GCSE Economics Revision Guide

Key Terms: What do they really mean?

1. Efficiency:

A measure of how well workers, businesses, government or a country produce goods and services. In economics we are interested in seeing how you can get the most of *workers*, *businesses* and *countries* with the minimum amount of waste.

How can we get workers to work harder? More pay, better conditions, more holidays?

With *workers*, we can normally see how efficient they are by measuring a worker's 'productivity', this shows how much is being produced, usually over an hour.

Businesses such as Toyota and Dell are often used as examples of very efficient companies, as they produce large quantities of goods with very little waste, and hold a small amount of stock whilst doing it.

Countries can be efficient if they use the least amount of resources to produce as much as they possibly can. You could argue that a country like Germany is very efficient as it produces a large amount of goods and services, but with few natural resources.

2. Profitability

A measure of business success through comparing profit made with the amount sold or invested.

Should we look at other factors other than profit to see if Tesco's is a success?

Profits are measures by subtracting total costs from total revenue coming into the business. Companies such as Tesco are seen as a very successful as it made £2.2bn profits in 2006 from sales of £42bn. Whereas, Marks & Spencer reported profits of £965m from sales of £8.6bn.

3. Sustainability:

A way of considering economic activities in terms of their impact on future welfare and resources

Is China's growth good for the world economy, or should we be concerned about its impact on world resources

How can we continue to produce more as countries, but not use up all the resources for future generations.

In 2006 the UK government set out its principles for sustainable development

1. Living within environmental limits
2. Ensuring a strong, healthy and just society
3. Achieving a sustainable economy
4. Using sound science responsibly
5. Promoting good governance
   (www.sustainable-development.gov.uk)

4. Quality of life:

A measure of welfare which includes factors other than money.

Does buying more goods make you happy?

The Economist Intelligence Unit's measures the quality of life in countries around the world. The key point is that money is not the only factor measured, when they consider how successful a country is. They measure the following;

1. Material wellbeing: GDP per person
2. Health: Life expectancy at birth
3. Political stability and security
4. Family life: Divorce rates (per 1,000 population)
5. Community life: high church attendance or trade-union membership
6. Climate and geography
7. Job security: Unemployment rates
8. Political freedom

9. Gender equality: Ratio of average male and female earnings
(www.economist .com)

5. Equity:

A way of considering fairness in the distribution of income and wealth and in the outcome of economic activities. Economics isn't just the study of 'making money', as some people seem to believe. Economics is also about looking at why people maybe less well-off, and what role governments, businesses and individuals have in making sure that this 'unfairness' is rectified.

Is it fair that it will take a nurse an average of four years what it would take a high-earning Premiership player to earn in a week.

Syllabus content

1. Basic Economic Problems and Decisions

- **Opportunity cost**: The cost of passing up the next best choice when making a decision
- **Rationalality:** a thought process based on sane and logical reasoning
- **Resource allocation:** The process of allocating resources in an economy, or between economies
- **Scarcity:** Not having sufficient resources to produce enough to fulfill unlimited wants
- **Scarce resources:** Goods and services which are scarce because of the limited availability of the factors of production
- **Factors of production:** The resources of land, labour, capital and enterprise
- **Specialisation:** The separation of tasks within a system, could be an individual, company or country who specialises
- **Division of Labour:** is a system whereby workers concentrate on performing a few tasks and then exchange their production for other goods and services

Issues involved

Opportunity cost

Governments, businesses and individuals are always having to face key decisions. Unless your Bill Gates or Laksmi Mattel then its likely that you will have to make choices about what you consume, as your resources, i.e. money is limited. Governments also face these type of decisions every day of the week. As resources are limited then they will have to choose to do certain things over others. A recent example is the governments decision to host the 2012 olympics. Just think of the amount of hospitals that could have been built with the current estimate of £9bn

LONDON 2012 vs

The hospital pictured, Queens in Romford, is estimated to cost the NHS £1.5bn over its 36 year repayment period. Money well spent?

Rationality

To understand the behaviour of individuals, firms and countries you need to begin with the concept of rational behaviour. The study of microeconomics is a study of rational behaviour. It is reasonable to assume that consumers want the best deals, firms want the highest profits, etc. Once this is understood, then you can start criticising these assumptions. Such as why people would spend over £3,000 on a Frontgate barbeque grill, compared to a £100 set from B&Q. Will the food be 30 times better?

Scarcity

It seems that every day brings a story of resources that are running out. Oil, water, rice, corn, palm oil, rain forests, to name but a few. As economists we have a role to play in offering solutions to how these resources can be more sustainable in the future. Issues involved such as taxation, subsidies, equality, and efficiency can all be applied here.

Factors of production

Some countries have to make do with a different set of factors of production compared to other countries. For example a country such as China has an abundance of labour, but not much in the way of natural resources, (land). Whereas a country such as Russia currently now has a lot of natural resources, such as gas.

Specialisation

Some of the Issues involved above mean that some countries have to concentrate on certain goods and industries. The UK is particular strong in financial services and music, whilst Germany's biggest exports are machinery and cars. Likewise, companies and workers concentrate on producing what they are good at. However, some people argue that Tesco should also be running schools and hospitals and spreading their expertise.

Division of labour

Division of labour this means that workers should be given a specialised task to do all day, and in this way their production will increase. See the back of the £20 for more information.

2. Market Systems

2.1: Demand

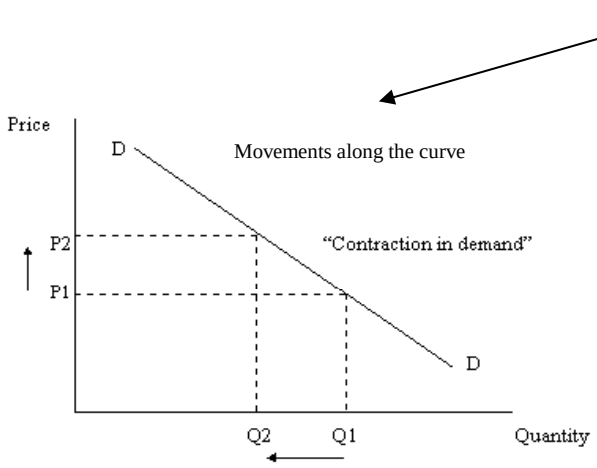
- **Demand:** The quantity of a good that consumers are willing to purchase at a given price.
- **Effective demand:** demand matched by a willingness to pay
- **The demand curve:** Shows the relationship between the amount demanded and price
- **Shift in demand:** A change in quantity demanded caused by something other than price
- **Movements along the demand curve:** A change in quantity demanded caused by a change in price.
- **Elasticity:** A measure of responsiveness
- **Price elasticity:** A measure of responsiveness of quantity demanded to a change in price.
- **Income elasticity:** A measure of responsiveness of quantity demanded to a change in income
- **Cross elasticity:** Measures the responsiveness of the quantity demanded of a good to a change in the price of another good.

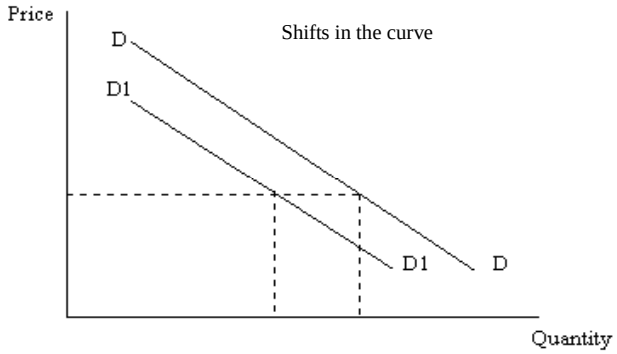
Issues involved

Beware of common errors when looking at and drawing demand and supply curves.

- Not labelling the axes with price and quantity
- Not showing the changes in price and quantity
- Getting demand and supply the wrong way around
- Getting a movement along the curve and a shift the wrong way around. Remember if there is no mention of price causing a change then it must be a shift

The demand curve





Caused by

- Change in price

Caused by

- Good becomes more popular
- Increase in advertising
- Substitutes increase in price
- Quality improves
- Increase in incomes

*Any factor **other** than a change in price*

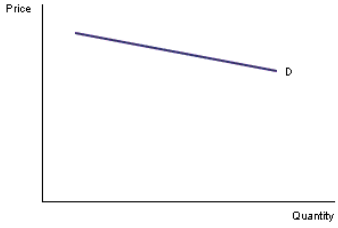
However, the amount demand changes depends upon

Elasticity

A measure of how much demand changes when there is a:

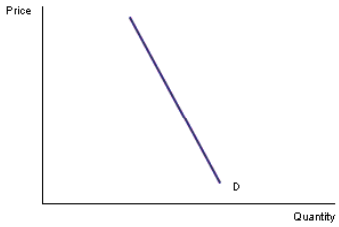
Change in price

If change in demand is greater than change in price the good =elastic



- Lots of substitutes
- Luxury
- Little loyalty to the product
- Often expensive

If change in demand is less than the change in the price of the good = inelastic



- Very few substitutes
- Necessity or addictive
- Strong brand loyalty
- Usually not too expensive

Change in income

Your income goes up, but by how much will demand go up, (if at all)

Normal goods:
If an increase in income causes an increase in demand then the good is normal

Inferior goods
If an increase in income causes a fall in demand then the good is classed as inferior

Change in the price of another good

A change in the price of another good may affect the demand for a good, but by how much?

Substitute goods
If price goes up of Burger King Whoppers demand for Big Macs goes up

Price of BK ↑ Demand for Mc ↑

Compliment goods
If the price goes up of iTunes downloads, the demand for iPods will go down

2.2: Supply

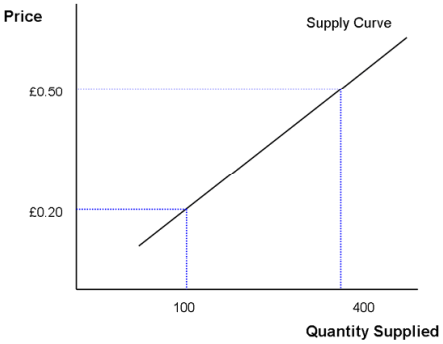
- **Supply:** the quantity that producers are willing to sell at a given price.
- **Profit:** the difference between revenue less costs; accounting definitions are **not** required. Candidates
- **Fixed costs**: are expenses whose total does not change in proportion to the activity of a business
- **Variable costs**: are expenses whose total does change in proportion to the activity of a business
- **Total costs:** the sum of variable and fixed costs.
- **Average costs**: the cost of making all of the goods divided by the number of goods made

- **Short run costs**: at least one factor of production cost is fixed
- **Long run costs:** All factor of production costs are variable
- **Economies of scale:** the cost *per unit* made declines with an increase in the number of units produced.
- **Diseconomies of scale:** the cost *per unit* increases with an increase in the number of units produced.
- **The supply curve:** Shows the relationship between the amount supplied and price
- **Shift in supply:** A change in quantity supply caused by something other than price
- **Movements along the supply curve:** A change in quantity supply caused by a change in price.
- **Price Elasticity of supply:** the rate of response of quantity supplied due to a change in price

Issues involved

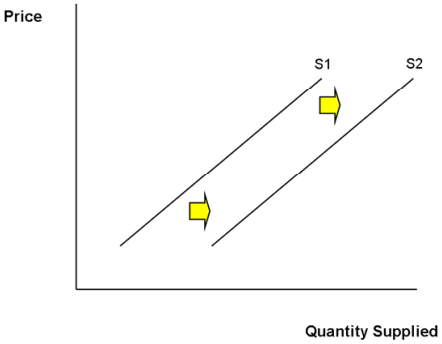
Remember what was said about rationality at the beginning. Producers will act rationally by producing more when price goes up. They are seeing price as a signal, and acting accordingly. Remember most companies are not charities and will want to earn as much profit as possible.

Supply Curve, movements and shifts



Caused by

- Change in price



Caused by

- Cheaper raw materials
- More efficient production
- Better productivity
- New technology

Elasticity of Supply

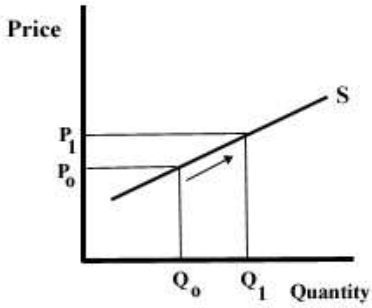
A rational producer will want to increase their output when they see price rising in their market. However, the extent to which they can increase the quantity supplied depends upon the elasticity, or flexibility, of the good.

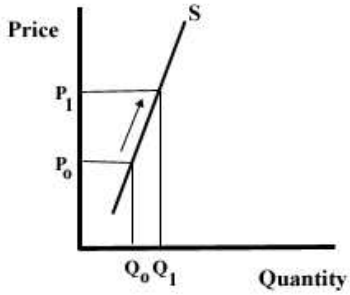
Relatively easy to increase supply: Elastic Supply

Hairdressers, could increase production easily if the market price goes up

Relatively difficult to increase supply: Inelastic supply

Coffee farmers might take years to increase production





However, the elasticity can depend upon how much stock is being held, even for an inelastic good

Different types of Costs

Fixed costs

Costs that stay the same regardless of what is produced, such as rent.

Variable costs

Costs that change in accordance with how <u>much</u> is produced, such as raw materials

Average costs:
Total costs / number of goods made

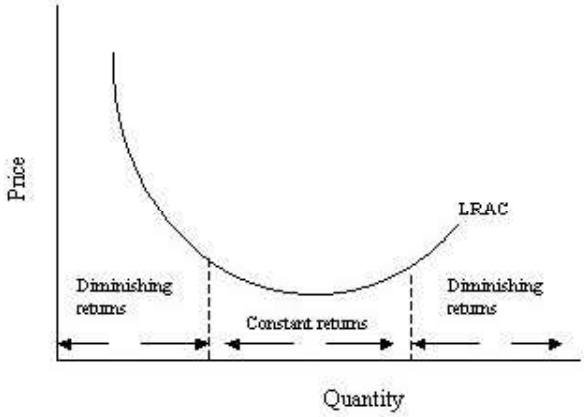
Short run costs
At least one *factor of production* cost is fixed

Long run costs
All factor of production costs are variable

Issues involved

Economies and diseconomies of scale

The term economies of scale normally comes up when companies are reported to be merging. The director of company A will usually justify spending millions of pounds buying company B, by stating that the new bigger company will achieve economies of scale. Basically, the cost of producing *one* good, will go down the more that is produced. Be careful not to confuse total costs and average costs. Of course total costs will increase on the chart below. But we are looking at the cost of producing one thing. This will decrease the bigger you are.



Think how much it would cost you to make a car in your own garage compared to Toyota. The reasons Toyota can do it cheaper are;

- Bulk-buying economies – they will get a cheaper deal because of the amounts ordered
- Technical economies – They have all the best technology in production
- Financial economies – They can get cheaper loans
- Marketing economies – They can spread the cost of advertising over more units
- Managerial economies – They will attract the best staff
- External economies of scale – Other companies and workers will move to them

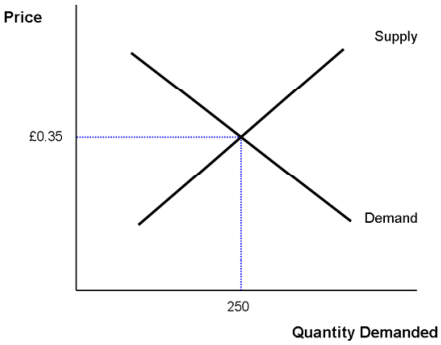
For more information see the section below on business growth

However, its not all good news being big. The past is littered with companies where bigger hasn't necessarily meant better. Mergers such as AOL/Time Warner and Mercedes/Chrysler and companies such as Marks and Spencer and Mcdonalds. These Companies have had problems controlling the size of the company, thus leading to higher costs per unit. This is seen in the later stages of the above chart.

However, the above show what *could* happen. A company could continue to grow larger and maintain economies of scale without necessarily experiencing problems. Tescos is a good example at the moment.

2.3: The Market Mechanism

- **Equilibrium:** a balance of supply and demand, the point where both sellers and buyers are happy with the price and quantity.



Issues involved

Equilibrium

Now we get the moment where market forces combine together to set the market price. To understand think of a person, Doug Allen, trying to sell his house

His 3 bedroomed house is up for sale at £295,000. Now this is the price set by him. But this doesn't mean this will be the price he will get. If Doug gets no interest, then what can he do?
He will have to drop his price until he get a buyer, maybe £285,000. Now if you was an idiot and decided to put his house on the market at £150,000, then he would soon realise, by the hundreds of people coming round to view and making him offers, that he has priced the house too cheaply, and therefore he will put the price up until he was left with one buyer willing to pay the price, probably around £285,000 again.

Is there a role for the government in any markets if prices are too high, or too low?

The key thing to remember here is that nobody, other than the buyer and seller are deciding the price. Market forces are determining the price of the house.

2.4: Labour markets

- **Trade unions:** An organization of workers formed for the purpose of serving the members' interests with respect to wages and working conditions
- **Labour market:** Only includes those who are able and willing to work, does not include full-time students, the retired, and children.
- **Unemployment:** someone who is able and willing to work but cannot find a job
- **Minimum wage**: the minimum rate a worker can legally be paid (often per hour) as set by government, currently £4.25 per hour in the UK
- **Supply of labour:** the number of workers willing to work at each wage rate
- **Demand for labour:** The number of workers required at each wage rate

Issues involved

Trade unions

The issue of trade unions comes up later on with supply side polices. Some economists argue that trade union powers should be restricted as they stop companies producing as much as they need and want. However, other economists argue that there must be limits to company powers as otherwise they will exploit their workers. Unions are generally there to stop any exploitation of workers.

Labour market

In this unit you must also be aware of the effects of immigration on the UK labour market. Some people argue that the recent influx of east european workers has resulted in massive benefits for the UK as it increased the UK's productivity, and the workers do jobs that UK workers will not. However, a House of Lords report on the issue found that immigrant labour drove down the wages of low paid UK workers.

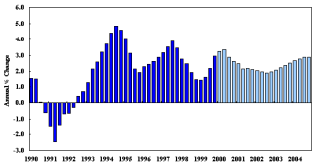
Types of Unemployment

Structural

Reduction in demand for certain types of industries.

Cyclical

Jobs are lost in the country due to a recession.



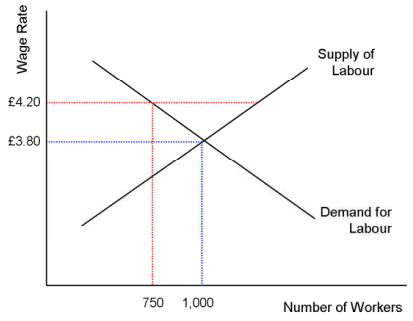
Frictional

People may be between jobs.

Seasonal

People may be out of work because of the seasons

Minimum Wage



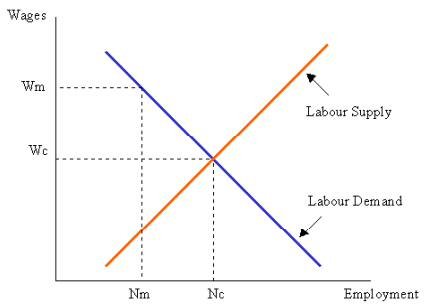
There is an argument that the minimum wage causes unemployment, as firms will no longer be able to afford the workers However, there has been no evidence of this so far in the UK, but some businesses argue this is because the minimum wage rate is still relatively low

The minimum wage is an example of governments not leaving the invisible hand of the market to set prices. With the labour market the government believed that the market price that some people were being paid was too low. They have intervened and decided that employers cannot pay a much below a certain amount, an amount that is somewhat higher than the market equilibrium.

Demand and supply of labour

The same principle applies in the labour market. Suppliers (the workers) will supply more labour the higher the price. Whereas, the employers (people demanding), will demand more, the lower the price. Wages will be determined when workers and employers agree on the wage

Figure 1. The competitive labour market



Notice on this chart has wages on the left hand axis and not price. This is because wage is the price of labour.

3. Business Behaviour

3.1: Business objectives and ownership

- **Profit maximisation**: The process by which a firm determines the price and output level that returns the greatest profit.
- **Market share:** the percentage of the total available market, that a company has
- **Sales growth**: trying to achieve a large amount of sales
- **Public sector:** The part of the economy concerned with providing basic government services
- **Private sector:** The part of a nation's economy which is not controlled by the government
- **Privatisation:** The return of state enterprises to private ownership and control.
- **Nationalisation:** changing something from private to state ownership
- **PFI:** Private Finance Initiative provides financial support for public-private partnerships
- **Deregulation:** The removal of government controls from an industry or sector, to allow for a free and efficient marketplace
- **Competitive tendering:** providers competing against each other to deliver a service

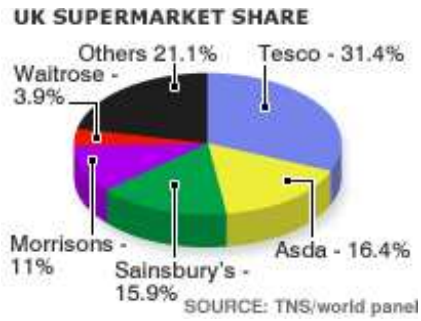
Issues involved

Profit maximisation

Be careful in just assuming that the goal of firms is just to make profits. In reality, businesses often sacrifice profits against other goals, such as increasing market share or achieving socially responsible targets, such as Marks & Spencer Plan A.

Market share

In 2006 Tesco had over 30% of the UK supermarket market, by far the largest



Are Tesco's too powerful? and should the government restrict their power?

Public and private sector ownership

Public sector

Private sector

vodafone

Should the government run any businesses that the private sector could run, such as Network Rail, what about schools and hospitals?

⇨⇨⇨⇨⇨⇨Privatisation⇨⇨⇨⇨⇨⇨

⇦⇦⇦⇦Nationalisation⇦⇦⇦⇦

Privatisation and Nationalisation

In simply historical terms most of the UK's nationalisations took place after the Second World War, but the government sold must of it back to the private sector in the 1980's. However, since the 2008 nationalisation of Northern Rock and government intervention to shore up the financial markets an active government role in the economy could be back on the cards.

Private Finance Initiative (PFI)

For its supporters this is the best of both worlds. The private sector will build you a school and hospital out of their own money, and the government or local authority will then pay the firm back in installments. This has resulted in a large increase in new hospitals and schools being built in this country. However, the total cost of these buildings over the time of paying back the loans, are generally a lot higher compared to paying for the build upfront in one go.

Will PFI be one of those government scandals that will crop up in 25 years time, when the full cost of these schemes will be realised

Deregulation

Some economists argue that the government have no role to play in the efficient running of the market, and the less interference the better. Organsitaions such as the CBI constantly call for a reduction in Red Tape. However, other people argue that there is no such thing as a 'free market', with companies relying on governments to ensure that they continue to make profits.

Competitive tendering

On paper this should work properly, the government asks private companies to bid for a project, for example, the olympics or building a hospital. They will then award the bid to the company with the lowest price.

However, what if companies collude together to all fix their price artificially high?

3.2 Growth of business

- **Mergers**: occur when two firms agree to form a new company.
- **Take-overs:** The acquisition of one company by another.
- **Horizontal merger:** A merger between two firms that produce the same or similar products.
- **Vertical mergers**: Merging with companies up or down the production process
- **Economies of scale:** Costs of producing one unit goes down as a company gets bigger
- **Diseconomies of scale:** Costs of producing one unit goes up as a company gets bigger
- **Productivity:** The amount of physical output for each unit of productive input.
- **Stakeholders:** Individuals, groups or organisations that are affected by and/or have an interest in an organisaton

Mergers

Mergers are a quick way to grow your business by buying up rival companies, of companies up or down your supply chain. However, a word of caution. There have been some spectacularly disatrous mergers, with Time Warner buying AOL during the dotcom boom in 2000. In 2002 AOL Time Warner reported a loss of $99 billion — at the time, the largest loss ever reported by a company.

Vertical merger

Horizontal merger

Economies of scale

As mentioned previously the benefits a company such as Tesco's receive the larger they become. Almost like a snowball effect.

Managerial
Employ specialist managers.

Financial
Easier to get a loan from the bank

Bulk buying
Buyer in big quantities and getting discounts

Economies of scale
As production goes up the average cost goes down

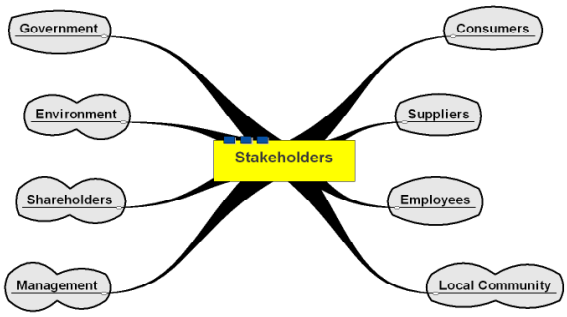
Mass production
Production in large quantities helping spread fixed costs

Diversify
Sell a range of products. Reduces the risk of failure

Advertising
They can afford to advertise on bigger formats and more often

Stakeholders

The challenge for all businesses is to keep all of your stakeholders happy at the same time, not just one or two of them. Companies like John Lewis seem to be more successful than others at achieving this. However, this may be due to the fact that the company is not owned by shareholders but by its employees.



3.3 Business competition and market structure

- **Competition:** the thing that should encourage innovation, efficiency, or drive down prices.
- **Competition Commission:** independent body responsible for investigating mergers, market shares

Issues involved

Competition

Websites such as Ebay are a perfect example of competition at work. If a number of sellers have a similar item to sell then prices are forced down as the customer can pick the lowest price. However, if there is only one seller, and a large number of buyers, such an in-demand concert ticket, then the seller can pretty much name their price. This is why in a market economy the government will attempt to encourage competition as much as possible, and outlaw some of the market failure detailed below. In the UK the body that does this is the Competition Commission, which describes itself as an:

"independent public body which helps ensure healthy competition between companies in the UK for the benefit of companies, customers and the economy".

4. Market Failure and Policies

4.1 Market failure

- **Monopoly:** where there is only one provider of a kind of product or service
- **Cartels**: producers whose goal it is to fix prices, to limit supply and to limit competition.
- **External costs**: the negative side-effect of an economic transaction
- **External benefit**: the positive side-effect of an economic transaction
- **Externalities:** costs (or benefits) arising from the decisions of an individual which impact on people other than that individual
- **Private costs:** The costs received by the firm that produces the good or service
- **Private benefits:** The benefits received by the firm that produces the good or service
- **Social costs**: Private costs + External costs
- **Social benefits:** Private benefits + External benefits

Issues involved

Monopolies

Be careful when using the term monopoly. Technically it is only one provider of a good or service. Examples of this are usually found in 'natural' monopolies, (When a monopoly occurs because it is more efficient for one firm to serve an entire market than for two or more firms to do so), for example Virgin Rail from London to Manchester. However, when discussing monopolies we usually mean a company with more than 25% market share.

Should a company such as Microsoft be 'punsihed' for being good at what they do?

Cartels

The most famous cartel is the Organization of Petroleum Exporting Countries, OPEC, which is made up of 12 oil producing countries. However, because of the high profile of OPEC you shouldn't assume cartels are legal. In europe cartels have been illegal since 1957, and companies who are found guily of colluding face massive fines.

OPEC argue they only want to "help oil producers achieve a reasonable rate of return on their investments". Are they right?

Costs and benefits

It is a common error to confuse social and external costs. A Social cost = private + external costs. The problem of social costs arises because of the rational decision making of individuals, companies and governments. They only consider their own private costs when making decisions, not the costs that may be incurred by others. Here are some examples of costs and benefits

Private costs

Shell's production costs

Social costs/externalities

Shell's pollution in Nigeria

What can the Nigerian government do to deal with social costs, and will they those policies work?

Private benefits

Shell's profits

Social benefits

Not just Bupa patients who benefit from being healthy

4.2 Market policies

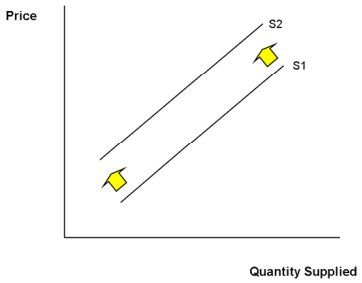
- **Taxes:** charge or other levy imposed on an individual or business by the government
- **Subsidies:** Grants of money made by the government to either a seller or a buyer of a certain product
- **Price controls:** Putting an upper limit on market prices
- **Regulation**: A legal restriction imposed by the government
- **Regional policy:** the means by which governments and the EU seek to reduce geographical inequalities.

Should we believe the government when they say they want to raise fuel duty to help the environment?

Issues involved

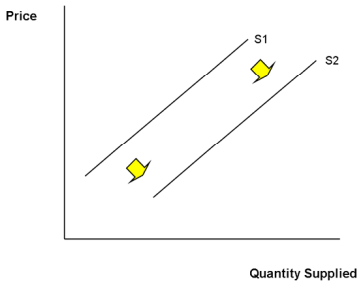
Reasons for changing tax

Governments set taxes for many different reasons. Raising income (income tax), changing behaviour (a sin tax such as alcohol duty) or redistributing income (tax credits). This is why some taxes are progressive in nature and change with peoples income (income tax), or are regressive, and are the same for everyone (VAT). The effect of an increase in tax on a good or service can be shown with this chart.



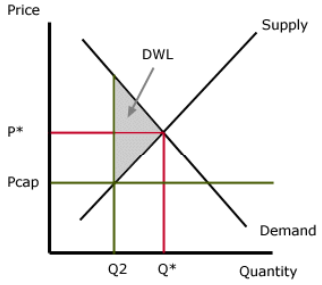
Subsidy

Subsidies can be a very contoversial area, as in some peoples eyes they are valid way to help key industries. However, some economists view subsidies as interfering in the free market and supporting inefficient industries, such as farming. In a completely free market, countries should be able to buy their food from the cheapest source. However, the US and EU subsidise their farmers, so consumers are forced to buy domestic produce, or pay higher prices for imports from countries such as Ghana.



Price controls

What can a country do if basic commodities become too expensive. They could use subsidies to help prices fall, as described above. However a blunter instrument, and an instrument used recently by countries such as Venezuala, Thailand and Russia are price controls. The government can bring in a law to set a price which is below the market equilibrium.



What do you think the effects will be on demand and supply at the new lower price?

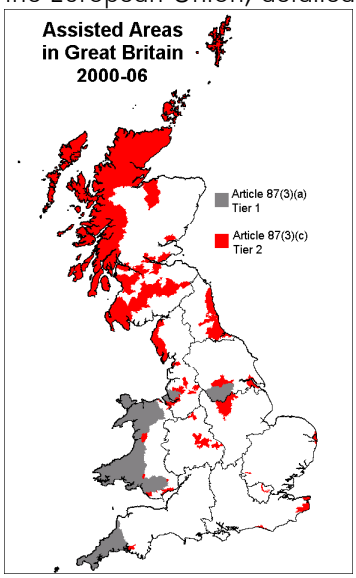
Regulation

This section contains a number of ways governments intervene in the market, as they believe the market is not working to the benefit of their people. From the governments point of view regulations are needed to protect people against the adverse actions of other people or companies. Laws such as the 'Health and Safety at Work Act', and 'Equal Pay Act' However, other economists believe governments regulations stop the 'free market' working properly. See the previous mention of 'red tape'.

HSE
Health & Safety Executive

Regional Policy

Regional assistance can help areas of the country which are suffering from low incomes, poverty and maybe high unemployment. Assistance can come from the UK government and the European Union, detailed belows



5. Macroeconomic Concepts

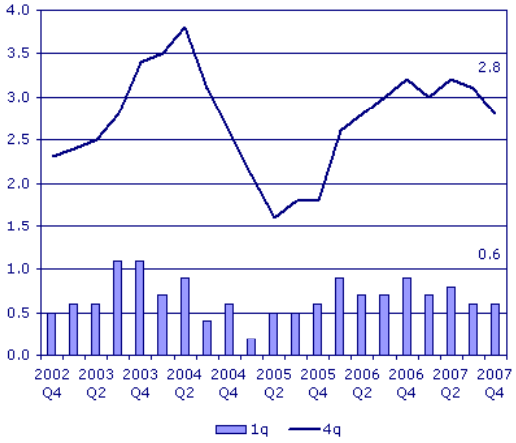
5.1 GDP and national income

- **Nominal GDP:** Total value of goods and services produced within a nation's borders, measured in current prices.
- **Real GDP:** Inflation-adjusted value of GDP; the value of output measured in constant prices.
- **Standard of living:** A level of material comfort as measured by the goods, services, and luxuries available to an individual, group, or nation.
- **Quality of life indicators:** the well-being of individuals, including standard of living, and other measures such as health, education, freedom, environmental conditions.

Issues involved

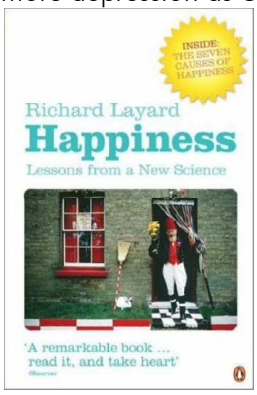
Nominal and Real GDP

Measurements in GDP can be distorted by a countries high price levels. If a country such as India has inflation running at 8% and the UK at 2%, and GDP at 10% and 4% respectively, then is it fair to say that India is doing better than the UK economically? This is why governments strip out price rises to get the actual or 'real' GDP.



Quality of Life indicators

Does money bring happiness? Economists are now beginning to question why countries whose GDP has risen over the years are not seeing a rise in peoples wellbeing, and sometimes seeing more depression as countries get richer!



5.2 Inflation

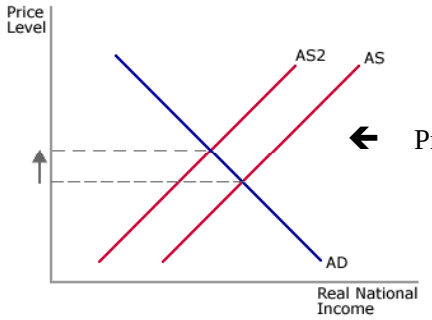
- **Inflation:** an increase in the price of a basket of goods and services that is representative of the economy as a whole.
- **Cost push inflation:** an increase in prices caused by an increase in costs.
- **Demand pull inflation:** prices rise when aggregate demand in an economy outpaces aggregate supply.

Issues involved

Inflation

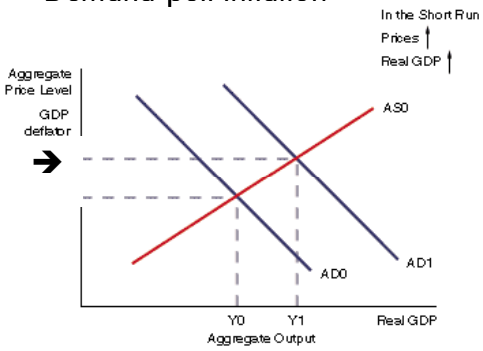
There is currently a great deal of controversy on how 'representative' the basket of goods is. The government are always trying to ensure it is up to date, with smoothies and muffins recently being included. However, one persons basket of goods will look very different to someones elses, so when the inflation figures are released, there are sometimes met with specticism.

Cost-push inflation



Prices going up

Demand-pull inflation



An example of cost-push inflation in 2007 was the 50p increase in the price of a standard sized pizza as a result of a 50% increase in the price of mozzerella.

Often described as 'too much money chasing too few goods'. Or, a lot of money in the economy and not enough goods to go round.

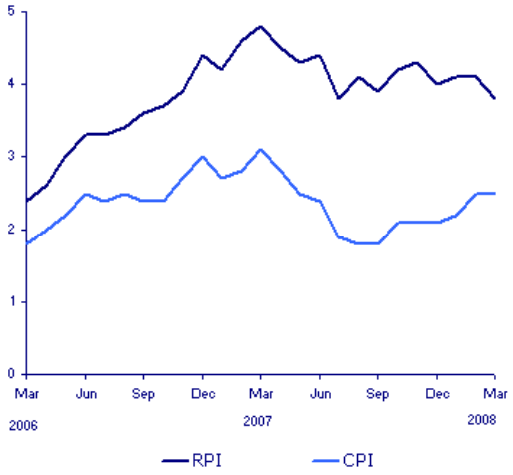
Consumer Price Index (CPI)

The Government's inflation target is based on the CPI. The Bank of England's Monetary Policy Committee sets interest rates to meet this target. CPI does not include Council Tax and a number of housing costs faced by homeowners. If the Monetary Policy targeted RPI then the effect of raising interest rates to curb inflation would simply result in more inflation, as the cost of housing would have gone up, thus making their only tool to reduce inflation useless. This is why CPI is used

The Retail Price Index (RPI)

is the more familiar measure of inflation. Tax allowances, state benefits, pensions and many other payments are often revised in line with this index. The index includes more than 650 items, and includes all housing costs.

Further reading – 'Consumer Price Indices A brief guide' a pdf file from 'National Statistics Online'



Is low inflation always a good thing?

5.3 Unemployment

- **Unemployment:** someone who is able and willing to work but cannot find a job
- **Structural unemployment:** Reduction in demand for workers in certain industries, which are in decline
- **Cyclical unemployment:** Jobs are lost in the country due to a recession.
- **Frictional unemployment:** Workers who are between jobs
- **Seasonal unemployment:** People may be out of work because of the seasons

Issues involved

Full employment

There is no definitive definition of 'full employment'. Some economists believe it is when there is 0% unemployment, others around 3%.

Remedies (with evaluation)

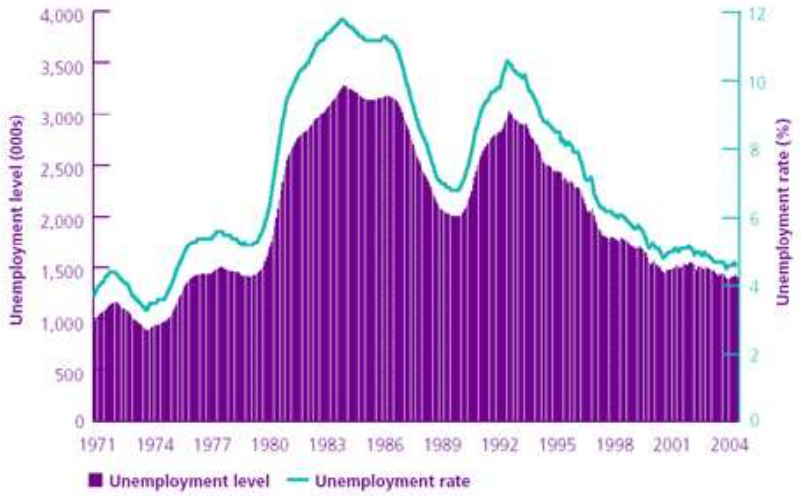
- Governments could subsidise struggling industries
  However this could result in 'lazy' inefficient industries
- Give unemployed people more training and skills
  Hard for the government to predict what skills employers will want in the future.
- Reduce or cut unemployment benefits. This reduces the 'dependency culture'
  Might lead to real social problems, and morally dubious.
- Increase government spending on projects such as road building, the NHS
  Money could be wasted on projects that are not really needed.
- Cut tax to encourage spending, (fiscal policy)
  Money may not be spent but saved or used to pay off debts.
- Cut interest rates to encourage spending (monetary policy)
  Not everyone has mortgages or loans, so the impact of a cut may be lessened.

Trade-off

Is it right to argue that unemployment is needed to control inflation? A high unemployment rate results in less spending thus low inflation. Can the government achieve both targets at once. Some economists argue that successful supply-side policies can achieve this.

Recessions

the unemployment rate is closely related to economic recessions. The high oil prices of 1974. Inflation busting measures of 1980. High interest rates, housing marking crash of 1990. Credit crunch 2008?



5.4 Balance of payments

- **Visible trade:** Trade in goods
- **Invisible trade**: Trade in services
- **The current account:** contains the import and export items of goods and services as well as transfer payments including net investment income.
- **Trade deficits:** Importing more than we export
- **Trade surpluses**: Exporting more than we import

Issues involved

Balance of payments – Current account

Visible exports and imports - Goods

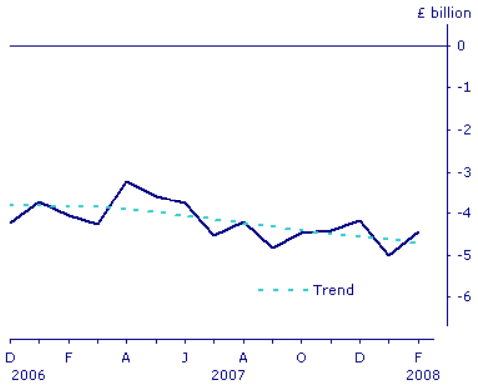
Not the UK's strongest point! In deficit by £7.5bn in February 2008

Invisible exports and imports - services

What were good at, finance, insurance, etc. A surplus of £3.0bn in February 2008.

The overall picture

Even though oil revenues and the strength of the UK financial sector boost the UK's trade in goods figures, we regularly record a trade deficit. This means we spend more on imports than we get back on imports.



Can we keep living beyond or means?

If a government in the 1960's were faced with a deficit of this size they would have been thrown out of office, as there would have been such a national outcry. Now it barely warrants a mention on the news. Some people say the deficit isn't a problem as the government can just rely on foreign investment or borrowing to cover the deficit. Also why bother manufacturing goods in this country when it's cheaper to buy them from low-cost countries such as China. However, are we storing up trouble for the future by racking up debts.

Why should the balance of trade be self-correcting?

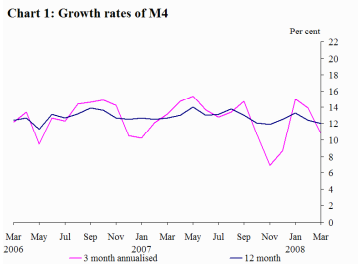
5.5 Money Supply

- **The money supply:** the quantity of money available within the economy.

Issues involved

Links with inflation

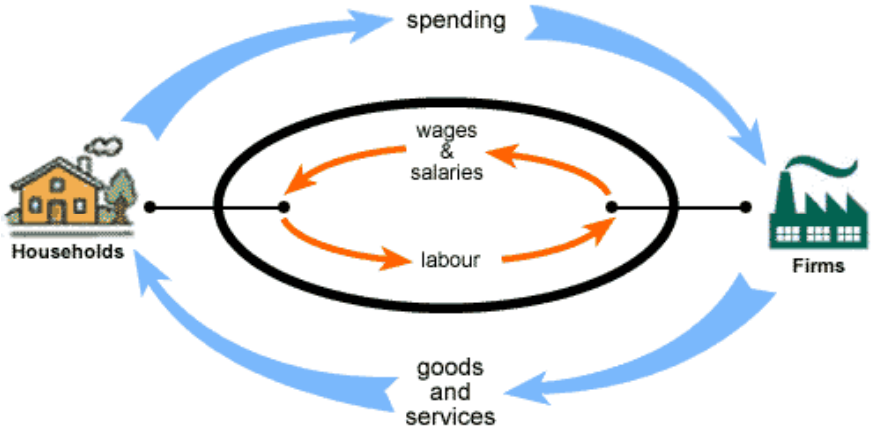
The money supply is measured by the bank of England and includes cash and bank and building society deposits. Back in the early 80's the government believed that to control inflation you had to limit the amount of money in the economy. The government set themselves 'monetary targets'. Nowedays interest rates are the only real game in town when it comes to controlling inflation. However, the Bank still watch the money supply numbers carefully as an indicator of possible inflationary pressures in the economy.



6. Macroeconomic systems

6.1 Flow system

- **Circular flow of income:** simple economic model showing the relationship between money income and spending for the economy as a whole



Issues involved

Injections
The size of the economy can increase as a result of certain injections into the economy. These could be from the government, through increased spending. More business investment, i.e. buying more machinery, and an increase in exports.

Withdrawals
However, money may 'leak' out of the economy. Through consumers saving. Governments increasing taxes or an increase in imports.

Links with macroeconomics targets
You can use the circular flow to help explain how inflation can happen, and how it could be lowered. Similarly unemployment could be explained by a contraction in the circular flow, with injections being the answer.

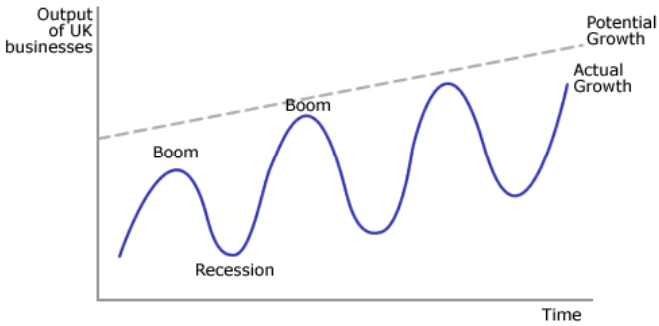
6.2 The economic cycle

- **Economic cycle:** The ups and downs in growth of the economy over a period of time
- **Boom:** a time of rapid growth in wealth
- **Slump:** A downturn in the economy
- **Recession:** a fall of a country's GDP in two or more successive quarters of a year.
- **Recovery:** An upturn in the economy

Issues involved

Economic cycle

The economic cycle has become more important over recent years since Gordon Brown announced his 'golden rule'. The 'Golden Rule' states that over the economic cycle, the Government will borrow only to invest and not to fund current spending. This implies that tax revenues coming in should equal or be more than current spending over the current economic cycle. This means the current budget should balance or be in surplus. However, it hasn't been clear in the UK how long the cycle from boom to recovery to boom again takes.



Recession

In the US, the National Bureau of Economic Research (NBER) define recessions as

" A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales."

The most commonly used definition is two or more successive quarters of negative economic growth

6.3 Exchange rates

- **Floating exchange rate:** exchange rate which is determined by free market forces,
- **Fixed exchange rate:** exchange rate regime where a currency's value is matched to the value of another single currency or to a basket of other currencies by the government or central bank
- **The single currency.** the euro is the official currency of 15 member states of the European Union

Issues involved

Exchange Rates

When the pound changes in value, there are both winners and losers. Lets assume the £/dollar exchange rate goes from £1=$1.50 to £1=$2, i.e. the pound strengthens.

- Winners - If you are on a shopping trip to New York this is good news as you get more dollars to spend in New York.
- Losers - However, US tourists coming the UK will be getting less pounds for their dollars
- Losers - If you're a big exporter to the US then your goods will cost more, in US dollars, in that country.

- Winners – For UK consumers the cost of US imports will be cheaper
- Winners – If you're a company using raw materials from the US then the cost of these materials will be cheaper

Effect on exporters of a strong pound

IF	£200 Dyson vacuum cleaner £1 = $2: price of cleaner in US is $400 £1 = $4: price of cleaner in US is $800		→ Sales ↓
IF	$200 Dell computer £1 = $2: price of computer in UK £100 £1 = $4: price of computer in UK £50		→ ↑

Strong
Pound
Imports
Cheap
Exports
Dear

The Single Currency

The issue of whether the UK should join the Euro has pretty much been put on the 'back-burner' by Gordon Brown, after he announced that Britain would have to pass 5 'economic tests' before it joined. The tests are

1. Are business cycles and economic structures compatible so that others and we could live comfortably with euro interest rates on a permanent basis?
2. If problems emerge is there sufficient flexibility to deal with them?
3. Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
4. What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
5. In summary, will joining EMU promote higher growth; stability and a lasting increase in jobs?

The sticking point seems to be number 1 as the UK consumer is more vulnerable to changes in interest rates, compared to Europe, as more of the UK's population buy their homes rather than rent. So lower European interest rates could lead to greater inflationary problems in the UK, if we joined the Euro.

7. Macroeconomic objectives and policies

7.1 The objectives of macroeconomic policy

- **Macroeconomic objectives:** full employment, low inflation, economic growth and a positive balance of payments

Issues involved

Trade-offs

As mentioned previously sometimes there are choice to be made when the government tries to meet its targets. Two of the main choices.

- Full employment vs low inflation
- Economic growth vs low inflation

By using supply-side policies can all targets be met?

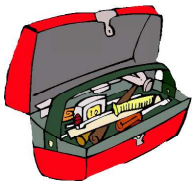
7.2 The nature and effects of macroeconomic policies

- **Fiscal policy:** the setting of the level of public expenditure and how that expenditure is funded (tax & spend)
- **Monetary policy:** changing interest rates, money supply and exchange rates to control the supply of money
- **Interest rates:** The cost of money which are set via the base rate by the Monetary Policy Committee of the Bank of England
- **Supply side policies:** Government attempts to increase supply in the economy
- **The new deal:** Government scheme to encourage the unemployed back to work, through restricted benefits and increased training

Issues involved

Government attempts to control and influence the economy

What tools have the government got in its 'tool box' to try and achieve its macro objectives



Fiscal policy
Taxation and government spending

Monetary policy
Interest rates and exchange rates

Supply Side policies
Attempts to increase supply

Evaluation of Polices – will they work? Some examples

Fiscal policy
Using taxation to curb inflation depends upon how many people are in work. Government spending to increase employment depends upon how efficiently the money is spent, or how permanent the jobs created are

Monetary policy
The succes of interest rates to control inflation depends upon how many people have mortgages or loans, or if banks pass on interest rate changes.

Supply Side policies
Government schemes to increase training and skills of workers will only work if the demand is there for workers afterwards.

7.3 Interest rates

- **Interest rates:** the price a borrower pays for the use of money
- **Transmission mechanism**: the effects a change of interest rates have on an economy

Issues involved

Interest rates and the Bank of England

Current Bank Rate View decisions and minutes	**5.0%** Next due: 8 May '08
Current Inflation (CPI)	**2.5%** Next due: 13 May '08
Inflation Target More information	**2.0%**
Latest Inflation Report View report and webcast	**Feb '08** Next due: 14 May '08

BANK OF ENGLAND

as at 30th April 2008

Transmission mechanism

1. A change in the official interest rate set by the MPC will affect other interest rates. Banks, building societies and other financial institutions have to react to any official rate change by changing their own savings and loan rates.

2. The changes in markets will affect the spending patterns of consumers and firms. In other words there will be an effect on aggregate demand. Higher interest rates are likely to reduce the level of aggregate demand, as consumers are affected by the increase in rates and may look to cut back spending.

3. The third stage is the impact of the aggregate demand change on GDP and inflation.

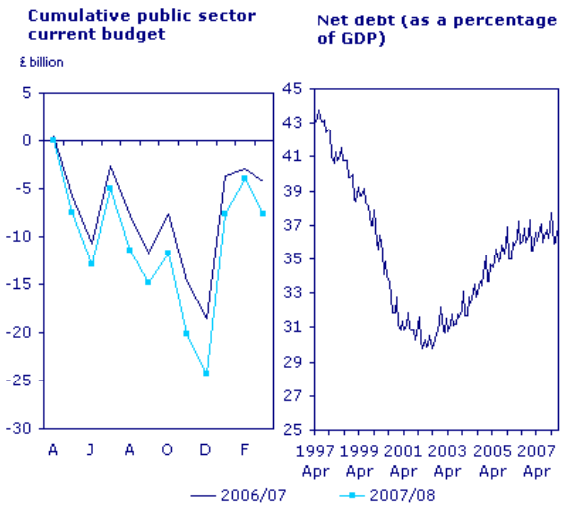
7.4 Government income and expenditure

- **Budget deficit:** The amount by which government spending exceeds government revenues.
- **Budget surplus:** tax revenues exceed spending

Issues involved

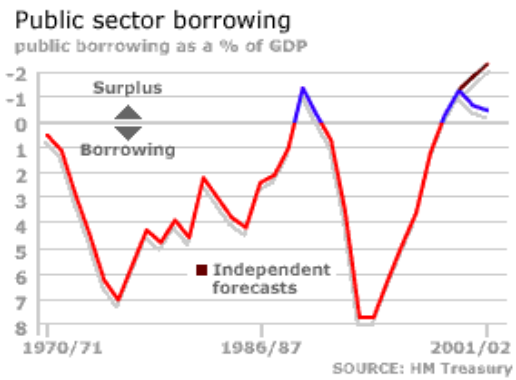
Budget Deficit

As of April 2008 the UK had a budget shortfall of £10.2bn. Basically the country is having to borrow to pay its way. There are certain implications of this. One problem is possible sanctions from the EU who state that you cannot have budget deficit of more than 3% of GDP. The other major problem is that lack of 'flexibility' it gives the Chancellor to use fiscal policy to affect the economy. For example, if the economy goes into recession then the government would normally cut taxes and increase spending to give the economy a lift. However, if the government are not getting enough money in at them moment then it leaves them very little room for cutting taxes and increasing spending.



Budget Surplus

It does happen sometimes in the UK, but not as often as deficits. Budget surpluses appear at the same time at economic booms, and the the UK was in surplus in 1988, and 2000.



7.5 The exchange rate as a policy instrument and a policy objective

- **Depreciation/devaluation:** The official lowering of the £ against one or more foreign currencies, with the aim to make exports more competitive and imports more expensive
- **Appreciation:** A rise in the value of £ in relation to other currencies

Issues involved

Exchange rate policy in the UK

Exchange rates can be used to help trade, but only if they are fixed are managed. In the UK they are left to 'float', which means the market decides the price by the interaction of demand and supply. However, China have used an exchange rate policy over the past decade.

Exchange rate policy in China

From the 1990's to 2005, the Chinese yuan was fixed to the U.S. dollar. Since 2005, the People's Bank of China, moved to a managed floating exchange rate pegged to a basket of foreign currencies. This means it can 'float' but only by a small amount from those currencies. The Chinese central bank is accused of keeping the yuan undervalued, mainly from the US, who believe Chinese goods are too cheap when the arrive in the US.

7.6 Trade policy and protection

- **Protectionism:** The restriction of imports into a country by government
- **Tariffs:** tax on imported goods
- **Quotas:** limits on the quantity of a product that can be imported into a country
- **Free trade:** Trade between countries without barriers

Issues involved

Trade policy

Just like a government borrowing, a countries trade policy can sometimes be affected by the economic cycle. Often when a country is facing an economic recession the pressure for some sort of resctrictions on imports are sometimes called for.

Infant Industries

However, sometimes restricitons are placed on imports so as to protect small growing industries.

Free trade

The opposite of using protectionism is to let the worlds countries trade with eachother without any restrictions or taxes. This should enable countries to increase the value of trade with other countries, and also enable goods to be imported from country who is most efficient at producing those goods, usually resulting in cheaper goods for consumers.

Is free-trade really free. Just look at the trade policies of the US and europe when it comes to free trade and agriculture?

7.7 The European Union

- **The single market.** The free movement of goods, services, capital and labour within member states.
- **The Euro**: the official currency of the European Union
- **European Central Bank (ECB)**: Has the job of setting interest rates for Europe
- **Common Agricultural Policy (CAP)**: a system of European Union agricultural subsidies
- **Enlargement:** The expansion of Europe originally from six countries in 1957, to 27 in 2008.

Issues involved

The European Union, in or out?

Staying in

- Promotes trade
- Spreads wealth throughout europe
- Laws that protect workers and consumers
- Strong environmental policies
- Free movement of labour
- Helps create jobs

Getting out

- Too much money wasted on bureacracy
- Common Agricultural Policy wastes money and inflates food prices
- Too many laws and regulations
- Too many workers from Europe

Exam technique

"Discuss how…"
Give reasons how and conclude by saying which may be more important

"Discuss why.."
Give reasons why, *(not if)* and conclude by saying which may be more important

"Discuss whether"

- **Argue for the statement and evaluate.**
- **Argue against the statement and evaluate.**
- Then conclude

Overall Rule
If you're asked to "DISCUSS" always finish with a conclusion. This *must* be an overall judgement or opinion, *not just a summary*

10 mark question

- If you have been asked to "use items K,L & M", then USE them!!
- Back up references with own knowledge and *conclude with an opinion*

15 mark question
"Discuss ways…and evaluate which one is best"

- Come up with a least 3 ways
- Evaluate and explain
- Conclude with a point of view
-

15 mark question

"Discuss whether…"

- Come up with a least 2 arguments for and against
- Evaluate and explain each point
- Conclude with a point of view