AQA GCSE ECONOMICS

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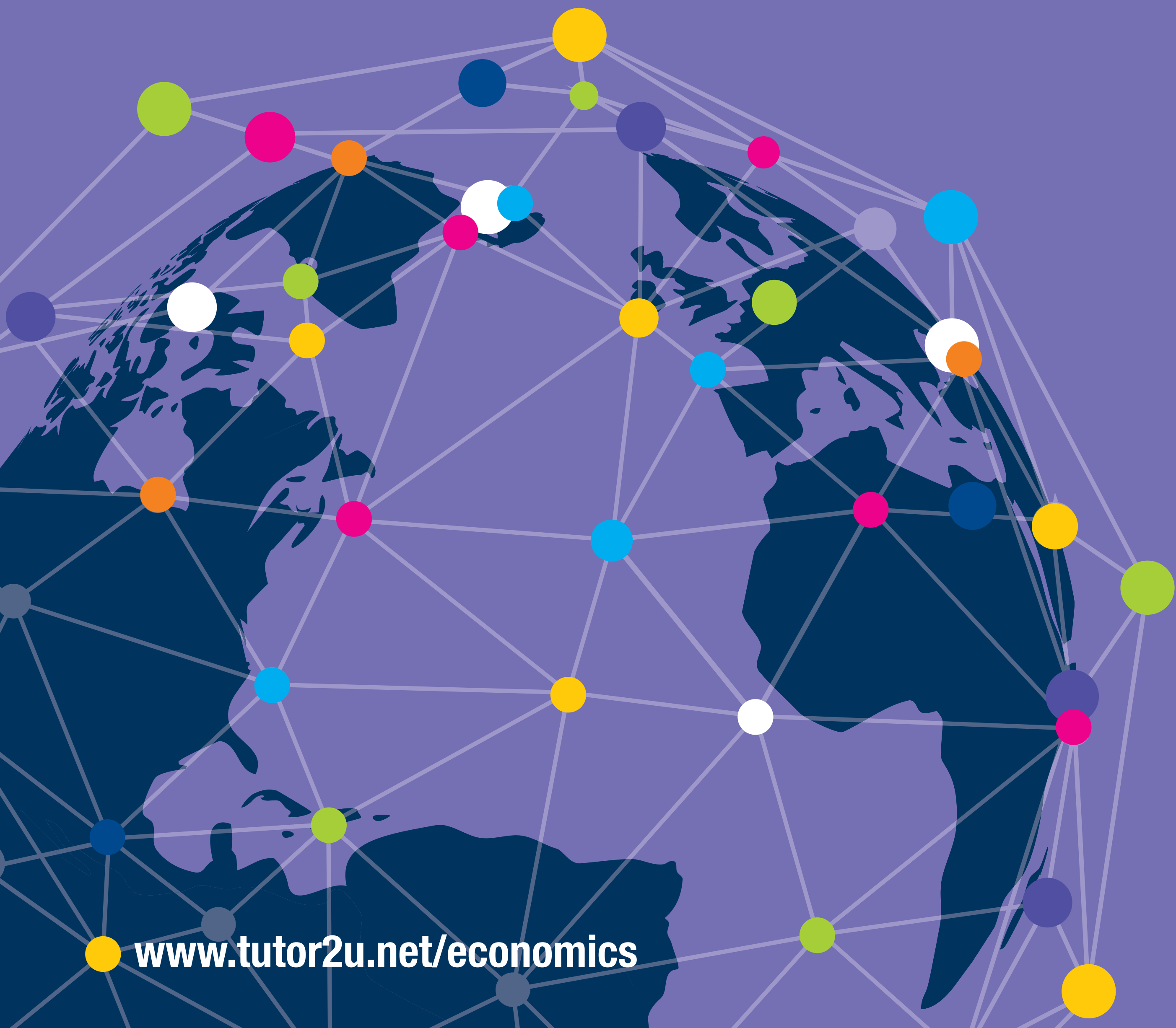
TOPIC COMPANION

How the Economy Works



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CHAPTER 1 INTRODUCTION TO THE NATIONAL ECONOMY

In this companion, we will consider how the wider economy works, beyond just markets and goods and the individual's economic decision making.

For the UK, the effectiveness of the economy has often been determined by the way that the government controls the relationship between consumers and producers. The UK has a democratically elected government which means that the direction of economic policy can alter depending on which group of people (and politicians) holds the most power.

However, the tools and instruments available to the government are similar no matter who is in control.

Interest rates, saving, borrowing, spending and investment

Saving

Key phrase: 'Savings' are any monies placed in an official scheme such as a bank or building society account. These monies may have been earned or gifted. People can retrieve this money from the account either by taking cash out of the bank or by using another form of payment such as a cheque, debit card or bank transfer.

Accounts that are considered 'saving' accounts will often reward customers with 'interest' (see below).

The ease of access to savings is agreed before an individual places money in an account. Many accounts allow customers instant access to their money but sometimes banks will ask for a period of 'notice' before money can be accessed. In this case, the interest rate offered to the saver is likely to be higher as a reward for not having instant access.

Spending

Key phrase: 'Spending' is another word that economists use to describe '**consumption**' – where individuals attain **goods and services** to **satisfy wants**. Often, this will involve a money-transaction such as purchasing a coat from a shop (in order to look fashionable and to keep warm).

People earn money (usually through payment for work) and whatever is left (after tax) is classified as 'disposable income'. This income is then used in the process of spending or saving.

How people spend is dependent on a number of factors:

- Age
- Gender
- Habits (e.g. smoking cigarettes)
- Taxation levels
- The make-up of the household (e.g. number of dependants such as young children)
- Wealth (accrued assets, such as ownership of a house)
- Confidence (for example, confidence in retaining a job and its income)
- Interest rates (see later)

What factors have impacted on spending in recent years?

1. Until the Financial Crash of 2007/2008, real incomes (the value of incomes after inflation is taken into account) generally rose year on year. The Crash saw real incomes fall over the following years. However, since 2013 these are beginning to rise again, and spending may increase as people feel better off.
2. Availability of credit – the more credit that is available (e.g. credit cards) the greater the level of spending.
3. Changes in sociological patterns – for example, people are now having fewer children and spending on other items.
4. People are more environmentally conscious.
5. People are more conscious of consuming healthily.
6. Rapid development of technology has altered consumer demand (e.g. people may prioritise having a smartphone over an expensive holiday).

ACTIVITY 1

Give 2 reasons why a person would save a proportion of their money rather than spending it

1

2

Borrowing

Key phrase: Consumers may wish to **borrow** money (spend more money than they earn). People can borrow from banks and building societies, other organisations that loan money (e.g. Wonga) or even friends and family.

Money borrowed will be repaid, often charged with what is called 'interest' (see below). These repayments will be made from future earnings.

'Personal debt' is the total stock of accumulated debt over a period of time (e.g personal car finances).

A person may borrow to pay off other debts, pay bills (such as heating/electricity), pay mortgages, set up their own business or finance education (e.g. Student Loans).

People are able to borrow money from high street banks, building societies and many other businesses who now offer loans alongside their traditional services. For example, supermarkets such as Tesco and Sainsbury's now offer credit and loans.

What factors have impacted on borrowing?

- Interest rates (see below).
- The relative wealth of an individual (the more wealth someone has the smaller their need to borrow).
- Job security (again, if people are more confident in keeping their jobs or if future consumption is predicted to grow).
- Availability of credit (e.g. the number of lenders who might offer credit).

ACTIVITY 2

Each of the organisations below lend money in the UK. Which would be classified as high street banks, and which are could be described as purely 'money lenders'?

AA, Admiral, Argos, Barclays, EDF, Lloyds, M&S, Natwest, TSB, Wonga, Zopa

High Street Banks	Money Lenders

Interest rates

'Interest rates' can have several meanings:

1. A percentage charge on a loan as a reward for granting the loan by the financial institution and the cost of taking out the loan for the loanee. For example, if a bank loans an individual £1,000 at a 5% interest, then the individual will need to pay the £1,000 back plus an additional (5% of £1,000) £50.
2. A percentage reward (often paid annually) to an individual holding money in a savings account. For example, if there is £2,000 in a savings account with a 2% interest rate, at the end of the year the financial institution will reward the saver with (2% of £2,000) £40 in interest. The savings account will now show £2,040.

What is the impact of a change in interest rates?

For consumers:

*If interest rates **rise**:*

- People will be encouraged to **save more** as the reward for saving has **increased**. For example, if interest on £2,000 of savings increases from 2% to 3%, the reward changes from £20 to £30 (per year).
- People are **less likely** to take out loans. This is because the **cost of borrowing has increased**.
- Monies paid into other investments will **decrease**. For example, monies can be earned from investing in shares (a proportion of the ownership of businesses). Individuals are more likely to put money into savings accounts as they are safer and earn more money than the 'share investment'.
- Consumers are likely to **spend less** as they are **saving more** and have **fewer funds** on which to draw as they are less likely to borrow.

*If interest rates **fall**:*

- People will be encouraged to **save less** as the reward for saving has **decreased**.
- People are **more likely** to take out loans. This is because the **cost of borrowing has decreased**.
- Monies paid into other investments will **increase**.
- Consumers are likely to **spend more** as they are **saving less** and have **more funds** on which to draw.

For producers:

*If interest rates **rise**:*

- Producers are likely to **save more** as the reward for saving has **increased**.
- Producers are **less likely** to take out loans. This is because the **cost of borrowing has increased**.
- Producers are **less likely** to invest. They are less likely to take out funds or use monies to purchase machinery or expand their business. This is because the **cost of borrowing has increased**.

*If interest rates **fall**:*

- Producers are likely to **save less** as the reward for saving has **decreased**.
- Producers are **more likely** to take out loans. This is because the **cost of borrowing has decreased**.
- Producers are **more likely** to invest. They are more likely to take out funds or use monies to purchase machinery or expand their business.

Calculating the interest on savings

Graham's bank offers a 5% interest rate per year on any money saved in his account. How much interest would Graham earn if he placed £1,250 in his bank and kept it there for a full year? How much money would Graham have in his bank at the end of that year?

Calculate 5% of £1,250

Interest = £1,250 x 5%
= £1,250 x 5/100
= £1,250 x 0.05
= £62.50

Savings at end of period = Total savings plus interest
= £1,250 + £62.50
= £1,312.50

ACTIVITY 3

Calculate the amount of interest earned in the following cases:

1 David saves £2,000 with a bank that offers a 2% interest rate per year

2 Madge saves £5,000 with a bank that offers a 4% interest rate per year

3 Clyde saves £7,500 with a bank that offers a 3.5% interest rate per year

In each case, how much money would be in the accounts at the end of the year?

1 David

2 Madge

3 Clyde

Investment

Key phrase: Investment is spending on capital goods such as new factories & other buildings machinery & vehicles. A broader **definition** of **investment** includes spending on improving the labour force through training and education to improve the skills and competences of workers.

How people spend is dependent on a number of factors:

- Future expectations – if firms are confident that demand will rise in the future then more investment may take place to ensure that output will meet that demand.
- The economic outlook – if the economy appears to be doing well (with economic growth improving and unemployment low) firms may invest more to meet the demands of a wealthier society.
- Cost of capital goods – as capital goods fall in price, firms may be inclined to invest more to improve efficiency or output.
- Technological change – as capital goods become more effective through technological advancement, firms may be prepared to invest more.

Multi-choice questions

1 Which of the following groups is **least likely** to benefit from higher interest rates?

A Savers

B Borrowers

C Pensioners

D High Street banks

2 Which of these factors is **most likely** to encourage a firm to **invest more in capital machinery**?

A Increase in interest rates

B Increase in savings

C Reduction in credit available

D Reduction in cost of machinery

3 Which of these factors is **most likely** to lead to an increase in **general levels of spending**?

A A fall in income tax for low earners

B An increase in interest rates

C A decrease in investment in capital machinery

D A poor economic forecast

4 In which of these circumstances is a **borrower** most likely to take out a **mortgage**?

A Purchasing a car

B Purchasing a house

C Starting a business

D Purchasing capital machinery

5 Which of these factors is **most likely** to lead to an increase in **general levels of borrowing in the UK**?

A An increase in the number of organisations willing to lend money to people with low incomes

B An increase in interest rates

C An increase in unemployment

D A downturn in the economy of the USA

Short answer questions

6 State **two factors** that have led to a change in spending patterns in the UK over the last 10 years.

1 ______________________________

____

2 ______________________________

____

2 Marks

7 Explain why an increase in **interest rates** leads to an increase in the amount of money that **savings** in the economy.

____

____

____

____

2 Marks

CHAPTER 2 GOVERNMENT INCOME AND EXPENDITURE

The government has several ways that it can influence the economy, including the use of legislation (laws) that will make individuals, businesses and consumers behave in a certain way.

To achieve many of its economic goals, the government will use a mixture of spending and taxation to ensure provision and encourage consumption of certain goods and services.

The main sources of UK government revenue - Taxation

In the UK, central taxes are collected by Her Majesty's Revenue and Customs (HMRC). Local councils will also collect taxes from individuals and businesses.

Taxation can come in two forms:

Key phrase: Taxation

Direct Taxation – any tax deducted directly from a worker's wages such as 'income tax' and 'National Insurance Contributions'. Direct taxes may also apply to the wealth and assets of individuals and businesses.

Indirect Taxation – any tax charged to the supplier of a good/service on sale of the produce. For example, Value Added Tax (VAT). An indirect tax is often paid for by the consumer and then collected by the government from the seller.

The *direct taxation* process in the UK is often made up of four strands:

- **Personal allowance** – a certain proportion of a worker's income will be 'tax free'. This is called a 'personal allowance' and will apply to everyone who must pay tax. This exists to ensure that lower paid workers pay a lower proportion of tax.
- **Basic rate** – the 'basic rate' is the proportion of income (above the personal allowance) on which basic rate tax must be paid. In the UK, this rate has been set at 20% since 1992-93
- **Higher rate** – a tax rate charged on higher incomes (note: high income workers will still have a personal allowance and pay the basic rate on the lower portion of their wages)
- **Additional rate** – an even higher tax rate levied on incomes significantly above the average wage (for example income earned over £150,000 per year).

Note: Since 2018, Scotland has introduced a different taxation rate with an increased number of 'allowance' bands.

National Insurance Contributions (NIC) – these are an additional direct tax charged by the UK government, paid partly by the worker and partly by their employer. Their main purpose is to fund state benefits and pensions. NICs can also be paid by self-employed people. The more NICs a worker has paid over a period of time the more that worker is entitled to some benefits should they need to claim them (such as the basic state pension).

Other examples of *direct taxation*:

- **Council tax** – charged by local councils and usually based upon the value of the property in which a person resides
- **Corporation tax** – a tax that is levied on the profits of companies (19% as of 2018)
- **Business rates** – these are a tax paid by businesses to their local authorities
- **Capital gains tax** – the tax on the profit made from selling an asset
- **Inheritance tax** – those who inherit assets above a certain amount will have to pay taxes on their inheritance

Examples of *indirect taxation*:

- **Value Added Tax (VAT)** – set at 20% (2018) on almost every good and service purchased
- **Excise duties** – an additional tax on certain goods such as alcohol, cigarettes, some vehicles (vehicle excise duty), air flights (air passenger duty), betting and gaming
- **Customs duties** – taxes on imported goods
- **Landfill tax** (charged to businesses per tonne of waste that they dispose through landfill sites)
- **Climate change levy** – charged to all businesses based upon the amount of energy they use

ACTIVITY 1

Ben earns £25,000 per year and Amy earns £52,000 per year. If the personal allowance is stated as £10,000 per year, a 20% basic rate of income is charged on any income between £10,000 and £50,000 and a 45% higher rate of income is charged on any income over £50,000, how much income tax do Ben and Amy pay per year?

Ben

Amy

ACTIVITY 2

Tax rates can change regularly and are reviewed annually by the Chancellor of the Exchequer. Conduct some research and find out the following:

Current personal allowance:	
Current basic rate of income tax:	
Current higher rate of income tax:	
Current additional rate of income tax:	
Amount of income for which the basic rate can be charged:	
Amount of income for which the higher rate can be charged:	
Amount of income for which the additional rate can be charged:	

Note: You will need to adjust your research and records if conducting this in Scotland.

Other sources of government revenue
The government has other sources of revenue alongside taxation. For example, it can earn money through sale of its own assets - such as selling state-owned banks to the private sector.

ACTIVITY 3

In 2018, children's car seats, cycle helmets and (physical) books were all exempt from VAT (i.e. no VAT was charged on these items). Using economic theory, explain the reason why the government may have exempted these items.

The main areas of UK government spending

Government spending is expenditure by the public sector on goods and services such as education, health care and defence.

ACTIVITY 4

According to government records in 2017, rank these 5 areas from the highest to lowest in terms of the amount of money spent by the UK government:

Defence, Education, Health, Social Protection (benefits and pensions), Transport

Highest	
2nd	
3rd	
4th	
5th	

The Government decides each year how much money should be spent on each of the areas and requires the government office controlling those areas to stay within budget.

What proportion of revenue should be spent on the different areas depends on the objectives of the government at the time. These objectives can change and, as such, the proportion of money spent can alter.

For example, in 1990 the government spent approximately 4.1% of the country's income on defence. By 2017, this amount had fallen to approximately 2.5% of the country's income. This fall may be a sign of the relative threat-levels that the government considers are facing the UK, alongside other factors.

Similarly, in 1990 the government spent approximately 4.2% of the country's income on pensions. By 2017, that figure had risen to 7.9%. This reflects the fact that the UK has a growing population with a higher proportion at a retirement age.

The UK's major spending areas:

Social Protection	This includes welfare benefits and state pensions.
Health	This is primarily for the NHS and will include payments for wages, running costs and building of hospitals.
Education	Including payments for teachers and lecturers at schools and funding for payment of students.
General public services	This is payment for such services as transport, housing and environment, personal and social services.
Defence	Payment for wages of military personnel and for maintenance of equipment and buildings alongside payments for new machinery and weapons.
Public order and safety	These are payments for protection of UK citizens, primarily through payment for the police, the court system and the prison services.

Local governments will also spend money on: education, healthcare, police, local services such as parks and transport.

Progressive and Regressive tax systems

Tax systems can be classified in two ways:

Progressive taxation – use of higher taxation rates for higher income earners. This provides revenue to fund welfare benefits for poorer sections of society, and thus is a useful tool for redistributing income.

Regressive taxation – takes a larger percentage of income from low-income earners than from high-income earners.

The UK's direct taxation is often referred to as 'progressive' as those on higher incomes pay a higher proportion of their income in tax.

There is an argument that Council taxes (charged on the value of the house) are not 'progressive'. Whilst in many cases houses of lower value will often be occupied by those on lower income (and vice versa), this is not always the case. For example, in London (where house prices have risen at the fastest rate in the UK) some people who have occupied houses for many years and have low incomes can live next door to people with much higher incomes. Here, the Council tax may be at the same rate for both levels of income.

Some indirect taxes may also be considered regressive:

- Those on lower incomes have a higher tendency to participate in gambling and may pay a higher proportion of their income on gambling taxes.
- Whilst higher income earners will often consume a higher amount of petrol, this is not usually a significantly larger amount. As such, the amount paid on petrol duties is likely to be a higher proportion of the overall income of low income earners.
- Higher income earners tend to save more of their income. As such, a smaller proportion of their income is spent on goods and services and they will therefore pay a smaller proportion of their income on VAT.

The government will often justify the existence of regressive taxes on the following grounds:

- Duties will be charged on goods considered demerit goods and services to reduce their consumption.
- The impact of the progressive income tax system more than compensates for any regressive nature of indirect taxes.

ACTIVITY 5

Explain two possible economic advantages for an economy that has a progressive tax system.

1

2

Multi-choice questions

1 What is the name of the most significant **income tax band**, charged on income just above the **personal allowance**?

A Basic rate

B Main rate

C Higher rate

D Standard rate

2 What is the name of the **tax** charged by **central** government on a proportion of a business's **profits**?

A Council Tax

B Landfill Tax

C Corporation Tax

D Capital Gains Taxy

3 What type of **taxation** is used to try and reduce the level of **inequality**?

A Direct

B Indirect

C Regressive

D Progressive

4 Which of these is an example of a **direct tax**?

A VAT

B Income tax

C Air passenger duty

D Climate Change levy

5 In recent times, which department tends to receive the highest amount of **government spending**?

A Health

B Education

C Defence

D Social Protection

Short answer questions

6 Explain why a **tax on gambling** may be considered an example of **regressive taxation**.

2 Marks

7 Explain one reason why the government may need to spend more on **social protection** currently compared to 1980.

2 Marks

CHAPTER 3 GOVERNMENT OBJECTIVES

Over the next few chapters we will be considering the economic objectives of a government and then looking at the policies to achieve those objectives. An 'objective' is a goal or target that a government is attempting to meet. Ultimately, the government has to succeed in trying to solve that very first economic problem – meeting the unlimited demand of society with a limited set of resources.

The primary economic objectives are:

- Maintaining **FULL EMPLOYMENT**
- Ensuring **PRICE STABILITY**
- Achieving **ECONOMIC GROWTH**
- Having a **BALANCE OF PAYMENTS**

Objectives:

Maintaining full employment

This means that the government is attempting to ensure that every citizen who is willing and able to work has a paid job. This involves supporting businesses to ensure that they can employ people and helping individuals to attain the skills that they need to become employable.

Ensuring price stability

It is very common for prices to rise continually – this is not a problem if the price rises are expected by individuals and firms, as wages can rise to compensate for such price rises. However, if prices change at a rate that is unplanned then uncertainty can be created in the economy. This uncertainty can lead to businesses reducing their investment and for individuals to lower their spending and consumption.

Achieving economic growth

The government wants the economy to be constantly growing so that individuals have growing incomes are becoming wealthier. Through economic growth the government is able to provide more and more public services to the population.

Having a balanced current account on the balance of payments

In its simplest form the **balance of payments** is a record sheet showing the flows of money in to and out of a country. The **current account** section of the Balance of Payments has details of how much the UK spends on foreign goods and services (imports) and how much the country receives from foreign countries when they purchase UK domestic goods and services (exports). The objective is to ensure that the flows of money going out of the UK are **BALANCED** with the flows of money coming in to the UK in the current account.

Reality check:

These objectives, in the UK are often quoted as:

- Full employment is where the UK has an unemployment rate of ±4% (assuming that you will always have some people searching for employment, so the economy is unlikely to have 0% unemployment).
- An inflation rate of 2% (±1%).
- Economic growth at a sustainable level of approximately 2.5% pa.
- A current account that is not permanently in deficit (i.e. UK spends more on foreign goods and services than it receives from abroad).

ACTIVITY 1

List 3 reasons why having high unemployment would have a negative effect on both the economy and for society:

1

2

3

ACTIVITY 2

List 2 reasons why having prices rising at an unexpected rate would have a negative effect on the economy:

1

2

Other government objectives

These include:

- **Reducing Inequality** – attempting to achieve a smaller gap between the lowest paid and highest paid workers in the economy, as well as reducing the gap between the least wealthy and the most wealthy households.
- **Managing environment change** – most governments now recognise that much of the environmental damage to the planet is caused by human economic activity. Research and evidence suggests that this damage is non-sustainable and can cause permanent, negative issues for humans, animals and plant life (for example, as a consequence of greenhouse gases). A more modern objective, therefore, is to attempt to ensure that economic activity has a reduced negative impact on the environment.

Objective Conflicts

One of the significant issues facing a government is that policies that it introduces to achieve one objective may end up having a negative impact on another. Here are some examples:

Achieving Full Employment vs Price Stability

The government may implement a policy to prevent prices rising too quickly (e.g. increasing income tax so that people spend less) which in turn reduces demand within the economy. This fall in demand leads businesses to reduce their output and potentially make some (or all) of their employees redundant, causing greater unemployment.

Achieving Economic Growth vs Price Stability

Stable prices may not encourage businesses to increase output as there is no incentive to increase profit levels at higher prices. The same businesses may feel unable to increase the wages of their employees. In this case, growth for the entire economy may not match the objective of the government.

Achieving Economic Growth vs Balance of Payments

If economic growth is positive, then individuals should earn higher incomes as businesses grow and more workers are employed. In the UK consumers are more likely to purchase goods and services (rather than increase their savings) as their incomes grow, and often this increase in consumption is on goods and services from abroad. This is because many of the goods that we consume in the UK are purchased from abroad where they are often produced at a cheaper rate than if they were made in the UK. This increase in spending on foreign goods is likely to increase the imbalance in the current account.

Achieving Economic Growth vs Inequality

Economic growth is often achieved through ensuring that businesses are able to thrive and grow. This economic growth can sometimes lead to an increase in reward (e.g. profit) for business owners (entrepreneurs) at a higher rate than it does for other employees. This difference can lead to a further gap between the lowest and highest paid workers.

Achieving Economic Growth vs Managing Environment Change

The faster the economy grows the more likely this is to be achieved through activities that have a negative environmental impact, for example creating water or air pollution.

ACTIVITY 3

Give 3 examples of negative environmental changes that may have occurred due to human economic activity:

1

2

3

The negative impact of government objectives

Government policies to achieve objectives can have a negative impact on various groups of people.

For example:

- A policy of reducing the availability of welfare benefits which is aimed at encouraging full employment could have a negative impact on relatively poor sections of the community who rely on those benefits and are unable to find paid work.
- A reduced rate of interest aimed at stimulating economic growth will have a negative impact on those people who save their money.
- A reduction in spending on public services such as education and health care in order to support other objectives (such as minimising government debt) can lead to lower quality services for those most in need.

Multi-choice questions

1 Which of these is an example of a valid economic **objective** for a government?

A High unemployment

B High inflation rate

C Imbalanced current account

D Sustainable economic growth

2 Which of these is an example of a valid **conflict** that may occur if the government undertakes policies to ensure **stable prices**?

A Lower than expected economic growth

B Higher than expected employment rates

C A fall in the amount of UK products sold abroad

D Higher than expected economic growth

3 Which of these is the most likely reason for why the government may wish to keep **prices stable**?

A To ensure a greater tax revenue

B To reduce levels of unemployment in the North of England

C To encourage business confidence

D To ensure a less harmful impact on the environment

4 Which of these policies could lead to less **inequality** in the UK?

A Increased income taxation

B Increased taxation on goods and services

C Increased spending on state-sector education

D Higher interest rates in banks

5 Which of these policies is most likely to lead to a more 'balanced' current account on the **balance of payments**?

A A policy to achieve full employment

B A policy aimed at economic growth

C A policy to reduce the environmental impact of business activity

D A policy to keep prices stable

Short answer questions

6 Explain why a policy to **increase economic growth** through building more motorways to improve transport links may have a **negative impact** on the environment.

2 Marks

7 Explain why a policy to **reduce interest rates** may have a negative impact on those who **save** a higher proportion of their wages.

2 Marks

CHAPTER 4 INFLATION AND PRICE STABILITY

What is inflation?

Key phrase: 'Inflation' is a persistent rise in the general price level.

If you purchase products regularly you may have noticed that, generally, prices tend to gradually increase over a period of time. This is not the case for all products as some will be put into a sale, or others come down in price when they are no longer popular, or become cheaper to manufacture as technology improves. However, if you were to ask a parent or relative who is decades older than yourself they will tell you how almost every single product is higher in price currently.

Inflation does not have to be a problem for economists – in fact a small amount of inflation each year is accepted as being positive as it demonstrates growing income in the economy and how aggregate demand may be on the increase. However, if prices rise too quickly and wages are not rising at the same rate then, in effect, individuals are less able to purchase as many products.**Inflation causes the value of money to fall**.

If this uncontrolled price rise continues for an extended period than the economy can witness a fall in growth which, in turn, can lead to higher unemployment, as confidence is lost and purchasing and investment plans are put on hold.

The economic objective, therefore, is to keep 'prices stable' – i.e. to allow prices to rise slowly and steadily. In the UK, the government asks the Bank of England (who have responsibility for maintaining price stability) to keep the inflation rate at around the 2% per annum rate.

Real and Nominal Values

As inflation exists, economists will often refer to 'real' and 'nominal' values. 'Real' values are any monetary values which are statistically altered to strip out the effects of inflation.

Take the following as an example:

Imagine Jim earned £100 a month and each month he purchases 100 items at £1.00 each. The following year, Jim earned £110 a month. However, all items that he purchased have gone up in price to £1.05.

Initially, it would appear that Jim's wages have increased by 10% (from £100 to £110). If prices remained the same, he would now be able to afford 110 items. However, because prices have risen he can 'only' afford 104 items (with a little spare change). In 'real' terms, Jim's wages have actually increased by just over 4%.

The rate of inflation

The 'rate of inflation' is the rate at which prices rise each year. It is calculated as a percentage increase in prices over a period of time. In the UK, we may look at the inflation rate in a month (e.g. the rate of inflation between May and June) or over a longer period (e.g. over a one-year period).

Calculating a general price rise over a period involves a considerable amount of record keeping so there are several ways that economists may record such changes. The measure most often used in the UK is the 'Consumer Price Index' (CPI).

The Consumer Price Index

The CPI is an **index** which is method of presenting statistical changes. An index converts data from an initial period (called the '**base**') into the number 100. Any changes in subsequent data is then converted to show the percentage difference from this 'base' of 100.

In the UK, the CPI shows inflation rates by comparing the prices of a selection of goods and services. This selection is called 'the basket of goods' (like in a supermarket). Not all products are accounted for as they may not be purchased regularly or by sufficient enough people. The basket of goods will include many of the products that are purchased frequently by the average family, such as food stuffs, transport costs and clothing.

Each of these goods is also given a '**weight**' – i.e. they are multiplied by a number to represent the proportion of a person's wage that might be spent on that product. So, for example, food would be given a higher 'weighting' than hotel accommodation as people spend a higher proportion and use food more regularly than hotels. In this way, the CPI attempts to show how price rises impact on individuals in a more sophisticated way.

Calculating the CPI

In country Y, consumers only purchase 2 products – pineapples and pens. They consume 5 pineapples and 2 pens in any time period.

The prices of both products changes over a time period as follows:

Time	Pineapple	Pen
1	£1.00	£2.00
2	£2.00	£3.00

What is the CPI for this time period (assuming that Yr 1 is the base year)?

We need to calculate the cost of a basket of goods in both time periods.

In time period 1, the cost of the basket of goods was:

(5 x £1) + (2 x £2) = £9

In time period 2, the cost of the basket of goods was:

(5 x £2) + (2 x £3) = £16

The CPI is (£16/£9) x 100 = 178. This suggests that prices have risen in country Y by 78%.

ACTIVITY 1

Consider the following data table for country Z. Calculate the CPI for time period 2 assuming that time period 1 is the base. In country Z, consumers purchase 6 apples and 3 biscuits in any given period.

Time	Apples (£)	Biscuit (£)
1	6	2
2	9	3

ACTIVITY 2

Consider the following data table for country P. Calculate the CPI for time period 2 and time period 3 (compared to time period 1) assuming that time period 1 is the base. In country P, consumers purchase 7 ‘crisps’, 2 ‘candles’ and 1 tube of toothpaste in any given period.

Period	Crisps (£)	Candles (£)	Toothpaste (£)
1	2	1	1
2	2	2	2
3	3	2	3

Time period 2 (compared to time period 1)

Time period 3 (compared to time period 1)

The causes of inflation

- **'Cost Push Inflation'** – this is where an increase in the costs of production is forcing suppliers to increase the prices that they charge to consumers. For example, if the workforce has negotiated a wage rise causing a significant increase in labour costs, businesses may feel the need to increase the price of their products to compensate. An increase in the cost of fuel (such as petrol) will increase costs for most businesses.
- **'Demand Pull Inflation'** – if there is a rise in general demand from consumers and businesses, for example caused by high levels of confidence, this may lead to shortages in the short run. To ration demand, prices may rise causing inflation.
- **Restriction in supply of products** – businesses may reduce their output of products (perhaps due to a lack of available raw materials or due to government restrictions on demerit goods) which, in turn, forces suppliers to increase their prices.
- **Monetary Inflation** – if there is too much money made available in an economy, for example through greater availability of credit, then consumers will have access to more funds. This will lead to an increase in spending, forcing prices to rise.

The consequences of inflation and price instability

The impact on poorer sections of society

If all or most prices are rising, the impact of inflation will be felt greater by poorer sections of society (and those dependent on benefit payments, such as pensioners). This is because they will have fewer available funds to match the increased costs of consumption but will still need to purchase necessities such as food and fuel.

The impact on savers

If the inflation rate is greater than interest rates, then the value of money held in savings starts to decrease. For example, if I save £100 at an interest rate of 5%, then at the end of a year my savings are now worth £105. However, if inflation is at 10%, then a product that was being sold at £100 at the beginning of the year may now be sold for £110.

In the UK, people save less now than in previous decades. Young adults are starting to save more as a proportion of their income as many are saving for a deposit to purchase a house (with housing prices rising regularly). The UK population is more likely to purchase products on credit (using loans or credit cards) than they are to save up for a purchase. Also, in the UK interest rates on savings has been low for several years which has discouraged savers.

The impact on businesses

A persistent increase in prices is likely to lead to wage increase demands from the labour force. Businesses may need to meet this demand to maintain steady employment and avoid strikes, and will therefore see an increase in costs. This could lead to a fall in profits for businesses.

If prices are rising quickly then businesses may also lose confidence in consumption in the future. As businesses lose confidence they become less inclined to invest and expand.

The impact on the current account of the balance of payments

If UK prices are rising at a quicker pace than other countries, then UK products become less competitive. This may mean that fewer countries purchase UK goods and UK consumers purchase more foreign goods. This can cause a greater deficit in the current account of the balance of payments for the UK.

The impact on banks

If prices are rising at a rate that is higher than the interest a bank is charging on the loans it has granted, then the value of that interest is lower for banks. This means that banks are less likely to approve loans during periods of high inflation.

ACTIVITY 3

Give 2 reasons why people currently are less likely to save their income than they would have in the final two decades of the 20th Century:

1

2

ACTIVITY 4

The data on inflation is published on the website of the Office for National Statistics (ONS). Find the website for the ONS and then find out recent data records on inflation in the UK. Find 5 examples of items that have been either 'removed' from or 'added' to the basket of goods in the last year. List them below:

1

2

3

4

5

Deflation

Deflation is a *'persistent fall in the general price level.'* Most economists argue that deflation is a negative outcome, even though a fall in prices would appear to be good for consumers. The argument is that during a period of deflation, consumers do not spend as much money as they are waiting for better (lower) prices in the future. This delay in consumer spending means a fall in demand for output from firms, who then in turn may need to produce less and possibly make redundancies. Deflation can be highly damaging to economic growth and employment.

As a consequence, economists set a target of inflation at a low but steadily increasing rate.

Hyperinflation

'Hyperinflation' is the rare condition that can occur when prices rise at a very high rate, for example 1000% per year. When hyperinflation exists it quickly erodes the 'real' value of income and can cause huge economic problems such as large-scale unemployment.

The German economy suffered from hyperinflation in the 1930's and this has been credited with one of the factors that led to the Second World War.

In 2008, Zimbabwe suffered from an inflation rate of 79,600,000,000%. At the height of inflation, prices of products were doubling every single day. Wage increases could not keep up with price changes so the real value of those wages quickly spiralled downwards. A similar hyperinflation crisis started in Venezuela in 2014.

Government policies to manage inflation

- **Control demand** – the government can attempt to curb a rise in demand. This can be achieved by increasing direct taxation to reduce the amount of disposable income available for spending
- **Use interest rates to control demand** – in the UK, the Bank of England (BoE) sets the base interest rate. Although the BoE is independent from the UK government, it has a remit of keeping inflation at about 2% per annum. The primary method that the BoE would use is to raise interest rates to reduce general demand. Many people in the UK have a mortgage (extended loan to purchase a house) set at a variable interest rate – a rise in interest rates would mean that homeowners would pay more on their mortgage repayments and thus reduce demand.
- **Control costs** – the government can support the control of costs to reduce cost push inflation. For example, it could reduce company taxes or regulate markets to make them more competitive and efficient.
- **Direct control** – one method that the government can use to control the spending of a large proportion of the population is to keep public sector employee awards at low levels, known as 'austerity measures'.

Multi-choice questions

1 What is the current **target** for **inflation** as measured by CPI in the UK?

A 1%

B 2%

C 5%

D 10%

2 Which of these economic agents is likely to **benefit** from a sustained level of high **inflation**?

A Savers if interest rates are lower than inflation rates

B Workers in low paid jobs

C Retired people on fixed incomes

D Producers if prices rise faster than costs

3 **Exchange rates** have changed making imported raw materials more expensive. This is an example of what type of **inflation**?

A Monetary expansion

B Demand pull

C Cost push

D Supply restriction

4 Which of the following is the most likely outcome if UK prices are persistently rising at a **higher** rate than those of **foreign competitors**?

A The UK will sell less goods abroad

B The UK will purchase less imports

C Savers will save less

D Banks will lend more

5 Consider the table below. Which year is most likely to have been considered the 'base' year?

Year	CPI
2015	96
2016	100
2017	102
2018	106

A 2015

B 2016

C 2017

D 2018

Short answer questions

6 Explain why persistently **high inflation** will have a **negative** impact on those who regularly save.

2 Marks

7 Explain why the changes in the price of **food items** may be given a higher '**weighting**' than non-essential spending on leisure goods when being used to calculate the **Consumer Price Index**.

2 Marks

CHAPTER 5 ECONOMIC GROWTH

What is economic growth?

Key terms:

Economic growth is the growth in GDP over time.

Gross Domestic product (GDP) is the total market value of goods and services produced in an economy in a year.

This total market value of output becomes the incomes for those who produce it. This income can be seen as wages, interest, profit and rent. If an economy experiences economic growth, both output and incomes are rising.

How is economic growth measured?

As governments see achieving economic growth as one of the main economic policy aims then it is important that the rate of growth is accurately measured. To do this the government needs to use the formula:-

$$\textbf{Rate of economic growth} = \frac{\textbf{change in GDP between year 1 and year 2}}{\textbf{GDP in year 1}} \times 100$$

For example if a country has an original GDP of £400bn and the next year the GDP rises to £410bn, then the rate of growth is:-

$$\frac{£10bn}{£400bn} \times 100 = 2.5\%$$

ACTIVITY 1

Using the formula above calculate the following **growth rates:-**

In Year 1	In Year 2	Economic growth rate
200	203	
300	302	
500	512	

What is GDP per capita?

When we divide GDP by the number of people in the population we get GDP per capita. This is used as a measure of the average income of each person in the country and is used to rank the economic development of countries. Remember that actual GDP will be distributed much less evenly!

We also use GDP per capita to help us compare living standards between countries. The figures give us an idea as to how much the average person in that country earns.

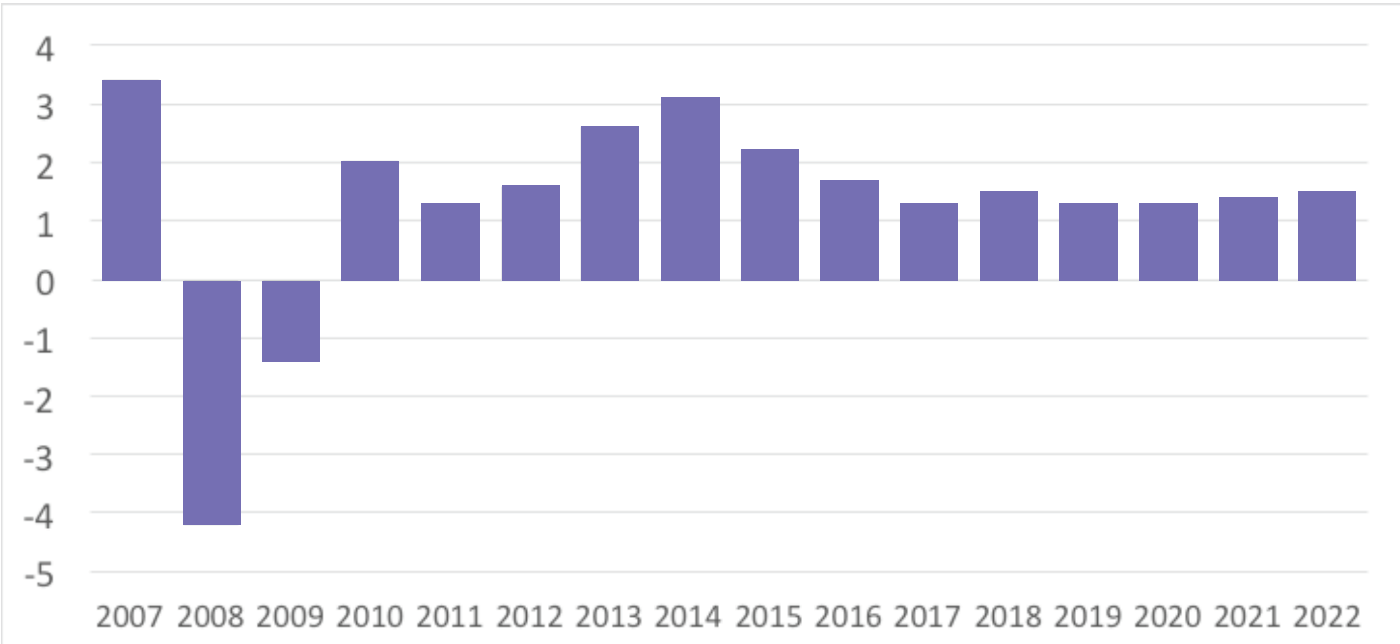
ACTIVITY 2

Calculate **GDP per capita** in each of the following cases
(£1bn = £1000m)

GDP(£bn)	Population (million)	GDP per Capita
600	60	
800	40	
500	12.5	

Analysing GDP data?

The chart below shows the annual growth rate (%) for the UK economy between 2007 and 2022 (2018 – 2022 are forecasted). We can clearly see that growth rates are not the same year on year. The data for 2007 would show that the UK was in a boom period. The period for 2008 and 2009 shows the UK in a recession.



Source: ONS

ACTIVITY 3

Explain what happens to GDP growth in a **Boom** period

Explain what happens to GDP growth in a **recession**

Analysing the determinants of economic growth

When an economy can supply more goods and services over time then it experiences economic growth.There are a number of supply-side factors that can enable this to happen.You will remember from previous chapters that the factors of production are needed to produce goods and services. Therefore, the quality and quantity of them is of key importance.

There are six key areas to focus on:

- **Investment** – in capital goods and in human knowledge;
- **Technology** – technological progress improves the quality of capital goods;
- **Education and training** – affects the quality and quantity of work done;
- **Labour productivity** – improving the output per worker in a given time period;
- **The size of the workforce** – a larger labour force enables the economy to produce more;
- **Natural resources** – for example, new supplies of oil or gas can stimulate growth.

ACTIVITY 4

The collapse in oil prices that began in 2014 in Canada snuffed out Alberta's energy boom more quickly and deeply than anyone expected. The Bank of Canada governor Stephen Poloz trimmed the benchmark lending rate by a quarter point to 0.5 per cent and slashed the central bank's growth outlook. The bank effectively confirmed suspicions that the economy entered a recession by noting in a statement that "real GDP is now projected to have contracted modestly in the first half of the year." While Canadian consumers have helped offset the damage by their seemingly unending willingness to borrow and spend, the resulting debt that households have piled on now represents an economic risk in its own right—particularly if job and wage growth weaken. No wonder some believe Canada is tiptoeing around the edge of the abyss. You have a resource economy that has been blown apart, sitting on top of a housing bubble.

Now, the debate is how long and deep Canada's downturn could be. Prime Minister Stephen Harper blamed any slowdown on overseas events beyond Canada's control, declining to elaborate on just how Canada allowed itself to become so exposed in the first place. The hope continues to bethat the U.S. economy will fuel Canada's rebound. For deep structural reasons, Canadian manufacturing has been slow to recover, despite a weakening dollar making our exports, at least in theory, more attractive.

1. **What evidence is there that the Canadian economy is in recession?**
2. **Analyse why Canada lacked economic growth in 2016.**

Growth can also be affected by Government policies:

- The amount of government intervention in the economy can have a significant effect on growth. A mixed economy such as the UK is often considered the most efficient, whereas a command economic system such as North Korea tends to be inefficient.
- How much investment in infrastructure is undertaken by the government can also have a significant effect. Good transport and communication links are vital for a successful economy.
- The macro management of the economy is undertaken by the government. The UK government, for example, can affect both the demand and supply side of the economy.

How significant are the benefits of economic growth?

As growth is one of the main aims of government economic policy it is perceived to bring about several benefits.

- **A rise in living standards** – everyone, on average, has more output to consume than before. For example, from 1992 – 2008 there were 16 years of consecutive growth in the UK economy. Many people saw improvements in their living standards with more restaurant meals and foreign holidays.
- **A reduction in poverty** – with more tax revenues from incomes and spending the government can use these revenues to raise the living standards of those on lower incomes.
- **A rise in the welfare of the population** – the additional tax revenues can also be spent on health and education improving the general welfare of the population.
- **A rise in employment** – more workers will be needed to produce the extra output. This will enable the government to achieve its aim of a high rate of employment.

The costs of economic growth

Economic growth brings with it some costs, these can be environmental. It may well be necessary for you to evaluate these.

- **Environmental costs** – the more goods and services we produce and consume, the more pollution will be caused.
- **Air pollution** – this can come from increased car usage and from and from the use of fossil fuels e.g. the burning of coal.
- **Global warming** – The increased worldwide output has led to global warming, which in turn has negative effects on the environment.
- **Congestion** – many of our urban areas have become overcrowded and suffer from traffic congestion. Also, there is increased pressure on services such as hospitals and schools.
- **Loss of non-renewable resources** – economic growth uses up natural resources that cannot be replaced We are particularly concerned about oil, gas, natural minerals and metals. However, we must also remember the wider damage to people animals and plants.
- **A lower quality of life** – although people may become materially better off, they may also experience changes to their lifestyles. These changes may involve moving into cities where life is busier and more stressful.
- **Inequalities of income and wealth** – the benefits of economic growth are not experienced equally by everyone. Indeed, the gap between the rich and the poor may actually become wider.
- **Inflation** – a rapid period of economic growth may also lead to rising prices.

ACTIVITY 5

In the section above, we have considered the costs and benefits of economic growth. If you were living in a country such as the UK would you consider the benefits of growth still to be a major aim of government economic policy? Remember to consider the costs and benefits of growth before giving a definitive answer.

Multi-choice questions

1 **Gross Domestic Product** is defined as:

A The market value of goods and services produced by households in a country

B The market value of goods and services produced by factors owned by the population of a country

C The market value of goods and services produced by factors within a country

D The market value of goods and services after capital consumption is taken into account

2 A country's **per capita GDP** is a useful measure of **economic welfare** because?

A It takes out the effect of inflation

B It reflects the average wealth of each factor owner

C It takes out the effect of output from foreign-owned businesses

D It measures the average income earned by each citizen

3 The rate of **economic growth** is measured by the percentage change in:

A Employment

B Bank of England interest rate

C Gross domestic product

D The average price level

4 If a country has a GDP of £600bn and a population of 20 million then its **GDP per capita** is:

A £300,000

B £30,000

C £300

D £3000

Short answer questions

5 State **two** determinants of **economic growth**:

1

2

2 Marks

6 Explain **two benefits** of **economic growth** for a country such as the UK.

4 Marks

CHAPTER 6 EMPLOYMENT AND UNEMPLOYMENT

When labour is used to produce goods and services we refer to this as employment. Labour is one of the factors of production and its reward takes the form of **wages**.

When there is **full employment** in the economy most of the available workers are being used to produce output.

Key terms:

Employment is the use of labour to produce goods and services in an economy.

Unemployment occurs when workers willing and able to work at the current wage rates are unable to find paid employment.

Labour force includes all those people in work and those registered as unemployed.

There will always be some workers who are moving between jobs, this is known as frictional unemployment. There will also be occasions when some industries are in decline and other industries are growing. Workers may move between these different industries but there will be a time lag with resulting unemployment.

Measuring unemployment

Although there are different measures for unemployment the Claimant Count is the method used by the UK government. It is measured by recording the number of people registered as claiming unemployment benefit.

Calculating unemployment

There are two ways of expressing unemployment:

- The **level** of unemployment = the number of people who are unemployed.
- The **rate** of unemployment = the number of people unemployed as a % of the labour force.

$$\frac{\textbf{No of Unemployed}}{\textbf{Labour force}} \textbf{ x 100 = Rate of unemployment}$$

ACTIVITY 1

There are 3 sets of data below on the unemployment in an economy. In each case calculate the rate of unemployment using the formula above:

Labour force	Number unemployed	Unemployment rate
1 million	75, 000	
30 million	3.5 million	
28 million	1.8 million	

Over time, the size of the working population is likely to change. This could mean that the level of unemployment (i.e. the number of people without paid employment) has risen, but that the rate of unemployment has fallen.

Causes and types of unemployment

- **Seasonal unemployment** results from regular changes in employment/labour demand at different times of the year. This will affect some industries more than others. For example, the retail industry will employ more workers at key times of the year, e.g. Christmas.
- **Frictional unemployment** or Transitional unemployment results from people moving between jobs. It will be seen through workers experiencing short spells of unemployment.
- **Structural unemployment** arises from the mismatch of skills and job opportunities as the pattern of labour demand in the economy changes. It often involves long-term unemployment and is prevalent in regions where industries go into long-term decline. Examples include industries such as mining, engineering and textiles.

ACTIVITY 2

Conduct some research into the city/town/region in which you live. List 3 industries that have been or continue to be located in your area.

Was there an industry in your area that no longer exists? Conduct some research to find out if that led to some structural unemployment in your region. How significant would it be if current industries suddenly closed – would many people be made unemployed?

- **Cyclical unemployment** results from the cyclical relationship between demand, output, employment and unemployment. It is caused by a fall in general levels of demand, which can lead to businesses making workers redundant because they lack confidence that demand will recover. This can lead to a loss of real national output.

The consequences of unemployment

Unemployment can affect both the economy and the people within it. Are there any **benefits to unemployment**?

- There may be occasions when some goods are no longer demanded by consumers e.g. Video tape recorders. At the same time consumers will have an increased demand for other goods such as tablet computers. There will be some frictional unemployment as workers move from producing video recorders to tablets. This unemployment was necessary to reflect these changes in demand.
- When there is a substantial amount of unemployment in a particular industry, creating competition for jobs, then wage rates will be unable to rise as other individuals will be willing to work for the lower wage rate. This can be seen as a benefit to firms as it will keep their labour costs down and help to make them more competitive.

More often the consequences of unemployment are mostly seen as unfavourable.

The costs to individuals

Workers who lose their jobs may then be subject to lower living standards. Although they will be able to claim benefits, these will be less than the income that they were earning. They will therefore be able to buy less goods and services.

In addition, workers may suffer from a lower status and a lack of self-esteem. Tied in with this could also be that the longer workers are out of work, the harder they will find it to gain employment as their skills become out dated.

There is also a cost to taxpayers as more benefit payments must be funded. In fact, those still in work may have to pay more direct taxes to help with the government's extra payments.

The costs to the government

The government could end up running a **budget deficit** where the government is spending more on benefits than it receives from taxation. In the section on Fiscal Policy you will learn how this will happen and how it may actually help unemployment.

Finally, there will be **costs to the regions** as unemployment is not spread evenly throughout the country. For example, the decline in the shoe making industry had a significant impact on Northamptonshire because the lack of demand led to unemployment, which led to lower income levels in the area, reduced demand for other goods and services and more people leaving the area in search of employment, leading to it becoming 'depressed.'

ACTIVITY 3

BAE Systems to cut nearly 2,000 UK jobs

In October 2017, the UK's biggest defence contractor BAE systems announced that it was to cut almost 2,000 jobs at its factories in the UK. 1,400 jobs were to be lost from its military aerospace businesses, nearly 400 at its maritime services factories and a further 150 at its cyber-intelligence business.

The company said that job losses would affect all levels of employment from shop floor to management. BAE systems also said that they were hoping that some people would volunteer for redundancy (in return for a more generous pay-off).

BAE employs 83,100 people worldwide, including 34,600 in the UK.

Analyse how the job losses could have adverse effects on their local economy.

Multi-choice questions

1 The main economic reason that a government is likely to have the objective of **minimising unemployment** is to:

A Avoid the waste of a scarce resource

B Create a low and stable inflation rate

C Create a stable current account on the balance of payments

D Reduce the government's budget deficit

2 Which **type of unemployment** would result from the closure of BAE Systems factory?

A Cyclical

B Frictional

C Seasonal

D Structural

3 **Seasonal unemployment** is often associated with?

A Car manufacture

B Train services

C Quarrying

D Tourism

4 Unemployment is measured by...

A The CPI

B Claimant count

C Exchange rate

D Job seekers count

5 Which of the following would **not** be a **cost** of **unemployment**?

A Higher wages

B Lower living standards

C Reduced output for the economy

D Increase budget deficit

Short answer questions

6 State **two examples** of costs to the **government** from **unemployment**:

1 ______________________________

____

2 ______________________________

____

2 Marks

7 Explain what is meant by **full employment**.

____

____

____

2 Marks

CHAPTER 7 DISTRIBUTION OF INCOME

The distribution of income refers to how the total incomes in an economy are shared out amongst its people. Most economies have an unequal distribution of income with some households earning more than others.

Key terms:

Income – is the reward for the service of a factor of production, including labour, or the reward for owning an asset.

Wealth – the market value of all of the assets owned by a person, group or country at a specific moment in time.

Wealth is a stock of assets such as money, land houses as it can be counted at any one point in time.
Income is a flow of money over a particular time period, e.g. a salary per year.

Most income comes in the form of wages from employment. Different jobs pay different wages. Generally, the higher the skill levels the higher the wage. Those in lower skill jobs may be on the national living wage or the national minimum wage.

Other main sources of income:

- Income from pensions and life assurance
- Interest from savings
- Dividends from shares
- Rent income from ownership of property

ACTIVITY 1

According to the ONS the average weekly wage in the UK was £516 in 2017. The golfer Rory McIlroy earned £26m in 2017.

1. **How many years would the average person have to work to earn the same amount as Rory?**
2. **Why is Rory able to earn such a high wage?**
3. **The author JK Rowling has earned £20m in a six-week period in 2018. If the average female earnings in 2018 are £500 per week, how many weeks would the average person have to work to earn the same as JK Rowling?**

Wealth

Wealth is a stock of assets that have a market value. Examples include:

- Savings Deposits with Banks
- Household assets such as computers, furniture
- Property
- Pension Fund contributions
- Life Assurance and other schemes

Wealth is a stock of assets that have a market value. Examples include:

- People with savings gain interest from deposits
- Property-owners gain rental income from lettings
- Households with shares gain dividends from companies

ACTIVITY 2

Lucy and Sam live in a two-person household. The table below shows their different items of income and wealth without stating which are which.

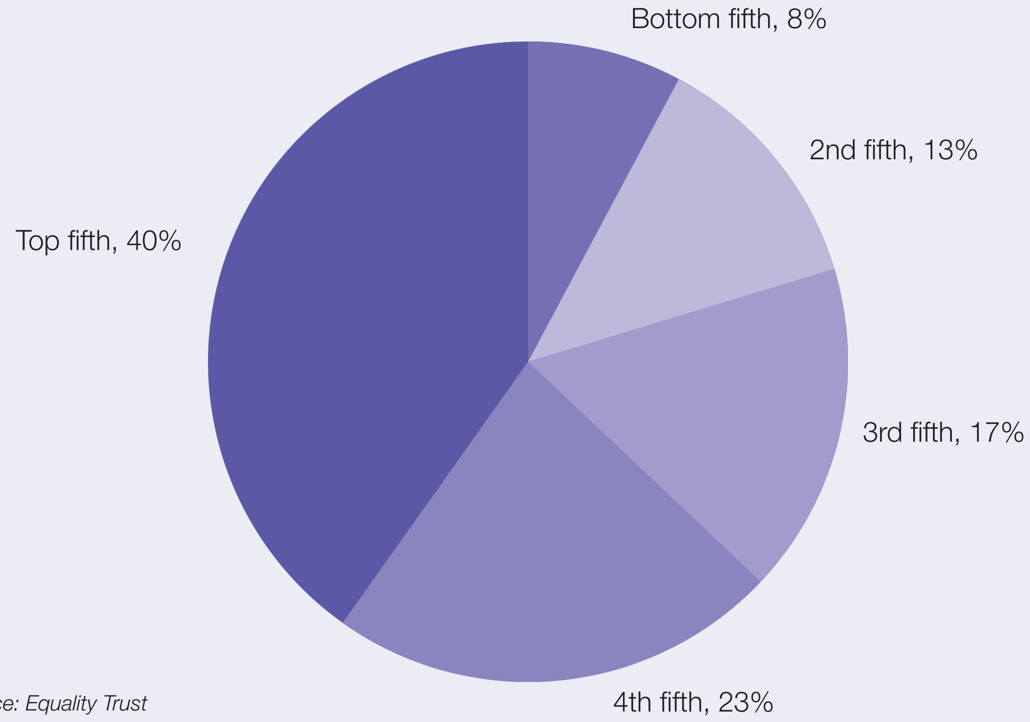
Item	Value
Lucy's salary	£30,000
Lucy's jewellery	£2,500
Lucy's car	£14,400
Sam's wage	£24,000
House furnishings	£12,600
Cash held in their joint bank account	£2,850
Cash held in Sam's ISA	£5,000
Lucy's pension fund	£35,000
Sam's profits from car repairs	£850
Calculate the value of household income	
Calculate the value of household wealth	

The distribution of income in the UK

The way in which income is shared out amongst various households in the UK is very unequal. The bottom 10% of the population has an average wage of £9,644. The top 10% have an average wage of £83, 875. The top 1% has an average wage of £253, 927. The top 0.1% has an average income of almost £1m.

ACTIVITY 3

How income is shared



Source: Equality Trust

The above graph shows UK income distribution for 2017. The population has been divided into fifths.

Using the above chart, comment on the distribution of income in the UK in 2016.

Why is income distributed unequally in the UK?

- There is a link here with wealth. Those sections of the population with more assets will be able to generate more income from those assets, on top of income earned from employment.
- Wage differentials – In the UK a significant number of workers are paid at the National Living Wage Rate, whilst other occupations pay many more times than this.
- Many of the poorest households in the UK rely on pensions or social security benefits for their income. Unemployment can also be a source of unequal income distribution.

- Age also has an influence, with those in middle age groups earning the highest wages.
- We are also aware of a significant gender pay gap in the UK with the average wage of females being lower than the average wage of males, despite this being illegal if it is for the same role.

ACTIVITY 4

Median Gross Disposable Household Income UK and constituent countries, 2016 (£)

The above chart shows difference between median household incomes in each nation of the UK.

1 **What do you understand by the term median income?**

2 **What could account for the differences in median income?**

The distribution of wealth

We also know that in the UK wealth is not distributed equally amongst the population.

Why does this uneven distribution of wealth occur?
This can be explained through different attitudes towards spending and saving. Over a time period some household groups will spend all of their income whilst others will do a mixture of spending and saving. The longer the time period, the greater will be the inequality.

There will also be issues around:

- **Inheritance**
- **Savings**
- **Purchase of property**
- **Enterprise**

What are the consequences for the UK economy of these differences in income and wealth?
The first issue is poverty and deprivation where many people are very poor indeed. This could include homeless people who cannot claim benefits and therefore live in absolute poverty. This is however much more wide-spread in developing countries.

More likely to be seen in the UK are families living in relative poverty, where they have less than 60% of the median income. These groups are unlikely to have any marketable assets, and could be living in poor quality housing.

ACTIVITY 5

The Seery brothers live in a Penthouse flat overlooking Longsands Bay in Tynemouth. They paid £4.5m for the property and spent a further £2m restoring it. They are joint shareholders in the Shields Brewery which brews a range of beers that are sold throughout the UK and the rest of the world. They also have shares in several restaurants in Newcastle and have recently invested in a golf, hotel and leisure complex in Rutland. Their wealth has recently been estimated at £2.4Bn.

Identify four assets that are part of the wealth of the Seery brothers.

Explain how the brothers can earn their income form their assets.

Multi-choice questions

1 Which one of the following provides a definition of **personal income**?

- **A** The human capital accrued by an individual over time
- **B** The stock of assets held by an individual
- **C** The flow that an individual receives from wages, dividends, interest and rents
- **D** The value of savings that an individual has in bank deposits

2 Which one of the following provides a definition of **personal wealth**?

- **A** The flow to an individual from wages, dividends, interest and rents
- **B** The stock of assets owned by an individual
- **C** The flow to an individual from dividends on shares that an individual holdsl
- **D** The flow to an individual from rents that an individual receives

3 Equality in relation to the **distribution of income** and wealth means a situation where income and wealth are?

- **A** Fairly distributed in an economy
- **B** Equally distributed in an economy
- **C** Distributed by the state
- **D** Distributed by market forces

4 In the UK, the Office for National Statistics records a household as being in poverty if they live in a household with an income below 60% of the national median income. This is a measure of...

- **A** Relative poverty
- **B** Absolute poverty
- **C** Housing poverty
- **D** Extreme poverty

5 **Absolute poverty** can be defined as a condition:

A in which people lack the minimum amount of income needed in order to maintain their average standard of livin in the society in which they live

B in which citizens do not have the material goods or experience conditions that are usually considered necessary for a pleasant life

C Characterised by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information

D Where there is concern for the distribution of opportunities within a society

Short answer questions

6 State **two** consequences of differences in income for an economy.

1 ____

2 ____

2 Marks

7 Explain what is meant by the **distribution of wealth**.

2 Marks

CHAPTER 8 FISCAL POLICY

What is economic growth?

Fiscal policy is the use of **government expenditure, taxation and government borrowing** to affect the levels of income and expenditure within the economy.

Key terms:

If **government expenditure** *exceeds* **government revenues**, then there will be a **budget deficit**.

If **government expenditure** *is less than* **government revenues**, then there will be a **budget surplus**.

We discussed government expenditure in chapter 2.

ACTIVITY 1

List 5 key areas of spending for the UK government:

You should recall, also, that the government revenue comes primarily from **direct and indirect taxation**.

Government Borrowing

Most years, the government of the UK has had to borrow money to pay for the services that it provides as the taxation revenue received that year in insufficient to pay for all of them. This means that the government has a **budget deficit** for that accounting year (April to April in the UK). At the end of each year, this deficit is shifted on to the **national debt**, (in effect, a different accounting book) and the government budget is reset to zero. This yearly borrowing has amounted to billions of pounds over time and has been building up since 1694 when the Bank of England was established, although some years if the government has a budget surplus, the excess revenue has been used to pay off some of the debt. It is worth remembering that governments needing to borrow in order to pay for all of their services each year is very common among many economies around the world, so many governments run a budget deficit that is added to their national debt each year. The UK's national debt compares favourably to other countries (such as Japan and Italy).

The primary source of borrowing from the government comes through the selling of 'bonds' (in effect, an I.O.U promising to repay the money at a later point, but paying a yearly interest rate in the meantime) to banks, pensions investors, private investors and overseas investors. The bonds can also be bought and sold between individuals and companies and are known as 'gilts' as the UK government is seen as being a very safe and stable organisation, therefore the likelihood of receiving the value of the bond at the end of its life is very high. Whomever owns the bond at the end of its life will receive the initial loan amount repaid by the government. Individual, large companies can also offer bonds for sale, however these tend to hold a slightly higher risk of not being repaid when compared to government bonds.

ACTIVITY 2

Suggest two reasons why investors might consider the government a 'safer' organisation in which to invest rather than in a large public limited company:

How fiscal policy affects levels of income and expenditure in the economy

Public sector jobs – the UK central and local governments employ approximately 5 million people in the UK. These include jobs in the armed forces, the National Health Service, the police and other civil service and local government activities. This employment provides wages that significantly contribute to consumption and economic growth in the UK.

Private sector jobs – central and local governments also contract out many activities to private sector companies. For example, catering in many schools is provided by private contractors, as is residential waste and recycling collection. Such government contracts are usually fixed term (i.e. last for a fixed period, such as 3 years) or have lump-sum project payments which enables many of the private firms to guarantee employment for their workers for the period of the contract.

Private sector expansion – the use of subsidies and government grants has allowed private businesses to bid for government funds if they are working in what is considered a key industry. For example the aerospace industry has been promised an extra £300m as it is felt that the UK should remain competitive in this industry. This enables such firms to afford capital expansion to support growth in their output. In theory, this should mean that business activities become more efficient and costs of production (and therefore prices charged to consumers) fall.

Welfare benefits – the UK has a welfare benefit 'safety-net'. This means that unemployed and people unable to work (and earn) receive some funds from government. Such benefits allow a level of consumption that the non-waged may not otherwise be able to achieve and, in theory, should eliminate absolute poverty.

Changes to tax – changes to taxation rates will have an immediate impact on income and expenditure. If the government reduced the amount of tax individuals must pay, then people will immediately have more money to spend and it is likely that general levels of demand will rise (although the government will receive lower revenues). Although the income tax rates remain constant in the UK, the government is constantly tweaking the Personal Allowance and income tax bands to change the amount of money people have to spend. Similarly, the government can use corporation tax alterations to encourage certain behaviours by firms, e.g. if corporation tax rates fall, firms will be able to keep more of their profits and may be encouraged to invest more.

Higher personal allowances also act as an incentive for people to start work (as they will keep a higher proportion of their income) so can be a supporting method for encouraging people away from claiming welfare benefits.

Government expenditure in the UK – since 2010, the UK government has attempted to reduce the rate of increase in its national debt by reducing its level of yearly expenditure, thus adding a smaller and smaller deficit to the debt each year. This has meant that almost every government department has been asked to reducing its spending: this continual process of reducing budgets has often been called 'austerity measures'. Whilst the amount of debt is still rising, it is rising at a much slower rate as a result of these measures.

How can fiscal policy be used to achieve government objectives?

Fiscal policy can be ‘**expansionary**’ or ‘**contractionary**’. Expansionary polices are aimed and *increasing* general levels of demand, whilst contractionary policies hope to decrease general levels of demand.

Maintaining full employment
Government spending on services such as education, health care, defence and law and order, as well as other payments to the private sector are likely to contribute to ensuring higher levels of employment.
Ensuring price stability
The government can use fiscal policy to support price stability. Greater direct and indirect taxes can be used to reduce demand and consumption if prices are rising too quickly due to demand pull inflation. A reduction in indirect taxes and Corporation Tax can be used to incentivise businesses to reduce costs. Government subsidies and spending on projects can also enable businesses to produce a lower cost and therefore help with preventing prices from rising too quickly.
Achieving economic growth
By using taxation and expenditure to promote demand the economy is likely to grow. For example, if the number of people who are employed increases due to government spending then, on average, households will have higher incomes – this will probably lead to an increase in consumption. If businesses are confident that spending by consumers is increasing they are more likely to invest and increase output.
Having a balanced ‘Balance of Payments’
If the government attempts to keep prices stable by reducing demand (through higher taxation) then UK products should remain competitive when being sold abroad. In this case, UK households are less likely to purchase imports and the UK is likely to sell more exports.
Achieving greater equality
Use of progressive taxation policies will enable the government to tax high income and wealthier people and use these revenues to support low income and less wealthy households (through tax breaks or other benefits).
A sustainable environment
The use of indirect taxation (such as VAT) aimed at products that have a more harmful impact on the environment could decrease their demand and help reduce the negative impact on the environment.

The consequences of a budget deficit or surplus

The UK's Budget Deficit (excluding public sector banks) (£ billion)

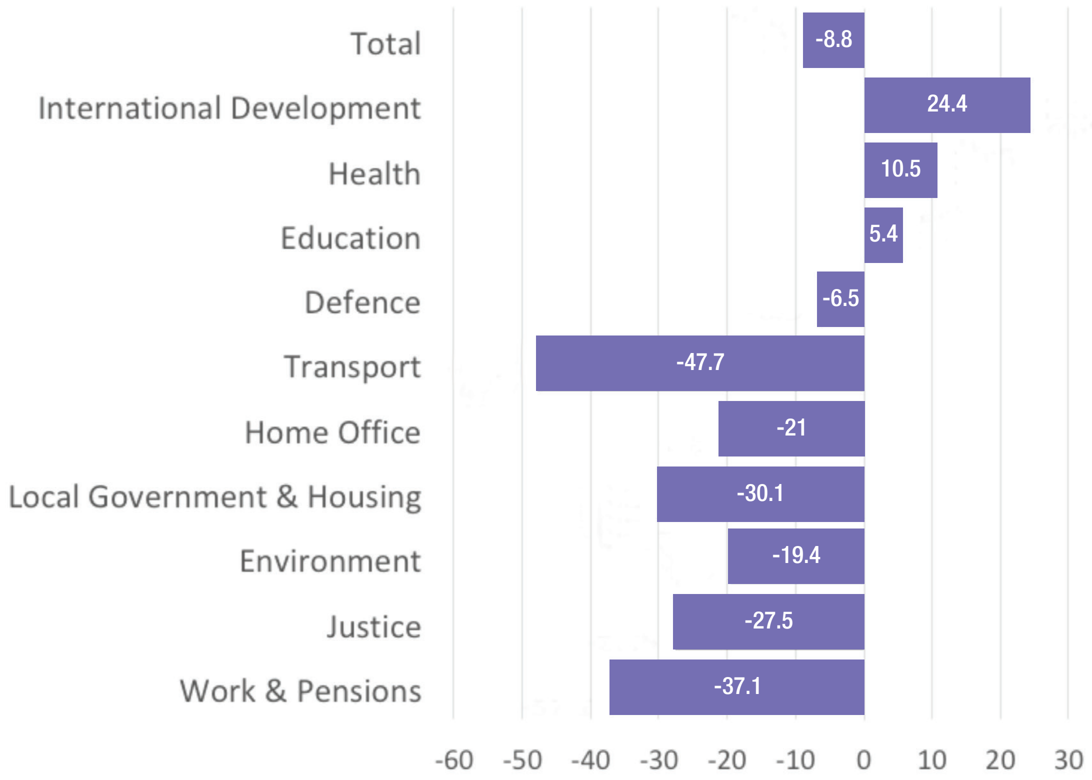
2010	100.4
2011	91.44
2012	80.31
2013	81.67
2014	67.57
2015	54.81
2016	38.9
2017	7.4

Source: OBR

The table above illustrates that the UK's Budget deficit from 2010 to 2017. It shows a decline in how much the government needed to borrow in order to match the difference between how much they spend on public services in comparison to how much was received in revenue.

The data illustrates that, directly after the financial crash of 2007/2008, the UK government had to borrow large sums to cover expenditure during a difficult economic period. To compensate for this, the government also had to cut spending using its austerity measures.

Cuts to departmental budgets between 2010 and 2017 (%)



Source: Institute for Fiscal Studies

ACTIVITY 3

Give 2 reasons why the Government may have increased spending on health and education whilst cutting funding to most other departments.

Debt interest payments

During a period of budget deficit, the government is forced to borrow money. When repaying this money, it must also pay 'interest' on this debt. These interest payments are 'lost' – i.e. they consume government funds which could have been used for public services.

Demand

Government spending can be seen as a necessity to keep an economy from shrinking. During difficult economic periods, the government may need to spend to help support key industries and to pump money into an economy to avoid unemployment and deflation. UK Government spending during the difficult economic period from 2008, it could be argued, prevented the economy from collapsing.

Funding Public Sector Investment

The Government's budget deficit has also allowed some public-sector investments to continue, such as the HS2 railway project. This investment may also support future growth of the economy, which leads to greater employment and possible tax revenues, which in turn could be used to pay off the debt and the interest. In addition, growing the economy will increase its GDP. Thus the amount of outstanding debt as a percentage of GDP will shrink, giving the illusion that the debt has been paid off.

Taxation

A deficit cannot continue indefinitely – the government will eventually have to balance their books. In the future, if this balance is not achieved through economic growth (which will bring in greater tax revenues) the government will have to either increase taxation or continue to reduce its expenditure.

ACTIVITY 4

Explain why large infrastructure projects such as the HS2 may need significant government support, including an injection of funding.

Multi-choice questions

1 Which of these is **not** considered a **fiscal policy**?

A Taxation

B Government borrowing

C Government expenditure

D Increasing the money supply

2 Which of these is considered a **direct tax**?

A Income tax

B Value Added Tax

C Alcohol duties

D Motor fuel duties

3 Which of these outcomes may be considered a negative **impact** of a continued **budget deficit**?

A Economic growth

B Higher unemployment

C More infrastructure projects

D Lost revenues through interest repayment

4 Which of these is an example of an **expansionary** fiscal policy?

A Increased income taxation levels

B Reduced borrowing

C Increased government spending

D Increased corporation tax

5 Which of these fiscal policies could be used to reduce the deficit on the current account of the **balance of payments**?

A Increased expenditure on health services

B Increased borrowing

C Increased income tax

D Increased expenditure on education

Short answer questions

6 State **two** impacts of a government running a **budget deficit**:

1 ______________________________

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2 ______________________________

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2 Marks

7 Explain how **government expenditure** can lead to reduced **unemployment**.

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____

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2 Marks

CHAPTER 9 MONETARY POLICY

What is monetary policy?

Key term:

Monetary policy is the manipulation of the base interest rate and other monetary tools to influence general levels of demand in the economy. The primary use of monetary policy is to control inflation to keep price stability and to encourage economic growth.

Monetary policy concentrates on influencing prices – many economists see this objective as primary. If prices are stable then business confidence is encouraged, abd growth and employment should follow.

How does monetary policy in the UK affect inflation?

The primary tool of monetary policy in the UK is the use of the base interest rate. This is particularly effective as a large proportion of the population have mortgages, loans or credit cards and therefore owe money to a bank or building society. The biggest loan is a mortgage (to purchase a home) which tends to be paid off over an extended period (often 25 years or more). As a mortgage can be a household's single biggest bill in any one month, and continued ownership of a home is important, most people will prioritise the payment of their mortgage over other bills.

If the Bank of England's base rate is changed, this will usually cause banks and other financial institutions to move their interest rates in the same direction. This means that a change in interest rate charged on mortgage repayments have a significant impact on monthly household income. If interest rates increase, then a large proportion of households will have to pay more interest on their monthly mortgage repayments, which gives them less money to spend on other items.

Likewise, if interest rates fall then monthly repayments fall and households have more available funds to purchase other items, and thus general demand levels may rise.

By influencing demand in this way, the use of interest rates can significantly impact prices in the UK. If prices are rising too quickly, then interest rates can be increased, cooling down demand and thus relieving demand pull inflationary pressure.

ACTIVITY 1

Draw a shifting demand and supply curve diagram to illustrate what may happen to the demand for cars if interest rates are decreased in the UK.

As well as mortgages, households may have other loans and credit cards. Changing the interest repayments on these may also have an impact on demand levels in the UK in the same way.

Interest rates and the Bank of England (BoE)

Since 1997, the Monetary Policy Committee at the Bank of England has had the responsibility of setting the 'base rate' of interest rates in the UK. As all financial institutions have funds saved with and must follow Bank of England rules, the BoE can heavily influence the rates set by banks around the UK.

The BoE was given this responsibility so that interest rates could be set for purely economic reasons and not for any political motivations that the government may have. The government sets the BoE a target inflation rate of 2.0% – if the economy is significantly above or below this rate, the BoE must write to the government explaining what they plan to do to remedy the statistic.

The base rate is set by a group of people called the Monetary Policy Committee (MPC). The MPC is made up of a series of BoE staff (including the Governor) alongside other individuals who have the expertise to advise on the state of the economy. Each time the MPC sits (usually the first Wednesday and Thursday of the month), they vote on whether to alter the current rate of interest given the forecast information they have at their disposal.

Historically, interest rates were altered frequently, however, in March 2009 (with the poor economic conditions continuing) the rate was reduced to 0.5% and stayed at that level until March 2016, when it was decreased even further.

ACTIVITY 2

Conduct some research and find out about the members of the Monetary Policy Committee (all information is available from the Bank of England website). Why do you think there is an odd number of people on the committee?

Other forms of monetary policy – Quantitative Easing (QE)

QE is a specific form of monetary policy used recently in the UK and a few other economies (such as the US). QE involves action by the government creating 'cash' in the economy, by purchasing a large number of assets such as company and government bonds, swapping cash for the paper assets. This purchase, in turn, reduces the cost of borrowing for many firms which, it was hoped, would lead to greater investment.

QE has been used in the UK as it is seen as a method of stimulating growth in the UK at a time when interest rates were so low they could not be brought down any further.

Other forms of monetary policy – Forward Guidance

Forward Guidance is a policy introduced in 2013. The idea is that the BoE gives very clear indicators about when it will or will not change interest rates in the near future. The guidance signals examples of statistics that would need to occur in the economy for the BoE to consider changing the interest rates (e.g. the rate of unemployment that would need to exist before an increase in interest rates would be considered).

The use of Forward Guidance was seen as a method of stabilising confidence in the economy. If businesses and households are more certain what will happen to interest rates (and therefore the level of their debt repayments) then can plan accordingly. In this way, businesses may feel more confident to invest now and not wait to see how economic conditions change. This can have a significant impact on growth and employment.

How does monetary policy affect economic objectives?

Ensuring price stability
The key principal with monetary policy is that, by influencing price levels, other economic objectives will be met. If prices are stable, then economic agents will be more confident which in turn should lead to greater business investment and expansion.
Achieving economic growth
Expansion of output that comes from greater business investment should lead to growth in the economy.
Maintaining full employment
This expansion should, in turn, mean that jobs are more secure, and employment may increase as businesses look to take on workers to support this growth.
Having a balanced current account on the Balance of Payments
If UK prices are stable in comparison to other economies, UK products should become more attractive to foreign purchasers whilst UK consumers will see an increase the price of imports. This should help keep the current account on the balance of payments balanced.
Achieving greater equality
In theory, if an economy grows and more people are employed, there should be a fall in the difference between the lowest and highest paid workers. Monetary policy should, therefore, reduce inequality. **NOTE:** some economists argue that QE has not supported greater equality. They argue that QE only really benefitted big businesses and those people that regularly purchase bonds – often those people with relatively high incomes anyway.

Monetary policy may not always be as effective as the BoE would hope. A change in the BofE's base rate has not always been followed by a change in interest rates by the banks themselves who may be willing to suffer losses to remain competitive. Likewise, an increase in interest rates may not always cause a significant change in demand and therefore prices.

Also, many other factors affect the price of goods (such as raw material costs, transportation costs and exchange rates) which may mean that a change in interest rates has less impact on demand.

Interest rates have been very low in the UK since the Financial Crash of 2008. The BoE have consistently stated that they do not wish to increase interest rates too quickly as they are concerned that this could trigger an economic downturn (as it may reduce business investment during a period of economic uncertainty).

ACTIVITY 3

Median gross annual residence-based earnings and media house prices for five regions within England, 2017

	Median gross annual residence-based earnings (£)	Median house price (£)
North East	26,061	135,000
North West	26,662	154,950
West Midlands	26,857	177,000
London	34,752	460,000
South West	27,537	239,000

Source: ONS

The table above shows the median earnings per household and the median house prices in five regions within England.

If interest rates were to rise by 1.0%, which of the regions is likely to be impacted the most? Explain your answer.

Multi-choice questions

1 Which of these is **not** considered a **monetary policy tool**?

A Changes in taxation

B Use of interest rates

C Forward Guidance

D Quantitative Easing

2 Which of these would **not** be affected by a change in **interest rates**?

A Mortgages

B Credit cards

C Car loans

D Personal allowance

3 If average wages increased by 5% and average prices increased by 6%, which of the following would be correct?

A Real wages fell by less than 1%

B Real wages fell by 6%

C Real wages rose by 5%

D Real wages rose by 6%

4 The **Bank of England** is responsible for setting:

A All interest rates

B The inflation rate

C The base rate

D The exchange rate

5 Which of these is most likely to happen if there is an increase in **interest rate**s?

A A fall in unemployment

B A fall in the inflation rate

C An increase in economic growth

D A fall in the exchange rate

Short answer questions

6 Other than a mortgage, give two further examples of **financial products** where individuals may have to pay **interest**.

1 ______________________________

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2 ______________________________

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2 Marks

7 Explain how a fall in **interest rates** can lead to higher prices.

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2 Marks

CHAPTER 10 SUPPLY-SIDE POLICIES

What are 'supply-side policies'?

Key term:

Supply-side policies are government policies that are aimed at increasing the productive capacity of an economy. This means that the economy can supply more goods and services in the long run.

It is important because previously we have looked at policies that increase demand in the economy, however some aspects of fiscal policy can affect the supply side of the economy.

If governments can increase demand but there is no increase in supply, then an economy is likely to suffer from inflation as there is a shortage of goods and services, resulting in prices rising to ration demand. This will not create economic growth. If, however, the increase in demand is matched by an increase in supply, then genuine economic growth can occur.

ACTIVITY 1

Recap your learning – draw a demand and supply diagram, showing the impact of an increase in demand on the price of a product.

What type of inflation occurs in this scenario?

ACTIVITY 2

Write down the factors of production and next to each one, explain how you can increase the quantity or the quality of each one.

1 L ______________________________ =

2 L ______________________________ =

3 C ______________________________ =

4 E ______________________________ =

Examples of supply-side policies

Supply-side policies can achieve one or more of the following:

- improves the **efficiency** of the economy, ie fewer resources are needed to produce the same output
- improves the **competitiveness** of the economy, creating a demand for our exports
- increases the **productivity** of the economy, allowing more output at the same cost

If a policy leads to any of these happening, then you are likely to be able to reduce costs of production in the economy and this shifts supply to the right and boosts capacity of production.

Supply-side economics first came to prominence in the 1980s under the leadership of Margaret Thatcher in the UK and Ronald Reagan in the USA. These are some of the key policies during that time.

- **Reduce Trade Union Power** – in the late 70s, Trade Unions (specifically in the UK) were deemed to have too much power. This meant that they could ask for very high real wages and stop production by going on strike or reducing it by using other forms of disruption, so the employer was powerless and often agreed to the pay rise, thereby raising costs of production and eventually leading to high rates of inflation. Therefore, the government wanted to weaken Trade Union power and create a more 'flexible labour market', meaning that union members could effectively be by-passed, and new employees could be taken on to do their job. This meant that businesses could increase production, lower their costs and increase supply.

- **Reducing Income Tax** – governments believed that reducing income tax would lead to a surge of competition in the labour market. If a worker keeps more of their disposable income, then they are incentivised to work more, and this leads to more production, increased productivity (due to the increased competitiveness of the labour market) and lower average costs for firms. It also encourages the wealthiest (the 'wealth creators'), who gained most from the tax cuts to use their increased incomes to invest in more entrepreneurial activities, such as setting up new businesses, that creates competition, creates jobs and boosts supply in the economy.

ACTIVITY 3

Why would reducing income tax lead to a fall in tax revenue?

Why would supply-side economists suggest that this is not the case and will actually boost tax revenue?

- **Reducing Benefits** – to encourage even more competition in the labour market, governments started to reduce benefits, especially for those that were unemployed. This created an incentive to become employed rather than to stay at home or work less hours, in order to claim benefits.
- **Privatisation** – before the 1980s, especially in the UK, there were many industries that were state controlled and run by one company, for example BT (British Telecom) that controlled all telecommunications. *Privatisation is the act of transferring a business from public to private ownership*. This means that the government sold shares in the company to the general public and made it a public limited company (PLC). This meant that the firm had to make profits for its shareholders. The rationale is that a private firm would be more efficient because in order to make more profit, they would have to lower costs and prices to compete.
- **Regulation and deregulation** – At the beginning there was little competition and so the firms were regulated (so they could not make excessive profit due to them being a private **monopoly**) but over time, the markets were **deregulated** in order to introduce competition. This created an even bigger incentive for firms to be efficient in order not to lose out to competitors. As more and more firms enter the market, innovation is also likely to occur and overall, there should be a big increase in potential supply and this should lead to falling prices for consumers in these markets. Many of these markets are now **oligopolies** and are still regulated by government, for example the gas and electric market is regulated by OFGEM.

ACTIVITY 4

Choose one of the following markets and investigate whether privatisation has led to the efficiency gains expected by supply-side economists.

- Electricity and Gas market
- Water market
- Railway market
- Air Travel market
- Postal services market

- **Reducing corporation tax** – to encourage more firms to set up, the government reduced the tax on profits for companies. This meant that foreign firms would be attracted to the country to set up (inward foreign direct investment), which creates competition within the domestic market and that drives efficiency gains. Corporation tax was often reduced for small firms as well in order to encourage entrepreneurialism. Once again, this leads to more competition. It also means that firms were also likely to have higher profits that can be invested into research and development. This normally leads to increased productivity and therefore increases potential supply even further.

The policies mentioned are key policies that were introduced by UK and USA governments during the 1980s when supply-side policies were at the top of the political and economic agenda. There are more generic supply-side policies that are continually used by governments across the world to boost the potential output of an economy.

- **Education and training** – in order for businesses to be productive, a good quality labour force is needed and therefore education and training is crucial in order to increase supply. It also leads to a more productive labour market that can drive down wages which can also help businesses produce more, resulting in increased competitiveness.
- **Investment in infrastructure** – improving or building more roads, railways and airports, is an example of the government trying to boost the infrastructure in a country in order to make it easier for businesses to operate. Over recent years there have been plenty of these projects that have caused huge debate, such as HS2 railway line and the third runway at Heathrow.
- **Healthcare** – this is seen as a supply-side policy because if you have a healthier workforce, then they should be more productive and have fewer absences from work.

As previously noted, any policy that increases the quantity and/or quality of the factors of production, can be seen as a supply-side policy. For example, a policy to boost immigration would be seen as a supply-side policy as it increases the quantity and quality of the labour market. Reducing 'red tape' is also another classic supply-side policy, which is the government making it easier for businesses to run. Examples of 'red tape' might be regulations linked to health and safety or the raising of the National Living Wage Rate, that increases business costs and reduces potential supply.

ACTIVITY 5

Using your economics skills, explain how these policies can lead to an increase in supply in the economy. In your answer, try and use one of the these three words – competition, efficiency and productivity:

- The government announces that there will be further investment in superfast broadband across the UK.
- The government announces all undergraduate courses will be supplied free of charge.
- The government privatises the NHS

How do supply-side policies impact on economic objectives?

Ensuring price stability

The process of improving economic efficiency should ensure that costs of production decrease or rise at a sustainable level.

Achieving economic growth

An improvement in efficiency should lead to an increase in output, generating improved profits, higher wages and economic growth.

Maintaining full employment

Supply-side policies aimed at improving skills should ensure that individuals become more employable. Increased efficiencies and profits for businesses should encourage greater employment. Some concerns remain that an increased drive towards robotization may lead to some unemployment.

Having a balanced current account on the Balance of Payments

If the UK's economic efficiency improves then UK products and services should become more price competitive, generating an increased demand for UK exports.

Achieving greater equality

Improved economic efficiency and economic growth can allow the government to ensure policies aimed at improving equality (such as an improved educational provision) are implemented. An improvement in employment opportunities should also lead to greater equality.

Advantages and disadvantages of supply-side policies

Supply-side policies can take a long time to have any impact. Some policies could take 10-15 years, but others could have an impact in a few months, therefore it is important to view **time lags** in the context of the policy that is being looked at.

Some supply-side polices can be very costly and this is important in the context of a budget deficit. Governments may not wish to introduce big infrastructure projects because of the cost and the impact it will have on government borrowing. There might also be a problem that in the short run, any spending on a supply-side policy, would be a fiscal, demand-side policy and if there is not spare capacity in the economy, then **inflation** could occur, and this could lead to wage demands that increase the costs of production. It is also important to appreciate the **opportunity cost** of any supply-side project. For example, it has been estimated it will cost the government £52 billion to build HS2 which is clearly a lot of money that can be used on a variety of different policies that may be thought of as more effective in the short run.

Policies that incentivise both the rich and the poor often lead to **distribution of income concerns**. If personal allowances are being raised to encourage people into the labour force, however social security benefits are being reduced, then the likelihood is that the gap between the workers and the non-workers will increase.

With major infrastructure projects, one must always consider the **environmental sustainability** of them. There is probably agreement between most economists that building another runway at Heathrow airport is a good idea from a capacity point of view, but there is also a significant environmental impact.

However, it is important to realise that if supply-side policies work, then a country can achieve what some economists call '**The Golden Scenario**' of low inflation, high economic growth, low unemployment and a a balanced current account on the Balance of Payments. As supply increases, it opens up the economy for growth without any demand pull pressure being put on prices. It also helps firms to be more efficient and productive, which then makes them more internationally competitive, thus creating even more jobs and growth.

Finally, it is important to appreciate that both Fiscal Policy and Monetary Policy have links to supply side policies. For example, if the Bank of England reduces the interest rate (which is a demand-side policy) it can be seen as a supply-side policy because businesses can afford to borrow more to invest. Another example would be government increasing spending in schools: in the short run it will be a demand-side policy but in the long run we would expect to see improved educational outcomes. Any policy that allows more **investment** in new technology, machinery, training of staff and so on can be described as a supply-side policy, which at times can be rather confusing but that is where it is important to consider time lags. The demand-side impact should be seen in the short run but the supply-side impact will often be seen in the long run.

Multi-choice questions

1 Which of these **supply-side policies** would most likely create more competition in the **labour market**?

A A ban on Zero Hour contracts

B An increase in the National Living Wage

C A reduction in corporation tax

D A reduction in corporation tax

2 What is a government policy that encourages increased **investment** by businesses?

A A cut in income tax

B A subsidy on 3D printers

C Interest rates reducing from 0.5% to 0.25%

D An increase in VAT

3 Which supply-side policy is **least** likely to have a positive effect on the **distribution of income** in an economy?

A Increased spending on apprenticeships

B Reducing the higher rate of income tax

C Cutting disability benefit

D Restricting Trade Union power

4 What is the **primary concern** with **privatisation** as a supply-side policy?

A Shareholders can make lots of money

B It might take a long time to introduce competition

C Privatising a firm is costly for a government

D There is always going to be an environmental impact

5 Which **supply-side policy** relates to the correct **factor of production**?

A Privatisation increases quality of land

B Immigration increases capital

C Reduced income tax increases entrepreneurialism

D Investment in infrastructure increases the quality of labour

Short answer questions

6 Explain how increasing the **National Living Wage** Rate could be both a positive supply-side policy AND a negative one.

4 Marks

7 Explain how an increase in **state-funded childcare** can increase the potential **output** of an economy.

4 Marks

CHAPTER 11 POLICIES TO CORRECT EXTERNALITIES

You may recall 'externalities' from the Microeconomics side of the specification.

'Externalities' refers to the impact of economic activity on a 'third' party who did not take part in the initial economic transaction. Externalities are the spill over effects of economic activity.

Positive and Negative Externalities

Pollution is the most common example of an 'externality' as environmental concerns grow and appear to be so far reaching. Pollution is seen as a 'negative externality'. However, some externalities may be positive. For example, if a new school opens in a neighbourhood and it is deemed to be a very good school, there is a chance that the value of nearby houses will increase as people want to move to that neighbourhood to allow their children to attend the school.

Consumption and Production Externalities

Externalities can occur either in the production stage of economic activity or in the consumption stage.

Production – many production techniques create externalities that are not 'paid for' by the business creating them. For example, some production techniques may also create harmful by-products (such as chemical waste or toxic fumes) that the producer does not pay to remove (nor pass on the cost of that removal to their customers) – either through using sewage systems, dumping in rivers or other sites or by allowing fumes to escape into the atmosphere from chimneys.

As neither the producer nor buyer are paying for these external costs, the burden for clear up may lie with the wider society. Some emissions are so harmful they may cause healthcare issues and, again, these are often paid for through the society's healthcare system.

Consumption – consumption of a good or service may have a spill over effect on others. For example, over-consumption of fatty-foods is leading to increasing rates of obesity which may have a knock-on effect as it creates greater pressure on health care systems at the expense of other medical treatments.

ACTIVITY 1

Separate these activities into those which have positive externalities in production and positive externalities in consumption:

Use of toothpaste, increased employment at a factory, increased property prices near a tourist attraction, improving language skills at a school

Positive externalities in production	Positive externalities in consumption

Government policies to correct externalities in consumption

1. **Indirect Taxation on products with negative externalities** – by placing an additional tax on the product, the government can force suppliers to increase the price of their goods to consumers. This increase in price should lead to a reduction in demand. This is a policy which has been used to reduce consumption of cigarettes, alcohol and petrol for example. More recently, the government has attempted to tax sugary drinks as a method of reducing consumption in response to obesity concerns.
2. **Subsides on products with positive externalities** – by assisting businesses in the cost of production, the government can encourage those firms to reduce the price of their products to consumers. In turn, this reduction in price should lead to an increase in demand. This may help increase the demand for products with positive externalities.
3. **Laws and regulations** – the government can implement laws and regulations to restrict consumption of goods with negative externalities. For example, there are age restrictions on the purchase of alcohol and cigarettes. The government restricts the use of cigarettes in public places. Some regulations exist that e courage retailers to publish fat, sugar, protein and salt content on processed foods – this gives consumers more information about the possible impact of consuming that food.
4. **Government campaigns** – the government can encourage consumption of goods with positive externalities and discourage consumption of goods with negative externalities through campaigns and advertising. There are various campaigns aimed at encouraging people to eat more healthily and to take exercise more often. The government has used campaigns to promote further vocational education (such as Apprentic ships) which can have wider positive effects on society.
5. **Nudges** – the government can also use behavioural 'nudges', or non-price-based activities that encourage people to change their consumption behaviour. For example, some local authorities deliberately make their household recycle bins larger than their general waste bins to encourage people to recycle more waste.
6. **State provision** – in some cases, products with positive externalities may just not be provided in sufficient quantities in a free market economy. In these cases, the government may choose to provide the product. For example, the majority of health and educational services in the UK are provided by the government free of charge.

ACTIVITY 2

In April 2018, the UK government introduced its new 'sugar tax'. Any drink that contains more than 8g of sugar per 100ml now faces an additional tax of 24p per litre.

Using a demand and supply diagram, illustrate how this new tax should reduce demand for sugary drinks.

Government policies to correct externalities in production

1. **Laws and regulation** – the government can set in place laws that either prevent businesses from polluting or just fine a business if they contravene laws. For example, a business may be fined for polluting a nearby river or for fly tipping..
2. **Subsides on products with positive externalities** – by reducing business's cost of production through subsidies, the government can encourage those firms to reduce the price of their products to consumers. In turn, this reduction in price should lead to an increase in demand. This may help increase the demand for products with positive externalities, e.g. the government subsidises the purchase of domestic solar panels in some areas.
3. **Property Rights** – the government can give an individual or a business property rights so that these people are able to charge a polluter of their property. For example, if a fishing company is given property rights over a section of a river, they can sue any another business who may pollute their water.

Multi-choice questions

1 Which of these policies might be used to encourage a greater **consumption** of bottled water (instead of sugary drinks)?

A Increased funding for schools

B Subsidies for producers of bottled water

C Subsidies for producers of sugary drinks

D Increased taxation on profits of fast food restaurants

2 Which of these policies might be used to reduce the number of micro-particles of plastic being dumped in the sea?

A Regulation to ensure waste-management companies do not expose of household liquids in rivers and seas

B Subsidies for producers of plastic containers used as packaging

C A government campaign to encourage healthy eating

D A decrease in income tax

3 Which of these is an example of a **positive externality in consumption**?

A Relocating to live in London

B Drinking sparkling rather than still water

C Using a smartphone rather than a landline

D Taking a train instead of using a car

Short answer questions

4 Explain why giving a fishing boat property rights to a section of a river may not be an effective way to reduce pollution in that river.

2 Marks

CHAPTER 12 INTERNATIONAL TRADE AND THE GLOBAL ECONOMY

In the study of microeconomics, arguments were put forward for **specialisation** for workers, businesses, regions and countries. So, to recap:

ACTIVITY 1

After finishing his studies, Ben has decided to become a make-up artist. What are the costs and benefits for Ben on focusing purely on this role?

Costs:

Benefits:

Clark Ltd is a company that produces energy drinks for supermarket own brands. What are the costs and benefits of Clark Ltd focusing purely on the production of these types of drinks?

Costs:

Benefits:

In Economics we see specialisation as being beneficial because it encourages efficiency in production, which lowers prices and increases output. These benefits are the main arguments for why international trade occurs. Countries specialise in what they are good at and then trade with other countries for other products in order to get lower prices, increased output (economic growth) and greater choice.

Key phrase:

International trade is the exchange of goods and services between countries.

The theory most associated with international trade is the theory of absolute advantage. This is when one country can produce a given product/service at a lower cost than another country. Through specialising in goods and services where the country has an absolute advantage, they can produce more (and potentially get economies of scale) and then trade with other countries which may improve living standards across the globe.

Imports and Exports

When you sell goods or services to a foreigner, this is known as an EXPORT

When you buy goods or services from a foreigner, this is known as an IMPORT

When trying to decide what is an export or an import, it is always good to follow the money. Is the money leaving the country or staying in the country? For example, if the Jones family go on holiday to France and have a nice meal, then they have imported tourism and hospitality from France. This might seem odd as they are in France, but the money has moved out of the UK economy and is now in French hands. Tourism is sometimes referred to as an invisible import.

ACTIVITY 2

Read the story of the jet-setting Sir Phillip Meen and work out which are the imports and which are exports referred to, with regards the UK economy.

Sir Philip heads off to France on a U.S. made Boeing plane that British Airways has purchased. On the plane he quaffs the finest champagne. In France he manages to sell software from his UK company to BNP Paribas. He also notices that in a local French supermarket, he can buy an Innocent Smoothie that is produced in the UK. When he has finished his business deals in France, he gets the same plane back and goes to his local tailor where he buys a bespoke suit and a silk tie from India. He then goes out for dinner where he has an Argentine steak, served with French beans from Kenya and potatoes from the UK.

Through the use of specialisation and international trade, there are many benefits gained by consumers and producers.

- As countries specialise, they can produce goods/services more efficiently and this reduces the average cost per unit. This may mean lower prices for consumers.
- As countries trade, it means that there is more choice for consumers and because of specialisation, there tends to be better quality products. Clearly there are some products that the UK cannot produce because of the resources available to it, or that may be prohibitively expensive to produce, such as kiwi fruit and bananas that would need expensive greenhouses. Through trade, we can now access these products quite cheaply.
- Businesses can also benefit from this specialisation as they can now achieve lower costs of production. Over the years, many clothing firms have moved their production to China in order to exploit their absolute advantage in the textile industry. Lower costs can lead to higher profit margins and this can lead to further investment into their business.
- As countries trade, there are more opportunities to sell abroad and to enter new markets. If the market size increases, then businesses can produce more and exploit economies of scale. This means that they can lower their average costs even further and achieve even higher profits.

There are numerous reasons why trade is beneficial to economies and it can also be a remedy to the basic economic problem of scarce resources and unlimited wants. Specialisation leads to the efficient use of resources and clearly this is desirable when resources are scarce.

ACTIVITY 3

Here is a list of the top 5 countries the UK traded with in March 2018. These are normally our main trading partners, but you can put them in order of volume of trade with the UK:

Imports – **China, USA, Germany, Norway, The Netherlands**

Exports – **Ireland, France, USA, Germany, The Netherlands**

Once the correct answer has been revealed, can you explain why these are the main countries the UK trades with?

Free Trade

In order for international trade to be more effective, it's important that there is free trade.

Free trade is where there is free movement of goods and services between countries without any restrictions (e.g. tariffs – which is a tax on imports, and quotas – a set number of imports)

Many countries across the world have free trade agreements with other countries. These agreements are encouraged by the World Trade Organisation (WTO) who have rules in place to address countries that wish to stop fair trade occurring, by imposing taxes on imports or by subsiding local industries. These barriers to trade distort absolute advantage as countries that can produce their goods/services at the lowest cost are now under-cut by rival countries (due to subsidies) or have to supply them at a higher rate (due to taxes) which makes them uncompetitive.

The UK has many trade agreements but the key trade agreement for the UK for the past 40 years has been the one with the member states of the European Union (EU). It is a reason why Germany, France and the Netherlands are some of our main trading partners.

ACTIVITY 4

List all the member countries of the European Union.

How many of those countries have adopted the Euro as their national currency? These are known as the Eurozone countries. Name 10 of the Eurozone countries below.

Why should using the Euro increase the volume and value of international between the Eurozone countries?

The EU is the world's largest single market. Not only does it agree trade arrangements within the EU, its members also agree to adopt exactly the same trade arrangements for all other countries outside of the EU.

In 2016 the UK voted to leave the EU and one of the reasons given for leaving is that it could arrange better trade agreements with other countries outside of the EU. It remains to be seen what trade arrangements will be reached once the UK leaves the EU but some fear that it is a backward step for the UK as it is no longer part of the largest trading bloc and this can have an impact on international trade and the benefits gained from that.

Multi-choice questions

1 Which of these is an **export** for the UK economy?

A UK car manufacturer buying Chinese steel

B A Chinese tourist buying a cake in an English tea shop

C An English football club buying a French footballer

D An English tourist buying a coffee in Paris

2 What is the name of the organisation that encourages trade in the **global community**?

A World Tariffs Organisation

B Worldwide Trading Office

C World Trade Organisation

D World Trade Office

3 Which of these is a benefit of **international trade** that is specifically for the producer?

A Lower prices

B More choice

C Increased quality goods or services

D Access to more markets

4 Which of these would be a key reason for China being in the top 5 import markets?

A China are part of a free trade area with the UK

B China have an absolute advantage in manufactured goods

C Chinese people enjoy coming to the UK and enjoying the attractions

D China are a growing market for UK firms

5 Which of these countries is not part of **European Union**?

A Norway

B The Netherlands

C France

D Ireland

Short answer questions

6 Explain why there has been a decline in manufacturing clothes in the UK over the past 30 years.

2 Marks

7 In 2017, the UK government began trying to agree a **free trade deal** with the USA. Explain one reason why the UK government was trying to achieve this aim.

2 Marks

CHAPTER 13 BALANCE OF PAYMENTS

Key terms:

The Balance of Payments is a record of all the UK's transactions with the rest of the world. It is made of three components – **the current account**, the financial account and the capital account. The main focus for most governments is the current account as it gives them an indication of the competitiveness of their economy in the global market place.

ACTIVITY 1

Amisha has been looking around her kitchen diner and has seen the following items. Can you match the items to the countries they were imported from?

Items: **Fine beans, Organic coffee, Kiwi fruits, Tinned Chopped Tomatoes, Daewoo microwave, White t-shirt and Halloumi**

Countries: **Brazil, Cyprus, Italy, Bangladesh, China, Kenya, New Zealand**

Using your economics knowledge, can you explain the reasons why each country produces what it does?

The Current Account

The current account is made up of four key areas and they are:

- **Trade in goods**
- **Trade in services**
- Primary income – investment incomes that include profit, dividends and interest
- Secondary income – transfer payments that include international aid

The value of the trade in goods and trade in services make up the balance of trade or the trading account. One of the four main macroeconomic objectives is the balancing of values of imports and exports and the balance of trade indicates how well a country is balancing the values of imports and exports of its goods and services. This will be the key focus of your studies.

Primary income relates to investments made by businesses and individuals abroad and records the return on these investments. For example, if a UK firm invested in a profitable foreign company abroad, any profits or dividends awarded to the UK investor would register as a positive flow in the Primary income section of the current account. If a foreign bank lends money to a UK resident, for example to buy a holiday home in Spain, then interest payable on that loan will register as a negative flow on the UK Primary income section. Primary income also includes remittances which is where economic migrants send back wages to their families in their own country. This can be a very large sum for developing economies, for example, 31% of Nepal's GDP was made up of remittances in 2016.

Secondary income records transfer payments (where money is just transferred from one agent to another with no goods or services being exchanged. An example here would be international aid or membership payments to a customs union such as the EU.

If money is flowing into the UK, for example, through exporting cars or a payment by the EU it would show as a credit, or positive figure, on the UK's current account. If money is flowing out, for example through importing oil or a Polish worker sending money back to his family in Poland, it would be a debit, or negative figure, on the UK's current account. This can be confusing, but remember to think about where the money is flowing.

ACTIVITY 2

Using the information above, where would these appear on the current account (and state whether they would be a debit or a credit to the UK):

- UK accountancy firm gets paid by a French multinational corporation for accountancy services
- UK delicatessen imports Parma ham
- UK car plant exports to Norway
- UK worker in Iraq sends money back to his home in Grimsby
- UK farmer gets paid a subsidy by the European Union
- UK company based in America sends profit back to the UK
- UK clothing company imports jeans from India
- American investor who has put money into UK banks receives interest
- UK government sends funds to a famine relief programme in Haiti

The current account measures the inflows (exports) and outflows (imports) in those four components. If exports and imports are the same, then there is a **balanced current account**. This is unlikely to occur naturally because of the huge volumes and values of imports and exports. Most countries will either have a **current account deficit** (where the value of imports exceeds the value of exports) or a **current account surplus** (where the value of exports exceeds the value of imports).

ACTIVITY 3

Using the information below, work out whether the UK had a balanced current account, a current account deficit or a current account surplus in 2017. All figures in millions.

Trade in goods = £-135582

Trade in services = £106962

Primary income = £-33280

Secondary income = £-20974

In recent times the UK has always had a surplus in the trade in services and a deficit in the trade in goods. However the deficit in goods has always been bigger than the surplus in services, which means that the balance of trade (or Trade Balance) overall has been in deficit.

Trade in services has been boosted by the growth of the **financial services** industry in the UK and especially in the City of London. Other successful service areas the UK exports is tourism and education. However,many of our traditional goods industries have struggled to survive because lower production costs are available abroad. For example, Sheffield steel and the textiles industry in the Midlands have not been able to cope with competition from China and therefore the UK has seen a large decline in demand for exports of these goods. Furthermore, as the UK's population grows and income levels rise, demand for cheaper imports has also had a negative effect on the domestic suppliers.

What has been unusual over recent times has been the decline in the surplus seen in the Primary Income section. In the past, the UK has enjoyed a healthy surplus in this section, perhaps indicating that British investment abroad was very successful. It has been argued that there has been a recent trend in UK firms being purchased by foreign firms through **mergers and acquisitions** and therefore profits are now being sent overseas. On the flipside, UK firms have also not been as successful investing overseas as they once were and the decline of British influence in past colonies has seen a large fall in profits in those areas and this may have caused further current account problems.

ACTIVITY 4

Germany and China have two of the largest current account surpluses as a % of GDP. Germany's surplus is approximately 5% of GDP and China's surplus is around 2.5%.

Give reasons why these two countries have such a large surplus.

Germany:

China:

Issues with a current account deficit

In theory, it is believed that having a current account deficit is not good for an economy. It shows that you are importing more (in value) than you are exporting and therefore money is flowing out of your country, which could have a negative impact on GDP. The UK's current account deficit is around 6% of GDP, as a rough rule of thumb, around 3% of GDP is considered an acceptable deficit if it has a specific (and temporary) reason to exist.

Here are some arguments to use when evaluating the current account deficit:

- A deficit may show a lack of **competitiveness** for an economy. If they are not exporting as much as they are importing, it suggests that firms are not productive or are not producing quality products. This would be a major concern for any government as this can be a difficult problem to solve.
- A deficit might be due to a strong currency and this might not necessarily be bad. A strong currency normally means that investors have faith in an economy and are willing to send investment flows in. It also means that imports become cheaper, which makes the deficit worse, but it also means that **inflation** is kept low as costs are kept down.
- A deficit may indicate that there is **strong economic growth** in a country as incomes are rising and more imports are being purchased.
- In the short term, a deficit might occur as raw materials are imported in order to manufacture them and add value, so that in the long term, exports increase.
- If a country has a deficit on the current account, then it has to be paid for and this appears on the financial and capital account of the Balance of Payments.
- A deficit could be due to foreign firms setting up in a country and sending profits back. This could be good for the country as a whole as foreign investment will often bring jobs and increase growth for an economy. It can also increase competition within the country which can lead to lower prices and more choice for consumers. Over time, the foreign firm also might start exporting which will end up as a positive on the current account.
- A deficit (in theory) should weaken the **exchange rate** as there is excess supply of that currency on foreign exchange markets. This is because demand for exports (which must be paid for in the exporting country's currency) is lower than the demand for imports (which creates the supply of the that currency on the market). Therefore, it should mean that any imbalance should even out over time, although historically this has not occurred for the UK.

Here are some arguments to use when evaluating a current account surplus:

- A surplus indicates that your economy is extremely competitive as it is exporting more in value than it is importing in value. This could also mean that **export-led growth** is occurring which can lead to increases in employment and all the other benefits growth brings.
- A surplus might suggest that a country is exporting so much that there might not be enough to satisfy domestic demand. This could lead to a rise in domestic prices which can reduce real living standards.
- A surplus could indicate that there is low growth in a country and they are saving rather than spending on imports. This could have wider implications on an economy as has been the case for Japan where they have had sluggish growth for years.
- As indicated above, a surplus should lead to a stronger exchange rate and therefore over time, the imbalance sorts itself out. However, one of the reasons why Germany has seen such a strong surplus is because they are part of a monetary union and therefore the Euro has not strengthened as much as it should have for Germany due to other countries in the Eurozone

Overall it is worth considering the size of a deficit or a surplus for a country in terms of their GDP. America has a huge deficit (when measured in dollars) but as a % of their GDP, it is not significant and very manageable for an economy of that size. However, this might not be the case for all countries.

ACTIVITY 5

State whether you think the following would lead to a reduction in the UK's current account deficit or make it worse.

- UK based firms invest in new machinery that improves productivity
- A recession occurs in America
- A profitable British oil firm in Venezuela has stopped its operations
- Income tax rates are cut in the UK
- UK's exchange rate gets stronger due to increased confidence in the UK
- The Bank of England increases interest rates

In recent times, the current account (in the UK) seems to have taken a backseat in terms of the key objectives for a government and therefore a deficit is not seen as a primary cause for concern. However, an imbalance across the world could lead to problems and some have argued that the Chinese current account surplus indirectly led to the financial crash in 2008. As the Chinese people saved instead of spent, their institutions had lots of money to lend to banks in America and the UK, who lent recklessly, which eventually created the crash. However, it must be said that many firms and individuals in the US and the UK borrowed recklessly too.

The reasons behind a current account deficit or surplus can be numerous and the government will have to decide which course of action would be best for their country. This assumes that the government feels a current account issue is a main focus and requires specific policy actions. In the UK, governments (past and present) have spoken of the '**productivity gap**' between the UK and their major trading partners as a reason behind the current account deficit. UK productivity rates tend to be significantly lower than our trading partners, pushing up the costs of production and making UK output uncompetitive in comparison to imports. Unfortunately this is a problem that successive governments have found hard to solve.

The UK's current account deficit could have significant implications for the UK economy as it could lead to reduced **growth** and increased **unemployment**. It could also lead to **inequality** as it is often the low skilled jobs that have been lost to overseas production. It might also lead to a worsening of the **fiscal deficit** as low growth and unemployment means lower tax revenues and higher benefit payments.

Multi-choice questions

1 Where would you find the sales of hotel rooms to foreign tourists on the **current account**?

A Trade in goods

B Trade in services

C Primary income

D Secondary income

2 Which of these would improve the **trade in goods** for the UK?

A Chinese tourists spending money in the UK

B A supermarket importing some French cheese

C A UK firm with lots of international investors increases their dividend

D India increase their imports for single malt Scottish whiskies

3 Which of these would be a reason for a government to be concerned about a **current account surplus**?

A Domestic firms are competitive on the global market

B Consumers are not spending in the economy

C Profits from domestic firms abroad has increased

D Consumers are spending too much on imports

4 Using the following figures, what would be the figure for the Current Account? Trade in goods = £3,666 million, Trade in services = -£1,456 million, Primary income = £984 million, Secondary income = £-372 million?

A £2,822 million

B £1,598 million

C £3,566 million

D £5,734 million

5 What would cause a reduction in the **current account deficit** for the UK?

A A reduction in payments to the Euro post-Brexit

B A reduction in exporting abroad

C A reduction in remittances being sent from UK citizens abroad back to the UK

D A reduction in France purchasing UK goods

Short answer questions

6 Give one reason why the government might not be concerned about the UK's c**urrent account deficit**.

2 Marks

7 Explain one way the UK government could reduce the **current account deficit**.

2 Marks

CHAPTER 14 EXCHANGE RATES

International trade means that countries buy from each other but in order to do this, they have to buy one currency using another. For example, if a restaurant wants to buy some snails from France, they would have to purchase the Euros in order to buy the snails.

The currency market is like any other market. It is through the use of demand and supply that most currencies are priced, and this price is the exchange rate.

Key term:
An **exchange rate** is the price of one currency in terms of another.

For example, £1 = $1.5 could be the exchange rate between the UK and the USA. It means that in order to buy £1, an American would have to pay $1.5 in order to receive it. They can then use that £1 to buy British goods or services.

The demand and supply of a currency

ACTIVITY 1

What would happen to the price of a good or service in the following scenarios, assuming all other things are equal':

Demand shifts to the right =

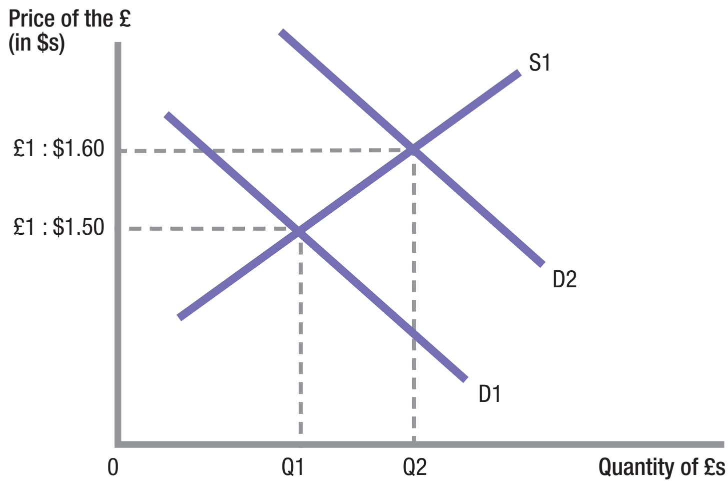
Supply shifts to the left =

Demand shifts to the left =

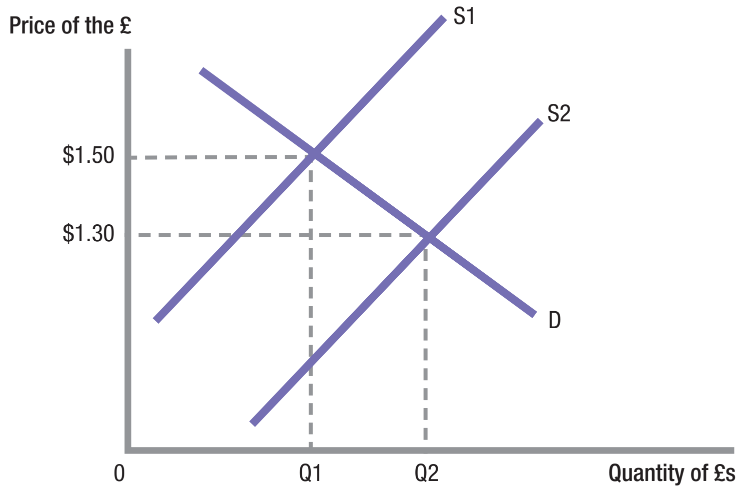
Supply shifts to the right =

When the price of a currency goes up against another currency, it is described as getting 'stronger' or that it is 'appreciating' in value. When the price of a currency goes down against another currency, it's described as getting 'weaker' or that it is 'depreciating' in value.

The exchange rate for most countries is determined on the foreign exchange market which is open 24/7 around the world. The equilibrium price that matches demand to supply is the exchange rate for the currency in question. In the first diagram below, demand has increased for the £ and this has meant the price of it has gone up in terms of the $. Therefore the £ has appreciated against the $. The £ did cost $1.50 and now it costs $1.60. Like any other product, the demand for the £ is influenced by many factors (see below) and it is worth remembering that it is consumers, producers and governments from overseas that will demand the £, not UK citizens.



In the second diagram below, there is an increase in supply of the £ onto the market and like any other market, this will lead to a fall in price. Again, it is worth nothing that the supply of the £ comes from UK consumers, producers and the government, as they sell the £ in order to buy other currencies, which in this case is the $. We can see that £ has depreciated against the $ from £1 = $1.50 to £1 = $1.30.



ACTIVITY 2

State whether the following would lead to the £ getting stronger or weaker – use diagrams to help you:

- UK consumers are struggling financially and therefore going on fewer foreign holidays.
- German businesses start leaving the UK due to concerns over 'Brexit'.
- American TV has decided to purchase more BBC productions.
- The UK government respond to a crisis in Greece by sending financial aid.
- UK supermarkets have started to import more meats from South Africa.

Factors impacting on exchange rates

There are a number of factors that influence the exchange rate:

- **International trade** – if a country is exporting more, then the demand for its currency will increase and appreciate. The reverse will occur if a country ends up exporting less. The same is true for imports. If a country starts to import more, then the supply of the domestic currency is going to increase as consumers sell their currency in order to buy the currency they are importing from. Therefore, importing more leads to a currency depreciating. The reverse will occur if a country ends up importing less.
- **Speculation** – over recent years, trading of currencies has been popular for those hoping to make a profit on movements in the exchange rate. For example, if a trader expects a country's currency to increase in value, they may purchase it at the current rate in order to sell it on at a higher rate at a later point in time. They can also do the reverse by selling currencies at a high rate in order to buy it back later at a lower rate. Speculation is now hugely influential on the currency markets and much of the movement in exchange rates is due to speculative flows that can influenced by some of the reasons that follow.
- **Economic Growth** – if a country is expected to grow, then foreign companies are more willing to set up in a country and in order to do this, they have to purchase the currency. Therefore, strong economic growth normally leads to a strengthening of the exchange rate. Concerns about UK growth after the 'Brexit' vote was a large reason why the £ weakened significantly after the vote.
- **Interest rates** – across the globe there are international investors looking to put their money in places that will earn interest. Therefore, if a country's interest rate increases, it is likely that 'hot money' flows from investors will enter the country and buy up the currency in order to put it into bank accounts in that country. This will then lead to a strengthening of the currency. Speculators might often gamble on whether interest rates are likely to go up or down and then buy or sell currency accordingly, in order to hopefully make profit from the deals in the future.
- **Political stability** – investors like safe places to store their money, therefore exchange rates weaken in countries where some political upheaval is going on, such as the outbreak of a civil war or a new leader is elected who is not well respected.

ACTIVITY 3

Investigate the use of computerised trading in the foreign exchange market and describe below what a 'flash crash' is and give an example of one.

Calculating currency conversion

Example 1

Joe has £350 spending money when he goes on holiday to America. If the exchange rate is £1=$1.50, then the amount Joe will get in dollars is £350 x 1.5 which equals $525.

If Joe finishes his holiday with $85, then how much money would he get when he returns to the UK? Using the same exchange rate of £1=$1.50, then the amount Joe will get in pounds is $90 ÷ 1.5 which equals £60.

Example 2

If Bob exchanges £400 and receives $320 in return, then what was the exchange rate? In this case, it is 320 ÷ 400 which equals 0.8 and therefore the exchange rate was £1 = $0.8.

To summarise:

Converting £ into $ (or another currency): £ amount x $ exchange rate = $

Converting $ (or another currency) into £: $ amount ÷ $ exchange rate = £

ACTIVITY 4

Calculate the currency conversions below.

1. Tom goes to France and buys a meal for €15 and the exchange rate is £1=€1.10. How much did the meal cost him in pounds?
2. A German business purchases teddy bears made in the UK. The UK company sells them for £25. The ex change rate is £1=€1.24. How much will it cost the German business in Euros for each teddy bear?
3. The German company wants to buy 1000 teddy bears. It orders them when the exchange rate is £1=€ 1.24 but ends up paying for them much later when the exchange rate is £1=€1.10. What's difference in the amounts that the German company has to pay in Euros? Is this exchange rate movement good or bad for the German company?
4. Priya has just got $335 dollars from her bank when she handed them £200. What was the exchange rate the bank gave her?
5. Harry has a company that sells Yo-Yos. It's a business that has its ups and downs especially when selling abroad. It costs Harry a unit price of 50p to make and he sells them for £1.50. At the moment he sells them in America and the exchange rate is £1=$1.80. How much does he sell them for in America?
6. Harry notices that the exchange rate has changed to £1=$1.40. He decides to keep on selling them at the original rate in America. What is the new profit he makes per Yo-Yo in British Pounds? Is this exchange rate movement good or bad for Harry?

Movements in the exchange rate are hugely important to businesses and consumers as it means that they are either get a better deal or a worse deal.

If a currency gets stronger, then it is cheaper to import and more expensive to export.

If a currency gets weaker, then it is more expensive to import and cheaper to export.

Therefore, a strong currency is good for consumers and businesses who import because the goods and services they are buying have become cheaper and it improves their real standard of living. However, it is bad for exporters, who will find it harder to sell abroad as their prices will increase. If they decide not to increase their prices, it will mean a cut in their profit margins.

The reverse is the case for a weak currency, as it is bad for consumers and businesses who import but better for businesses who wish to export.

The acronym **SPICEE** is an easy way of remembering this.

Strong Pound - Imports Cheap - Exports Expensive

The effects of changes in the exchange rate

The effects of changes in the exchange rate are many for both consumers and producers and this has an impact on the economy as a whole.

If the exchange rate weakens the following will potentially occur:

- **Consumers are likely to be faced with higher prices** for imported goods and therefore they would see a reduction in their real standard of living. The UK traditionally is quite dependent on imports and therefore it will have a significant impact on consumers.
- **A rise in import prices means that cost-push inflation is likely to increase** as we 'import inflation'. This is because many firms will import their raw materials from abroad, and this now costs more. This could then mean that all UK businesses increase their prices, and this will lead to further falls in the standard of living.
- **Producers will be faced with the higher import prices** and therefore their costs of production will rise. This will shift supply to the left and lead to a rise in prices. Depending on the market, the producer will see a fall in demand and lower revenue, assuming that price elasticity of demand is elastic.
- **However, some producers will see an opportunity to export more abroad**. The UK could potentially get 'export-led' growth as exporters can sell their goods at a cheaper rate in foreign markets. This will likely lead to an increase in demand and therefore a rise in revenue and then profits.
- **Tourism is likely to increase in the UK**, which is good for suppliers in the industry, but it will be more expensive for UK consumers to go abroad.

All of these effects will feed through to the macroeconomic objectives of government.

- Inflation is likely to rise due to higher import prices (**cost-push inflation**) and there is also an argument that increased demand for UK products (due to lower export prices and higher import prices) means that there will also be demand-pull inflation.
- **Unemployment could potentially fall** due to export-led growth although rising inflation may lead to a wage-price spiral that ultimately makes unemployment worse.
- **The current account deficit would expect to reduce** as the UK exports more and imports less although again this depends on the price elasticity of imports and exports. If the UK continues to import at higher prices and exports the same at lower prices, the current account deficit could get even worse.
- **Economic growth would be expected to rise** due to **export-led growth** but as previously stated, this is dependent on the impact of inflation on the economy.

The reverse of this will happen if the exchange rate gets stronger.

Exchange rates and macroeconomic objectives

A government may decide on a particular policy related to exchange rates based on their **macroeconomic objectives**. For example, the UK government wanted the UK to have a strong currency in the 1980s because it helped reduce inflationary pressure (because of lower import prices on both finished goods but also on raw materials) but it also gave producers an incentive to become more efficient in order to be competitive abroad. In this case, **inflation** was the key macro-economic objective. The Chinese government on the other hand manipulate their currency so that they have a weak currency in order for their manufacturers to be extremely competitive in the global economy. In this case **economic growth** (caused by export-led growth) is the key macroeconomic objective.

Multi-choice questions

1 Which of these would lead to the £ getting stronger?

A UK consumers buy more imports

B UK government increases aid to the developing world

C The Bank of England lowers the base rate

D An increase in tourism in the UK occurs due to Chinese visitors having higher incomes

2 If the exchange rate went from £1=$1.45 to £1=$1.62, who benefits the most?

A UK exporters selling in America

B UK businesses that import raw materials from the US

C UK consumers who import from France

D US consumers importing from the UK

3 Jon wants to buy some headphones from Germany. He saw the price was 30. Whilst saving the money, the exchange rate changed from £1=€1.10 to £1=€1.20. What's been the change in price he has to pay in English pounds to the nearest pence?

A £2.73

B -£2.73

C -£2.27

D £2.27

4 Which of these could be a **macroeconomic consequence** of a strong £?

A Increased employment due to export-led growth

B The price of imported apples will go down

C Lower inflation due to cheaper imports

D An improvement in the current account

5 Which of the following could be a reason the £ getting stronger against the between 2013-2015?

A Speculators were concerned about the UK economy

B Interest rates were increased in the Eurozone

C The UK's current account deficit worsened

D The UK's economy was growing faster than the Eurozone area

Short answer questions

6 Explain one problem that China might be faced with by keeping their exchange rate artificially low in the long run.

2 Marks

7 Using the concept of **exchange rates**, explain why a c**urrent account deficit** or a **current account surplus** should always reduce over time.

2 Marks

CHAPTER 15 GLOBALISATION

What is Globalisation?

Key term:

Globalisation is the process by which countries become much more interdependent. This is achieved through increased trade and improved international collaboration through organisations such as The World Trade Organisation (WTO), The International Monetary Fund (IMF) and The World Bank.

There are a number of factors that have caused an increase in globalisation:

- **Rise in real living standards** – as economies have achieved economic growth, consumers have seen a rise in incomes and this has meant that they have wanted to try new goods and services or explore new places, and this has led to huge movement around the world and a vast cultural exchange bringing increased trade between countries.
- **Multinational corporations (MNCs)** – as firms have got bigger, they have expanded outside of their original market in order to make more profit. They do this in several ways, for example, setting up production facilities in places where labour and other costs are cheaper or setting up shops in order to target a new market.
- **Reduced transport costs** – over several years, transportation costs have reduced due to new technology meaning transportation is financially viable. For example, the increased enlargement of tanker ships has meant that it has become much more affordable for firms to set up in one country and then transport them at a lower average cost to another. This is a benefit for producers, but consumers have also benefited from new technology that has meant cheaper flights and this again, leads to a cultural exchange that further boosts globalisation.
- **Global institutions** – after the Second World War, two international institutions were set up that eventually

  increased interdependence between countries. The IMF and the World Bank have encouraged economies to embrace trade liberalisation and to open up their markets. Clearly this leads to more trade, which has been further encouraged by the WTO, which was set up to reduce protectionism across the global economy. Trading Blocs such as the European Union have also emerged.
- **New technology** – over the last decade, we have seen how much easier it is to communicate withthe other side of the world due to advances in technology such as the internet. This has made it easier for businesses to expand across the world and allow workers to communicate across the world.

There are many factors behind globalisation and as can be seen, the factors are inter-linked. For example, in order for MNCs to expand abroad, they need consumers who can afford their goods and services, but they also need cheap transport to make it cost effective and no protectionism in order to make their goods and services affordable. They might even use new technology to make their products known in other countries or use payment systems that make it easier for consumers to buy their products. It is therefore difficult separating the factors, but it is interesting to think for different countries and different times, what the most significant factor might be.

It is also worth discussing whether globalisation is new. Some argue that there have been three stages of globalisation. The first stage was countries like Great Britain creating their empires across the globe. The second stage was when large corporations branched out across the world and the third stage was the post-WW2 globalisation that created vast movements of capital, labour and trade.

ACTIVITY 1

Choose two MNCs and show how they have been impacted by the different factors of globalisation – here is an example:

Company: **Sainsbury**	Use internet to promote stores and have a website.	Sell products from around the world. As consumers get richer they demand French wines, Japanese electricals, etc.	Cheaper to fly in Kenyan tulips than get them from Europe
Company:			
Company:			

Use research to help support your links – Sainsbury is UK based but see if you can find MNCs that are based around the globe.

Measuring Development

Economic development is the process in which a country increases the welfare of their people over time. This is normally linked to economic growth and hence the reason why **economic growth** is a key macroeconomic objective but there is a number of methods that can be used:

- **GDP per capita** – economic growth is essential for development as it shows the increase in goods and services produced over time. If GDP increases, then incomes within a country increase. GDP per capita is used as it gives a measure of development that relates to the population as whole. It is used as a measure of the standard of living within a country. If GDP per capita is high, then it suggests the economy is well developed and the population can afford goods and services that boost their welfare.

ACTIVITY 2

For each of the countries below, calculate the **GDP per capita:**

Country	GDP	Population size	GDP per capita
1	£300 billion	65 million	
2	£40 billion	7 million	
3	£850 billion	50 million	

Re-calculate again given that GDP of Country 1 grows by 5% next year, Country 2 grows by 3% and Country 3 grows by 2%.

Over time, many saw GDP per capita as a very narrow measure of development and therefore started to look at other factors:

- **Life expectancy** – if a country sees an increase in life expectancy, then it is fair to suggest that there has been development within their country as it shows that they have improved their health care facilities, can afford better diets and have better sanitation. It also might reflect greater education as the population know how to look after themselves and better governance, as there is less fighting over resources and better allocation of resources.
- **Access to health care** – if a country has better access to health care, then you would expect it to have a healthier workforce and then further development is likely. Family planning can also be improved because if children are expected to live, then families can plan ahead for the future. High levels of child mortality and maternal deaths in child birth reflect poor access to health care, as does a high rate of diseases that have little impact in the developed world.
- **Education** – if a country can provide education for all, then there is a likely to be an increase in the literacy rate, which acts as a sign of development. The number of years of schooling has a clear role to play here, as well as bridging the gap between males and females being educated. It is the case in some developing countries that many girls are not educated compared to boys.

Over the years, many rival indicators have been adopted to challenge the role of GDP per capita as the key indicator of development. The main one has been the **HDI – Human Development Index**. It is a composite indicator that includes GNI per capita (broadly similar to GDP per capita), life expectancy, expected years of schooling and mean years of schooling. The value is between 0 and 1 with a higher score meaning more developed. As one would expect with this indicator (because it includes GNI per capita), there is a strong link between GDP per capita and HDI and therefore, there is a case to be made that there is still a strong focus on economic growth in order to get economic development. This makes sense when you consider that increased output leads to increased incomes, which then leads to higher tax revenue for government. This can then be spent on health and education, which creates a virtuous circle.

ACTIVITY 3

In 2015...
Australia were ranked 2nd for HDI and 21st for GDP per capita
Iceland were ranked 9th for HDI and 29th for GDP per capita
Qatar were ranked 31st for HDI and 1st for GDP per capita
Saudi Arabia were ranked 38th for HDI and 12th for GDP per capita

Suggest **two** reasons why these differences exist.

There are many other ways that economists measure development and over recent times, **technology** has been used as an indicator because in the developing world, it has been used to enhance financial institutions, commerce and democracy. There is often a link also to technology and research and development (R&D) and the reason that this is so important for development is that it shows how much the country may grow in the future.

ACTIVITY 4

Economists have come up with a variety of different measures to investigate development. A recent one is the GPI (Genuine Progress Indicator) that was developed by the NEF (New Economics Foundation).

Investigate what factors are included in the GPI and state what the major conceptual difference is between GPI and HDI.

Take the activity one step further by developing your own 'development indicator' – what would you include and why? What problems might you face when collecting the data that you require?

A developed country is one with a high GDP per capita and has seen a movement from the primary/ secondary sector to the tertiary sector as its main contributor to GDP.

A less developed country is one with a low GDP per capita and still has an economy that is highly dependent on the primary sector but has seen some growth in the secondary/tertiary sector.

Evaluating the costs and benefits of globalisation

For developed countries:

- Consumers have benefited from globalisation as there has been an increase in the range of goods and services for them to purchase. Competition should also lead to an increase in the quality of the goods and services, as well as innovation within those markets, which also leads to better products.
    - However, across the world, there are generic high streets filled with big brand names as smaller firms cannot compete against these huge companies.
    - Consumers' incomes have risen everywhere due to globalisation, there has been a rise in demand for scarce resources. As demand increases, this leads to a rise in prices (as we have seen with commodities such as oil and copper) which then makes people worse off in real terms.
- Consumers are able to visit more places and experience new cultures, and this can be of benefit to society as a whole.
- They might also benefit from the increased amount of immigration that has occurred across the globe. This has meant 'skills gaps' have been filled in the developed countries and this has suppressed business costs and therefore lowered prices.
    - However, increased immigration does mean that demand has increased for local goods and services and this can be problematic for consumers as prices will rise accordingly.
- Producers are able to set up almost anywhere in the world and this means they can find the workers with the lowest wages plus governments with the lowest taxes and environment regulations in order to lower their costs and boost their profits.
- Producers also benefit from increased markets as they can expand across the globe and this also allows them to benefit from **economies of scale**, which reduces their average costs, which should increase profits. They can also learn quickly from other producers as ideas spread rapidly. For example, when Japanese companies moved to the UK, they brought with them a host of new ideas about stock control (JIT or Just In Time), production methods (lean production) and management systems (Kaizan) that were soon being used by UK firms.
    - However as economies are interconnected, producers are often trying to cope with quite volatile markets. This has certainly been the case for manufacturing firms in the UK that have found it extremely difficult to compete with Asian producers and have found themselves collapsing due to this.
- Producers are able to buy resources from all around the world and attract skilled labour, which should lead to lower costs and boosting productivity.
    - However the price of certain resources may increase due to a rise in global demand and it may actually lead to increased costs.
- Workers have more opportunities in the global market place as long as they are free to move. However if producers are selling more due to a globalised economy, then profits are likely to rise and workers can receive an increase in their pay.
    - However many jobs have been lost in developed countries due to outsourcing by producers to cheaper.

For developing countries:

- Producers in developing countries may struggle to cope with increased competition from abroad as they do not receive as much assistance from their governments due to a lack of finance. The amount of subsidies that developed countries provide their farmers can really skew the specialisation model of world trade.
  - However, even though local producers can be faced with increased competition, it could lead to better infrastructure as governments will often build more roads and ports in order to attract foreign direct investment and then benefits all producers within a country. This is an example of externaleconomies of scale.
- Producers also find it difficult to retain the most skilled workers as there is an opportunity now to move abroad and find jobs elsewhere. This is particularly the case for health and educational professionals that are in high demand in developed countries and this leads to what is known as the 'brain drain'.
  - However, it is important to note that those who earn money overseas will often send money back in the form of remittances to their family and this can increase demand domestically for local producers.
- Consumers in less developed countries can access global brands and thanks to the internet, be able to access products that might not necessarily be available in local markets, that could potentially be life saving (like medicines) or transformational (like new payment systems that can be used on your phone).
  - However, rising prices may occur and this is particularly harsh for those in less developed countries due to their low incomes.
- Workers in less developed countries have seen their incomes improve as a result of globalisation but there is an argument to be made that they are exploited by MNCs and their work is very precarious as firms can easily move from one country to another.
  - However globalisation has opened up the job market and there are clear opportunities for workers in the less developed world.

It is important to remember that many of the costs and benefits of globalisation for developed countries are the same for less developed countries but the lack of money in the less developed country makes many of the costs even worse as there might be no support structure for those workers or producers that struggle due to globalisation.

Globalisation and economic, social and environmental sustainability

Environment

Increases in trade and income lead to a large rise in pollution as more goods and services are consumed that lead to resources being used up. This is particularly the case in less developed countries as it has been argued that much of the 'dirty' production (significant pollution) has been outsourced to them. It is also true to suggest that rise in consumption has devastated the rainforest and other natural habitats as the plundering of the planet continues. Rising sea levels due to climate change is leading to situations where countries are in threat of being submerged (such as Bangladesh) and this has a knock-on effect on other countries as well as this leads to migration caused by environmental damage. This leads to a huge strain on other countries and therefore it impacts social and economic sustainability also. However, increased globalisation has meant that as countries have become more interdependent, general agreements are being reached on certain issues such as the environment. There is also a greater sharing of information across the globe that can also help improve environmental sustainability. As countries have higher incomes, they can invest more into 'green' technology and this can lead to a sustainable future.

Economic

From an economic perspective, globalisation has led to continued growth through trade and this has created increases in income for the majority. However, it is important to note that it has also created greater inequality.

Social

From a social perspective, it can be argued that globalisation has been good for society as there are more opportunities for people around the world and income levels have increased which means there has been a big improvement in the standard of living across the world and a large reduction in poverty. However, it has been suggested that through globalisation, societies are losing their individuality and that the growth of MNCs has led to a dilution of cultural diversity. It can also mean that families are also spread out further and this can have a detrimental impact on mental health.

Multi-choice questions

1 Which of these would lead to an increase in **globalisation**?

A Increased protectionism

B A reduction in global incomes

C A general agreement to limit the size of super tankers

D Improved broadband technology across the world

2 Which of these is most likely to be found in a **developed economy**?

A Low life expectancy and a high GDP per capita

B High literacy rate and a high infant mortality rate

C High life expectancy and a low infant mortality rate

D High average years of schooling and a low GDP per capita

3 What would be a benefit to producers in **less developed countries** from globalisation?

A Domestic workers moving overseas to get a better job

B Great opportunities in the global market place

C Increased competition from MNCs

D Vulnerability to shocks in the global economic system

4 Which of these would most likely be a benefit of globalisation to **environmental sustainability**?

A Increased tourism leading to more travel

B Increased incomes leading to more tax revenue for R&D projects

C Increased jobs due to an increase in global output

D An increase in trade agreements between Africa and Europe

5 Which economic groups are most likely to gain from an agreement on a **global minimum wage**?

A Consumers and Producers

B Workers and Consumers

C Producers and Government

D Workers and Government

Short answer questions

6 Give one reason why the rise of the internet has led to an increase in **globalisation**.

2 Marks

7 Explain a cost of **globalisation** for a worker in the UK.

2 Marks

CHAPTER 16 THE ROLE OF MONEY AND FINANCIAL MARKETS

The role of money

Before the existence of money, people traded goods through a **barter** system. For example, a carpenter who wanted to buy some bricks, needed to find a brickmaker who may be in need of carpentry services and swap products/services. Of course, this assumes that both parties want to make the trade – if the carpenter cannot find a bricklayer who needs their skills, they may not be able to make a trade.

Money allows that **exchange** to happen easily. As long as all parties have confidence in the currency being used they will swap the money for products or services in the knowledge that they can use the money elsewhere.

Other functions of money:

- **Store of value:** this can refer to any asset whose "value" can be used now or used in the future i.e. its value can be retrieved at a later date. Money performs this function, because it allows purchasing power to be transferred from the present to the future. This means that people can save now to fund spending at a later date.
- **Unit of account:** this refers to anything that allows the value of something to be expressed in an understandable way, and in a way, that allows the value of items to be compared.

However, whatever item is being used as 'money' it must meet certain criteria:

- It must be durable and not fall apart easily
- It must be portable and easy to carry
- It must be divisible – i.e. be able to break down into smaller denominations (e.g. 1p, 5p, 20p)
- Complex enough to prevent people making counterfeit versions
- Accepted by everyone
- Limited in quantity (so that it maintains some value).

ACTIVITY 1

Consider the following items and imagine that they were used as a form of money. Give one advantage and one disadvantage of each item if it were used as money.

Item	Advantage	Disadvantage
Pebbles		
Grains of rice		
Coconuts		
Diamonds		

The Role of importance of the financial sector of the economy

The financial sector in any country exists to manage the process of transferring money in an economy. In modern economies, the financial sector in any one country (or internationally) is vital to ensure that economic transactions take place. The financial sector has the following functions:

- **Facilitating the exchange of products and services** - this is achieved by storing money and transferring money when required. Many people have 'cards' that allow transfer of money through electronic machines or allow people to withdraw cash from cashpoints.
- **Allow saving** – individuals or organisations can store their money in a financial institution (for later use) and the financial sector keeps this money secure.
- **Management of risk** – the financial sector attempts to spread risk by lending to large numbers of borrowers and absorb any 'defaults' through earning interest on loans.
- **Offer advice** – the financial sector attempts to offer advice to private individuals and organisations on the best way of storing or investing their money.
- **Monitoring borrowers** – the financial sector monitors the performance of businesses and individuals to minimise the loss of money.

Some key terms:

Savings	'Deposits' made into a bank or building society to be stored in an account. Money held in savings accounts will often earn 'interest' which encourages the saver to store money in the account.
Loan	A set amount of money lent to an individual or group. This money may be used to purchase something (e.g. a car) or pay off debt. The financial institution giving the loan will earn money by charging 'interest' at a set rate (quoted as a percentage).
Mortgage	A long-term loan used by individuals to purchase property. Because property is usually the most expensive item an individual will purchase, the loan tends to be a large amount. Repayment of a mortgage is usually over many years (e.g. 25 years). Again, the financial institution will earn money from charging interest on the mortgage – this interest may be 'fixed' (does not change) or 'variable' (changes over time at rates set by the lender).
Overdraft	A smaller, often short-term loan, usually for weeks or a few months. In effect, the financial institution allows account holders to withdraw more money from their account then they have placed in that account. The financial institution may charge interest on the overdraft or may lend the money for free with prior agreement.

Main institutions in the Financial sector

- **Banks** – banks can exist in several forms. You will find different banks on many High Streets in the UK, but they can also be accessed using other methods (such as telephone banking or internet banking). Banks allow people to store their money securely and then access this money through taking out cash or transferring money electronically (or by using cheques). Banks will offer their customers 'overdrafts' (the facility of short term borrowing directly from an account), short and long-term loans and other services such as financial advice. Banks earn most of their own finances through the interest on loans they have given out.
- **Building Societies** – in the UK, building societies have become less popular than banks as the number of services that they offer is more limited. Building societies are owned by their 'members' (the people who save) and operate more to the benefit of their members than banks (who tend to be more profit focused). The primary services offered by building societies are saving accounts and long-term loans (especially mortgages).
- **Insurance Companies** – insurance companies enable people to reduce risk. Individuals or organisations will purchase insurance against something bad happening (e.g. accidentally breaking a mobile phone, a house being burgled, a holiday being cancelled). The cost of the insurance is much smaller than the item being insured but the financial institutions make profits from the fact that most people do not make a claim.

ACTIVITY 2

Conduct some research: find information on the four nearest banks to where you live. The information should include:

- Opening times
- Interest rate offered on any savings account that the bank offers
- Interest rate charged on any loans that the bank offers

Choose an adult who may be prepared to tell you information about their bank account (such as a parent or guardian) and ask them what made them choose this bank. Discuss your findings with other class members and see if there are any common themes.

Some more key terminology:

Base rate	The 'Base' rate in the UK is set by the Bank of England. This is the percentage rate charged to banks for borrowing from the BoE. This base rate then affects the interest rates set by the High Street banks.
AER	Annual Equivalent Rate – the amount of interest a savings account will earn in a single year, or the amount of interest charged over a year.
Gross annual	This is the annual income from a savings account that is earned before tax is deducted.
Compound interest	This is where a savings accounts starts to earn by receiving interest payments from the interest already earned from the account.
Access	Different banks will allow different levels of access to savings. Some accounts allow holders to instantly withdraw any amount. Other accounts may only allow the holder to withdraw after they have given notice that they wish to do so (e.g. 30 days' notice).

Multi-choice questions

1 Which if these is **not** a function of money?

A Medium of exchange

B Store of value

C Illustration of wealth

D Unit of account

2 Which of these is the best definition of an '**overdraft**'?

A A short-term loan allowing an individual to withdraw more from their account then the amount that has been deposited

B A long-term loan primarily used to purchase a house

C The amount of additional payment an individual must make when repaying a loan

D The reward from saving

3 Which organisation sets the '**Base rate**' in the United Kingdom?

A The Government

B Individual banks set it for their customers

C Building Societies

D Bank of England

4 What will happen to the general levels of money placed in **savings accounts** if interest rates on savings are *increased*?

A Increases

B Decreases

C Will remain the same

5 Explain 2 criteria that should exist for an item to be considered a useful form of money.

A £3,366

B £66

C £3,960

D £660

Short answer questions

6 Explain 2 criteria that should exist for an item to be considered a useful form of money:

1 ______________________________

____

2 ______________________________

____

2 Marks

7 Explain why the existence of insurance companies is beneficial to economic activity.

____

____

2 Marks