2.6

Note that China shoots to the top of the list, since the cost of living there is relati

This method of adjusting for living standards is based on the concept of **purchasi** 'parity' means being equal, so once GDP is PPP adjusted, the purchasing power of

For example: *suppose Country A's GDP is $[illegible] billion, and Country B's GDP is $80 information alone, we would assume that Country A was richer. However, suppo family in Country A costs $100 in Country A, but only $50 in Country B. If all the c then Country B's adjusted PPP GDP would be $160 billion. Note: when statistician information on the costs of all kinds of different goods and weight them by their r for different exchange rates – a tricky calculation!*

This method isn't perfect; for example it has trouble accounting for differences in countries.

Other considerations

Even if we perfectly capture the differences in the cost of living between two cou measure of living standards. Here are some further limitations of GDP:

- **Does not account for inequality**. GDP per capita gives no indication of ho countries could have the same GDP per capita, but be very different. For have very similar GDP per capita levels, but Mexico is far more unequal th Even if a society experiences rapid economic growth, there is no guarante the population: the benefits could accrue to a small minority.
- **Does not account for happiness**. Does having more stuff make us happie invest in, say, a new motorway, or creating new, faster smartphones. It preserve areas of natural beauty or fund community centres, yet some pe sorts of things make us happier as a society.
  Economists tend to shy away from studying happiness because it is so diff Nevertheless, in the UK the ONS (Office for National Statistics) has started being' indicators, which account for factors such as our activities, health, relationships: factors that are all missed when looking at GDP alone.

Review questions: The measurement of macroec

1. According to the World Bank, in 2014 Indonesia's GDP was $890bn and th
   Does this mean that Indonesians are richer than people from the Netherl
2. Suppose that the market exchange rate between the US dollar and the In
   economist knows that living costs are lower in India and adjusts the excha
   power parity. Therefore:
   A The PPP exchange rate will be the s m as ore
   B The PPP exchange rate wi h than the market exchange rate (
   C The PPP exchang e wi be lower than the market exchange rate (i
   D The PPP e cannot be calculated
3. Rea llo ing article from the Economist, and write a short paragrap
   the n eas:
   http://www.economist.com/news/briefing/21697845-gross-domestic-p
   measure-prosperity-it-not-even

4.2.2: How the Macroecono

By the end of this topic, you should understand...

- ✓ **The relationship between the marginal propensity to consume and the n**
- ✓ **The Keynesian long-run aggregate supply cur**

Aggreg d and the level of economic ac

In Year 1 economics, we introduced the idea of the multiplier. This is the idea that injections into the circular flow of income have a greater than proportional effect on aggregate demand. For example, if the government invests £100m in a new infrastructure project, AD increases by an initial £100m, but then the workers who are employed spend their wages, increasing AD further. Those who receive the workers' spending increase their expenditure, and so on until withdrawals remove the effect of the initial injection. If the eventual increase in AD is, say, £500m, then the multiplier is 5.

The marginal propensity to consume

An important factor that determines the size of the multiplier is the marginal pro proportion of any new income received that is spent by consumers. For example, £1000, of which £800 is spent, then the marginal propensity to consume is 0.8 (a

The higher the marginal propensity to consume, the higher the multiplier effect considered a withdrawal from the circular flow, and a higher MPC means lower r formula for calculating the multiplier from the MPC:

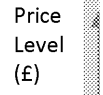
Multiplier = 1 / (1 – MPC)

So if the MPC was 0.8, then the multiplier would be 1 / (1 – 0.8) = 1 / 0.2 = 5.

Different consumers will have different MPC values. Lower-income consumers t income, so their MPC will be high, whereas higher income consumers tend to sav income. Different countries have different MPC values as well. China has specta average MPC is relatively low.

Determinants of long-run aggregate supply

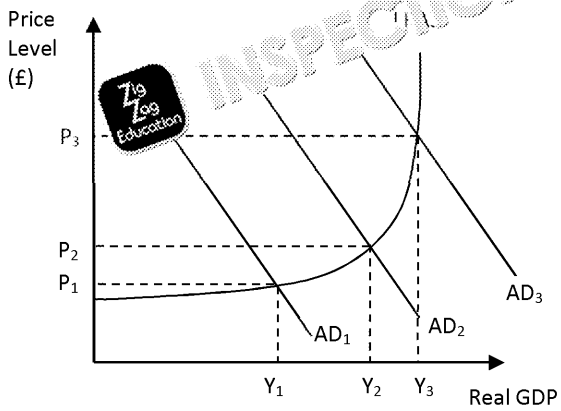
In Year 1, the long-run aggregate supply (LRAS) curve was introduced as being vertical. Here we introduce another interpretation, the Keynesian LRAS:



The Keynesian LRAS is shaped such that the vertical portion of the LRAS only occurs at high levels of real GDP, i.e. when the economy is operating at full capacity. Before this, aggregate supply increases gradually with the price level. Increases in output are possible on this part of the curve since some resources are not being used (e.g. some people are unemployed).

The Keynesian LRAS curve might shift for the same reasons as the vertical (classical) LRAS. A shift to the right might be caused, for example, by an improvement in productivity (perhaps through a better educated or a healthier workforce), immigration, or a technological breakthrough.

The diagram shows an example below of how the Keynesian LRAS interacts with aggregate demand:



An increase in demand from AD_1 to AD_2 leads to a large increase in output and o level, since there is still plenty of spare capacity in the economy. However, wher is significant inflation (this is a case of **demand-pull** inflation; **cost-push** inflation left in LRAS). Note that inflation could be avoided if LRAS were also to shift to th

The importance of institutions

Another important determina of LR is the strength of 'institutions' in an eco government. Economies with strong and trustworthy financial/banking sectors t individuals and businesses are likely to have a higher productive capacity (LRAS f

The importance of institutions is an important theme in development economics, economies become more developed. Many development economists argue that economic growth potential of economies (and economic growth tends to be link an effective banking sector, another example of a strong institution would be a g good of society, rather than 'extracting' resources from society.

Review questions: How the macroeconomy wor

1. Suppose that £5m is injected into the economy by the government. For e
   households spend 40p and save 60p. Calculate:
   (a) The value of the multiplier
   (b) The total increase in income in the economy.
2. Show the effect of an increase in aggregate de u ng:
   (a) a classical LRAS curve
   (b) a Keynesian LRAS curve
3. Decide whether each o e fo wing scenarios in the UK would lead to a
   (also state the d on of the shift):
   (a) ea in immigration.
   (b) A education spending.
   (c) A rise in the world price of oil. (Note: the UK is a net importer of oil)
   (d) A cut in VAT.

4.2.3: Economic Perfor

By the end of this topic, you should understand...

- ✓ **The causes and consequences of the economic cycle**
- ✓ **Different types of unemployment**
  - Voluntary/involuntary unemployme t, eal- ge unemployment, the n
- ✓ **Fisher's equation of exchange a uantity Theory of Money**
  - More detailed asp t of n on
- ✓ **Conflicts betwe n a conomic policy objectives**
  - la Phillips curve in the short-run and long-run

Economic growth and the economic cycle

Economic growth, as measured by the rate of change in GDP, is one of the key in this section we evaluate the importance of economic growth and discuss the ecc introduced in Year 1 macro) in more depth.

Costs and benefits of economic growth

Economic growth has some clear benefits, including:

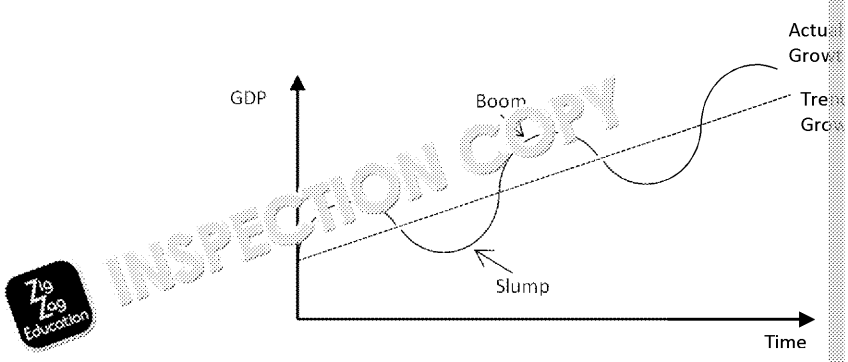
- **Higher living standards** (at least on average)
- **More job opportunities** (economic growth usually opens up new possibi
- **More room for investment or research and development** (this should in potential of the economy)

However, there are some drawbacks to e c growth in certain situations

- **Inflation** – inflation can b e for an economy in many ways (see
- **Inequality** – the e economic growth could be unevenly distribut ma p ety benefit very little from economic growth
- **Env ental damage** – this depends on how economic growth is achie that nomic growth and development often comes at the expense of t
- **Economic growth can be unsustainable** – before the 2008 Financial Crisi performing very strongly. Many people seemed to expect economic gro so when the crash came it hit the economy very hard. Some commentat explosive economic growth over the last few decades is unsustainable as

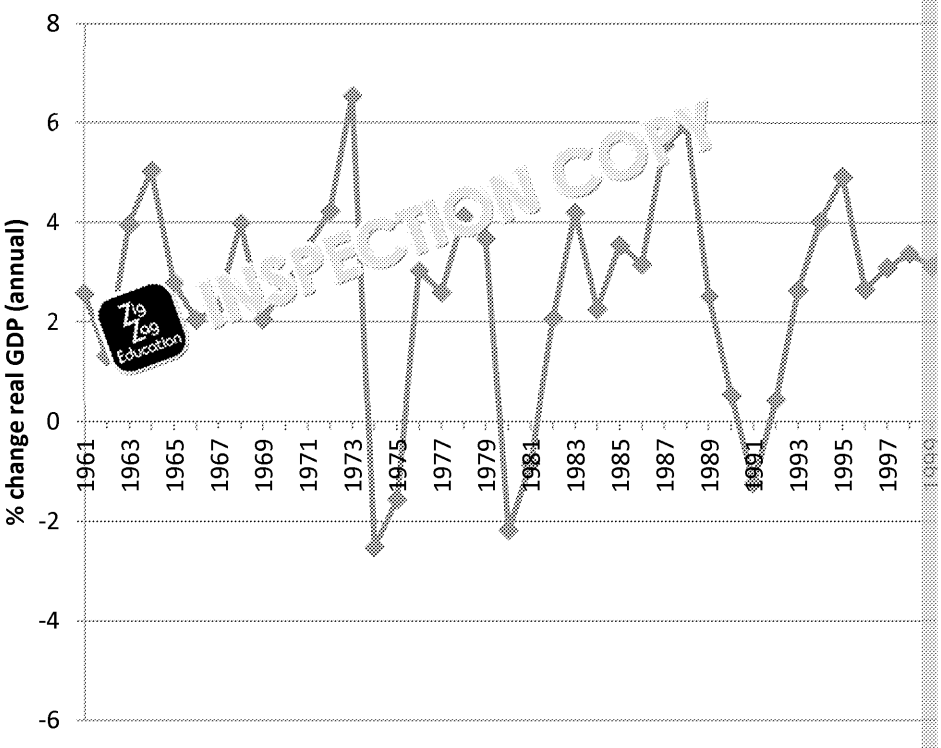
The economic cycle

This topic should be familiar from Year 1 macro – the standard economic cycle di



The diagram shows the observed pattern of economic growth in most economie economic growth is followed by a slowdown and then a slump, where economic g negative. The economy then picks up again, and the cycle continues.

In reality, the pattern often isn't as neat as the diagram above. Here's the UK's r



Source: World Bank

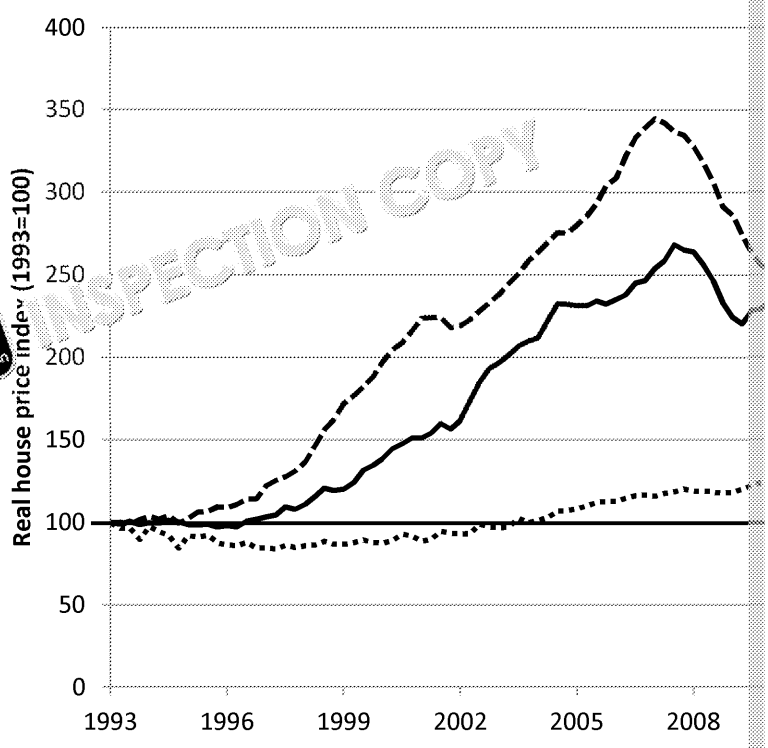
The average rate of growth over this period is around 2.5% a year, but this varies cycle.

Causes of the economic cycle

Economists have struggled to pinpoint the exact causes of economic cycles, but there are several factors that are suspected to have a role in creating the 'booms and busts':

- **Government policy** – in terms of monetary policy, if the economy is performing strongly and inflation is going up, then the central bank might choose to raise interest rates, dampening economic growth and contributing to a slowdown. In terms of fiscal policy, a government could engineer a boom by increasing government spending, which could cause a boom via the multiplier effect. Note that government policy can also counteract the economic cycle, particularly through *automatic stabilisers*.
- **Consumers/business confidence** – if confidence is low in the economy, a happen, e.g. if people believe a pessimistic forecast for economic growth spending/investment, causing the slump (a self-fulfilling prophecy). On t optimistic, they might increase their borrowing/spending/investment, ca likely to extend credit in boom times as well, enabling economic growth t conversely, banks are likely to restrict credit in slumps).
- **External factors** – as well as domestic changes to demand and supply, in a per[illegible]ce of other economies has an important effect on the domest trading partners were to enter a recession, for example, then UK exports in the UK and potentially triggering a slump.
- **Bubbles in different markets, e.g. housing** – markets for assets such as h the market feels confident then the price of these assets rises, contribut However, eventually market confidence collapses and prices plummet, c

example of this is the housing market in Ireland, which collapsed spectac
(see graph below).



Ireland's housing bubble. Source: *The Economist* h

Employment and unemployment

Having a strong employment rate is a top priority for most economies – unemplo
both society and affected individuals.

Voluntary and involuntary unemployment

Voluntary unemployment is when someone could be in work, but chooses not to
usually in the hope of finding a better job, or perhaps if the wage rate were temp

Involuntary unemployment is when someone is actively seeking a job but cannot find one, perhaps because the labour market is particularly competitive or because the individual lacks job skills.

The distinction between these two types of unemployment is important historically in economics. Classical economists believed that only voluntary unemployment was possible: involuntary unemployment would be eliminated by market forces.

When the Great Depression started, the classical solution to unemployment was to lower wages, since they viewed it as a case of wages being above equilibrium (so that there was an excess of supply over demand for labour). This was **real-wage unemployment**. However, Keynes argued that the real problem was a lack of aggregate demand in the economy (so that cutting wage rates would reduce aggregate demand further less disposable income). The real cause of unemployment was probably 'demand known as cyclical unemployment).

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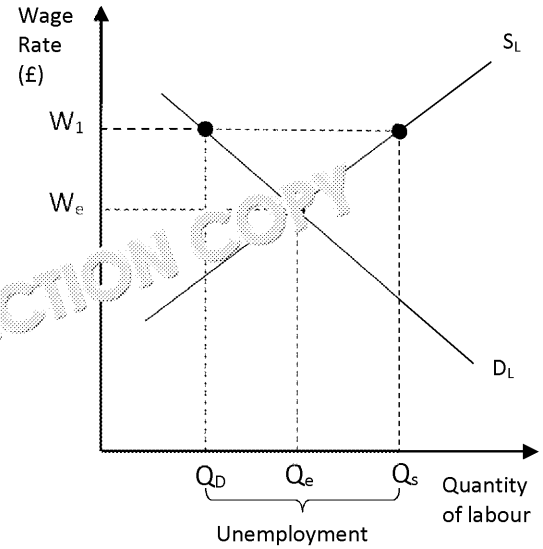
The classical view of unemployment ('real wage unemployment') is shown below



If the wage rate is above the market equilibrium at W_1, then there is an excess of causing unemployment of Q_D to Q_S. According to classical economists, free marke reduce the wage rate back to W_e. Then the only type of unemployment left wou people who could work for the wage of W_e but prefer not to. Classical economist unemployment in the Great Depression by arguing that wages were stuck at a hig deliberately by the government.

The natural rate of unemployment

The natural rate of unemployment is the level of unemployment that would exist market is in equilibrium. Any attempts to decrease unemployment below this le economy will gravitate towards this level in the long run. The difference betwee wage level and those who are willing and able to work is the natural rate of unem includes frictional and structural unemployment – those who want a job at the cu working but they are waiting for another job to start or do not have matchin

Inflation will increase if unemployment is less than its natural rate. Equally, infla unemployment is greater than its natural rate. For this reason the natural rate of called the non-accelerating inflation rate of unemployment.

The consequences of unemployment

Unemployment is almost universally negative for individuals and the economy. S unemployment on different parts of the economy are listed below:

Workers

- Unemployed workers are not receiving an income and will find they are le services.
- Workers out of work will find their human capital falling as their skills be
- Those who are unemployed for a long period of time will find it harder to
- Claiming unemployment benefits has a stigma attached to it. Unemploye self-esteem and lead to levels of depression.

Firms

- Falling incomes and falling spending by consumers will mean firms will su goods.
- However, if firms did want to increase supply there would be a pool of u would flatten their supply curves (make supply more elastic), so long as u necessary skills

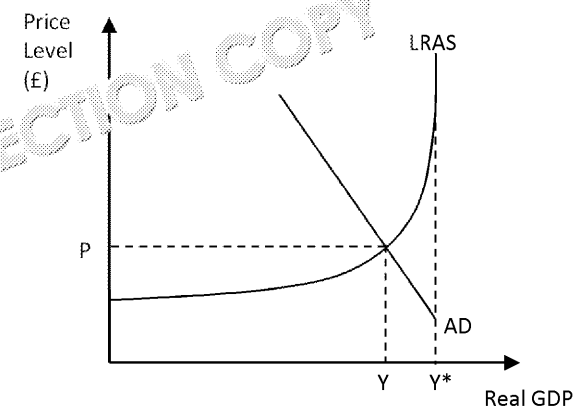
The government

- Higher levels of unemployment mean there are more people claiming Jo
  government spending will increase.
- Lower employment means fewer people are receiving an income and the
  revenue from incomes and national insurance, for example.
- Falling incomes and falling consumption mean the government will recei
  goods and services.
- Falling tax revenue and increased govern ment spending will mean the go
  expenditure deficit, which may l ad to higher levels of national debt.

The economy and soci

- Hig p ment can cause people to lose confidence in the economy
- Falli mes mean living standards will fall.
- Because government spending is made possible by the collection of taxes,
  spending on benefits is likely to be followed by higher taxes in the future
- Higher levels of national debt are likely to cause higher taxes.
- Research has found that higher levels of unemployment can lead to incre
- Communities can become run down if there are high levels of unemploym
  incomes can cause both the closure of local shops and a fall in living stand
- Higher levels of unemployment can increase inequality and strengthen a
  as those without jobs lose their incomes and potentially fall into poverty
- On the other hand, it does mean the cost of production for firms is relati
  work for lower wages.

Unemployment on the AD/AS diagram



If the economy were operating at full employment, output would be at Y*. How
unemployment due to cyclical unemployment, AD is weak so output is only at Y.
gap between Y and Y*.

The effects of unemployment can also be shown on the LRAS curve: if a spell of h
skills and motivation of the workforce then LRAS is likely t s ft inwards, reducin
of the economy. Spain and Italy are both experie cin c nic youth unemploym
could well fit into this category. Indeed, l ing Italian and Spanish workers
of better job prospects.

Inflation and deflation

Inflation is an important economic phenomenon with several implications for so
increase in the price level and can be caused by demand-pull or cost-push factor
describe a fall in the rate of inflation (not to be confused with deflation! , e.g. de
of -2%, disinflation would be a fall in the rate from, say, 5% to 3%).

Most economists agree that a low and stable rate of inflation is desirable. The B
inflation per year, allowing 1% either way. In recent years it has missed this targe
almost negative). A low rate of inflation encourages people to spend money, sinc
will slowly diminish in value over time. When people spend money, AD is high an
However, inflation can be a problem if it is too high or negative for a sustained p

Equally deflation creates winners and losers. Deflation increases the value of mo
value of their savings rise while borrowers will lose out. More importantly, the re
country rises.

Consequences of inflation

Redistribution of income – inflation creates winners and losers. If you've just bo
inflation is good for you. For example, suppose you borrowed £100, and had to p
in a year's time. If inflation was high (say, 10%) then £120 would be worth less t
of your borrowing has fallen in real terms.
On the other hand, inflation is bad for lenders, since the value of their repayment
savers: if you store £1000 in a bank with a 2% annual interest rate, then if inflatio
real value of your deposit will fall!

Uncertainty – inflation makes it difficult to predict the costs of future transaction
in case your money loses value, or should you save more, in case the economy st
is generally bad for an economy since it discourages economic activity, potentially

Menu and shoe-leather costs – menu costs refer to the hassle firms face when experiencing high inflation – they have to update their prices more regularly, which takes time and effort. Menu costs increase with the level of inflation – in countries experiencing hyperinflation (e.g. Zimbabwe in 2015), it becomes almost impossible for firms to keep up with changing prices.

Shoe-leather costs refer to the difficulty that consumers face in comparing prices when inflation is high. The 'shoe-leather' name comes from all the walking consumers would have to do between different shops to work out the prices of goods!

People on fixed incomes lose out – most workers' wages rise in line with inflation, but some people are on fixed incomes. These people will lose out if inflation hits, since the real value of their incomes will fall. The same applies to those with fixed-rate investments, e.g. a savings account offering a fixed interest rate that does not change with inflation.

Fall in international competitiveness – this is linked to, but not caused by, inflation to rising costs of production (e.g. raw materials, wages). Higher costs of production competitive.

In the short run, high inflation might reduce exports since goods appear relatively country experiencing inflation is likely to experience a fall in its exchange rate, of exchange rate may be because inflation is seen as a sign of economic weakness, a fall.

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Consequences of deflation

High inflation can be ruinous for an economy, but some economists fear deflatio struggled on and off with deflation since the 1990s. The problem with deflation i to stop spending. If the value of money will be higher in the future, why spend n wait until prices fall. If everyone in the economy thinks this way, then consumer reducing AD (since consumption is the biggest component of AD) and potentially Economists sometimes refer to this as a 'deflationary spiral'. Deflation can also b increases the *real* value of an economy's national debt burden. However, there i If a country's prices are falling relative to other countries, that country's exports become m international markets, and so there could be an increase in exports.

The role of expectations of inflation

In the section on the economic cycle, we noted that booms and recessions can b people's expectations of the future. The same can happen with inflation.

For example, one of the important factors that contributes to the overall inflatio go up. If wages increase a lot, inflation will rise. So if workers suspect that inflati will demand that their employers increase their wages (to stop them losing spend goes up (assuming that employers agree!) and so does inflation, as a result of the

This analysis is clearly a simplification: not everyone in society pays close attentio central bank, which is responsible for controlling inflation, considers it an importa of inflation. If people have confidence that the central bank will be able to keep more likely that inflation will be under control, since businesses won't raise their demand higher wages (both of which create inflation).

The quantity theory of money

During the financial crisis, many large economies including the UK increased the su via 'quantitative easing' (QE), where the central bank creates electronic assets in a economy (this is discussed more in the financial markets and monetary policy sect that increasing the supply of money could cause inflation – this view is based on th

The theory is that an increase in the money supply directly increases the price lev closely associated with the economic school of *monetarism*. Monetarists empha money supply in influencing the economy. They argue that increasing the money the long run, but can increase output in the short run.

Fisher's equation of exchange

We can help describe the quantity theory of money by looking at Fisher's equatio

$$MV = PQ$$

Where M = money supply
V = 'velocity of circulation' (the number of times money changes hands over time)
P = the price level
Q = quantity of goods and services traded

PQ is nominal national income since it is price times quantity of output).

Note that this equation is true by definition: it is an 'accounting identity'.

For the quantity theory of money to hold, any increase in M must increase P by th true, V and Q must be constant. Supporters of the theory would argue that Q is a assumed to be in equilibrium), and V is likely to be constant in the short term as w

Critics of the theory argue the V in particular is unlikely to be constant, as it depe
and business confidence. If market confidence is low, the velocity of transaction
be increased without causing a rise in P. In light of the financial crisis, where vast
did not lead to an obvious rise in inflation (and there was a fall in lending), this vi

In the 1970s, however, when inflation was very high in the US and the UK, it turn
supply was a successful way of curbing inflation.

Further Y… …omic Knowledge...

…tarism

…netarism is an important school of thought in economic history.
monetarism from the IMF:
http://www.imf.org/external/pubs/ft/fandd/2014/03/basics.htm
(Note: the content here is much more detailed than is required for y

Possible conflicts between macroeconomic polic

In Year 1 macro you should have looked at output gaps. Negative output gaps ar
below full capacity – there is likely to be unemployment, but on the plus side infl
occur when the economy is operating temporarily above its maximum capacity (
overtime). So unemployment is low, but inflation is likely to be high.

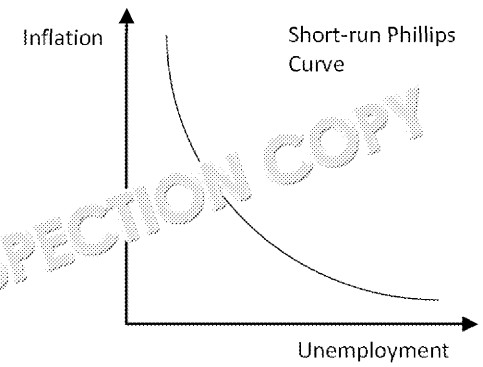
This suggests that there is a trade-off betwee… in…ati… …nd unemployment – ide
and low unemployment, but the scen… …s…t… suggest we can't have both.

The short-run P…… curve

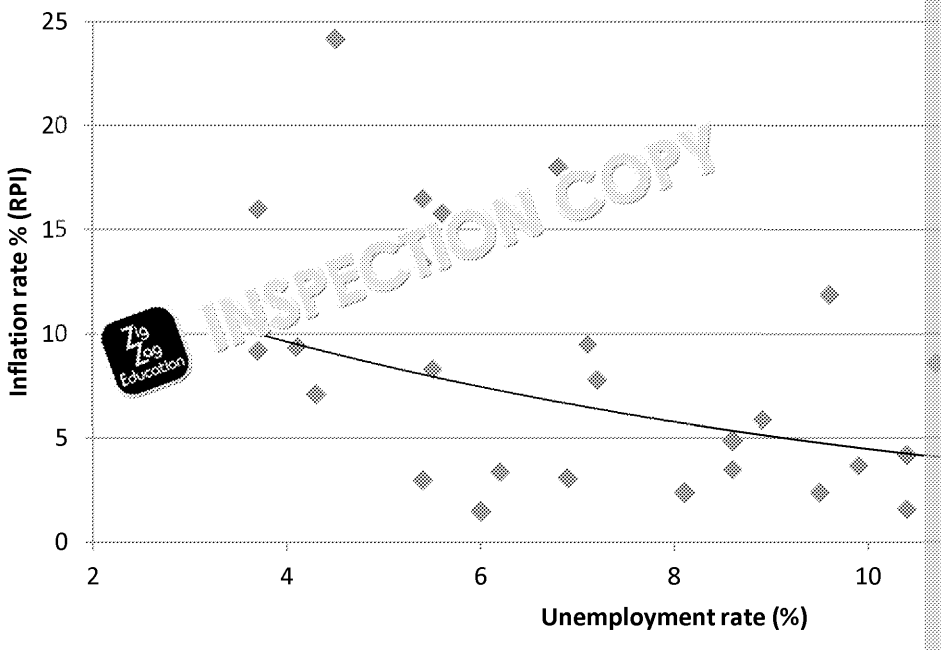
The New Ze… …conomist William Phillips suggested that the relationship betw
unemploym… …ould be plotted as a curve. The diagram below shows this 'Phill

How can we explain the shape of this curve? When the economy is performing v
high, firms can afford to lower wages, which reduces inflation. Conversely, wher
strongly and unemployment is low, firms need to raise wages to attract more wo

Empirical data on this isn't hugely supportive of this relationship; here's an exam
unemployment and wages from the UK:



UK Inflation and Unemployment



Source: ONS. Note: each dot represents one year.

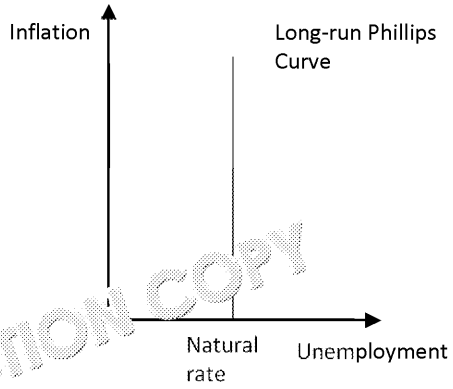
The relationship certainly isn't as neat as the short-run Phillips curve suggests. A
relationship pretty much disappears for the UK: one possible reason is that the B
inflation targeting when it became independent in the late 1990s.

The relationship also broke down in the 1970s when US and UK economies w
'stagflation' – high inflation and high unemployment (due to a combination of hi
left, and poor economic polici[illegible] such as inflationary increases in the money sup

The weak e[illegible]al evidence for the short-run Phillips curve has led most econom
of the econ[illegible]ver time, these doubts led to the development of the long-run

The long-run Phillips curve

In the long run, economists reckon that inflation and unemployment are unrelate
towards a 'natural' rate of unemployment. Therefore, the long-run Phillips curve



Here's anot[illegible]ol[illegible]n for the shape of the long-run Phillips curve: suppose t
reduce une[illegible]ment and they undertook expansionary fiscal policy. Then une
inflation would rise (since aggregate demand has increased). The shift in AD mea
they are earning higher wages. However, once inflation kicks in they realise that t
increased in real terms, so they reduce their efforts and unemployment returns t
government policy 'surprises' workers into working harder, but only in the short
and returns the economy to the natural rate of unemployment.

Policy implications

The Phillips curves do provide some important lessons for governments and polic
be aware that trying to push unemployment down too far can cause inflation. Si
inflation can cause undesirably high unemployment. Essentially, policy-makers h
the equilibrium, as it could make matters worse.

Another important implication is that if fiscal and monetary policy cannot reduce
inflation, then a better strategy might be to try to reduce the natural rate of une
achieved by reducing frictions in the mar[illegible]ch as geographical immobility, or
workforce via better education.

Note: The Phillips curve topic is one of the most technical topics you have to deal with
exam questions on this topic are likely to be quite basic. Make sure you have a good und
are shaped the way they are, but don't spend too long trying to work out all the nuances

Review questions: Economic performance

1. Explain the difference between a slump and a recession in the economic
2. Explain two potential causes of the economic cycle.
3. (a) If unemployment benefits are very high, is this likely to lead to volu unemployment?
   (b) How about if there is a lack of aggregate in the economy?
4. (a) State Fisher's equation of exchange
   (b) Which term in this equation is related to the inflation rate?
   (c) Suppose that the velocity of exchange is constant, and that the mon equation implies the implications of this.
5. Explain why there might be an inverse relationship between inflation and

Exam-style questions: economic performance

1. Automatic stabilisers are:
   A increases in infrastructure spending during booms and falls in infrastru
   B the tendency for the interest rate to rise in booms and fall in slumps
   C changes in the (X-M) component of AD in booms and slumps
   D mechanical changes in government spending and tax revenue through
2. Real-wage unemployment occurs when:
   A there is no voluntary unemployment
   B the wage rate is above the market equilibrium
   C inflation reduces the value of real wages
   D the wage rate is below the market equilibrium
3. Expectations of high future inflation are likely to lead to inflation becaus
   A Workers might ask for higher wa
   B Businesses might increase prices
   C Consumers might increase their spending
   D All of the above
4. The long run Phillips curve shows:
   A no relationship between inflation and unemployment
   B an inverse relationship between inflation and unemployment
   C a negative relationship between the interest rate and investment
   D a positive relationship between the interest rate and unemployment
5. Explain how a government might try to tackle the trade-off between infla

4.2.4: Financial Markets and Mo

By the end of this topic, you should understand...

- ✓ **The nature of money**
- ✓ **The role of financial markets**
  - Prices and yields of government bonds
- ✓ **The difference between commercial banks and investment banks**
  - The role and objectives of banks
- ✓ **The functions of central banks**
  - The monetary policy transmission mechanism
- ✓ **How the financial system is regulated**

The structure of financial markets and financial

Introduction

This chapter should provide you with a good working knowledge of financial mar the world of finance can be difficult to understand, with all sorts of bizarre jargon Nevertheless, given how important it is in the modern world (particularly in the U your head round it. Most other A Level Economics exam boards do not cover this

The characteristics and function of money

What is money? Economists typically describe the functions of money as:

- A medium of exchange (enabling people to trade goods and services)
- A store of value (enabling people to save up for future purchases, e.g. in t
- A unit of account (providing an easy way to compare the costs of differen

The history of money is very interesting; the earliest civilisations probably operat one person traded their goods for another person's goods. This is much less effi since it requires a 'double coincidence of wants' (i.e. you both need to want wha problem is avoided with money). More modern examples of barter economies e war camps, where soldiers might use cigarettes as a currency.

As early as the Ancient Egyptians, precious metals have been used as a form of m because they are difficult to forge, and unless a new supply is suddenly discovere value. In fact, until the 1930s many economies including the US and the UK linke gold reserves: a note could always be exchanged for a given amount of gold, to g

Nowadays we have abandoned the gold standard and our money is a so called 'fiat currency', i.e. it has no intrinsic value (you can't do much that's practical with a £5 note!), but it took a long time befo re was enough trust in the system to allow this to happen. Even now, governments hoard large stockpiles of gold. The UK central bank holds 5,500 tonnes of gold, worth around $235 billion (although most of it is owned by foreign governments tonnes are held in a vault in the Federal Reserve Bank of New York. China has be as well in re ea

Nevertheless, despite the dominance of gold throughout history, now paper mon bank deposits!). In our modern economy, banks are the main suppliers of money is effectively the 'bank' to other banks. The central bank is often considered to b

The money supply

We introduced the idea of the money supply in the section on the quantity theory that the supply of money is changed is by printing more notes or minting more co England is responsible for making sure that the supply of paper money/coins is s transactions in the economy. This type of money is known as **narrow money**, and money (i.e. it can be used immediately for transactions). However, this only con money supply.

Broad money includes both narrow money and bank deposits. Bank deposits are always be used for immediate transactions.

In simple terms, money is supplied in three main ways. These are:

- Printing more notes / minting more coins
- Banks loaning money to individuals/businesses
- The central bank conducts **open market operations**

Following the financial crisis, quantitative easing has also become a way of increa covered in the section on central banks and monetary policy.

Further Your Economic Knowledge...

Open market operations
(Note: you don't need to know this for your exam!)

Conducting open market operations is a central bank's bread-and-bu money supply. Open market operations when a central bank buys (government debt, or bonds is explained in more detail later in this s

Suppose the central bank decided to buy up a large amount of gove people who originally held this debt get cash in exchange – so th

On the other hand if the central bank decides to sell government de for it with money. Therefore, the money supply in the economy fall

The central bank wishes to keep the money supply at an appropriate transactions to take place (and to encourage bank lending, within re the market with money and create inflation.

Money markets, capital markets and foreign exchange (FOR

Financial markets can be divided into many different sub-markets. Three of the introduced here.

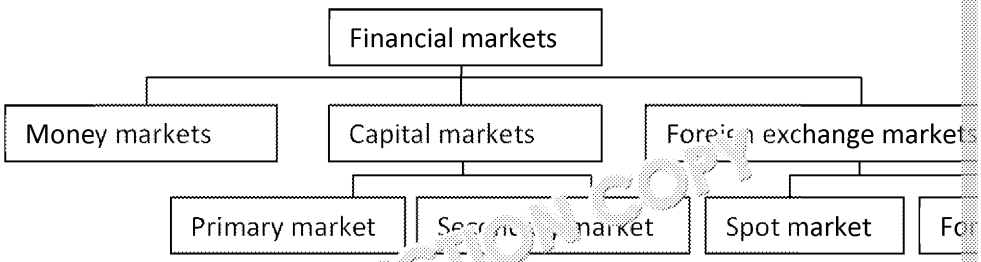
The money markets

The money market refers to the market for short-term finance. This could be len of money (e.g. via a bank or a payday lender), short-term borrowing by the gove a variety of 'maturities' (e.g. you could buy a government bond that pays ba several years) borrowing by firms and banks.

The capital markets
The capital market has the same purpose as the money market, but it applies to medium and long-term finance. Government bonds with long maturity dates would fit into this market, as would the stock market. It would also apply to wealthy individuals looking for profitable, long-term investment opportunities.

The foreign exchange market
This is the market for different currencies, like pounds, euros and US dollars. The exchange rate between currencies fluctuates on a regular basis, so there's an opportunity for canny traders to make money by exploiting changes in exchange rates. For example, if the exchange rate started at £1 = $1.50, then changed to £1 = $1.25, then an investor who successfully predicted this would have sold pounds at the original exchange rate, then bought them at the lower rate – turning a profit.

The FOREX market is also important to firms that import and export goods. There is a risk to firms that trade in this way that the exchange rate will change unfavourably, so they often agree to trade at a particular exchange rate in advance of the actual transaction (this is known as a forward market, as opposed to the spot market, which is instantaneous).



These markets are all important features of the modern economy. Without financial markets, economies would not grow, individuals and firms would not be able to borrow to buy large assets such as houses, and governments would not be able to borrow to fund current expenditure. So in principle, allowing these markets to develop is a good thing, but the financial crisis of 2008 showed that too much lending can be destructive. Economists refer to this problem as banks being too highly 'leveraged', meaning that the value of their assets is too high relative to that of their reserve funds (which is obviously very risky!).

Debt vs equity

Debt and equity are two different types of finance. A common dilemma for firms is whether to raise finance via debt or via equity.

A firm could get a loan to finance their spending today: this would be an example of debt finance, with the borrower receiving a loan on which interest must be paid. For example, when the government issues bonds, this is a type of debt, since the bond buyer receives interest. Consumers may also take out loans, which is another form of debt. In fact, when we deposit our savings in banks, they are effectively borrowing from us, in return for a (usually small) rate of interest on our deposits.

On the other hand, equity involves the firm receiving a stake in the business. The stock market is an example of an equity market rather than a debt market: people who buy shares aren't paid interest, but instead their stake changes in value and they receive a share of the firms' profits (dividends).

Equity is sometimes used as a bit of a catch-all term in finance, for example people might refer to the equity they have in their house, which is how much ownership they have in the house (market value minus the outstanding mortgage). Just remember that in finance, the term equity implies ownership, or having a stake in something.

Going back to firms, their main source of debt finance would be borrowing from banks, and their main source of equity finance would be

Government bonds

We all know that the government is concerned about its budget deficit and the U
where does the UK borrow all this money from? The main answer is the governm

A government bond works just like any other kind of loan, when you buy a UK go
you loan the government a certain amount of money (say £1,000), and every six
an interest payment to you. The 'principal' (or initial amount you gave them) is
'matures' (i.e. when the loan expires, this could be after a few months or several

If you were shopping for a new government bond, you would look at the 'coupon
coupon rate is the annual rate of interest the bond generates, for example 5%. So
coupon rate would receive £50 a year in interest (or £25 every six months in
maturity dates tend to offer higher coupon rates, so investors who are willing to
return on their investment.

Like most other financial products, there is a secondary market for government b
government bond that is halfway through its lifespan, for example. Here's where
bond comes in.

Suppose you bought a £1,000, 10-year bond with a 5% coupon rate. Then suppos
the coupon rate depends on) suddenly fell, so that any new government bonds o
bond becomes relatively valuable: someone might offer to pay more than £1,000
£1,100, then we would say that the **yield** on the bond is now less than 5%.

QUANTITATIVE SKILLS

Calculating bond yields

The bond yield is calculated by the annual amount of interest paid (as given by the
the price of the bond.

The yield of a bond is what many investors consider before buying a bond on the sec
more informative than the coupon rate.

The original yield when the bond was issued was simply 5% – the coupon rate. B
has gone up, the yield (its value to an investor) has gone down to £50 / £1100 = 4

If, on the other hand, market interest rates went up, then your 5% bond would b
sell it for £900. In that case, its yield would be £50 / £900 = 5.56%.

Therefore **there is an inverse relationship between market interest rates and b**

Some bonds are automatically adjusted for inflation and some are not, investors
want to risk inflation eroding the value of their interest payments or not (high in
this case the government).

Commercial banks and investment banks

A **commercial bank** is the type of high street bank where you deposit your savings commercial banks are responsible for accepting deposits (usually paying low interest (usually for slightly higher interest rates). However, it would be wrong to think that deposits to extend loans (although this is would seem like common sense). In reality, when banks lend money they create a deposit for the person they lend to. If someone borrows £10,000 from a commercial bank, they aren't given £10,000 in cash; instead they are credited with £10,000 in a bank account. So the bank doesn't need to have that money from an existing deposit, effectively they create new money.

Commercial banks also offer other financial services such as providing foreign currencies and processing payments.

Investment banks are very different from commercial banks, although often the same firm will have both commercial and investment divisions (e.g. Barclays and Barclays Capital). Investment banks offer a much wider range of financial services to all sorts of clients. The City of London is a major global activity.

For example, an investment bank might advise two firms considering a merger or considering whether or not to issue shares. Investment banks also trade in the financial market (money, capital and FOREX), either in their own interest or on the behalf of their expertise. Some aspects of this type of complex.

> ***A film about economics and finance?!***
> *If you haven't seen it yet, watch* ***The Big Short****, a film about the financial crisis of 2008 based on Michael Lewis' book.*

After the financial crisis, regulators have been looking to 'break up' investment and commercial banks to prevent the investment side from hurting the commercial side. Some progress has already been made towards ensuring that this is the case (the Vickers Report led the way on this), but

The objectives of commercial banks

Commercial banks are ultimately out to make profit, just like most other firms. They do this by loaning money out and earning the interest. The higher the interest rate, the more they earn. However, there's always a risk that borrowers will be unable to make their payments. If too much of a bank's loans end up being defaulted on, it could go bankrupt. As such, one of the key objectives of commercial banks is to look after their **liquidity**.

A liquid asset is an asset that can be used for payment immediately. It is important to have liquid assets (*or reserves*) in case of an emergency. Loans to individuals and firms are considered illiquid because they cannot be retrieved immediately. Since liquid assets tend to generate less interest, banks must balance between liquid and illiquid assets.

One of the key causes of the financial crisis was that banks were making riskier and riskier loans for higher returns, often without appreciating how risky they actually were, and with very little liquid reserves. Clever financial innovations such as 'collateralised debt obligations' (CDOs) made it seem as if risk was being eliminated from the system, but in reality many of these assets were never going to be paid back ('toxic' assets).

When the crisis finally hit, it was difficult to tell who was going to incur the losses because the trading arrangements were so complex and interlinked. Also, since most of the banks had the same kind of assets, they were all exposed to the eventual losses, and ended up

The balance sheet of a commercial bank

The balance sheet of a business is used by accountants to keep track of its finance sections, assets (things that the business own) and liabilities (things that the busi sheet is designed means that total assets are always equal to total liabilities. This with, since it seems to suggest that there are never any profits made. However, t that profits (or an equity the owners have in the business) is counted as a liability

Here's a fictional example of how a bank's balance sheet might be structured:

Assets	[illegible] (£bn)	Liabilities
Cash	15	Capital
Current assets	20	Current liabilities
Non-current assets	65	Non-current liabilities
Total	100	Total

On the assets side, cash is completely liquid – representing the bank's reserves (i cash). Current assets are assets that are currently illiquid (e.g. loans) but should b within one year. Non-current assets are longer term, e.g. any bank loans that last though this counts as an asset on the balance sheet, it will be a while before the g materialise.

On the liabilities side, capital is the owner stake in the business. If more than £20 people defaulted on their loans), then the bank's capital would be depleted and it liabilities are any short-term borrowing undertaken by the bank, while non-curre borrowing (e.g. deposits by customers).

The more loans a bank extends, the larger its balance sheet grows, e.g. if they inc additional £1bn would be added to both the assets and liabilities sections. In the limit, e.g. there is a finite demand for credit and the central bank requires comm amount in reserves. However, during the financial crisis it seemed that banks and complacent: banks' balance sheets were bloated – too much consisted of illiquid of reserves and on crash (the term for this is that banks were 'highly leverag

This is just one example of a (very simplified) balance sheet, in reality each sectio further components. For the purposes of the exam, you just need a rough under sheet works.

Further Your Economic Knowledge...

Alchemy

Mervyn King, governor of the Bank of England from 2003 to 2013, d between the creation of money by banks and the medieval practice common metals into gold.

King's new book *The End of Alchemy* discusses the financial system (you're interested you could read a summary of the book (see links be (warning – it's quite heavy going!)

http://www.telegraph.co.uk/books/what-to-read/the-end-of-alch banks-are-the-achilles/

http://www.theguardian.com/books/2016/mar/14/mervyn-king-e future-global-economy-book-review

Central banks and monetary policy

The functions of central banks

The central bank is a highly important institution in the financial system. Some c
of include the Bank of England, the European Central Bank and the Federal Reser
England has been independent from government since 199[illegible] o prevent the gove
economic system for short-term political gain.

The role of the central bank is to:

(1) Help the governme[illegible] macroeconomic stability (particularly by t
and k[illegible]ing [illegible]ney supply at an appropriate level)
(2) Hel[illegible]tain confidence and stability in the financial system. The centr
firm[illegible] banks to help achieve this objective.

The central banks' tool for achieving its goals is **monetary policy**. Traditionally, m
following tools:

- **Changing the base interest rate** – the interest rate set by the central ban
affects other interest rates in the economy, e.g. the rate of interest that
depositors. The central bank can use the interest rate to control econon
slow the economy down and low interest rates heat it up (see monetary
later in this section).
- **Adjusting the money supply –** this was discussed in detail earlier in the c
financial markets and financial assets.

More recently, central banks have been using **quantitative easing** (QE) as an additional way of stimulating the economy. QE involv[illegible]e purchasing of various assets, which expands the money supp[illegible]s nc[illegible]hose who sold the assets now have money in the form [illegible]posit). The intention is to encouraging more lending and [illegible]vit[illegible]e economy (a common misconception is that Q[illegible]ting money – but this is not the case). Since the fi[illegible]l cr[illegible]s, the Bank of England has used several rounds of QE to try to [illegible]he economy, totalling around £375bn.

In order to maintain stability in the financial system, the central bank is also responsible for providing liquidity to banks in the event of a crisis. If there is a bank run, instead of letting people lose their deposits, the central bank can temporarily support commercial banks via loans. This is why the central bank is often referred to as 'the lender of last resort'.

On a separate note, the central bank can also influence the exchange rate of a co
currencies on the foreign exchange market. China has been accused of keeping t
undervalued in this manner.

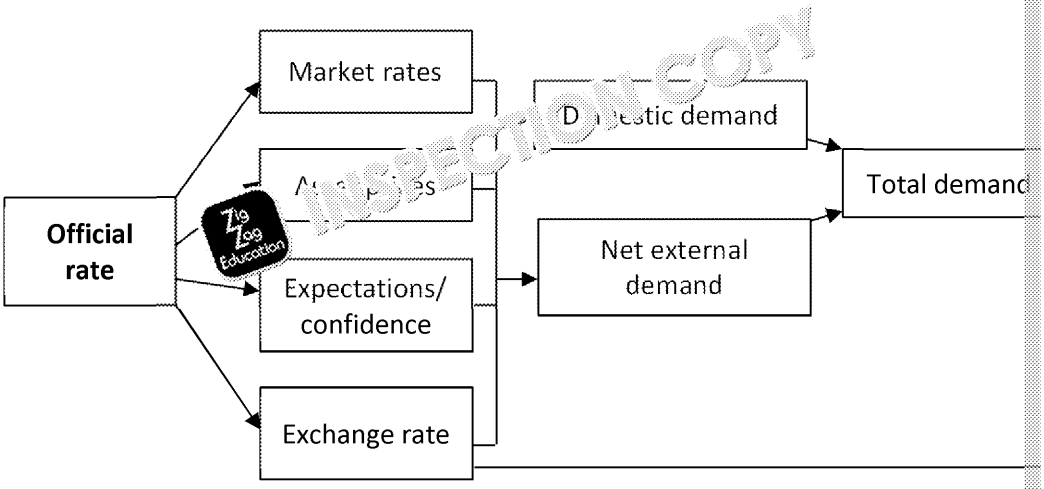
Funding for Lending and forward guidance

The Funding for Lending Scheme (FLS), introduced [illegible]ne UK in 2012, is designed t
economy, following the damaging effects [illegible]'credit crunch'. FLS encourages l
long-term funding which is linked [illegible]s lending performance. As of Quarte
outstanding loans is arou[illegible]n.

'Forward gu[illegible]' is, very simply, when the central bank tells the market what i
is to influenc[illegible]expectations: if the central bank can convince the market that the
stable, then the market is more likely to be confident and thrive. This policy was
England's current governor, Mark Carney. Of course, the success of this policy d
believes the central banks statements – if they turn out to be completely wrong,
the reputation of the bank will be tarnished.

Changing the bank rate (interest rate)

The main tool that the central bank has at its disposal is changing the bank rate. T
of the Bank of England (consisting of nine senior members) meets once a month t
change the bank rate. The bank rate affects the economy through various 'chan
following diagram shows a simple version of **transmission mechanism of monet**



The financial crisis, and historically low interest rates, have changed this model s
explaining how it should work normally.

Suppose that the bank rate starts at 5%. The central bank notices that economic
inflation is very low (nearing deflation). So it decides to reduce the rate to 3%. W
economy?

- Market interest rates also fall – since banks ar[illegible] financial institutio
  the central bank, they can offer more [illegible] rates on their loans
- When the interest rate falls, th[illegible] assets (such as government bon
  assets were priced ba[illegible] on t[illegible] higher interest rate of 5%, so they are li
- A fall in the int[illegible] at[illegible] likely to lead to a fall in the exchange rate. A
  inv[illegible] are interested in saving in pounds, so the demand for pounds f
  dep[illegible]s.

These factors all act to boost aggregate demand in the economy. Low market int
households are more likely to take out loans, increasing consumption and invest
AD). High asset prices leads to a fall in demand for these assets, which leaves mo
Finally, a low exchange rate makes exports relatively cheap and imports relativel
component of AD. This could also help to reduce a current account deficit, if the

As you know from Year 1 macro, a shift to the right in AD should increase econo
economy (using a Keynesian LRAS). Of course, the eventual change in the econo
to LRAS – this is something that is beyond the control of the central bank, but the
before taking important decisions like whether or not to change the bank rate.

Note that the monetary policy transmission mechanism dia[illegible]m also points out t
have an effect on expectations and confidence. H[illegible]ver, whether a fall in the b
reduce confidence is hard to say. On the o[illegible]n h[illegible] might indicate to markets t
reducing confidence. Alternativel[illegible] t[illegible] indicate to markets that the central b
well, boosting confidence[illegible]. The effect is ambiguous.

This analysis[illegible]e [illegible]eated for an increase in the interest rate, although at the t
rate has bee[illegible] all-time low of 0.5% since March 2009, and there doesn't seem
rate rise for a while to come! Some countries (including Japan and Sweden) have
interest rates to try to boost aggregate demand in their economies. Negative inte
savings are guaranteed to be losing value, encouraging them to spend rather than

The regulation of the financial system

The financial crisis highlighted the importance of effective regulation of the bank
economists prefer to market to operate freely, in order to maximise efficiency. I
however, more effective regulation might have prevented (or at least mitigated)
the run up to the financial crisis, regulators were 'asleep at the wheel'.

Financial regulation in the UK

In the UK, various bodies are resp[illegible] for regulating finance. This section disc
regulators in turn:

The Bank of England

We have alr[illegible] mentioned the role of the Bank of England as a 'lender of last re
the Bank, including the FPC and the PRA, have specific roles in regulating the fina

The Prudential Regulation Authority (PRA)

The PRA works to ensure that banks operate sensibly and do not take excessive r
individual firms must adhere to, such as how much capital they must set aside in
where a firm is likely to fail, the PRA is responsible for making sure that this take
minimal disruption to the wider financial system. The PRA was set up in 2012, fo
regulatory regime. It was hoped that the new system, where individual authoriti
be more effective than the old system where the FCA had a very broad remit.

Financial Policy Committee (FPC)

The FPC was also set up fairly recently, in 2013, as a response to the financial crisis. The FPC's role is to look at systemic risks [illegible] banking system as a whole, rather than risks in individual [illegible] (which is the PRA's role). An important feature of the financial crisis was the interconnectedness of banks, and the fact that if one failed, other would likely fail as well. The FP[illegible] charged with monitoring system-wide risks such as the[illegible] and also making the system safer.

Financial Conduct Authority (FCA)

The FCA works to protect consumers and promote competition with the financia
information to consumers, handle complaints, and set of rules for financial firms

Bank failure

As discussed earlier in this course companion, banks might fail if a large proportion of their loans end up never being paid back. There is always a risk of this happening, since banks have an incentive to earn more profits on riskier investments. It wasn't until the financial crisis that banks realised how risky many of their loans actually were.

Regulators require banks to hold reserves in case of sud[illegible]sses – they might require a bank to achieve a minimum **liquidity ratio** or **capital ratio**.

The liquidity/capital ratio that [illegible]y require banks to meet often depends on how banks' activities to be [illegible] risky bank might need to have a liquidity ratio of at [illegible] might need [illegible]% [illegible]more). However, this is quite difficult to analyse in practi predictor of [illegible]er a bank will fail or not is simply the total amount of leverage of lending compared to its reserves), as opposed to trying to weight loans by the

Moral hazard

Moral hazard is the idea that someone's behaviour might change if they know th
For example, a homeowner with insurance against a fire might take fewer precau
cost of any damage will be refunded.

In the context of the financial sector, it is argued that there is a moral hazard pro
big to fail' know that they will be bailed out by the go[illegible]t. This encourages
of a banking crisis falls disproportionately on t[illegible]y at large, rather than t

Some argue that this isn't a co[illegible]ete [illegible]ccurate explanation of the financial crisis
aware that they were [illegible] the whole system at risk, and there was still a short
banks durir[illegible]ris[illegible](so they did bear some of the cost).

However, going forward, the problem of moral hazard should be taken seriously
banks to think that they are guaranteed to be bailed out in the event of another
more irresponsible behaviour today.

Financial crashes and the wider economy

We know from the section on the economic cycle that the economy tends to go
many reasons that might be unrelated to the financial sector. However, when th
(often after a long period of prosperity), the following slump or recession tends t
prolonged: a collapse in finance has ripple effects across the broader economy.

One of the key consequences of a financial crisis is a fall in lending (a credit crunc
ordinary households and businesses, reducing aggregate demand in the economy
role here too: less confident consumers are likely to save [illegible]n in the form of pa
which causes an economic slowdown.

Naturally, this suggests that the g[illegible]ve[illegible]t should try to prevent these types of
first place. Most econo[illegible]a[illegible]e that more effective regulation of the financia
crisis, altho[illegible]er[illegible]e disagreement as to the extent to which they should

On the one hand, tighter regulation reduces the risk of another future crash. Ho
overbearing regulation could restrict the socially useful aspects of the financial se
which is definitely something we want to avoid. Regulatory capture – when regu
interests of the industry they're supposed to be regulating – is another potential

Further Your Economic Knowledge...

There's plenty of additional reading you could do on the financial se
recommends two books by Phillip Coggan:
Paper Promises – Money, Debt and the New Wo[illegible]d
The Money Machine – How the City Wo[illegible]s

An excellent (and not t[illegible]g) book on the financial crisis (written i
Whoops! Wh[illegible]n Owes Everyone and No One Can Pay

[illegible]'re considering studying economics at university, it's definitely
[illegible]e subject to show that you're interested!

Review questions: financial markets and monet

1. State the three main functions of money.
2. What is the difference between broad money and narrow money?
3. Why might there be a trade-off between liquidity and profitability for com
4. Name one function of the central bank other than to control monetary po
5. State two ways in which banks are regulated.

Exam-style questi… …ancial markets and monetary

1. A t… …ar government bond has a coupon rate of 4%. The bond holde… for … …nd later sells it for £600. After the sale, the yield on this bond …
   A 7.5%
   B 3%
   C 5.33%
   D 4%
2. Which of the following is **not** a function of an investment bank?
   A advising on mergers and acquisitions between companies
   B receiving deposits from the general public
   C trading on the foreign exchange market
   D buying and selling mortgage-backed securities
3. Which of the following statements about the monetary policy transmissi…
   A the official bank rate affects confidence and expectations
   B aggregate demand affects inflation
   C market interest rates affect the official bank rat…
   D the official bank rate affects the exchan… …te
4. Moral hazard is most likely to affe…
   A agricultural markets
   B the energy mar…
   C the … …ou… …k…
   D i… …e markets
5. In lig… …f the financial crisis, explain how the financial sector could be m…

4.2.5: Fiscal Policy and Supply-s

By the end of this topic, you should understand...

- ✓ **The principles of tax and spending**
- ✓ **The importance of the budget balance and the n... l debt**
- ✓ **Different types of supply-side policies**
  - Free-market and interventionist ...ies

Fiscal p... y

Fiscal policy is the use of taxes and spending by the government to influence the ... familiar with the basics of fiscal policy from Year 1 macro. Some ideas you shoul...

- how fiscal policy influences AD and/or AS,
- the difference between direct and indirect taxes,
- proportional, regressive and progressive tax systems
- the budget balance and national debt

We explore these concepts (plus some new ones) in more detail in this section.

Government spending

The government spends tax revenues in different ways and for different purpose...

Current expenditure is the government's regular, ev... ...e. penditure. This is ... the money has been spent, the good has be... is d... Examples of current expend... service employees, electricity bills f... ...ee lighting, paying for the maintenance ... drugs for the NHS.

Capital exp... ...re ...long-term investment by the government that will improv... PPF (Produc... ...ossibility Frontier). This expenditure is good for promoting gro... example, spending money on building or expanding schools and hospitals will im... workforce by increasing the human capital and health of workers, and, as such, w... productive potential. Alternatively, building a new motorway or spending on a p... would improve the transport of goods and factors of production, thus increasing ... produce goods and services.

Transfer payments are payments that are given by the state to individuals but wi... services in return. Transfer payments would include Jobseeker's Allowance, or en... are unable to work due to illness. They are often used as a way of supporting soc...

Taxation

Taxation is generally used to finance government ... ...ure. In the UK, we hav... income tax (the largest tax), which means th... ...arners pay a larger proporti... earners. Most people agree that ... ...ve tax system is the fairest, since ric... a heavier tax burden. Th... ...r characteristics of a 'good' tax system whic...

- **Simpl... ...** – ... ...portance of having a tax system where taxes are easy t... und... ...d cannot be overstated. Having an unnecessarily complex syst... and ... ...usion, and can end up being far more costly than expected.
- **Broad-basing** – the tax system should include as much of the population ... group is penalised. In the UK, the first £11,000 per year earned in incom... above that gets taxed .That excludes some low earners from income tax, ... sort of tax through consumption taxes (e.g. VAT) and/or national insuran...

- **Tax rates should be at an appropriate level** – obviously if tax rates are v
won't be able to generate enough revenue to finance its spending. How
the tax rate is not too high. An excessively high tax rate can discourage p
would hinder economic growth.

The main taxes in the UK

- **Income tax** – annual income tax begins at £11,00[illegible] here any additiona
known as the basic rate). Any income ab[illegible] 4[illegible]00 is taxed at 40% (kn
income above £150,000 is taxed [illegible] (t[illegible] is known as the additional r
largest component of tot[illegible] nue.
- **National insura[illegible]** another tax on workers, used to fund pensio
An[illegible]ge [illegible] earning over £155 a week pays national insurance. Na
ver[illegible] so many people are surprised at how large it actually is: 12% o
any income over £827 a week).
- **VAT** – 'value added tax' is a tax on the consumption of most goods and s
20%, up from 17.5% in 2011. This tax increase was an important factor i
reduction plan. Unlike NI and income tax, VAT is an indirect tax.
- **Other indirect taxes** – certain goods and services are taxed more heavily
negative externalities. The largest of these taxes are fuel duty (4% of tot
(1.5%) and alcohol duty (1.5%). If the government's plan to tax sugary d
added to the list as well in the next few years.
- **Capital taxes** – these include inheritance taxes, capital gains tax (which i
investments) and stamp duty (a tax on houses above a certain value).
- **Taxes on firms** – this is mostly corporation tax. Corporation tax rates ha
28% to a planned 18% in 2020.

Tax type	[illegible]ction of total tax re
Income tax	
National Insuranc[illegible]	
[illegible]	
Ot[illegible]ct taxes	
[illegible]apital taxes	
Taxes on firms	
Council tax	

Note: the remaining tax revenue comes from royalties, interest and dividends, a

The budget balance

The coalition government of 2010 and the Conservative government elected in 2
on 'balancing the budget' (also referred to as eliminating the deficit). In simple t
government aims to reduce its spending such that the government's expenditure is equal to its revenue received from taxation – that is, it is the absence of a budget surplus or deficit.

What is the budget?

The Chancellor of the Exchequer announces th[illegible] ove[illegible]ent's budget for each year in March – just before the [illegible] financial year (which starts in April). The budget contains fo[illegible]asts [illegible] economic performance and any planned changes in fi[illegible]cy, e.g. government spending projects or tax change

If the govern[illegible]spends more than it earns in tax revenues (funded by borrowing then the result is a **budget deficit**. In the UK, the budget has been in deficit for 52 o the government runs a **budget surplus**, this means that the government's revenue

Cyclical deficit vs structural deficit

The simple measure of the budget balance above can be split into two parts, the s**cyclical budget deficit**. The cyclical budget deficit reflects automatic changes in g recession: spending on unemployment benefits goes up while tax revenues from recession, more people are unemployed). The part of the total budget deficit tha cyclical deficit. The structural deficit is the rest of the deficit that cannot be expla

Most of the time when you here 'the deficit' being discussed in the news they are r

How big is the UK's budget deficit?

There are two ways to measure the budget deficit: as a percentage of GDP (the m and just as a number. Here's some of the statistics on the UK budget deficit in rec

Year	Budget deficit (% GDP)	
2009–2010	10.3	
2010–2011	8.1	
2011–2012	7.1	
2012–2013	7.2	
2013–2014	5.8	
2014–2015	5.0	
2015–2016 (estimate)	3.9	

Source: ONS Public Sector Finances March 2016

When the deficit is measured as a percentage of GDP, then this percentage will fa as GDP grows at a faster rate (e.g. if GDP growth is 3% and the deficit grows by 2% percentage of GDP will fall).

By both measures, the deficit has been falling after peaking in 2009–2010, but not initially hoped. Now they are predicting that the UK will reach a surplus in 2020, b sceptical. Forecasting the economy is notoriously difficult.

The consequences of budget deficits and surpluses

The main concern with running a persistent budget deficit is that it adds to the stock be paid back, so a larger national debt means that an economy has to spend more o the debt). This has an opportunity cost, since the government can't then use that m

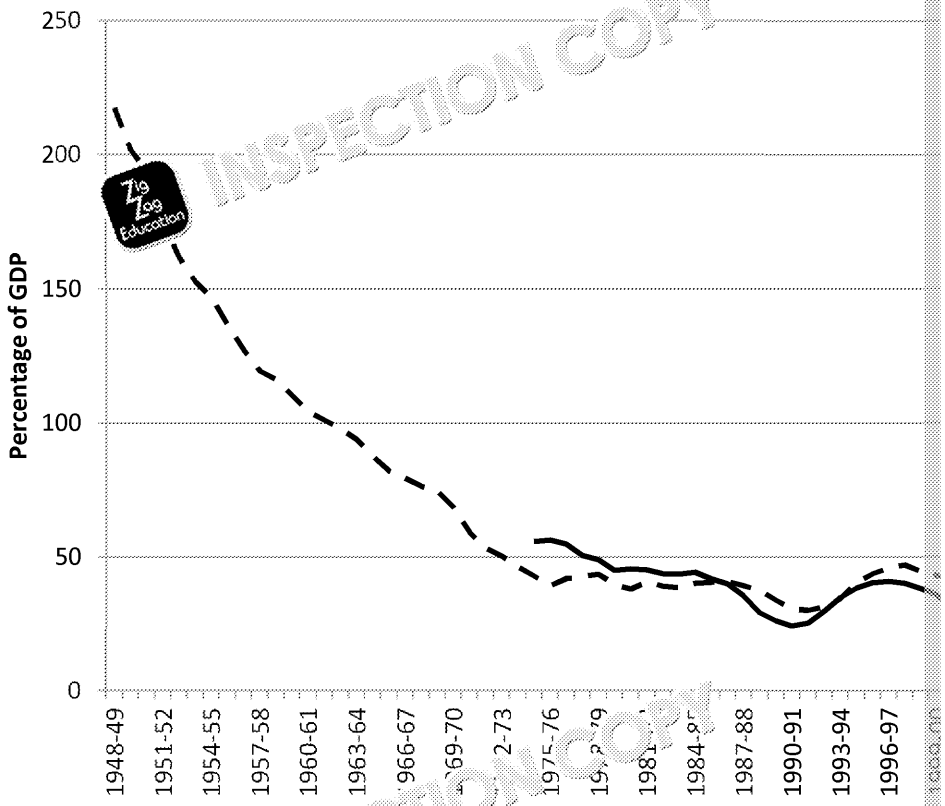
The cost of running a large budget deficit also depends on the interest rates at whi Economies with good credit ratings (like the UK) can generally afford to borrow at potentially run a larger deficit than a country with a poor credit rating. However, b private sector can lead to crowding out. This means that funds that could have be no longer available because they are being used by the government to increase sp

If a country is running a budget deficit, this suggests that the government has incr And since government spending is a component of aggregate demand (AD), AD in creates jobs and increases GDP. However, it also leads to higher inflation – which hi Budget surpluses are good for a nation's finances since it means that the total sto Therefore, future interest payments will be lower, allowing the government more However, in the short term maintaining a budget surplus prevents the governme areas. The current government has been criticised for cutting public spending too affecting the weakest. This is the main cost of trying to achieve a budget surp

In general, most economists agree that it is sensible to try to run budget surpluse prosperity (to reduce the national debt) and to run budget deficits during slumps growth). Not all governments have heeded this rule, however. A good example is crisis, where the government ran a large deficit during a boom. This made it muc recover during the recession, since the government had less scope to increase sp

The national debt

The national debt is the total stock of debt a country has. In one sense, the natio
previous budget deficits (minus any debt that has been paid back already).
Like the budget deficit, national debt is usually calculated as either a percentage
following graph shows the UK's national debt as a percentage over time:



Source: IFS. The two different lin… two different data sources.

The nation… in 2014–2015 was calculated to be 82% of GDP (around £1.5 tr… highest it's b… since the 1960s, it still doesn't come close to the levels seen aft…

The UK's national debt is quite high by international standards, although not nea… (around 176% of GDP) and Japan (over 220%). The size of the national debt shou… can conceal important differences between economies. For example Japan has a… Greece, so it can afford to borrow more cheaply, despite having a larger national… GDP is important: a high GDP growth rate can help to overcome the burden of a h… percentage of GDP).

The Office for Budget Responsibility (OBR)

The OBR, set up in 2010, is an independent body that oversees the UK's public fi… government is meeting its fiscal targets, and check the gove…ment's numbers fo… provide official economic forecasts, such as future GD… wth. Ultimately, the O… sure that the government's finances are sus…nable.

Supply-side policies

Supply-side policies were introduced in Year 1 macroeconomics. Successful supp
curve to the right, increasing an economy's productive capacity. Typical example
be policies that improve productivity (e.g. improving education and healthcare),
of labour (e.g. migration, encouraging participation of women in the labour force)
technological advances (e.g. more funding for research and development).

Free market vs interventionist supply-side policies

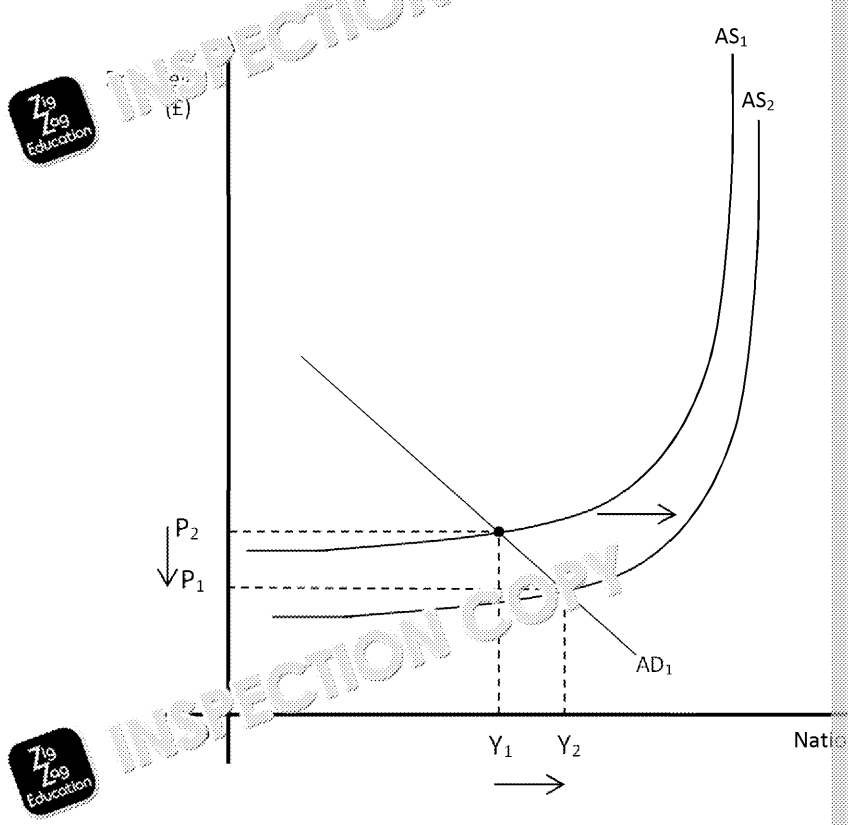
Supply-side policies can be split into two main groups.

Market-based policies: *There is very little government intervention with market-based policies is to support and use the forces of the free market to increase efficiency, product Market-based policies try to boost aggregate supply by improving the ability of the free m any barriers.*

Interventionist policies: *Interventionist policies are the opposite of market-based poli quite an active role within the economy. Its role is to intervene in order to correct any fa and to guide an economy to a better equilibrium.*

There is a wide range of things that affect the aggregate supply, none of which th level of control over as it does with demand-side policy instruments. The main w aggregate supply is through spending on supply-affecting investments or by chan

Let's remind ourselves of AS/AD analysis. If aggregate su shifts outwards, th being equal:



Below are some conditions that affect aggregate supply, and explanations of how policies to affect those conditions.

- **Promote competition**
  If there are lots of producers in a market, then there is more competition will give producers an incentive to find ways of cutting production costs b goods at a lower price, thereby gaining more customers. To do this, the g loans to start-up companies, reduce barriers to e[illegible] obstacles that may market'), or enforce laws that prevent mo[illegible]ol[illegible] (large firms that othe reducing taxes on imports or sub[illegible]or domestic firms, there will be a will increase competition [illegible] market. By both reducing taxes on i enter a market a[illegible] subsidies to domestic firms, an economy ca allo[illegible] firms to remain. This will boost LRAS because domest rep[illegible]ith foreign production, but the competition drives the firms to thereby pushing out the LRAS curve. Privatisation can also boost compet worried about increasing revenues or cutting costs to boost profits; there competitive. By giving the business to the private sector, it will increase will compete against other market players.

- **Reform labour market**
  Reforming the labour market refers to the quantity and quality of labour, an market forces from acting freely within this market. Structural unemployme mobility of labour. Trade unions are another barrier to the free-market syste strength to an individual worker by uniting them together as one large body bargaining power when it comes to negotiations on wages and working con immigration, an economy can gain workers and thereby increase its ability t affects aggregate supply, laws around migration are supply-side policies. Inc make more workers willing to work. Equally, redu[illegible]unemployment bene from accepting the benefits and encourage[illegible]work. However, unemp protect those without incomes a[illegible]re is a trade-off between protectio

- **Quality of workf[illegible] and education)**
  If th[illegible]ern[illegible]invested in schools by, for example, buying new learnin wou[illegible]e a better education system, creating a more productive work may provide financial assistance for pupils to continue into further educa Educational Maintenance Allowance (EMA) was granted to students from has now been scrapped in England. Investing in training courses for wor human capital of an economy. This is particularly useful if there are stru because it will help the mobility of workers between markets.

- **Infrastructure**
  Spending on infrastructure means investing to improve the physical conditions or organisation of the economy – for example, investing in transport systems such as railways and roads, or investing in buildings for factories, offices or houses. By improving these factors, society will be happier a[illegible] the economy will function more smoothly. If th[illegible]re adequate housing, then the workforce would [illegible]ha[illegible]r, if the roads were smoother and straig[illegible]er, the lorries could move between factories [illegible]ently.

  Learn
  To se
  spend
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  orga
  F

- **Qu[illegible]capital and production processes**
  Inve[illegible]t into research and development will create a technological ad machines are invented and more efficient methods of production are cre curve out because a more productive and efficient economy can produce positive net investment will indicate increased capital stock. Greater qua means there is the possibility for more production.

Strengths

- Shifting the aggregate supply curve outwards will not cause inflation – in f
  pressure on the price level through competition and improvements to pr
  costs and, hence, prices.
- Increasing aggregate supply is an increase in production, as long as it is n
  demand (movement along the AD curve). This indicates a rate of econon
  as resources are generally improved or increased in the long term.
- Increasing production and economic growth will mean there is job creati
  level of unemployment.
- By improving the productive capacity of an economy and reducing the co
  will become more competitive in the global market. This will mean expo
  trade deficit

Weaknesses

- Supply-side policies have long time lags. Improving the quality of the wo
  education can take 13 years, as children start aged 4–5 and finish aged 1
- These policies can be very costly, which would have a negative impact or
- Although the government can manipulate the economy, the global mark
  government has no control over. The government policy is weak to exte
- Data collection is slow and long-winded. The information provided to go
  inaccurate but also out of date, causing the government to react slowly a

Review questions: fiscal policy and supply-side p

1. Explain the difference between the cyclical and structural budget balanc
2. Why might it be more useful to measure the national debt as a percenta number?
3. Explain the role of fuel tax.
4. Name one method a government might use to reduce a budget deficit. A policy?
5. Give an example of a free market supply-side policy and one interven

Exam-style questions: fiscal policy and supply-side poli

1. If a government runs a budget deficit for five years in a row…
   A Total national debt must rise
   B National debt as a percentage of GDP must rise
   C Borrowing costs must go up
   D The exchange rate must fall
2. Which of the following policies is *guaranteed* to reduce a budget deficit?
   A Cutting government spending
   B Increasing income tax
   C Devaluing the exchange rate
   D None of the above
3. Which of the following is a free-market supply-side policy?
   A Increased spending on education
   B Building a third runway at Heathrow air
   C Subsidising research into new tech
   D Cutting income tax
4. If the government increases spending on education, then:
   A AD won't shift but LRAS will increase after a time lag
   B AD will increase after a short time lag but LRAS won't shift
   C AD will increase after a short time lag and LRAS will increase after a lon
   D AD won't shift but LRAS will decrease after a time lag
5. Evaluate the case for increasing government spending on infrastructure g growth.

4.2.6: The International E

By the end of this topic, you should understand...

- ✓ **The characteristics of globalisation**
  - Implications for developed and developing countries
- ✓ **The role of trade**
  - The theory of comparative advantage
  - The nature of protectionism
- ✓ **The characteristics of trading blocs**
  - Including the EU and the single market
- ✓ **The components of the balance of payments**
  - The importance of imbalances
  - Policies to correct imbalances
- ✓ **Floating vs. fixed exchange rate systems**
  - Currency unions
- ✓ **Economic growth and development**
  - Developed and developing countries
  - Policies to promote growth and development

Globalisation

Globalisation has no set definition and can be described differently across various
would tend to say it is the ability to move production to anywhere in the world a
for production can be sourced from any country. It is a process of integrating se
economies into a single global entity. Borders and barriers between people and
become more interdependent. As the world becomes more globalised, there is g
economic agents and factors of production can be sourced from anywhere acros

It is a phenomenon that has been happening for years and years. Here is a quote
about the world in 1914:

> 'The inhabitant of London could order by telephone, sipping his morning t
> of the whole earth, in such quantity as he might see fit, and reasonably e
> his doorstep; he could at the same moment and by the same means adv
> resources and new enterprises of any quarter of the world... He could s
> cheap and comfortable means of transit to any country or climate withou

Factors that have contributed to globalisation over the last

- **Transport infrastructure and operations**
  The improvements in transportation and infrastructure around the glob
  more cost-effective movement of resources. As a result, this has increa
  services across countries, and the use of factors of production from var
  less costly to do so. Because producers will want to use the resources t
  in transportation costs mean they are likely to spread their production
  more globalised.

- **Communication technology and IT**
  The improvements in the ability to communicate across the world mean information is more free-flowing and imperfect information as a barrier to trade is reduced. The increased use of the Internet allows the world to share cultural and social experiences.

- **Trade liberalisation**
  Agreements signed by the World Trade Organization (WTO) have prevented countries from enforcing trade barriers. As barriers to trade are removed, economic agents are more freely allowed to trade their goods, services and resources across nations, thereby becoming more globalised.

Containerisation

Containerisation, the practice of containers that are easily trans other forms of transportation, i McLean's invention in 1956. Be McLean's invention, cargoes, s wo[illegible]ers, were placed to[illegible] like a jigsaw puzzle, and c to remove these containers fro taking prolonged periods of ti 1960s and 1970s of international and size of metal containers re shipping practices and marked allowing businesses to distribu globe far more effortlessly and Consequently, containerisation the process of globalisation.

- **Increasing transnational corporations**
  Transnational corporations (TNCs) and those that are spread across cou economies and produce their goods in various nations. The increasing of TNCs have led to greater activity in the global market and thereby in

- **The dissolution of the Soviet Union**
  When the Soviet Union dissolved at the end of [illegible] economies that w world began to open up to the global m[illegible]ts then led to an increa

- **International financial m[illegible]t**
  As financial mark[illegible] across countries, mainly due to the increase spec[illegible]tor[illegible]ders were able to operate in various countries, caus fr[illegible]oss nations and thus making financial markets more globalised

Impacts of globalisation

There are many effects that have resulted from globalisation; some are good, so others is debatable. See below for the impacts of globalisation.

- **Increased interdependence of economies**
  As producers begin to move their production process to different natio different markets, they rely on the countries in which they are operatin become more globalised and integrated, they also become more interd

- **Increased living standards**
  It is generally believed that living standards increase as the world becom specialise in producing the goods in which they have a comparative adva naturally grow, and there will be more jobs a[illegible]e for people, thereby

- **Decrease in current global su[illegible]ers**
  It has been theorised that as developing countries deindustrialise, and China, begin t[illegible], power that was typically held by countries in Nor to[illegible]ov[illegible]alternative economies.

- **Gr[illegible] consumer choice**
  As economies open up to the global market, there will be an increase in available for consumer purchase. Consumers will have the ability to co produced in their domestic economy.

- **Lower prices**
  Some believe consumers will be presented with cheaper goods as they h
  products from a greater (global) range of producers. As countries speci
  advantage means they can produce the goods more cheaply and prices
  were produced by comparatively disadvantaged countries. Equally, as p
  their production processes to wherever is cheapest, they are able to lo

- **Worker exploitation**
  TNCs are able to move production where labour is cheapest. However, th
  will be treated fairly, and often countries have cheap labour because of th
  procedures to protect workers. TNCs are able to set up production in co
  procedures due to their large influence and market power, they are

- **Environmental damage**
  Globalisation is associated with economic growth, which has many nega
  transportation of goods and production increases as economies grow, th
  greenhouse gases, which contribute to global warming and the deterio

Globalisation creates winners and losers: those who benefit from the advantages
and those who suffer the disadvantages of exploitation and interdependency. Lo
disadvantages below and try to identify who are the winners and losers; economi
categories depending on the circumstances:

Advantages of globalisation

- **Increased competition**
  By opening up to the global market, economies are opening up to more
  means there is a greater choice of products for consumers and a greater
  they buy their products from. This means there is greater competition w
  competition is believed to create a downward pressure on prices and d

- **Reduces domestic monopoly and monopsony power**
  Greater competition will reduce the market power of domestic monopo
  as they will have to compete with foreign firms and foreign employers.

- **Bigger market means greater economies of scale**
  More-globalised firms will have access to a bigger market. This means t
  greater demand for their product. This gives firms the ability to grow a
  economies of scale.

- **Increased capital flows and inward investment**
  As barriers are removed and there is greater freedom in the movement
  economies can find they have an inward flow of investment. This injec
  used to stimulate its growth, increase jobs and improve standards of liv
  also help spread new technology and knowledge to the country. Interna
  costs as they can avoid areas of high taxes and expensive regulation.

- **Free movement of resources**
  Barriers to free movement of resources are removed, allowing factors o
  to move to where they are most needed. Firms can be more competitiv
  the cheapest factors of production anywhere in the world. This is calle

- **Greater resource allocation**
  With barriers, resources and factors of production are able to move
  and are allocated where they are most needed.

- **Increased trade and specialisation**
  Economies that are globalised have the ability to specialise in producing
  comparative advantage, and trade with other countries to obtain the g
  comparative advantage. This means a more globalised world can gain f

and trade, which are: reduced costs and prices, increased efficiency and greater choice for consumers.

Disadvantages of globalisation

- **Increased numbers and power of MNCs**
  Multinational corporations (MNCs) have the ability to abuse their high ... a threat to consumers, workers and developing nations. The removal of ... multinationals to exist and to grow.

- **Free movement of resources leads to a brain drain**
  Because resources are free to move between countries, countries can find ... resources that can enter the economy. If skilled workers leave a country ... then the country can find themselves in a brain drain (see Top...

- **Global monopolies and monopsonies**
  Monopolies and monopsonies, just like in the domestic market, can emerge ... These firms and employers tend to be more powerful than domestic firms ... a greater market (the global market). They will have a great ability to restrict ... inflate prices. Equally, as they are internationally spread, there are very few ... regulations that can control them.

- **Use of scarce resources, and greenhouse gases**
  As trade increases, production increases. Further to this, production and ... transportation increases as resources and goods are shipped across the world ... and non-renewable resources more quickly than if the world was less global. ... growing concern for the global society and the environment as a whole ... bottlenecks and global warming.

- **Loss of cultural independence and rise of Americanisation (standardisation)**
  As the world becomes more global, cultures begin to bleed into one another. ... Critics of globalisation call this 'Americanisation', referring to the loss of ... background and distinction fades away and societies tend toward ...

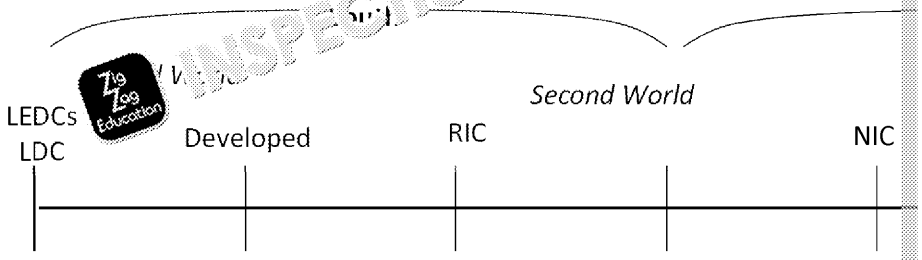
- **Regulation and tax avoidance**
  From an environmental and social point of view, globalisation is bad because ... necessary regulations which are designed to protect citizens, workers, ... This represents a large missed opportunity for an inflow of tax revenue. As a ... result, governments may raise taxes elsewhere. It is equally anticompetitive ... which have no choice but to abide by these regulations and taxes which ... entry.

- **Interdependency**
  As countries become more dependent on each other, they become more ... may evolve in other countries. Equally, if countries become more specialised ... one market, 'putting all their eggs in one basket'. This means that if there ... then the whole economy can suffer greatly. Countries can support many ... the prosperity of another; this is the advantage of diversification.

Further Your Economic Knowledge...

Talking about development: categorisation

Countries are often grouped into categories to refer to their develop
industrialised status, and there is a wide variety of categories used.
root and meanings of these categories. You may have heard of some
this box will explain why and how some of th[illegible] may be outdated o
differentiate between these in your [illegible] is merely for addition
those of you who are intere[illegible] expanding your cultural horizons



The most common categories are those that spilt countries into one
developed, and less economically developed countries (LEDCs, or LD
development countries (MEDCs or MDCs). These refer to countries b
development measures, such as GDP or HDI. What is good about the
compared to developing/developed is that it identifies the distinctio
economy and living standards, whereas 'developing' may imply the
has a backward and deficient culture.

There are other categories such as the North–So[illegible]th divide. This cate
countries in the North are more develop[illegible] than those in the South.
the two, although this does not [illegible] to the equator; this grou
development level is sta[illegible] and unchangeable.

West and Ea[illegible] another locational classification; however, this refe
[illegible] Ve[illegible]ulture is generally 'American' culture, and Eastern cul
criticised because it groups all Asian cultures into one, such a
when in reality these cultures are vastly different, and some may fin

Another one you may have heard of is First World, Second World an
the previous categories, which specify that countries either 'are' or
group that countries can fit into. Originally, this looked at grouping c
economic stance, First World being capitalist, Second World being c
referred to as 'non-aligned countries'. This concept is now outdated
to First and Third World in terms of income and wealth. However, th

The classification of recently industrialising countries (RIC) and newl
looks less at the two extremes and instead looks at the currently cha
manufacturing status. NICs are countries such as China which are fu
recent years, unlike countries such as the UK [illegible]h started industria
century. RICs are countries such as B[illegible]a[illegible] Mexico which are start
industrialised.

What may be id[illegible]ed h[illegible]e is that it is hard to categorise countries
the ma[illegible]ociety, economic and political stances all vary by so
[illegible]o [illegible]ntify set similarities and differences. Mexico, for example,
[illegible]oped, wealthier or industrialised categories, does, however, ha
established sustainable transport system than countries in other gro
be better off talking about a spectrum of development, as this highli
between certain categories. It is important to think critically about th
they differentiating countries on? What do they imply? Are they accu
belong at this point on the spectrum? Can countries be grouped, or a

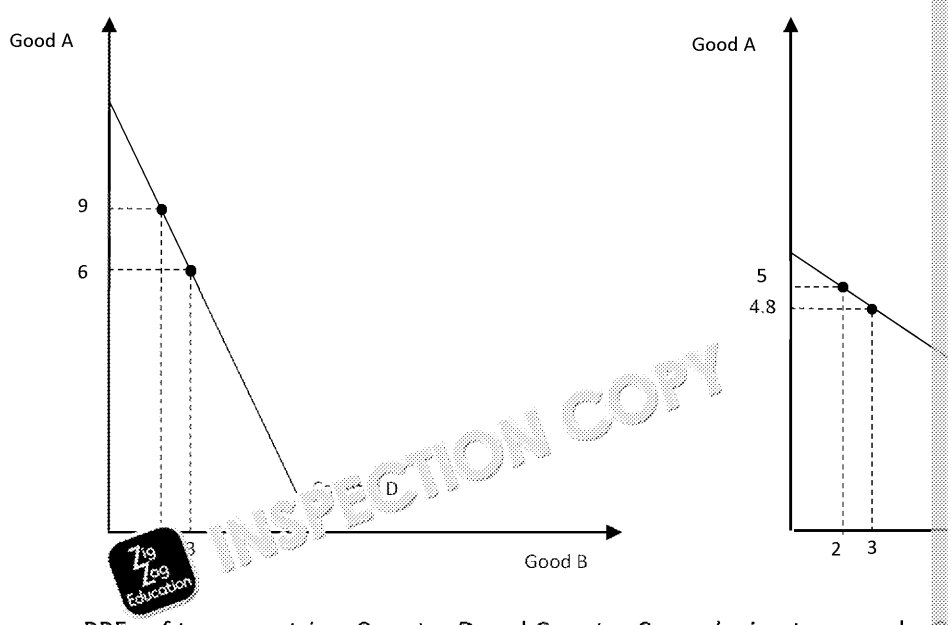
Trade

Trade between countries is a very important part of the modern world. Economi
two countries enriches them both, and that much of the improvement in global l
century is a result of the expansion of trade.

The **comparative advantage** model, formulated by the fa ou English economis
century, is a useful way of explaining how trad c n b beneficial.

Comparative advant assumptions

- No ale (constant costs of production)
- N port costs
- Per knowledge
- Free mobility of resources between industries
- Environmental degradation is ignored



Here are PPFs of two countries, Country D and Country C, producing two goods, G
has a comparative advantage in producing Good B because its opportunity cost o
Country D's opportunity cost of 3 units of Good A. This means Country D has a c
producing Good A.

This, pointed out economists such as Adam Smith and David Ricardo, means that
producing both goods and having high opportunity cost, Country D should specia
Country C should specialise in producing Good B. The countries should then trad
then have access to both goods but at a cheaper price.

Note that, given these opportunity costs, Country D could produce a maximum o
5 Good Bs (if they dedicated their production to one or the other). Likewise, Cou
of 5.4 Good As and 27 Good Bs. Hence, if they de ica e their production to the
comparative advantage, total output would increase.

Note that countries can have a comparative advantage even if another country h
production in terms of good. For example, if Country C could produce 20 of
would have an absolute advantage over Country D (which can only produce 15 o
absolute advantage means that a country is able to produce more of both/all pro
country. Nevertheless, Country D would still have a comparative advantage in pr
opportunity cost of producing another unit of Good A is lower than Country C's o

Advantages of specialisation and trade

- **Lower prices**
  By producing the goods in which a country has a comparative advantage cheaply than another country could. Therefore, goods will have lower p by the country that has the comparative advantage.
- **More consumer choice**
  By trading, consumers have access to m[illegible] from other countries
- **Larger markets**
  Firms can benefit f[illegible]isation and global trade because their aud (glob[illegible] m[illegible]
- **Ec[illegible]s of scale**
  Because firms have a greater audience, there is greater demand for the the opportunity to expand and gain from economies of scale.
- **Increased living standards**
  If countries follow the suggestions of David Ricardo and Adam Smith, th increase in living standards. If they produce the goods in which they hav advantage, and trade for the rest, their consumers will benefit from low consumer choice from international goods. The economy will see an inc production increases.

ACTIVITY

Does Scotland have a comparative advantage in producing wine? Think about th Smith:

By means of glasses, hotbeds, and hotwa[illegible] good grapes can be raised in Sco can be made of them at about thi[illegible] expense for which at least equally go countries.

Adam Smith, The Wealth Of Nations, Book

Disadvantages of specialisation and trade

- **Trade deficit**
  If a country is uncompetitive, then it could end up with a trade deficit.
- **Dumping**
  Countries with excess goods can sell them in foreign markets at a price t order to get rid of them. The economy of the country that the goods a damaged as the increase in supply and fallen price can put some domes it shocks the market.
- **Contagion (increased exposure to external shock)**
  As has been seen by the recent global finan[illegible] asi[illegible] economic shocks can be spread across econom[illegible]s. Th[illegible]s due to the interdependence of econo[illegible] a[illegible]he economy begins to crash, the countries that [illegible]de[illegible]ndent on its trade will find they are also hit by [illegible]o[illegible]turn, and so economic shocks will be spread a[illegible]or[illegible]mies.
- **Global monopolies**
  International trade can allow the rise of global monopolies with global influence and power for market manipulation.

- **Problems for emerging and developing economies**
  Emerging economies and developing countries are generally susceptible
  monopsonies and from more developed countries that have access to t
  knowledge.

Patterns of trade

Patterns of trade are influenced by comparative advar[illegible]s clear that countr
specialise in (e.g. Saudi Arabia produces oil, th[illegible]U specialises in services).

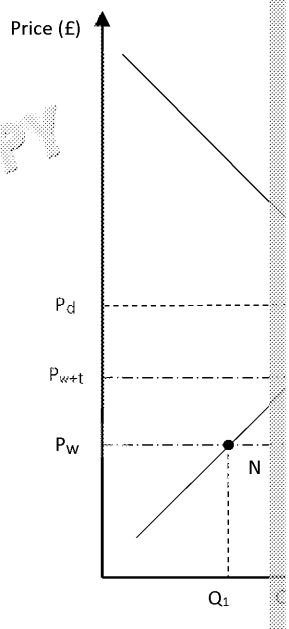
Since the creation of the EU, ther[illegible]a great deal of trade creation among
the reduction of trade ba[illegible]between them (indeed, the EU is the UK's largest t
has been di[illegible]a[illegible]non-member countries (trade diversion) since the
countries is[illegible]easier due to the EU trade bloc. Commonwealth countries and
relationship has deteriorated since the creation of the EU, as the EU countries ha
external tariff against imports from non-members. Thus, no country can benefit
member. Trade with emerging economies has increased over recent years as the
expand their export markets.

Trade flows are also affected by relative exchange rates. Countries with highly v
benefit from greater imports, but they may find it harder to sell their exports (sin
expensive). An example of the opposite case is China: rapid Chinese growth dep
and China has been attempting to depreciate its currency to help promote expor

Types of trade restriction

Tariffs

Tariffs can also be known as import duties or customs duties. Tariffs are simply taxes that foreign firms [illegible]
to pay in order to sell in the country. The[illegible]al taxes increase the costs for foreig[illegible], therefore, prices on imp[illegible].



Closed to in[illegible]onal trade: The diagram to the right shows t[illegible]market for a good. The demand and supply curves are the domestic demand and supply. P_d is the market equilibrium price if the economy was closed to the international market.

Open to international trade: However, the price of the good on the world market is lower, at P_w. If the country opened up to international trade, then domestic supply would fall to Q_1 because most domestic firms could not compete with international firms. However, at this price, domestic demand would be at Q_4 and so the countr
order to meet the demand.

Imposition of a tariff: The price would be pu[illegible]d [illegible]to P_{w+t}. This means more d
market, and the quantity of domes[illegible]produced goods will rise to Q_2. At this h
will fall to Q_3. Because Q_4 is [illegible]ter than Q_2, the country will still need to im

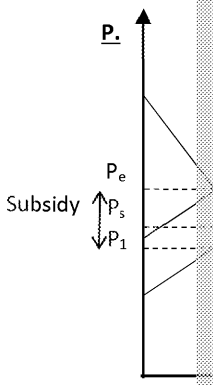
The shaded [illegible]s t[illegible]amount the government will receive in tax revenue from

Quotas

Quotas are similar to tariffs, but instead of imposing a tax on imported goods, qu
limit on how many goods and services an economy can import. The diagram is si
except no tax revenue is raised for the government because there is no tax. The
point where the government has set the cap. The quota is aimed at reducing the

Subsidies

Remembering your Year 1 microeconomics, a sub
grant the government gives to domestic
to lower costs and become more
comparison to internati



Subsidies w
Unlike a tari
governments need to give money to producers.

Non-tariff barriers

There are other ways in which a government can manipulate imports that are more hidden than an obvious, upfront tariff or quota. For one, a government can implement expensive and lon
procedures in order to deter foreign trade. Environmental or health and safety r
of non-tariff barriers.

Why might a country want to restrict trade?

- **Infant and sunset industry argument**
  A sunset industry is an old and declining industry. Income flows tend to become stagnant as investors
  industries due to the decline in profi
  goods. However, these ind
  economies and need
  the opposit
  sti
  kn
  protect these industries from global competition and facilitate them to

- **Protect employment**
  The general idea is that trade barriers will increase the price of foreign
  threaten domestic ones because they are more competitive. Demand
  produced goods to imports, the domestic industry will go into decline a
  barrier is believed to shift domestic demand from imported goods to do
  the industry to expand and create jobs (or protect the current level of e
  increase employment. This can be done in a particular industry, by appl
  goods, or to protect the employment levels in the whole economy by s

- **Retain self-sufficiency**
  Some countries may be uncomfortable with
  countries to provide certain goods a
  order to allow their economy
  other countries fall i
  recession or a war interrupts trade patterns.

- **Ba
  Th
  for imports. As imports fall, it is hoped a trade balance deficit will fall an**
  here is that a trade barrier will increase the price of imports and

- **Retaliation**
  If a country imposes trade barriers on another country's goods, the cou
  retaliation restriction.

- **Prevent dumping**
  Dumping occurs when a foreign country sells its excess goods in the do
  price. This is bad because it can put domestic suppliers out of business
  barriers restrict the volume of goods a country can sell in the domestic
  country from dumping its goods.

- **Reduce competition**
  Foreign countries may have a comparative advantage and be able to pr
  than the domestic economy. Therefore, a country may impose a trade
  level of competition threat in the foreign markets.

- **Protect strategically important industries**
  During times of conflict or global instability, normal trade patterns are d
  wa[illegible]rotect certain industries that produce goods that are invaluab
  are comparatively disadvantaged because, during times of disrupted tra
  need a steady supply of these goods.

Further Your Economic Knowledge...

The paradox of free trade

It is believed that free trade benefits all economic agents in all coun
(protectionism) only harm it, and prevent the benefits that come wi

Industries in one country may be harmed by opening up to the glob
competitive. Policymakers may wish to add protectionist measures
foreign competition and thus ensure job security for the workers of
common consumer will suffer from high[illegible]es because cheaper g
entering the market. By protecti[illegible]m structural unemploym
higher living costs and [illegible]er purchasing power. Free trade suppo
protectionism will [illegible]e economic efficiency worldwide as resour
m[illegible]d provide a greater benefit for all.

[illegible]ever, developing countries are not always able to compete with fir
who have access to knowledge and capital, even if they have a compara
measures are often unfairly used to dampen competition from countri
power. The paradox is that free trade can harm some countries and pro
global economic welfare if used in the right circumstances. Developing
protectionism because it allows them the fighting chance they need to
establish themselves to compete in the global market. Once they have
can use the generated funds to reduce poverty and raise living standard

Impacts of protectionist policies

Consumers

Consumers often suffer from protectionist policies as cheaper and more competi
entering the market. Instead consumers' demands are directed towards domest
comparative disadvantage. The hope is that the domestic firms will gain a compa
self-sustaining to produce the goods competitively.

Producers

The impact of protectionist policies on producers will have different effects depe
is domestic or foreign and whether it imports materials, exports goods or sells do
should find that demand for their products increases as protectionist policies dive
imported goods and domestically produced goods. Domestic exporting producers
protectionist policies from tit-for-tat retaliation from other countries, which will
producers may import parts for production, such as a table-making company imp
These producers may find their costs increase as protectionist policies are aimed
Foreign producers who sell goods in the country will find demand for their goods
increase their prices.

Governments

Governments may add protectionist policies due to a political agenda, or to prote
voter support. However, protectionist policies, such as subsidies, can be very co
deficit, leading to debt increase. Alternatively, the government may impose a ta
although the bureaucratic procedures can be just as costly as the money earned
find they are met with tit-for-tat retaliation policies from trading partners, which
economically damaging.

Living standards and equality

Protectionist policies are designed to protect the domestic economy and the peo
such as domestic producers and their workers. Without protectionist p
lose their incomes, pushing them into poverty and reducing living standards. By
domestically produced goods, jobs can be created, thereby reducing income ineq
without jobs and low earning incomes. However, countries which face the prote
and harder to export their goods. This can cause economies to decline, business
and equality to rise. It is often developing countries which bear the brunt of prot
the countries that need trade the most. Protecting developing countries from co
developing countries' chances to trade and grow will increase inequality.

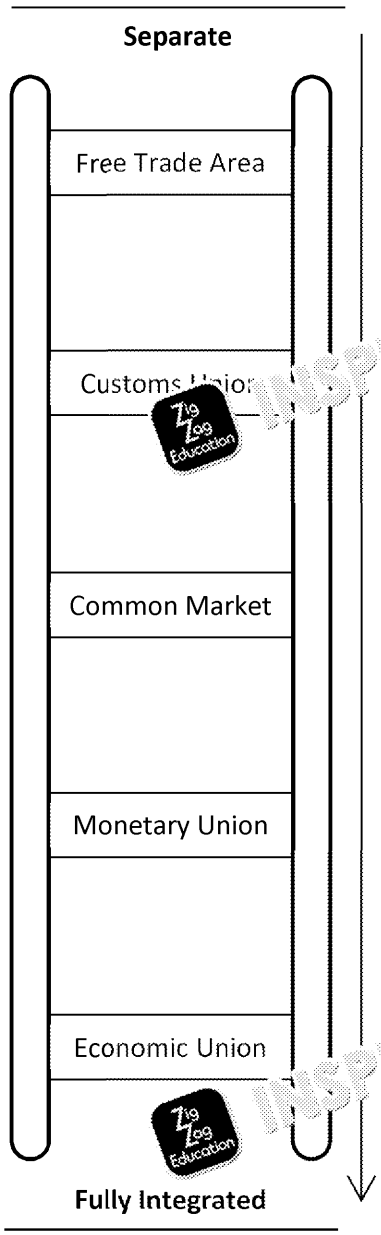
Trading blocs and the WTO

Trading bloc = A set of countries which have an agreement on the level of trade
each other.

WTO = The World Trade Organization is the international governing body on the tra

Examples of trading blocs:

- NAFTA = North American Free Trade Agreement
- EU = European Union
- LAPA = Latin American Pacific Alliance
- SADC = Southern Africa Development Community



Free trade areas

Free trade areas are groups of countries w
free trade between them. By this, it is mea
restrictions or barriers between the countr
be increased trade among these countries.

This agreement ... ermines the way in
the othe... c un... s within the agreement.
... are allowed to set their own, ind
countries outside the agreement (non-mem
member countries can bypass potential hig
member countries by entering through the
lowest/cheapest trade barriers. Once they
area through the low-barriered countries, t
other member countries without the high-b
'Rules of origin' laws are often put in place
circumvention.

Customs unions

Just like a free trade area, a customs union
member countries to have low to no trade
trade among member countries. However,
member countries avoiding barriers, a cust
common protectionist measures. By this, it
countries will set th... ne barriers and rest
countries. The EU is a customs union with

Common markets

A common market, like a free trade area, h
member countries to have low to no trade
protectionist measures, like a customs unio
union, a common market allows free move
among its member countries. The EU has the Single Market. It promotes interna
who lives within the EU member countries to move freely, without restriction, i.e.
travel between EU countries without a visa or a passport (although travelling via
still requires a passport, so this rule is somewhat redundant for UK nationals).

Monetary unions

A monetary union, also known as a currency union, is the last step towards full in
the euro single currency used in various EU member states. A monetary union, li
no trade barriers to free trade; like a customs union, it has a set of common exte
like a common market, it has perfect mobility of factors of resources. However, t
the member countries adopt a single currency (e.g. the euro!). There is another s
member countries attempt to align their economic po
onetary and fiscal)

Costs of monetary unions

- **Transition costs of a sin cy**
  There are cost with changing prices on menus, price labels, e
  wi be period of adjustment while people realign their price expe
- **Lo overeignty**
  As countries join together and agree to a change to a trade policy, the c
  control and change its policy. A monetary union will mean the individua
  their independence to change monetary policy and lose exchange rate fl

Benefits of monetary unions

- **Eliminating transaction costs**
  Once all the countries are on the same currency, there is no cost in atte
  currency to another in order to make transactions.
- **Price transparency**
  It is much easier to make price comparisons if all goods and services are
- **Reduction in exchange rate uncertainty**
  Exchange rates are constantly changing. Some countries may adopt fixed exchange rates, where the gov ent make small adjustments on the financial ma ke order to keep the currency at the same t but this is costly and still not certain. With o cy, transactions between France and Ger y, for example, can occur without the w of th ange rate changing.

Learn M
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and the
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Fo

The UK and the EU

In June 2016, the UK held a referendum on its membership of the EU. Prior to th
debate between supporters of either side of the argument. Here is a brief summ
and against staying in the EU both economic and non-economic. (Disclaimer: the
written before the referendum, but I've tried to keep it unbiased!)

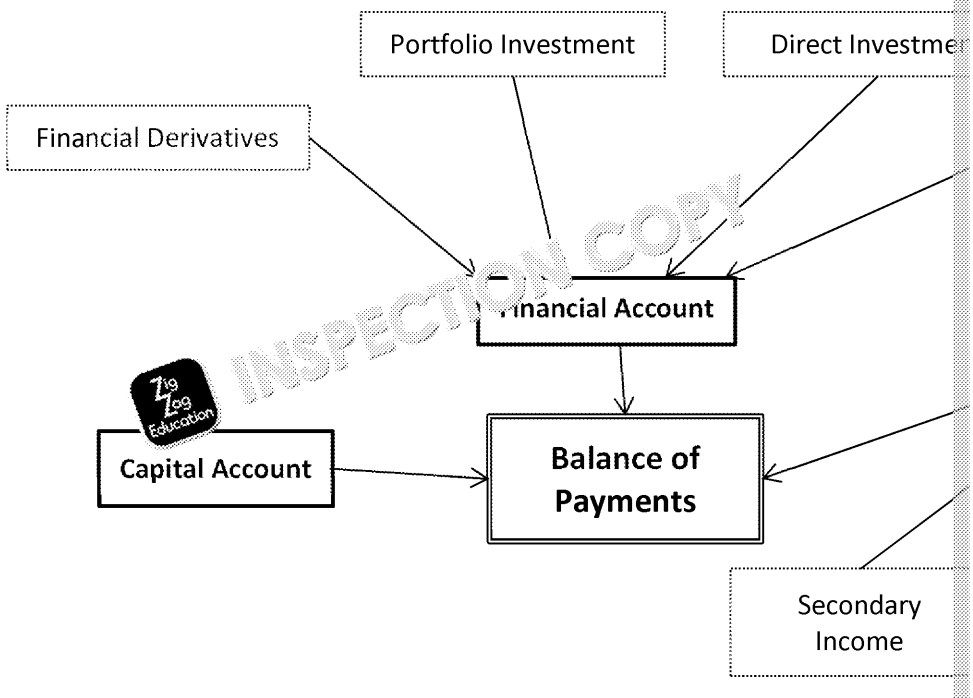
Arguments for remaining in the EU

- **The importance of EU-trade for jobs and economic growth**. The EU is th
  and leaving the EU would risk losing access to the single market. If we w
  market, we may have to pay a fee or accept free movement of labour as p
  counter-argument to this is that we are larger than Norway so have mor
  deal, but this is quite uncertain. It is generally agre we would have to p
  access the single market, since if we got acce fre it would encoura
- **If we leave the EU we lose our repr nt tion in the EU parliament.** W
  have a say on how our con is governed.
- **Our voice on the in al stage would be diminished if we leave.** S
  the UK's po major global power would deteriorate if we left th
  be s a unit. In important international matters, such as the confli
  imp t point. Eurosceptics might argue that our membership of the E
  and that we would still be a member of international organisations such a

Arguments for leaving the EU

- **Allows greater control over EU migration**. Some people are concerned a
  coming to the UK from Europe. As part of our membership deal, we have
  migrants, so leaving the EU would enable us to tighten our borders if we
- **Increase our national sovereignty**. Opponents of the EU argue that the p
  regulations diminishes our ability to set our own laws. A counter-argume
  often than not we vote in agreement with the rest of EU for our laws, and
  regulations increases trade (particularly in product markets and with resp
- **Eliminate membership costs**. According to some figures, we are a net co
  we would get this back if we left. A counter-argument to this is that it he
  contributor, since we are helping our future trading partners to develop.
  do so in ways beneficial for the economy (e.g. infrastructure spendi
  Northern and Wales), and there's no guarantee that a UK government w
- **We would be able to forge stronger trade relationships outside the EU.**
  opponents of this argument say that being part of the EU does not stop u
  arrangements outside the EU.

The balance of payments



Components of the balance of payments

The balance of payments is made up of three parts: the capital account, the current account and the financial account. Your exam expects you to know these three components, but only need to know the current account in detail.

The balance of payments must always equal zero. If we spend more on imports than we sell in exports, then we will need to fund these purchases from another component of the account, such as selling a government bond, wh financial account. So, deficits in one component must be counterbalanced by a s

The current account

- **Balance of trade**
  There are two parts to the balance of trade: the trade in goods balance, a
  The balance of trade looks at the value of goods that have been exporte
  imported, and the overall balance of these. An import appears as a neg
  money leaves the economy in return for the imported good, and an exp
  account because money enters the economy in return for the exported g

  Current account deficit can occur when the value of imports exceeds th
  overall value is negative, meaning more income is flowing out of the ec

  Current account surplus can occur when the value of exports exceeds t
  overall value is positive, meaning more income is flowing into the econ

- **Primary income**
  The income part of the current account looks at the income earned by f
  includes things such as profits, interest and dividends on investments a
  domestic citizens on overseas assets is counted as a positive on the cur
  coming into the economy, whereas the income earned by foreign citize
  counted as a negative because money is leaving the economy. Therefo

  Current account deficit can occur when the value of domestic assets ow
  the value of foreign assets owned by domestic citizens and the overall v
  income is flowing out of the economy.

  Current account surplus can occur when the value of foreign assets ow
  the value of domestic assets owned by foreign citizens and the overall v
  income is flowing into the economy.

- **Secondary income (previously current transfers)**
  This looks at the transfers between governments. A transfer is someth
  for something else (i.e. it is not income as a result of trade because this
  exchange for a good). When a government lends money to another, th
  current account. When a government borrows money, it is recorde
  foreign aid. Aid is money given by one country to another for a speci
  grants. Another would be when the UK receives money from the EU's Common A
  support the UK's agricultural sector. This would appear as a positive on
  Therefore…

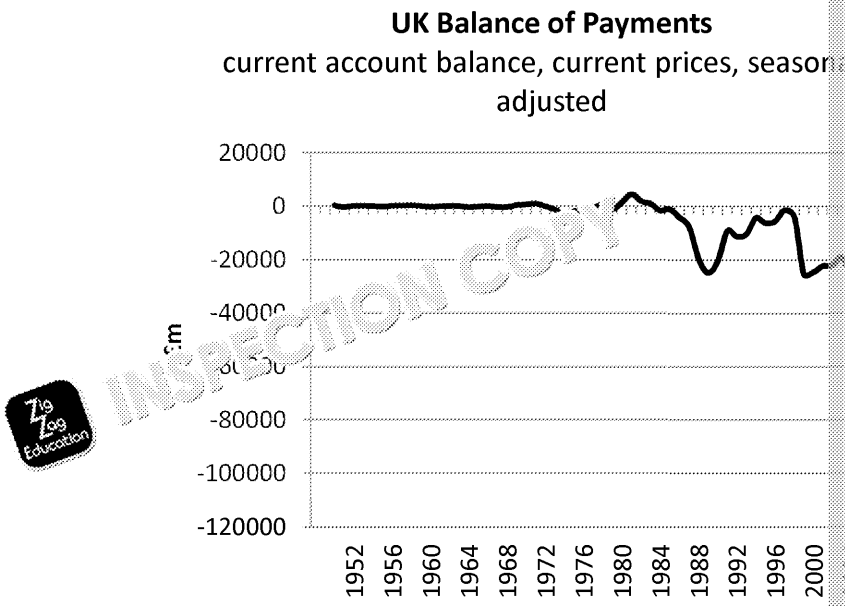
  Current account deficit can occur when a country lends or gives more m
  receives and the overall value is negative, meaning more income is flow

  Current account surplus can occur when a country receives or borrows
  lends and the overall value is positive, meaning more income is flowing

In summary…
A current account deficit occurs when the current account is negative because t
leaving the country (-) exceeds the total value of money entering the country (+)
income into the economy.

A current account surplus occurs when the current account is positive because t
leaving the country (-) is less than the total value of money entering the county (+
income out of the economy.

The chart below shows a history of the UK's balance of payments between 194
generally run a deficit on the current account since the 1970s.



Source: ONS

QUANTITATIVE SKILLS

Real and nominal prices

The graph above shows the balance of payments in **current** prices rather than **co**
the figures are **nominal** rather than **real.** The effect of inflation hasn't been take

QUANTITATIVE SKILLS

Seasonally adjusted figures

The figures in the graph are **seasonally adjusted.** This means that any va
regular int (p during the summer, for example) has been smoothed o

The capital account

The capital account is a relatively small part of the balance of payments. It looks
ownership of domestic firms and domestic ownership of foreign firms.

The financial account

- **Direct investment**
  This accounts for the transfer of capital between an enterprise and an i
  could be capital that is provided to an investor by an enterprise, or rece
  investor. Direct investment tends to have a beneficial impact on an ec
- **Portfolio investment**
  This component looks at the investment in equities and debt securities
  difference between direct inve (also known as FDI) and portfolio
  investment involves di over the business entity that receives
- **Financial derivatives**
  A financial instrument is accounted for in the financial derivatives pa
  va these instruments are priced on the value of the underlying a
- **Reserves assets**
  This part looks at the foreign financial assets that the Bank of England a
  use in order to regulate payment imbalances and for financing.

Note: a positive addition (credit) on the current account will always be m addition (debit) on the capital account, and vice versa.

Causes of current account deficits and surpluses

- **Value of the country's currency**
  If a country's currency is overvalued, then its goods and services will ap other countries' goods and services. Simultane , an overvalued cu cheap. This will mean demand for the co xports will fall, while d rises, and this could cause a cu count deficit. If a country has an demand for its exports e because its goods and services will could potentia to a current account surplus.

- **R nflation**
  Inf represents the price of a good or service. If a country has rela the country's goods and services will appear at lower prices compared find it easy to sell exports, potentially leading to a current account surp higher prices than another, their prices will appear relatively higher tha demand for their exports will fall, potentially creating a current accoun

- **Economic growth from imports**
  Economic growth tends to bring about higher average incomes. This m their consumption and, if domestic supply cannot meet the increased d import. Rapid economic growth often results in a current account defic between increasing demand and increasing supply. Equally, in the UK w import and there can be the view that imported goods are better than d wine rather than UK wine. So when people's incomes go up, they will s Imports increase and the UK potentially has a curre account deficit.

- **Non-price factors (quality and design)**
  People don't base their decisio a good or not solely on the pric design or quality of a good c come into play. If a country produces g a greater dem for its exports and, thus, is likely to have a current ac co ha appealing packaging, this may reduce demand for its exp a account deficit.

Measures to reduce current account deficits

- **Expenditure reduction**
  This is a deflationary policy aimed at reducing aggregate demand. A fal a fall in consumption (as this is a component of aggregate demand). A there is a fall in the purchasing of imports, thus alleviating the deficits. falls, it is hoped that firms will try to sell their goods to foreign consum and further help to reduce a deficit.

  Problems: A fall in aggregate demand can mean an economy has negat Equally, unemployment may rise as firms cut back production to meet t

- **Expenditure switching**
  By adding tariffs, quotas or other trade barriers, domestic consumers c expenditure from imported go domestically produced goods. By habits, a current acco deficit can be reduced.

  Problems. lead to tit-for-tat retaliation from other trading part its exports falling; the deficit problem may not be corrected.

- **Supply-side policies**
  Spending on policies that improve productivity and human capital can b demand for exports through increased quality of goods, boosting intern **Problems**: Supply-side policies tend to have long time lags, so their effe

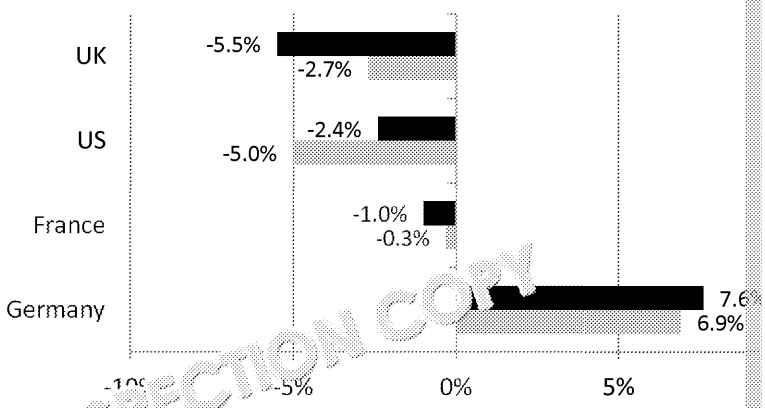
Global imbalances

It is not sustainable for a country to have a reoccurring current account deficit be
via another component, most commonly through a surplus on the capital or fina
borrowing large sums of money can only alleviate the problem in the present tim
interest or a return on their investment.

Scaled up to a global level, this can have significant proble The recent collaps
2008 suggested that large current account deficits are sustainable. Equally,
problematic if they last for a long time. Limited wards and consumer choice ma
surplus suggests resources are being for export purposes rather than being

The graph on the following page shows the change in current account balances i
2007 (before the financial crisis) and in 2014. Note how the UK's current accoun
time period, the US's improved. Germany ran a current account *surplus* in

Current account balance in the UK and select countries
(% of nominal GDP)



Source: ONS, Eurostat, Bureau of Economic Analysis, INSEE

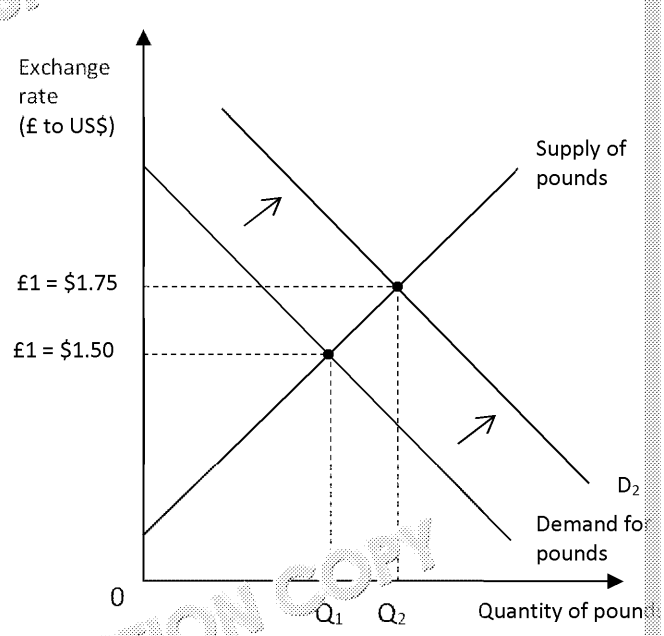
Exchange rate systems

The exchange rate is the price of one currency expressed in terms of another cur
between the pound and the US dollar could be £1 = $1.50.

There are two main ways in which exchange rates work: a free floating exchange
Most large, modern economies today use a free floati nge rate (including

Free floating exchange rat

Under a free floating exch e supply and demand for a currency deter



In this diagram, the initi m is where £1 = $1.50. If demand shifts to the th exchange rate (or 'price' of pounds in terms of dollars) goe ow £1 can buy more dollars.

Demand and supply for a particular currency can change for a number of reasons, including:

- **Economic prospects**. A country that is performing strongly is likely to have a higher demand for its currency.
- **Interest rates**. A country with a high interest rate makes it attractive to save in that country, boosting demand for the currency.
- **Inflation**. Inflation reduces the value of money. A country experiencing a high rate of inflation would see a fall in demand for its currency.
- **Speculation**. Some investors buy or sell currencies on the foreign exchange markets to try to earn a profit. For exam , if they expect that value of the pound to rise, the buy pounds at a low exchange rate, then sell them e the exchange rate goes up.

Fixed exchange rates

The opposite of a free floating exchange rate is a fixed exchange rate: in this case value of the currency rather than leaving it to the free market. Often an economy currency to that of a leading currency, such as the US dollar or Euro. For example pegged the Swiss franc to the Euro at €1 = 1.2 Swiss francs.

The main advantage of a fixed exchange rate is that it creates a stable environment who import and/or export goods. They are no longer at risk of sudden fluctuations the price of their goods.

However, the problem with a fixed exchange rate system is that the government take steps to maintain the fixed exchange rate. In the Swiss case, many investors were seen as a safe haven, which in a free market would have pushed up the exchange rate peg, the government had to print new francs and exchange them for Euros (increasing to fears that it would cause inflation. In the end, downward pressure on the value quantitative easing by the European Central Bank) made it impossible for the Swiss abandoned it.

Most countries that experiment with fixed exchange rates tend to abandon them too much pressure on the central bank to artificially maintain the peg, which prevents areas. For example, the central bank is constrained when it comes to changing the would like to change the interest rate to manage economic growth. However, unless are likely to need to change it in order to maintain the peg instead (e.g. increasing market value of the currency: this could cause a slowdown in the economy).

Currency unions: advantages and disadvantages

Lots of the arguments around fixed and floating exchange rates also apply to currency Eurozone. These pros and cons were covered in the section on trade, but here's a

Advantages of currency unions

- Eliminates costs of converting between currencies, this saves time and effort
- Reduces exchange rate uncertainty – economies within the currency union no longer have to worry about exchange rate fluctuations
- Easy for consumers to compare costs and prices in different countries (transparency)

Disadvantages of currency unions

- Loss of monetary policy for individual countries. This is an important one. In a crisis, the German economy would have benefited from high interest rates while it would have benefited from low interest rates. The European Central Bank is why economists say that currency unions only work if participating economies cycles, i.e. they go through booms and slumps at roughly the same time.
- Initial set-up cost – costs of printing new money, for example.

Economic growth and development

Economic growth is the monetary value of a country in terms of the size of its ec

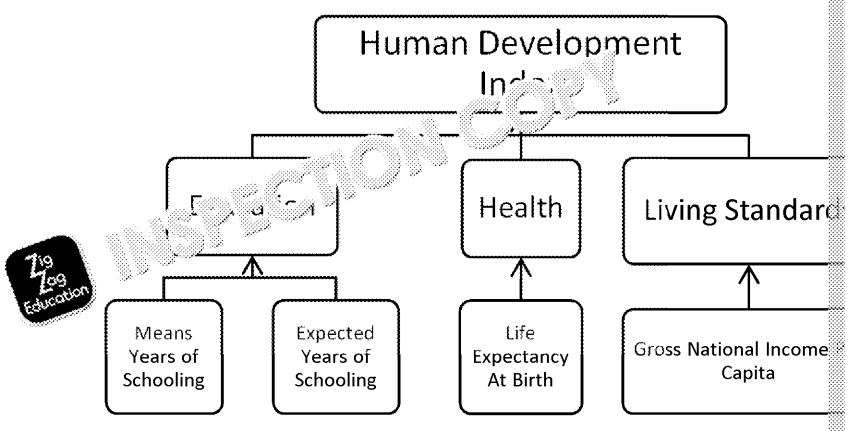
Economic development is the quality of a country in terms of how established a
welfare are.

How do they differ…?
Development and growth differ in terms of what they are concerned with, and so
variables. Production is better at showing the size and value of an economy, whe
is better at showing the quality of workforce. There is often a relationship betw
relationship between the two does not always hold true, it is believed that increasi
increasing economic development. This is because an economy that is growing h
and this income can be used to improve other aspects of society, such as funding
goods and services; it can be taxed, meaning there is more money going to the g
redirected towards improving schools and hospitals, for example.

Human Development Index (HDI)

1. **Education**: Mean years of schooling for an adult aged 25 and expected y
2. **Health**: Life expectancy at birth
3. **Real GNI per capita**: Adjusted using purchasing power parity

The measures come together to create an index value between 0 and 1. Countri
to how developed they are, 0 being less developed and 1 being more developed.



Advantages and limitations of HDI

+ It is multidimensional as it combines economic growth measures with m
  for showing development.
+ It allows for easy comparison and ranking between countries.
- It does not take into account inequality, and only looks at the mean ave
- It does not take into account ecological or environmental considerations

QUANTITATIVE SKILLS

Understanding composite indicators

A requirement of the curriculum's quantitative skills element of the course is the understanding
the most common composite indicators. Important of these.

A key idea about HDI is unitless: it is an index, composed of various factors as sh
can only be interpreted, therefore, as a means of comparison with other countries

The HDI is a geometric mean of the three components (education, health, and livi
need to calculate composite indicators in your exam. However, the formula fo
you understand it:

$$HDI = \sqrt[3]{Education\ Index \times Life\ Expectancy\ Index \times I}$$

Top 10 Countries in 2014	
Ranked by HDI	**Ranked by GDP per capita**
1. Norway	1. Luxembourg
2. Australia	2. Norway
3. Switzerland	3. Qatar
4. Denmark	4. Macau
5. Netherlands	5. Swit
6. Germany	
7. Ireland	Denmark
8. United S	8. Sweden
9. Canada	9. Singapore
10. New Zealand	10. USA

Source: United Nations/World Bank, 2016

The table to the left sho
world ranked by HDI an
lists are quite different.
world as determined by
10 countries as ranked b

Other development indicators

- **Economic indicators (GDP, GNI, GNP)**
  Economic indicators can show development because there is often a corre
  development. By measuring the national income in an economy, it can in
  to expand and improve. However, economic measures are not accurate a
  there is no guarantee a large economy has a progressed society with high

- **Inequality (Lorenz curve and Gini coefficient)**
  The problem with economic measures a
  Averages may appear at good l
  these values if there is a small group that measures extremely highly. Beca
  people and not
  cu
  po

- **Inequality-adjusted Human Development Index (IHDI)**
  IHDI attempts to take into account the damaging effects of inequality.
  averages that were calculated according to the inequality levels within
  then the averages will be lowered in order to account for this.

- **Multidimensional Poverty Index (MPI)**
  MPI looks at poverty from a versatile point of view. It goes beyond a si
  and looks at a wide variety of measures, such as sanitation, and conside
  they are deprived of one-third or more of the items measured.

- **Mobile phones**
  By looking at the number of mobile phones there ar per 1,000 people,
  can be determined. This can indicate the le de elopment a count
  the incomes are high enough to af ll xy items, and also whether t
  access to technology whic in ove production.

- **Access to cle e**
  C te s basic human right, and the accessibility can show the a
  ne s indicating a country's level of development.

Factors influencing growth and development

- **Primary product dependency**
  Primary product dependency refers to countries whose main bulk of exp
  (raw materials) such as wood or coal. This can limit growth for a variety
  products generally have little return, hence why they are sometimes call
  means the value of exports is very low and there will be only a small inflo
  Secondly, commodity prices fluctuate, which causes swings in a country's
  exchange rate, and can create economic instability and limit the ability to
  are income elastic, so as world incomes rise, there will be little change to

- **Volatility of commodity prices**
  Commodity price volatility can create econo st bility from inflatio
  producers varying revenue. This w le er otential investors in the co
  from gaining the influx of i e ey may need to grow and develop.

- **Harrod–Doma (savings gap)**
  Th oc nar model explains that there are two factors that affec
  le a country: the savings ratio and the capital-output ratio. The c
  efficiency of capital to produce goods; the more productive capital is, t
  country can produce and so the quicker it will grow. The savings ratio l
  country. The higher the savings ratio the easier it is for banks to lend n
  to invest and grow.

- **Foreign currency gap**
  Developing countries may suffer from a foreign currency gap. This is wh
  payments deficit (on the current account) is higher than capital inflows
  are heavily dependent on exports (perhaps coffee beans or bananas).

- **Capital flight**
  This is when investors move their capital from investing in one country a
  happen for a variety of reasons. For example, t n the original cour
  so the return on investment will fall and as a r sponse, investors shift t
  political and economic instabili o investors move their money to
  consequence of capital ligh country's currency will fall dramatically a
  fluctuate; equ s oney leaves an economy it may begin to deflate
  re g ts on growth and development.

- **De graphic factors**
  The demography of a country refers to the distribution of age of a popu
  population are likely to be restricted in growth rates because a lot of th
  the workforce as they are outside working age.

- **Debt**
  If countries are spending money to repay old debts, then they are unabl
  or development policies. Debt repayments represent an outflow of mo
  nominal value of the debt is less relevant; the sustainability of the debt
  economy and its ability to afford it. This is why debt is often measured

- **Access to credit and banking**
  If the people within a country do not have a[illegible] to capital or the ability
  then they will not be able to prote[illegible] their wealth, or take out
  accessibility can prevent a[illegible] from growing and developing.

- **Infrastructure**
  Infrastructure determines the ease with which resources can be moved
  infrastructure will prevent businesses from transporting their goods, the
  prevent businesses from acquiring the resources they need for product
  businesses from manufacturing. These barriers will prevent a country fr
  businesses and economy.

- **Education and skills**
  Education and skill can improve human capital. Countries which invest in
  will find their growth and development rates will increase as they have a

- **Absence of property rights**
  Property is often used as collateral when somebody takes out a loan. If p
  a property, then this may prevent them from obtaining a loan, and hence
  development rates may suffer.

Non-economic factors

Non-economic factors affect the country's ability to [illegible] and regulate society,
efficiency of the economy and reduces growth levels. These factors can also redu
of life, which adversely affects a country's development levels. Some examples a

- corruption
- poor governance
- war
- political instability
- geography
- distribution of resources (resource curse)
- landlocked countries

Market-orientated strategies are strategies where the government attempts to
growth and development, rather than the government directly changing the cond

Interventionist strategies are strategies where the government takes a more dire
the market, the government will simply change the market conditions.

Market-orientated strategies

- **Trade liberalisation**
  By reducing trade barriers and liberalising trade, it is hoped a country w
  from an increased market. More exports means a country can increa
  inflows of income into the economy. This should also increase job creat
  which, in turn, helps the economy from greater demand (due to th
  improved investment and living standards.

- **Promotion of FDI**
  Foreign multinational companies can bring an inflow of money into an e
  can boost economic growth and development. If a foreign MNC sets up
  because the tax rates are low, then the theory is that it will offer jobs fo
  that will boost the economy.

- **Removal of government subsidies**
  By removing a subsidy, industries that were once protected by state int
  competition. Inefficient industries will collapse as they are unable to c
  the long run, it is hoped that removing subsidies will improve resource
  were tied up in these industries, or the resources spent on protecting t
  and allocated to more efficient industries that will provide more revenu
  However, while one industry collapses and ano[illegible]egins, there will b
  which will reduce growth and developm[illegible] Imports will rise if domest
  to go with domestically produc[illegible]ds any more, and this could cause
  deficit. However, the [illegible] the government isn't spending on su
  elsewhere, such [illegible]supporting those who lost their jobs from the declin
  gr[illegible]an[illegible]opment policies.

- **Flo[illegible]g exchange rate systems**
  Countries that have spent money on artificially keeping their currency l
  a floating exchange rate. This is when they allow their currency to appr
  with change in demand and supply. The currency will depreciate from i
  there will be a boost in exports and a fall in imports. This inflow of mor

- **Microfinance schemes**
  Microfinance is a way for people to loan a small amount of money to fund other people's investment projects. It is often aimed at people who have little access to banks and funding, to help promote their innovation and entrepreneurship. By providing finance to those who lack the ability and opportunity, a country can find a positive impact on its growth and development levels

Learn M
Deki is
website
the sch
http://
Fo

- **Privatisation**
  Privatisation can make an [illegible]om[illegible]more inefficient. Equally, any reso
  the organisation c[illegible]e spent on development and growth policies
  the c[illegible]pa[illegible]ow generate profits which will be taxed, adding to th
  g[illegible]er[illegible].

Interventionist strategies

- **Human capital**
  By improving human capital, a country can increase the productivity an
  thus increasing GDP and economic growth. Equally, the more skilled ar
  workforce, the more likely it is that industries that produce complex an
  up; this in turn will bring in higher revenues and greater incomes for th

- **Protectionism**
  Protecting industries will protect the jobs of those within the industry.
  ensure critical goods will still be produced and provided for the domest
  living standards may fall. Protecting infant industries can allow a marke
  advantage, and the economy will expand int[illegible]n[illegible]arket and economi

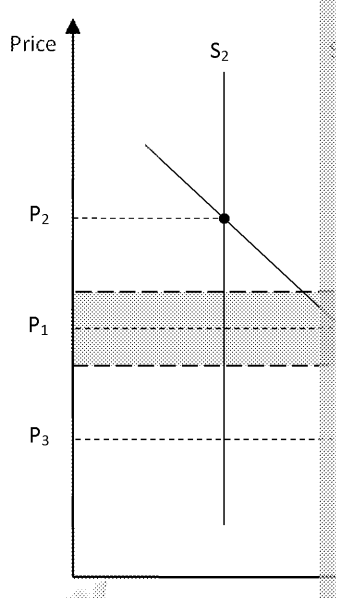
- **Managed exchange rates**
  A government can man[illegible]ge[illegible]hange rate by changing the demand a
  interest rate ch[illegible]s. By doing this, a government can depreciate the
  st[illegible]e[illegible]. The inflow of income from greater exports can incre

- **Infr[illegible]acture development**
  The economy works as your body might: every little component has a f
  these components can have significant effects on the whole system. Th
  and arteries: it allows the economy to function and transport resources
  inefficiencies and time lags which will only add barriers to economic gr

buildings and roads can have negative effects on living standards and q
investing in infrastructure can improve the economy and surroundings.

- **Promoting joint ventures with global companies**
  By promoting the engagement of global companies, a country can bene
  direct investment which can inject money into the economy for growth
  jobs and provide employment and incomes to the people within the co
  growth rates through increased aggregate demand, but will improve de
  be able to afford the goods and services they require.

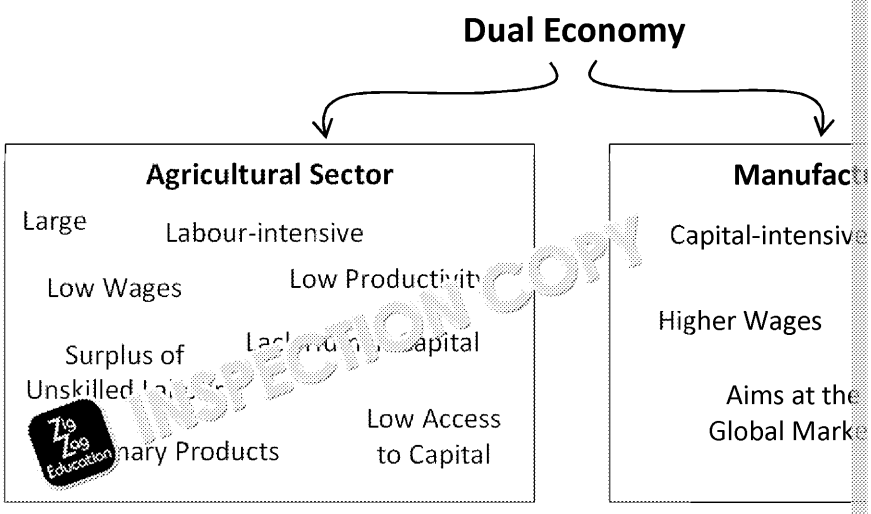
- **Buffer stock schemes**
  Agricultural goods such as commodities are
  susceptible to price volatility. This is
  detrimental for farmers as some years
  they will have very little income and they
  cannot always plan ahead for investment
  as they do not know what returns they
  will have in the future. This can be
  detrimental to an economy, especially
  one that has a large agricultural sector,
  as this not only will affect the balance of
  payments and output of an economy,
  but also the farmers are other
  businesses' consumers and if their
  incomes are low, it can have knock-on
  effects for other markets. Buffer stocks
  are designed to mitigate these
  fluctuations and allow farmers the ability
  to plan, invest and grow. To show how
  this works, we will use the example of corn (see graph). One year there
  the supply curve would be at S_3 and the price would be at P_3. This is belo
  considered the minimum income for farmers to meet their basic needs a
  government will buy corn in order to reduce supply to S_2 and bring the p
  benefit of corn; perhaps there was particularly bad weather for g
  S_1 and price at P_2; this is the government's chance to sell its stored stock
  previous bumper harvest. Selling the stored corn will push the supply cu
  down again to be within the set limits. This also ensures there is enough
  consumers to buy, and at a price they are able to pay.



Other strategies

- **Industrialisation**
  Industrialisation is the idea that a country develops its sectors from a lo
  higher-return industrialised sector. Industrialised markets tend to be m
  goods that bring in higher revenues, which results in higher wages. The
  with prices. This increase in the value of goods should boost an econom
  better living standards through more advanced goods and higher wages.

- **The Lewis model**
  William Arthur Lewis came up with a development model to explain how
  agricultural to industrialised. He believed countries would have
  m economy would have a large agricultural sector and a smaller
  of economy assumes the agricultural sector would have a surplus o
  manufacturing sector would have higher wages, but that these would be
  from the agricultural sector would be attracted by the higher wages and
  sector. The firms in the manufacturing sector would invest their profits i
  people joined this sector, leaving the agricultural sector, and as firms gre
  would expand, and as the agriculture sector diminished the economy wo



- **Tourism**
  The tourist industries tend to require more labour-intensive work than capital-intensive work. This means countries with low levels of capital, but that are 'labour abundant', can access these markets. Holidaymakers present an inflow of money into an economy as they consume the goods; they also tend to have slightly more inelastic demand curves.

Evaluation Poin
Tourism can presc
For example, tour
environment thro
travel. Airports n
in CO_2 emissions,
airports. Resource
sometimes provid
nationals.

- **Fair trade schemes**
  Often, developing countries are unable to compete on the global mar[illegible] due to the market power of developed countries and their protective policies. The WTO aims to reduce protective policies in order to provide developing countries with the chance to fairly trade their goods and services.

Eval
Fair
'misa
indus
resou
other

- **Aid**
  Supporters of aid believe money given to countries can be spent on development policies which improve growth and development rates. However, critics of aid believe money will be spent on policies that appeal to the public but are actually inefficien development. There are different types of aid:

  Humanitarian aid = things given in times of emergency, such as tempor
  Grants = money given ('free of charge') to fund projects
  Soft loans = money given with the intent of being paid back, usually at a

- **Debt relief**
  Countries that have borrowed money may [illegible] they are unable to pay it 1980s and 1990s 'debt crisis' countries with high repayment costs will money on development and growth policies because they are instead re back these loans. This means the government can put the money into the

Review questions: the international economy

1. (a) Name one advantage and one disadvantage of globalisation.
   (b) How do the effects of globalisation differ for developed and less-dev
2. Explain how a country can have a comparative advantage in the product
   country has an absolute advantage.
3. What is the difference between a tariff and q
4. Describe the characteristics of the Sin le ur an Market.
5. Explain the difference betwe xp ture-switching and expenditure-r
   of the balance of pay ts.
6. (a) Describ components of the current account of the balance of pa
   (b) ib he UK's current account position.
7. The ts of the Eurozone are quite clear: it lowers transaction costs a
   uncertainty for businesses and consumers. What is the main disadvanta
   the Eurozone?
8. Why might a country want to fix their exchange rate?
9. What are the three components of the Human Development Index (HDI)?
10. Name three factors that might prevent a country from developing.

Exam-style questions: the international economy

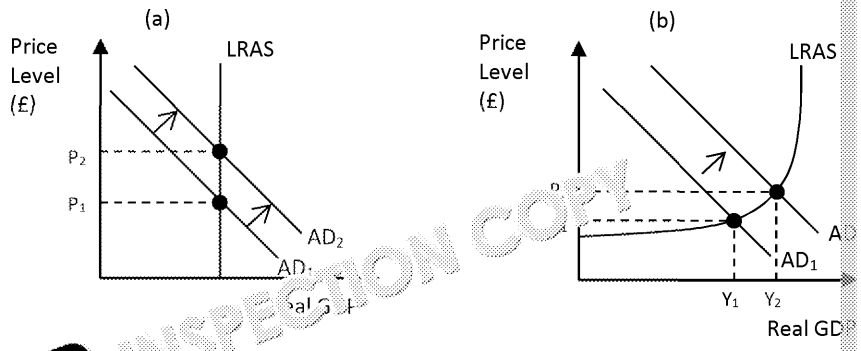
1. *'Globalisation and the rise of free trade have allowed the Chinese econom
   over the last few decades. More people have been lifted out of poverty in
   development than any other single factor.'*
   Discuss the costs and benefits of globalisation, cons ring both develop
   your answer.
2. Evaluate the policies that the UK g n might use to reduce the cu
   balance of payments.

Answers to Review Que

The measurement of economic performance

1. The main problem with this is it does not account for population size (GDP fourth most populous country in the world (a... inc. 256m people), wh... population of around 17m. So comparing the GDP of each country witho... is misleading: on average people from the Netherlands are much better o...
2. The correct answer is (c) buys fewer rupees at the PPP exchange rate. Think of this example: if India's original GDP were, say, 100 billion rupees, exc... rate ($1 = 60 rupees) it's GDP in US$ would be $1.66bn. But si... bett... measure of GDP would be higher: so if the PPP exchange rate were ... would be $2.5bn, higher than the original number. (Note: these numbers ...

How the macroeconomy works

1. (a) If households spend 40p from every extra £1, then the marginal pro... multiplier is equal to 1 / (1 – MPC), so in this case the multiplier is 1.6...
   (b) If the initial injection is £5m, then the eventual increase in income i...
2. 

3. (a) ... likely to shift both AS and AD to the right. More immigrants m... which increases aggregate supply. Immigrants also demand goods a... aggregate demand.
   (b) This is likely to lead to a shift to the left in AS, since it could lead to a... determines productivity. There would probably be a long time lag fo...
   (c) This should shift both AS and AD to the left. AD would fall since the ... demand would worsen (since the UK imports more oil than it exports ... feel that their real incomes are being squeezed by higher fuel or ene... the left since oil is a raw material used in production for many indus... make it more expensive for firms to produce goods.
   (d) This should shift aggregate demand to the right, since it will encoura... tax on consumption). You could argue that it would reduce governm... government spending, shifting AD to the left ... government spend... than consumption, so it likely that th... is ...ption effect would be ...

Economic performanc...

1. A slu... is ju... ...down in economic activity, i.e. when the rate of eco... is o... as two consecutive quarters of negative GDP growth rate. So a rece...n, and a recession is a particularly bad slump (look back at the gr... time, in most of the slumps GDP growth is low but still positive).
2. Possible answers include: government policy, confidence in the economy, factors such as booms and slumps in other economies.

3. (a) Voluntary unemployment
   (b) Involuntary unemployment
4. (a) MV = PQ
   (b) P
   (c) This suggests that either P or Q (or both) must fall. In other words, w either the price level will fall (which is the same as deflation) or the a being traded will fall (or both). Both of these are considered bad fo contractions in the money supply lead to a fall in economic growth (might not be true!).
5. When the economy is performing weakly and unemployment is high, firm which reduces inflation. Conversely, when the economy is performing st firms bid up wages to attract more workers, increasing inflation.

Financial markets and monetary policy

1. A store of value, a means of exchange and a unit of account.
2. Narrow money consists only of notes and coins, whereas broad money co well as bank deposits.
3. Because illiquid assets tend to generate a higher return, it can be more p as much into illiquid assets as possible. While liquid assets are safer, the y return. Hence there is a trade-off.
4. Other functions include: lender of last resort, maintaining macroeconom confidence in the financial system
5. Regulatory measures include: reserve/liquidity/capital requirements, me from malpractice, monitoring the riskiness of individual bank activities, m financial system as a whole.

Fiscal policy and supply-side policies

1. The cyclical deficit (or surplus) is the part of the total budget balance tha economic cycle. The automatic fall in government spending and rise i aut ri in government spending and fall in tax revenues in a slump The ural budget balance is the rest of the difference between spend cannot be explained by cyclical factors (e.g. the government is simply spe
2. Measuring national debt as a percentage of GDP is generally considered t national debt could rise, but if the economy is growing at a faster rate th is offset by the increase in GDP. The faster the economy grows, the more have to pay back its debts.
3. Fuel tax serves a dual purpose: to raise tax revenues (it accounts for arou for the negative externalities caused by fuel consumption (in terms of po
4. Possible measures include:
   Cutting government spending – but this runs the risk of lowering econom
   Raising taxes – again this has a dampening effect on economic growth
   Trying to boost economic growth – this is more of a long-term strategy: i increased then future tax revenues should be high . However, there is a fail to boost growth, or that they will increase the budget deficit in the sh government borrowing costs.
5. Free-market policies could include: tax cuts, deregulation (e.g. of the fina Royal Mail), labour market reforms (e.g. reducing the power of trade unio Interventionist policies could include: spending on education/training, sp dev nt, nationalisation, regulation (e.g. of the financial sector), ind infant industry).

The international economy

1. (a) Possible advantages might include: more trade (which means higher choice, lower prices, better cultural integration/understanding, elim collaboration on research and technology, etc.
   Possible disadvantages might include: temporary loss of domestic jobs potential for greater inequality within countri[illegible]otential exploitation
   (b) Developed countries are likely to ben[illegible] fr[illegible] cheaper goods from a of goods in general. Howev[illegible] co[illegible] be damaging for less-skilled who find that their jo[illegible]er threat.
   Developing [illegible]es should benefit from globalisation as they have [illegible]he [illegible] be exploited by trans-national companies. They may [illegible]led workers migrate to developed countries.
   Note: these are just very basic consequences of globalisation, in reali to country and the arguments can be much more in-depth.
2. Comparative advantage refers to the opportunity cost of producing a goo of a good that can be produced. As such, it is quite possible for a country advantage in a good (perhaps because it is particularly well suited for pro another country could produce more in total if it chose to.
3. Both are protectionist policies that aim to restrict imports. The differenc tax) on imports coming in, which makes them more expensive, whereas a total number of a good that can be imported.
4. The Single European Market is mainly concerned with free trade in goods a members, i.e. all protectionist barriers to trade are abolished. It also specif regulations for businesses operating within the market, e.g. labour laws ar also associated with the liberalisation of financial markets, to allow smooth countries. Free movement of people between [illegible] countries is anothe Common Customs Tariff (a charge on imp[illegible]ts [illegible]n outside the EU) is also a
5. Expenditure-switching refers t[illegible]s [illegible]gy of making imports more expen encourage consumers [illegible] swit[illegible] to domestic products. Expenditure-redu consumption i[illegible]c[illegible]omy, which should reduce the quantity of impo pol[illegible]m [illegible] correct a current account deficit on the balance of payme
6. (a) [illegible]urrent account can be broken down into the balance of trade (down into the balance of trade in goods and the balance of trade in s incomes.
   (b) Traditionally, the UK runs a surplus in trade in services but a large de an overall deficit in most years. The incomes part of the current acc (and most other countries).
7. The big disadvantage is that it results in a loss of monetary independence because the central bank can only set one interest rate (if each country se currency would be undermined), so if the economic cycles in different co central bank will not be able to set a policy that benefits everyone. For ex but Greece is in a recession, then an interest rate rise to benefit Germany versa for a rate fall.
8. The advantage of a fixed exchange rate is that it [illegible]es exchange rate ri (they know the value of the currency wor[illegible]ct[illegible]te over time, which wo future costs and revenues uncer[illegible], his stability and certainty should h an economy.
9. Life expectancy [illegible] [illegible]ears of schooling (education) and GNI (gross na
10. Pos[illegible]ar [illegible] to development include: corruption, lack of basic institu infr[illegible]ure, poor education, absent property rights, the resource curse go to promoting one industry, at the expense of the rest of the economy),

Answers to Exam-style Q

Exam-style questions: economic performance

1. D
2. B
3. D
4. A
5. For this answer you should first introduce the short-run Phillips curve
   trade-off between inflation and unemployment in the short-run. You
   run, this relationship doesn't seem to hold, since the economy t
   level of employment (as shown by the long-run Phillips curve). Tech
   unemployment should be defined in your answer (in this case it is th
   the labour market is in equilibrium).
   Since the natural rate of unemployment is so important, the governm
   policies to try to reduce the natural rate of unemployment. This cou
   improve the geographical mobility of labour (e.g. by building new ho
   system), or other issues that prevent people finding work. You shou
   in your answer.
   In your answer you should note that it is pretty much impossible for
   trade-off in the short-run: if it tries to reduce unemployment below it
   the result.
   Note: this question is probably harder than anything you'll have to
   the real exam, essay questions will be based on case studies, so you
   support your answer with.

Exam-style questions: financial markets and monetary

1. C
2. B
3. C
4. D
5. Some of the main ways in which the financial sector can be regulated inc
   Increasing the liquidity/capital reserve requirements for banks – part o
   crisis was that banks were too highly leveraged – i.e. the value of their lo
   their reserves/capital. Also, the assets they held were illiquid, so they co
   cash to pay off their debts. Requiring banks to hold larger reserves mean
   losses without going bust. There is a trade-off with this, however, if ban
   then they won't be able to make as much profit.
   Monitoring the activities of banks, making sure they aren't taking exces
   regulators were completely ignorant of the risk involved in some banks' a
   oversight of these kinds of activities is very important, since it can help t
   makes banks think more carefully about investing in certain products. Ho
   products are very complicated, and banks [illegible], so it's no easy task t
   Better protection for consumers – [illegible] banks have been found guilty o
   More effective regulation in [illegible] (particularly avoiding 'regulatory ca
   and transparency) in the industry.

Exam-style questions: fiscal policy and supply-side poli

1. A (B is not necessarily true, because the economy could grow at a faster
2. D (a government could cut spending, but the budget deficit might still ris
   slow down and tax receipts to fall. Income tax rates could go up but tota
   discourages people from working).
3. D (the other three are interventionist policies)
4. C (LRAS increases because of an improver [illegible] iman capital, AD will s
   AD increases. Note that this que[illegible]sses that the increase in spend
5. You could first explain ho[illegible] cture spending boosts growth. The i
   leads to higher i[illegible] workers they employ. In terms of a diagram,
   righ[illegible]lin[illegible]gher real output.

   The [illegible]se in national income/GDP will depend on the size of the mult
   the marginal propensity to consume). If the workers the government hir
   eventual economic growth will be much higher than the initial increase i
   You could also argue that improving the infrastructure of a country will h
   benefits, e.g. in the case of better roads it reduces transport costs and cu
   potentially shifting LRAS to the right after a time lag.

   However, there are some drawbacks to this policy. Firstly, there is an op
   particularly expensive project could lead to a higher budget deficit and a
   imposes a future cost on society in terms of debt repayments. Furtherm
   will depend on how well it is implemented – there are many examples o
   (particularly IT related projects).

   There is also a risk that the increase in AD will lead to inflation: this depe
   is in the economy (this can be shown on a diagram) the economy is in
   less likely to be inflationary, whereas it is [illegible]y to be inflationary in

Exam-style questions: the international economy

1. [illegible]a very broad question, and there are many different points yo
   [illegible] points you might want to bring up include:

   Developing countries

   - Globalisation increases opportunities for trade by developing cou
     benefits (you could explain the theory of comparative advantage
     incomes in the economy. China is a good example of this, as ma
     poverty due to rising incomes. However, even if this leads to mo
     could lead to inequality within individual developing countries.
   - Globalisation gives less-developed countries access to better tec
     would have been able to create themselves. Many developing e
     access to mobile phones, infrastructure and modern agricultural
     40 years ago.
   - However, there are some disadvantages of [illegible]balisation for deve
     countries might become depende[illegible]on exporting a particular co
     exposed to a collapse in the [illegible]r a production crisis. Furthe
     in various ways b[illegible]national companies (or indeed foreign g

   Develop[illegible]

   - [illegible]ve[illegible]ped countries benefit from globalisation as they have acc
     [illegible]ports and have the opportunity to import a wider variety of go
     This improves living standards and could boost economic growth
     risk of running a persistent current account deficit.
   - One disadvantage of globalisation is that it makes certain profess
     produced considerably cheaper abroad, either the industry has t
     losses) or the country has to resort to protectionism (which can

contraction in total trade). A counter argument to this is that glo
than it destroys, but the main problem is that it seems to be unsk
disproportionately affected by globalisation. Unskilled workers w
by foreign workers (or machines) may struggle to find decent em
get support from the government.

- Make sure your answer is a balanced discussion of the costs and b
less-developed and more-developed cou
- Note: this question is very topical wit
candidate in the US in 20
has revived old
that glo
is a force for good.

2. rrent account component of the balance of payments is made
plus net income from investments. Given that investment income is
account (and that the government has little control over it) it makes
net trade in goods and services.

There are two ways in which a trade deficit could be corrected: eithe
reducing imports.

Policies to increase exports

- Most policies to increase exports involve some interventionist po
example, subsidising a particular industry, or funding research an
technologies. Improving the quality and quantity of exports in th
current account deficit, but it does have an opportunity cost in te
and it might be viewed as anticompetitive. If other countries res
industries, the policy might not be effective
- Any measure to improve internationa
tiveness would he
- Another way to increase exp
to devalue the currenc
as it conflicts with
economic objectives (and most co
than a man
ange rate system). However, China does pe
ate
rd, partly with the goal of increasing its exports. Th
roa
though (particularly from the US), who feel that they are
dvantage.
- An alternative method of increasing exports could be to sign a fre
trading bloc – although this is likely to end up increasing imports

Policies to reduce imports

- Policies to reduce imports are actually quite similar to those aimi
the quality of domestic production might mean that people choo
imported products (expenditure-switching).
- The government could also use deflationary fiscal/monetary poli
in the economy. If consumers are spending less, they will reduce
exports will not be affected (since this depends on demand from
policies, if used at a bad time, could lead to a recession.
- The other main method of reducing imp
via protectionism:
barriers (e.g. product standards).
this both reduces im
for the government. In
however, it might lead to retalia
reduction in to
overall.
- In your
, you could also consider the view that a curren
at
of a problem. It can be argued that we benefit so muc
rth running a deficit to pay for them, so long as the deficit doe

Glossary

Absolute advantage	When an economy can produce more of a good than an
Accelerator process	The idea that a small rise in national income can provok increase in investment levels.
Aggregate demand	Total spending on all goods and services in an economy
Aggregate supply	Total output in an economy.
Automatic stabilisers	Changes in government spending on benefits and tax re occur automatically during the economic cycle, partly b
Balance of payments on the current account	A measure of the inflows and outflows on the current a
Balance sheet	An accounting document used to track the assets, liabil
Bond yield	The return an investor gets from buying a bond, based o price.
Broad money	Money in the form of bank deposits, plus notes and coi
Budget balance	The difference between the government's revenue and
Central bank	An institution responsible for monetary policy, issuing c financial system.
Circular flow model	A basic model that describes how goods, services and m economy.
Claimant count	A measure of unemployment: the number of people cla
Commercial bank	A bank whose core functions include accepting custome
Comparative advantage	When an economy can produce a good at a lower oppo econom
Coupon rate	The amount of interest a government bond pays annua
CPI	The official measure of inflation used by the Office for N include the cost of housing.
Currency/monetary union	When a group of countries adopts a single currency (e.g
Current account	An account that comprises trade in goods, trade in serv transfers.
Customs union	A group of countries with low or zero trade barriers bet of protectionist measures on trade from outside the un
Cyclical budget deficit	The part of the budget deficit due to changes in the eco
Cyclical unemployment	Unemployment that is due to the economic cycle. Jobl enter downturns or recessions.
Debt (vs equity)	A method of financing a business via borrowing.
Deflation	This occurs if the price level is falling.
Demand-side shocks	Unexpected events that change the level of demand – a
Direct tax	A tax that is paid directly by the individual or organisati cannot be avoided or shifted to another person or orga
Disinflation	This occurs if the rate of inflation is falling.
Economic cycle	A cycle of peaks and troughs in growth experienced by
Economic growth	This is represented by a rightward shift in the long run A
Equity (vs debt)	A method of financing a business via issuing shares.

Exchange rate	The price of one country's currency in terms of another
Exports	Goods and services that are produced in a country and s determinant of aggregate demand.
Factor mobility	The ability to move **factors of production** (land, labour, one productive process to another. A determinant of lo
Fiscal policy	The use of taxation and publ[illegible]ng by a governme
Fixed exchange rate	When the value of a [illegible]r[illegible]y is fixed by the governmen
Floating exchange rate	Whe[illegible]e v[illegible]e of a currency is determined by market f
Forward g[illegible]ce	[illegible]hen the central bank explains to the general public w
Frictional unemployment	Unemployment due to people being 'between jobs'.
Globalisation	The economic and cultural integration of different coun
Imports	Goods or services brought into an economy from other aggregate demand.
Index numbers	A method used to compare economic figures with an in the CPI measure of inflation.
Indirect taxation	Tax that is collected by an intermediary between the co These sorts of taxes can be avoided through consumpti
Inflation	An increase in the price level of goods and services ove
Injections	Sources of demand for firms' output that do not arise f expenditure in the circular flow model. For example, go investment and export expendit[illegible]
Interest rate	The amount paid by bor[illegible]rs[illegible] money to the lenders the amount tha[illegible]he[illegible]al banks pay the central ban
Interventionist	A poli[illegible] apt[illegible]ch that favours governments stepping in [illegible]s by markets. In contrast to the **laissez-faire** a
Investmen[illegible]	An injection into the circular flow of income model. It c and also LRAS.
Investment bank	A bank engaged in a variety of financial activities. Does
Labour Force Survey	A statistical survey used by the government to capture unemployment rates.
Laissez-faire	A French term used to describe an economic system wi involvement (such as tariffs or subsidies) in which the p operate.
Liquidity	The ease with which assets can be converted into mone immediately. Cash is the most liquid asset, whereas so illiquid.
Long run Phillips curve	A vertical curve showing no relationship between inflat long run.
Macroeconomics	The branch of econo[illegible]ic th[illegible]ooks at economies *as a* w aggregate [illegible]y [illegible]demand, price levels, real growth
Marginal propensity to consume	[illegible]p[illegible]portion of additional income that is spent.
Merger	When two firms combine into one.
Monetarism	A school of thought in economics that emphasises the i on the economy.
Monetary policy	Policy that is used by governments or central banks to i the cost or supply or money. Measures used include se quantitative easing.

Monetary Policy Committee (MPC)	A committee of the Bank of England that has responsib the UK.
Moral hazard	When someone's behaviour changes after becoming i e.g. banks might engage in riskier activity if they know t the event of a crash.
Multiplier	The extent by which a rise in national income exceeds a
Narrow money	Money in the form of notes and coins.
National debt	The total stock of debt owed by a government (accumu
National income	A measure of the goods and services produced with
Natural rate of unemployment	The rate of unemployment that occurs when the labou change over time due to supply-side factors.
Nominal income	A measure of income that is not adjusted for changing
Output gap	The difference between the *actual* output of an econo can be either positive or negative.
Price stability	A possible objective of government macroeconomic po volatile periods of high inflation or deflation.
Productivity of labour	A measure of output per worker: how much each work of time.
Progressive taxation	Tax rates that increase as income increases. Those ear *proportion* of their income in taxes than lower earners
Proportional taxation	Taxes that are set at a constant rate regardless of tota £10,000 will pay the same proportion of their salary in £100,000.
Protectionism	The restriction of trade through tariffs, quotas or othe
Purchasing power parity	The theory that exchange rates will adjust over time to standardise different countries.
Quantitative easing	A large-scale asset purchases (usually government bond money supply and lending in the economy.
Quantity theory of money	The theory that changes in the money supply directly a economy.
Quota	A limit on the quantity of a particular good that can be
Real GDP	GDP that has been adjusted for inflation.
Real GDP per capita	GDP that has been adjusted for inflation *and* populatio
Real income	Income that has been adjusted for inflation.
Real-wage unemployment	Unemployment caused by wages being above the mar
Regressive taxation	Tax rates that decrease as income increases. Those ea *proportion* of their income in taxes than lower earners
RPI	A measure of inflation that includes housing costs.
Saving	A withdrawal from the circular flow of income model. income minus consumption.
Seasonal unemployment	Unemployment that is caused by variations in demand
Short run Phillips curve	A theoretical inverse relationship between the inflatio
Structural budget deficit	The part of the budget deficit due to factors apart fro
Structural unemployment	Unemployment that is caused by a mismatch between economy have and the skills demanded in the employ

Supply-side policies	Policies that have the aim of shifting the LRAS to the rig
Supply-side shocks	Something that brings about a sudden change in aggreg either positively or negatively.
Target rate of inflation	2.0%
Tariff	A tax on imports
Trade-off	The idea that something must be sacrificed in order to g
Transmission mechanism of monetary policy	The various channels through which changes to mone activity.
Unemploy	The percentage of people in an economy who are econ employment.
Voluntary unemployment	When someone could be in work but chooses to wait fo same as economically inactive, which is when someone
Withdrawals	'Leakages' from the circular flow of income model: mon firms or households. For example, saving and import e

Exam Tips!

AQA has designed this specification to create critical and broad-thinking economists. Try to remember the objectives when you write your answers because these are the skills they will be looking out for when they mark your exam papers.

AQA wants you to...

- be critical
- understand the specific concepts and be able to apply them to various situations
- understand the theories and ideologies from various schools of thought
- be able to draw on real-world examples (there is no need to remember exam knowing a few relevant case studies means you can add in a sentence or two
- make connections and links across all the topics in each topic relevant to the

The Structure of the Exams: A Level

Paper 1: 'Markets and market failure', Paper 2: 'The national and and Paper 3: 'Economic principles and issues'

⏳ **Time**: 2 hours per paper ✓ **Total Marks**: 80 per paper

Paper 1 *looks at microeconomics*. Paper 2 looks at macroeconomics, and Paper 3 from both micro and macro as well as questions on a case study provided in the e concepts with macro concepts; try to keep them clear and differentiated in your

Within both papers there are different sections which all require slightly different For Papers 1 and 2:

- In **Section A** you are given a choice between two different 'contexts'. After must answer a set of short answer questions (one of which is a calculation qu question you should skip through both the content and questions contained deciding which one you can answer best. This section is worth 40 marks, so the same amount of time on each section (no more than 1 hour on each).
- In **Section B** you must answer two essay questions, based on a short quote / given a choice of three possible sets of questions, so think carefully about w knowledgeable about before you start writing – make sure you plan your es

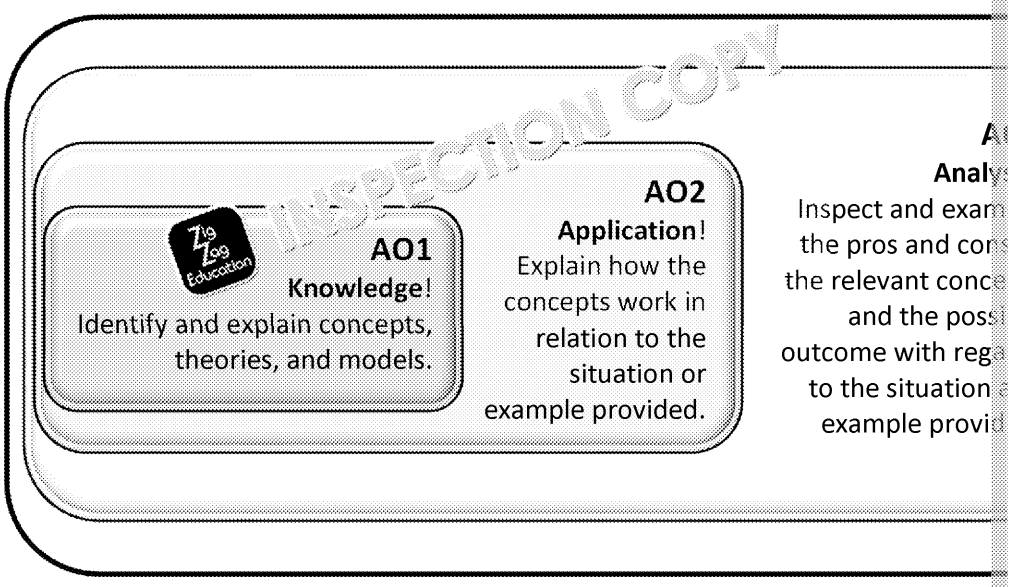
For Paper 3:

- **Section A** contains 30 multiple-choice questions. Since this is worth 30/80 m than 45 minutes on this section (or 1 minute 30 seconds on each question). with a particular question, just move on and come back to it at the end if you more marks!
- In **Section B** you must answer three longer, 'open-response' questions based probably best to take the time to read all the way through the source booklet bits, before writing your answers.

It's up to you which section you tackle first, but it might make sense to do the mu get your brain into gear

Assessment objectives

Assessment objectives, or AOs, determine the level of your answers and show th
should award. Not all questions will require all the levels; make sure you have fu
gain the highest marks, without wasting time on answers that go above and beyo



Be careful and remember

How to tackle a question

It's a good idea to underline the keywords while you're re g a question. This
points and skills the question is testing. This also as at when you come ba
can quickly recognise what you're suppo be ecking for.

Essay-style and long-ans s will require an answer that is succinct, str
seem like a ut spending just a few minutes brainstorming and pla
your respo e time in the long run and make it easier for the examiner ma
examiner's l easy by showing them what you know – remember that this is yo
knowledge! By planning what you are going to say and in what order, you will m
Equally, this gives you a chance to trawl through your memory and draw upon re
through writing and forgotten the other point you were going to mention, or tho
have to tack on? If you have a plan, it can guide you through all the points you th

Things to always check before finishing

- Each axis on your graph is labelled, and labelled correctly.
- Lines/curves on diagrams are labelled, and labelled correctly.
- Micro concepts are kept for micro questions.
- Macro concepts are kept for macro questions.
- Calculations are correct. Start with the end number work through the c
  checking to see whether the number you th e. h matches the origina
- You have answered all the questio eed to answer, all sub-questions
  looking for.