Economics Unit 4 Revision Guide

4.3.1 — What are the causes and effects of globalisation?

Definition of globalisation (from Peter Jay): 'The ability to produce any goods (or service) anywhere in the world, using raw materials, components, capital and technology from anywhere, sell the resulting output anywhere, and place the profits anywhere.'

Characteristics
Globalisation refers to the **increasing interdependence of economic actors (producers, consumers, governments, entrepreneurs)**. Key phrases include global branding and global sourcing, although it is not just about the activity of multinational companies (MNCs). Globalisation is characterised by increasing foreign ownership of companies, increases in trade in both goods and services, deindustrialisation in developed countries, and increasing global media presence.

Causes:

- improvements in transport infrastructure and operations e.g. container ships and aeroplanes
- improvements in communications technology and IT (especially the Internet, allowing a global media presence)
- reduced protectionism (although this is debatable, with the increase in trading blocs' power)
- development of international financial markets
- increasing number and influence of multinational companies
- end of the Cold War.

Q1 – Which 3 of these would you use for a part a of an essay question? How would you evaluate them?

Consequences of globalisation:

• increased dependency of economies on the output of other economies – so problems if war / conclict e.g. Russian supplies to energy to the Ukraine
• greater consumer choice
• lower prices, through specialisation according to comparative advantage
• increasing environmental destruction and other negative externalities
• 'Footloose' companies (which can cause unemployment as they move from Place to place)
• possible loss of culture/national identities e.g. adoption of American style culture

Q2. You may need to discuss these factors in a part b of an essay. Which four would you discuss. You would need to evaluate them

Other issues:

• some people argue that **globalisation is not a new phenomenon** and that we have been in a continual process of globalisation since the time of the first humans — this is supported by the fact that the rate of increase in exports has not really changed recently.
• de-industrialisation in developed countries, combined with a global search for new sources of energy (especially oil/gas reserves) and the growth of economies such as China and India has left many 'Western' countries concerned about their future and their future power in the global economy.
• **trading blocs** are seen as both a contributor to globalisation, with their emphasis on creating trade within their boundaries, and also an inhibitor to globalisation, since they divert trade away from economies not within their boundaries.

Note – these could be used as evaluation points

4.3.2 — Why trade?

International trade can be defined as the buying and selling of goods across international boundaries.
Why do countries trade? The basic reason is that countries are not able to produce everything that they want in today's society — gone are the days when people lived off local produce and owned very few assets. This is associated with economic development and increases in income. Trade allows countries to **specialise** in producing the goods/services that can be produced efficiently — receipts from exports can then be used to buy goods that would be inefficient for that country to make.

We buy goods from abroad because of their:
• **availability**, eg we cannot grow coconuts in the UK so we import them from the Caribbean
• **price**, eg other countries may be able to produce much more cheaply than we can in the UK, because of lower labour costs or easier access to raw materials
• **product differentiation**, eg a car is not just a car — many British people now want to own large American SUVs.

Patterns of trade

The UK's share of world trade in manufacturing has fallen significantly over the past century; this is true of all G7 countries, but the fall in the UK's share has been the largest. In global terms, trade flows with **Newly Industrialised Countries** and the **Tiger Economies** have radically increased. Trade within trading blocs, such as the EU, has also significantly increased (**trade creation**), but at the expense of trade with more traditional trading partners, such as between the UK and the Commonwealth countries (**trade diversion**). Trade has also been influenced by the increase in outsourcing over the past decade or so.

Note – the UK has over 60% of trade with the EU

Q3 – What might some economic consequences be for the UK leaving the EU and the single market?
The main macro objectives are a helpful checklist when looklng at economic effects

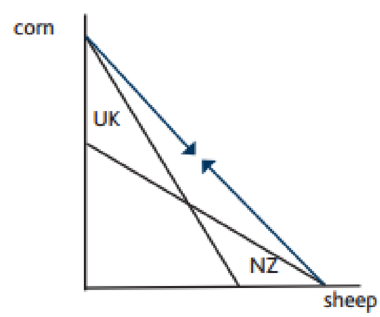
- **Employment**
- **Inflation**
- **Growth**
- **Balance of payments**
- **Income Equality**
- **Budget deficit**

Arguments FOR free trade (advocated by the World Trade Organization, WTO, who act to reduce trade barriers and settle trade disputes):
- increased consumer choice
- lower prices, through existence of economies of scale
- reduced domestic monopoly power
- increasing world output as a result of comparative advantage

Comparative advantage Is the ability to produce a good or service at a **lower opportunity cost** than another country, ie a country has a comparative advantage in production of a good if it has to forego the production of fewer other products in order to make it. This differs from **absolute advantage**, which is the ability to produce a good or service at a lower cost than another country.
The **Law of Comparative Advantage** states that countries should **specialise** in the production of a good in which they have a comparative advantage and then trade, causing global output to increase.

Problems with comparative advantage and specialisation:
- ignores transport costs (ie it may be cheaper to produce sheep in the UK rather than pay for shipping from New Zealand (NZ))
- ignores external costs of production (eg environmental degradation)
- ignores gains from economies of scale
- assumes factors of production can easily be switched from producing one good to producing another (which they can't)
- assumes perfect knowledge (which doesn't exist)
- reduces self-sufficiency.

Using PPFs to illustrate comparative advantage



New Zealand has a comparative advantage in production of sheep, and the UK in corn (the country with the 'shallower' PPF has the competitive advantage in production of the good on the x-axis). NZ should make only sheep and UK only corn, and then trade (shown by red line) to reach a point outside their PPF

Using numerical examples to illustrate comparative advantage

Devoting 50% of resources to corn and 50% to sheep, UK can produce 16 tonnes of corn and 8 sheep, and NZ 8 tonnes of corn and 12 sheep (so world production is 24 tonnes of corn & 20 sheep). To produce one more tonne of corn, the UK must give up production of ½ sheep and NZ 1½ sheep. To produce one more sheep, the UK must give up production of 2 tonnes of corn and NZ ¾ tonne. Because the UK gives up fewer sheep to make more corn it has a comparative advantage in corn (similarly NZ for sheep). If the UK uses 100% of its resources for corn production, it will produce 32 tonnes of corn. NZ will produce 24 sheep, thus world production has increased!

Q4 – Which activities / types of business would you say the UK has a comparative or absolute advantage in?

<u>Why protectionism?</u>

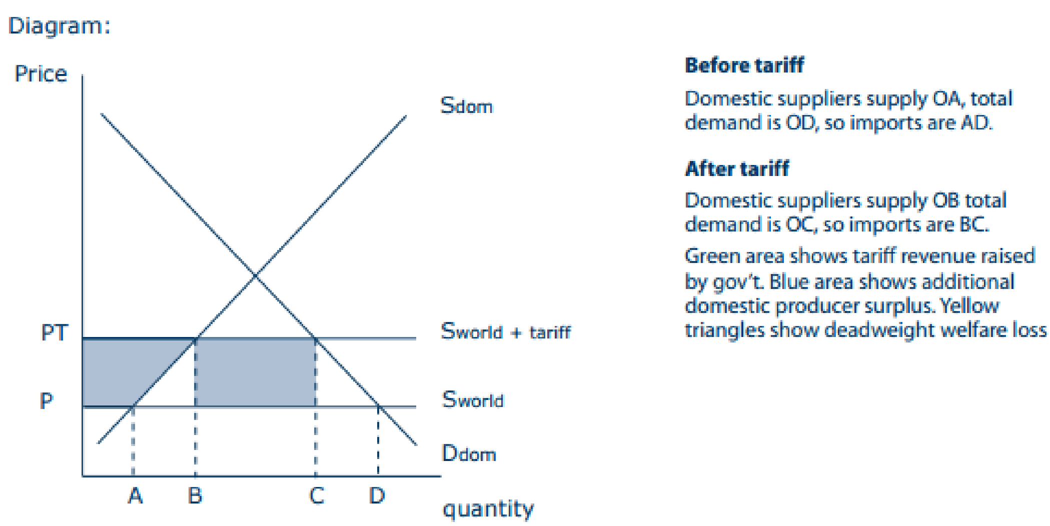
• protect infant industries and sunset industries. These are?

• employment protection
• retain self-sufficiency
• tackle balance of payments current account problems
• retaliation
• prevent dumping – when goods are sold below cost to force a countries producers out of business
• prevent competition from countries with cheap labour and poor Labour/environmental laws
• protect strategic industries, eg defence, essential foodstuffs, electricity generation.

Q5 – Which 3 of these is the most important to the UK? Can you prioritise?

Types of protectionism

Tariffs are taxes on imported goods. They are also known as import or customs duties. They raise prices to consumers and restrict imports.



You must learn this diagram for the exam

Quotas are a physical limit on the quantity of imports.
They:

• have a similar effect to tariffs but no tax revenue is raised, therefore there is larger domestic welfare loss

• create shortages. In the Uruguay Round of WTO negotiations, the abolishment of quotas on textiles/clothing was achieved from 2005.

Remember – you can use a slightly adjusted Tariff diagram to show quotas

Q6 – Using the diagram on page 5 – if a quota of BC on imports was set what would the effects be?

Domestic subsidies: are grants given to domestic producers to enable them to lower production costs, thus lowering prices and should make the country's products more competitive internationally. It: • is difficult for WTO to tackle because not overt protectionism • incurs an opportunity cost.

Non-tariff barriers: protectionist measures that do not necessarily result in price increases; these might include restrictions on quality (eg Kite Marks) or product specifications etc.

Trading blocs

There are several types.

Free Trade Areas are blocs in which groups of countries agree to abolish trade restrictions between themselves but maintain their own restrictions with other countries. **Customs Unions** have free trade internally and a common set of protectionist measures. Examples include the EU, NAFTA, and ASEAN. They comply with the aims of the WTO in terms of creating trade between members, but they contradict the aims by causing **trade diversion**, where non-members are excluded from trade in favour of less efficient producers within the bloc.

Note – trading blocs are often the focus of exam questions – remember free trade is promoted within them as a the potential market is larger economies of scale can develop. Larger businesses can develop with may be bad for competition but might allow larger companies to complete globally.

Q7 – Consider the advantages of UK membership of the EU . you looked at some problems in Q3

4.3.3 — How is international trade recorded and financed?

The **Balance of Payments** is a record of all a country's financial dealings with the rest of the world over the course of a year. It has three parts: the current account, the capital account and the financial account.

The current account has three parts -

1. **Balance of Trade** — this looks at the value of imports and the value of exports. **Exports** are goods/services that are made by UK companies and sold abroad. They appear as a **positive entry** into the Balance of Payments because they bring money into the country. **Imports** are goods/services made abroad and sold to people in the UK. They appear as a **negative entry** into the Balance of Payments because money **leaves** the country. We can split the Balance of Trade up even further by looking at trade in goods, or **visible trade**, and trade in services, or **invisible trade**.

2. **Income** — this is made up of income earned by UK citizens who own assets overseas. It includes profits, dividends on investments abroad (payments made to shareholders by companies who earn a profit) and interest. Growth in investment income has increased significantly since 1999.

3. **International transfers** — these are usually money transfers between central governments (who lend and borrow money from each other) or grants, such as those that we receive as part of the CAP from the EU. However, our transfers to the EU are normally in deficit — we give the EU more money than we receive.

If we have a **current account deficit**, then **value of money leaving the country > value of money entering the country**. We usually abbreviate this to value of imports > value of exports.

If we have a **current account surplus**, then **value of money entering the country > value of money leaving the country**, or value of exports > value of imports.

The capital account refers to transactions in fixed assets and is relatively small. The largest aspect of the capital account refers to flows of capital associated with migration. As immigration into the UK increases, this increases the surplus on the capital account, as immigrants' assets become part of the UK's assets. This account has been in surplus now for 20 years or so.

The financial account refers to transactions in financial assets, or what is more commonly known as Foreign Direct Investment (lots of older textbooks refer to this as the capital account — don't get confused, the name changed a few years ago!). This has shown a significant surplus over the past 6
or 7 years.

The Balance of Payments must always balance

If we have a current account deficit, we must have a surplus on the capital and financial accounts.

This is because we have to pay for everything we consume and fund it in some way — to fund our current account deficit, we must be selling assets to foreign investors. It is debatable whether this is sustainable in the long run, since if people invest in the UK, at some point they will require a return on their investment, and this will cause a deficit on the financial account. Additionally, because the data is never completely accurate, the accounts also incorporate a 'net errors and omissions' item, which makes sure that everything will balance.

Correcting problems on the balance of payments current account

Governments tend not to be as concerned with correcting surpluses or deficits on the current account as they used to be, but there is evidence of global imbalance, with some countries running the largest (persistent) deficits they have ever seen and others (particularly oil-producing counties and China) running enormous surpluses. Theoretically, under a floating exchange rate regime, current account imbalances will be self-correcting. In practise, this tends not to happen for a multitude of reasons. there are essentially three ways of correcting a deficit: **expenditure-reducing, expenditure switching and supply-side policies.**

Expenditure reducing policies require the government to cut the income of its citizens, so that they spend less on imports (for example, through deflationary fiscal policy); however, a side-effect of this is that spending on domestic goods also decreases, so AD falls. This can reduce economic growth and cause recession. It is an unpopular policy, especially politically, and therefore unlikely to be used.
Expenditure switching policies require the government to find ways of reducing its citizens' spending on imports, using protectionist measures such as tariffs or quotas, or even a devaluation of the currency under a fixed exchange rate regime. However, since this often leads to retaliation, exports will also fall, and the current account deficit may not be corrected. Supply-side policies, such as spending on education and training in order to improve the quality and therefore competitiveness of exports, aim to boost export demand rather than reduce import demand. Whilst they can incur an opportunity cost, they contribute positively to economic growth and can be anti-inflationary in the long run.

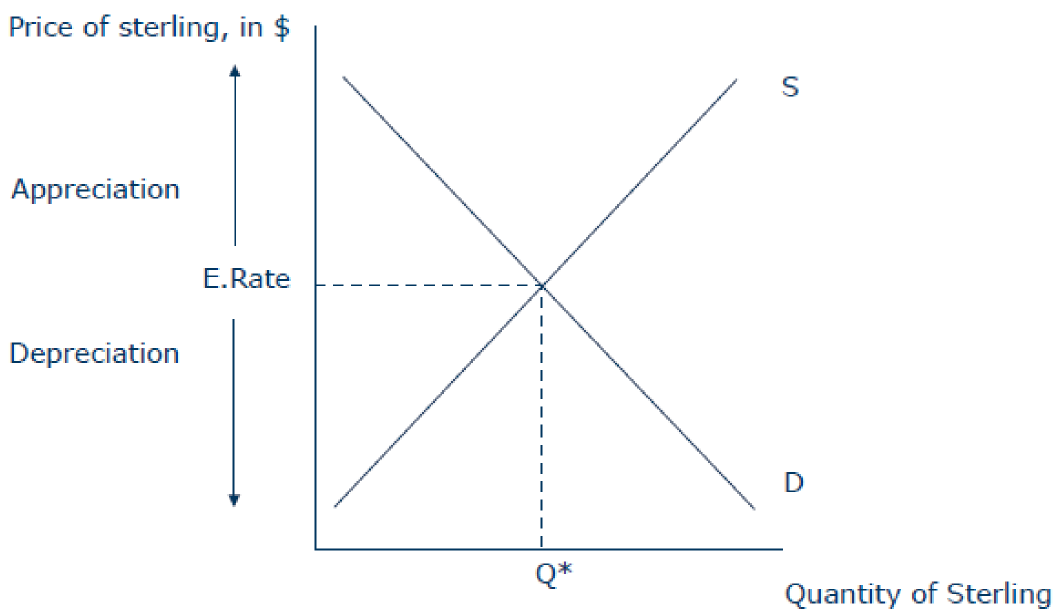
Are persistent imbalances on the current account a cause for concern?
Traditionally, deficits have been seen as 'worse' than surpluses. However, a small imbalance should not be cause for concern; persistent large imbalances are more worrying. Large and persistent deficits can be a problem because there is a need to finance the increasing expenditure on imports, usually through loans from abroad (which show as a surplus on the financial account); having large debts, especially with creditors abroad, can be problematic when those creditors want their money back or decide to discontinue lending. Large and persistent surpluses can be a problem because resources are focused on producing to meet export demand rather than domestic demand, so consumer choice and resulting living standards could actually be low.

Q8 – The UK's balance of payments recently recorded one of its highest recorded deficits. To what extent is a problem?

Q9- What R is a common idea when evaluating trade related questions?

Exchange rates: are the price of one currency in terms of another. Exchange rates are determined much like any other price in a free market, via demand and supply.
The demand curve for sterling
1. Demand for the pound comes from demand for our exports from abroad. We want to be paid in pounds, no matter where our customers come from, and so people abroad have to purchase pounds on the foreign exchange market. **If demand for exports increases, then demand for the pound on the foreign exchange market increases.**
2. Demand for the pound also comes from demand for saving in UK bank accounts — if the UK interest rate goes up compared to interest rates abroad, then people abroad will want to save their money in UK bank accounts. Because you can save only pounds (rather than dollars or euros) in UK banks, **demand for the pound on the foreign exchange market will rise if the interest rate rises.** The stocks of funds that move around the world in search of the best return is called hot money.
3. Long term capital movements are also important. So, **inwards investment into the UK increases demand for the pound.**

The supply curve for sterling
1. Supply of the pound onto the foreign exchange market comes from our demand for imports.
People abroad want to be paid in their own currency, so we take our pounds along to the foreign exchange market, releasing them on to the market in return for other currencies. **So, supply of the pound on the foreign exchange market increases if demand for imports increases.**
2. If the interest rate abroad increases relative to the interest rate in the UK, then funds will move from the UK to overseas bank accounts, increasing the supply of the pound on foreign exchange markets.
3. If there is net outwards investment from the UK economy, then the supply of pounds will increase.
The exchange rate is determined at the point where the demand curve and supply curve for sterling on the foreign exchange market meet.



Depreciation means that the value of the £, in terms of other currencies, goes down. For example,
£1 = $1.60 to £1 = $1.40 — in the second example, it takes fewer dollars to buy £1. With a depreciation, even though a good may still be priced at £10, it now costs Americans only $14 instead of $16 — demand will increase.
Appreciation means that the value of the £, in terms of other currencies, goes up. For example,
£1 = $1.50 to £1 = $1.70 — in the second example, it now takes more dollars to buy £1. With an appreciation, even though a good may still be priced at £10, it now costs Americans $17 instead of $15, therefore reducing demand for our exports.

Q10 – How would an increase in the UK interest rates affect the value of the pound?

Q11 - How might q10 affect the UK balance of payments?

Q12 – What two conditions can be used as evaluation points when discussing the effects of a change in the balance of payments ?

The effect of speculation

The minute-to-minute fluctuations in the exchange rate are caused by speculation, ie people trying to earn profit from buying and selling currencies by predicting which way market forces will move.

Speculation actually causes a self-fulfilling prophecy. Think about this scenario — imagine that traders in the City of London expect the value of the pound to rise. In order to make a profit, they should buy pounds while they are cheap and then sell them once they have risen in price. So, they start to buy pounds on the foreign exchange market. This increases demand for the pound, and therefore increases the price — exactly as they anticipated! Until about 30 years ago, many developed economies imposed exchange controls on their currency movements in order to prevent speculation. Under a strict exchange control, currency could only be bought and sold through a country's central bank. China is one country that still has some degree of exchange control.

European Monetary Union: adoption of the European single currency, the euro, and the centralisation of monetary policy for the Eurozone. The European Central Bank sets one interest rate for all countries in the EMU. There is little immediate prospect that the UK will join adopt the Euro and enter the EMU.

Assessment of EMU	
Pros	**Cons**
Reduces transactions costs	Irreversible decision to join
Reduces exchange rate risks of trading with European partners	'One size fits all' monetary policy unlikely to be appropriate for the different member states
Protection against damaging effects of currency speculation	Restricts use of fiscal policy (and therefore supply side policy) through Growth and Stability Pact
Can encourage FDI	Possible loss of national identity and sovereignty
Increased trade and FDI may result in higher employment and economic growth	Poorer/weaker countries may see increased unemployment as their goods are not demanded internationally
Lower inflation from strong monetary policy control by ECB	Asymmetric inflation target may limit economic growth

Q13 – Which 3 factors for and against do you think are the most relevant for the UK?

4.3.4 — How does a country compete?

Competitiveness refers to the ability of a country to sell its goods/services abroad. Competitiveness is usually determined by the price and/or quality of the good or service.

Measures of competitiveness The price of a good abroad depends on both its cost of manufacture and the exchange rate.

Cost of manufacture:

- unit labour costs compared to competitors
  - o **productivity – measured by GDP per capita** – influenced by level of education/training, trade union activity, labour laws, level of investment of wages – depends on cost of living, productivity, trade union activity, labour laws etc
- costs of capital
  - o depends on cost of finance eg interest rates
- transport costs compared to competitors
- rate of inflation.

Exchange rate:

- real, rather than nominal, exchange rate is important
  - o the exchange rate adjusted for inflation
- terms of trade: index of export prices/index of import prices

Improving competitiveness

Competitiveness can be improved by influencing any of the factors outlined above.
Supply-side policies are the most likely to be used in most developed countries — these will improve productivity, reduce 'red-tape' surrounding businesses, reduce trade-union activity and so on.
It is impossible for countries with floating exchange rates to manipulate the exchange rate to improve competitiveness (although countries such as China, with fixed exchange rates, have been accused of deliberately keeping their exchange rates undervalued in order to maintain competitiveness). Governments want to improve competitiveness in order to boost AD (exports are a component of AD), thus reducing unemployment and causing economic growth, and therefore an increase in living standards.

Q14 – What factors do you think are particularly important in reducing the competitiveness of UK exports?

Remember – we used to Car industry as an example here

4.3.5 — What is poverty and inequality in developed and developing countries?

Relative poverty exists when a person is poor compared to others in their society. Most poverty in developed countries tends to be relative poverty. Absolute poverty exists when a person's continued daily existence is threatened. Much of the poverty in developing countries tends to be absolute poverty.

Inequality can occur in terms of either income or wealth. Income is a flow concept — people earn income, either through paid work or through dividends on financial assets. Wealth is a stock concept — it is a measure of the value of people's assets.

Causes of unequal income distribution include:

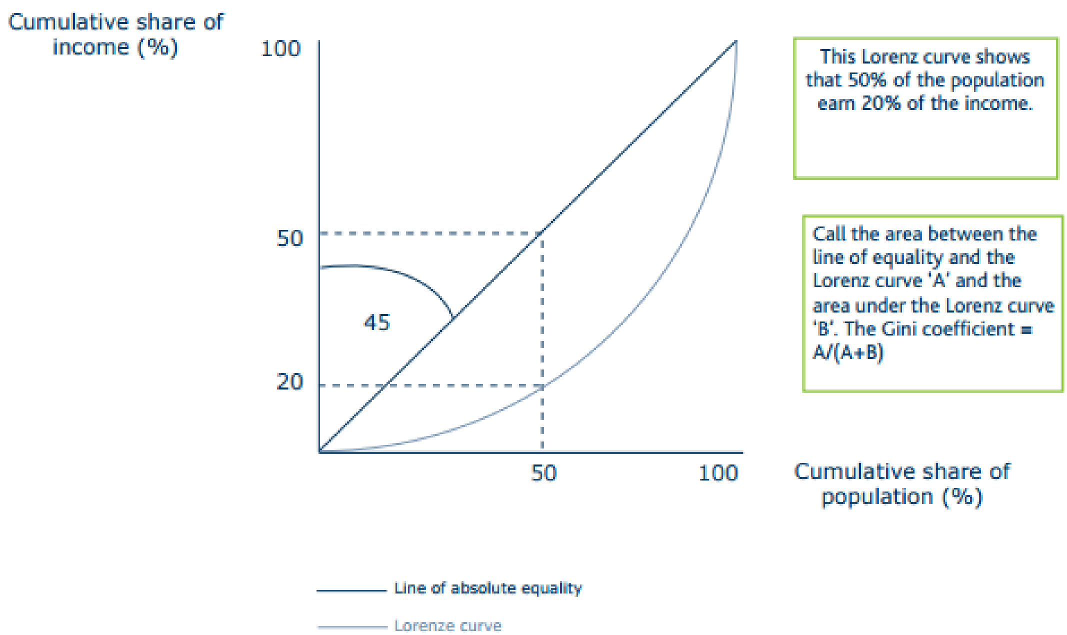
- receipt of different wages
    - different abilities/skills resulting in differing levels of productivity and therefore differing wages
    - discrimination
    - compensating differentials, eg some jobs are considered intrinsically rewarding and therefore attract lower pay
    - regional differences in pay
- unemployment
- varying ownership of financial assets, since these generate income
    - people on higher income are able to afford to purchase assets, which in turn then generate more income, leading to a virtuous cycle.

Inequality in a free market economy is inevitable, since people with higher skill and ability will attract higher wages, and some people, perhaps with disabilities or poor skill levels, will earn nothing. This is one of the strongest arguments in favour of a mixed economy with government intervention to redistribute income through the tax system.

Causes of unequal wealth distribution include:

- different levels of income
- inheritance.

Measures of inequality include the Lorenz curve and the Gini coefficient. Lorenz Curves plot cumulative share of income (or wealth) against the cumulative share of the population with that income (or wealth). The Gini coefficient is a numerical measure between 0 and 1 of the degree of inequality in a society; it can be measured using areas on a Lorenz curve. 0 denotes absolute equality; 1 is absolute inequality.



4.3.6 — What are the limits to growth and development in developed and developing countries?

Economic growth: an increase in real GDP/an increase in the productive potential of a country. Measured by assessing growth in GDP, or sometimes GDP per capita.

Economic development: an increase in living standards — this could relate to income per head, levels of education, healthcare, access to housing etc. Measured in many ways, usually using composite measures such as the Human Development Index (HDI), which provides a score between 0 and 1 based on GDP per capita, literacy rates and life expectancy.

Classification/characteristics of countries

Developed countries:

- 'First World Countries', or 'Most Developed Countries' (MDCs)
- tend to be those countries thought of as 'Western'
- many have entered a phase of de-industrialisation, and have developed their service sectors (including financial and IT services)
- high GDP per head
- high levels of education and healthcare
- reliable and safe transport infrastructure and operations
- non-corrupt democratically-elected government
- high productivity and investment.

Developing countries

- 'Third World Countries' or 'Less Developed Countries' (LDCs)
- tend to be located in Africa, South America and Asia
- wide range of levels of development
    - Newly Industrialised Countries (NICs) include South Korea, Taiwan and other Tiger Economies — are industrialised, with good education, transport and other infrastructure
    - Low Income ('Fourth World') — generally less than $1000 income per head
    - Middle Income ('emerging economies') — generally less than $10 000 income per head
- often led by corrupt, non-democratically elected governments
- may have had recent civil war
- agriculture-based or subsistence economy with small industrial sector (not true for NICs)
- poor financial infrastructure
- poor education, healthcare, transport, and communications infrastructure
- high unemployment and underemployment
- low productivity and investment
- high birth/death rates

Q15 – Remember essay questions often get you to use country examples in your responses. Which countries would you feel confident in writing about?

Developed?

Developing?

Reasons for different levels of development

Reason	Explanation/examples
Different availability of natural resources	Countries such as Nigeria have significant oil wealth — if used wisely, this could improve growth and development. Other natural resources would include precious metals/ minerals. However, control of these are often fought over in **civil war**. Many LDCs have subsistence or **primary-sector** economies, which produce low-value-added goods and therefore low income. Consequently, people cannot save any excess income, and funds for investing in the secondary sector are not available.
Differing geographical terrain	Highly mountainous regions may struggle to develop transport infrastructure and primary/secondary sector economies, eg Himalayan communities. However, Switzerland is a counter-example.
Climate	Many sub-Saharan economies are severely affected by droughts followed by flooding, making it difficult to establish any industry and attract any investment.
Political stability	**Democratically-elected**, non-military governments tend to have less corrupt economies that are more able to develop. This is perhaps because of the ability to raise taxes and spend on public services.
Education	Countries which place an emphasis on education and provide some state funding are more likely to grow and develop eg 'Tiger' economies and China take education seriously. This improves **human capital** and shifts the PPF outwards.
Investment	Low investment means that economic growth is unlikely. Low investment could be due to lack of confidence by businesses/consumers/MNCs, **low savings rates** leading to lack of finance (Harrod-Domar model), poor availability and trustworthiness of financial institutions (this may be heightened by poor transport infrastructure, reducing access to banking). Low public sector investment in education, healthcare, transport or communications could be due to corruption or inability to raise taxes (due to low incomes and poor infrastructure). This is true of many African economies.
Population	Many LDCs are characterised by **high birth and death rates** — families aim to have many children in order to increase family income, but these children are often underemployed in the informal sector in low value-added jobs — result: low development. There is also significant **urbanisation** in many LDCs as people search for better jobs in the cities; however, healthcare and sanitation is severely reduced in the resulting slums, and unemployment increases (**Lewis two-sector model**). Some of the biggest slums in the world are Kibera (in Nairobi, Kenya) and Dharavi in India.
Finance	Many LDCs are laden with **international debt**, on terms that they cannot afford to repay. Many people blame the IMF for making poor lending decisions, others blame incompetence on the part of the borrowing government. Due to corruption in some LDCs, loans have been used to fuel extravagant lifestyles of those in office rather than to improve their country. Pressure groups such as **Jubilee 2000** are trying to persuade governments and the IMF to cancel third world debt. Another problem is **capital flight**. The owners of any extra income that could be saved and therefore used for investment often leave the country in search of higher return for their money; this reduces the growth of capital and therefore economic growth.

Q16 – For one developing country of your choice identify the main factors affecting / limiting its development.

Q17 – What are the main causes of the UK's budget deficit ? See next page

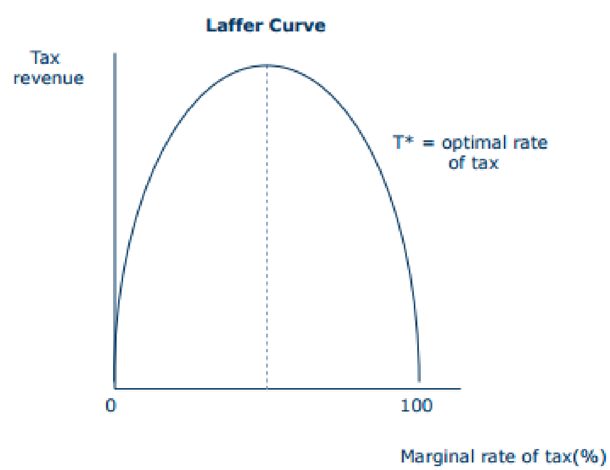
4.3.7 — What is the role of the state in promoting growth and development?

Fiscal policy — any policy concerned with government spending, taxation or government borrowing. If government spending = taxation, there is a balanced budget. An increase in government spending/a fall in tax, causes an increase in AD (expansionary fiscal policy). In the short-run, this can be inflationary, reduce unemployment and increase GDP. In the long run, depending on what the government spends its money on, it can be anti-inflationary, raise employment and cause sustained economic growth (if the LRAS increases due to spending on education for example). The opposite is true of a restrictionist or deflationary fiscal policy.

Budget deficit:

- government spending exceeds tax revenue
- caused by
  - economic recession or slump
  - increase in supply side policy
  - economic shock requiring government response
- funded by rise in current borrowing, to be repaid by increasing future taxes, or issue of gilts
- consequences can include:
  - rise in productive potential of country if spending improves education
  - increased dependency on benefits
  - inflation (and resulting loss in international competitiveness and rise in inequality) although this may be wiped out if the supply side improves and LRAS increases
  - reduced attractiveness for FDI if government seen as incompetent, although could raise FDI if the deficit has led to an improvement in the supply-side etc.

A **budget surplus** is essentially the opposite. Governments are able to pay back loans, raising their creditworthiness. If taxes become too high, governments need to be aware of the **Laffer curve effect**, where tax revenue may begin to fall as people decide that work is not worth the effort to simply pay high taxes.



More key terms:

Automatic stabilisers/automatic fiscal policy — government spending/taxation vary automatically over the course of the economic cycle (eg G rises in a slump due to increased benefit payments and T falls as less people work and spend).

Discretionary fiscal policy — deliberate alteration of G and T.

Progressive taxation — as income rises, a larger % of income is paid in tax (eg UK income tax).

Regressive taxation — as income rises, a smaller % of income is paid in tax (eg VAT).

Proportional taxation — the same % of income is paid in tax, no matter what the level of income.

Direct tax — a tax taken directly from a person's or business' income (eg income tax and corporation tax).

Indirect tax — a tax paid as a result of the purchase of goods or services (eg VAT, excise duties).

The UK's tax system has become more regressive as there has been a shift away from using direct taxes to raise revenue to indirect taxes. This may increase inequality in society. It is difficult to say whether this is the case, however, due to the provision of benefits (particularly means-tested rather than universal). The UK government does very little to manipulate taxes now as it can prove to be very politically unpopular. It is also nearly impossible to 'fine-tune' the economy effectively using fiscal policy.

Reasons for taxation:

- reduce consumption/production of goods with negative externalities
- raise funds to provide public goods eg defence, roads
- fund government
- provide goods with positive externalities such as education and healthcare
- redistribute income, reducing inequality.

The size of the public sector has a direct bearing on the use of fiscal policy. Many developed European countries have 'leftist' governments, and the involvement of the state in provision of services is large. This is also true, however, of China, with its Communist political regime. Many LDCs, however, have a relatively small public sector, and thus fiscal policy is not a significant factor in improving growth or development.

Adam Smith's comments on what makes a good tax:

1. The cost of collection should be low relative to the yield of the tax.
2. The timing of collection and the amount to be paid should be clear.
3. The timing of collection and the means of payment should be convenient to the taxpayer.
4. Taxes should be imposed according to the ability of the taxpayer to pay.

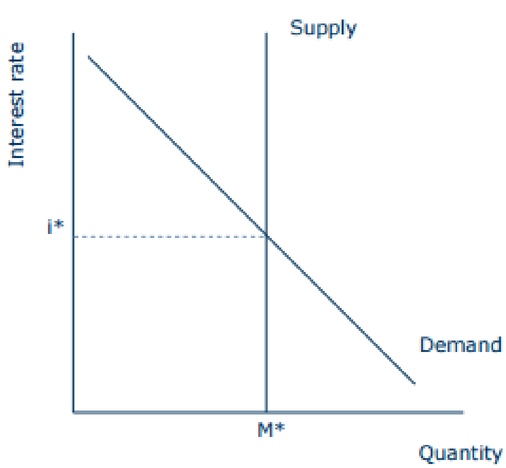
Q18 - Identify at least 3 evaluation points that could be used when assessing the use of fiscal policy in the UK

As globalisation increases, we may also want to add the idea that domestic tax systems should be compatible with foreign ones, so that people and businesses are not tempted to move between countries in search of lower tax rates.

Monetary policy — any policy concerned with manipulation of interest rates, the money supply or exchange rates. The UK, Europe and a number of other countries have independent central banks — this means that they set interest rates in order to control inflation rather than to satisfy political whims. This independence gives their policy more credibility — if people believe that the changes are permanent and correct, then they will adjust their spending more quickly.

Firms and households choose to keep hold of some of their money in order to make transactions more quickly. However, if they keep hold of cash, they are unable to use that money to purchase financial assets which would provide them with interest. So, the opportunity cost, or the price of money, is the interest rate.

The money market



The government cannot control both the money supply and the interest rate. If the government wanted the money supply to be M*, it could either control the money supply and allow the interest rate to adjust automatically to i*, or it could control the interest rate and allow the money supply to adjust automatically to M*.

Control of the money supply itself is extremely difficult, as it is nearly impossible to actually measure the amount of money. So, in the UK, we choose to control the interest rate in order to control inflation.

However, control of inflation is becoming more difficult as the influence of globalisation increases. Domestic causes of inflation include increased government spending, low domestic interest rates (increasing availability of credit), increased business/consumer confidence (perhaps through increased house prices, trust in the government etc. There are also a number of international causes of inflation, which domestic central banks can do less to correct, for example the growth of China has pushed up prices (due to increased demand) of raw materials such as copper and oil — this causes cost-push inflation in the domestic economy. This makes the decisions of policy-makers all the more difficult, as the level of complexity increases, causing more uncertainty about the future.

Evaluation of monetary policy

Strengths	Weaknesses
Stable inflation increases consumer/business/investor confidence, thus allowing economic growth to be more easily achieved	It can take up to two years for the effects of interest rate changes to fully affect the CPI — this is not helpful if there are significant external shocks to the economy
The implications of changes in the interest rate are clear to understand	Just because the Bank of England changes the base rate, doesn't mean that interest rates change for everyone in the economy
It has effects on both AD and AS, so can have short-term and longer-term effects	Affects the exchange rate, which can alter the competitiveness of the economy (although this could be a strength!)
There is clear framework and remit for the MPC, removing political bias	If inflation is primarily cost-push, rather than demand-pull, then a rise in interest rates will increase the costs of businesses as the interest to be paid on their debt increases, which could make inflation worse
Initial effects on consumer and business spending can be fairly rapid, so long as the MPC's decision is credible	In the UK, many poorer people currently face significant debt problems, and already face high interest rates — monetary policy may therefore worsen the distribution of income
Evidence — since 1997, the rate of inflation has been low and steady	We can't calculate the exact effect of a rise in interest rates — data is uncertain and incomplete
Particularly effective in the UK as there is high household debt (high house prices, high borrowing) so changes in interest rates are felt quickly	We cannot attribute the low inflation rates solely to effective monetary policy from the MPC — much of the recent low inflation reflects recession abroad (reducing demand for exports) and falling worldwide commodity prices (with the exception of oil)
	Many businesses borrow their funds overseas, where interest rates are lower, so a rise in interest rates in the UK will have relatively little effect
	Goodhart's Law — this states that economic variables often lose their relationship with other variables once we try to control them

Q19 – Identify what you think are the three most important strengths and weaknesses of Monetary policy in the UK.

Q20 – Are there any other problems with Monetary Policy not listed ? Hint – does it affect everybody the same

<u>Quantitative easing</u> – when government buys debt back early (by repaying bonds and bills early). Effectively means that money enters the financial system which can then be lent out to businesses and consumers by banks and financial institutions.

Supply-side policies — any policy concerned with increasing the quantity or improving the quality of a country's factors of production, in order to increase the productive potential of the country and increase LRAS. Such policies might include improving education so that it is appropriate to the skills required in the modern economy, reducing 'red-tape' for new business start-ups, improving healthcare so that people take less time off sick, teaching entrepreneurship, reducing access to benefits, encouraging increased labour force participation (this latter point is one of the major reasons behind Ireland's growth since joining the EU).

These policies are usually funded through tax revenues — there is therefore a close link between fiscal policy and supply-side policies. Supply-side policies can take several years to have an effect on the economy, and may be inflationary in the short-run as government spending increases. Governments also need to ensure that they are not spending their money on training people in skills that will soon be outdated, since this will then contribute to future structural unemployment.

Key evaluative points for supply-side policies

There is an opportunity cost of spending on education and training. Additionally, how do we know what sort of skills will be needed in several years' time? By the time education programmes have been developed, they may be out of date and inappropriate.

Labour market flexibility is not necessarily desirable from the point of view of many workers — it makes it easier to lose jobs and increases competition for jobs, which can cause stress.

Taking away unemployment benefits does encourage people into work, but care must be taken to protect the vulnerable, who really are not able to work. In addition, benefits must not be so low that people choose to stay in jobs they do not like rather than become frictionally unemployed for a short period in the hope of finding a better job — this would be inefficient.

Care must also be taken not to make the tax system too progressive, as this will discourage highly skilled workers from working harder or being more productive. However, there is a need to prevent high inequality. This is a difficult trade-off to make.

4.3.8 — What other measures can be used to promote growth and development?

Models/theories of growth and development

Harrod-Domar	Now considered an 'old' theory that focuses on the role of investment for growth, this theory states that the rate of growth equals the marginal propensity to save (which provides funds for investment) divided by the capital-output ratio. A problem with this theory is that it doesn't help LDCs to establish a financial system in which savings and investment are possible in the first place.
Rostow's 5 stages of development	The 5 stages of development are: traditional society, precursor to take-off (high savings), take-off, drive to maturity, mass consumption. Again, savings and investment are key. To help LDCs gain enough funds for investment, Rostow suggested that foreign aid could be used.
Lewis 2-sector	This is a structural change model. Lewis said that growth would be achieved by the migration of workers from the rural primary sector to the modern industrial urban sector — this would occur through higher wage incentives. However, despite evidence from current developed economies, this model often seems inappropriate for LDCs, where the population in the urban slums is often unemployed, and would be more productive in the rural sector. This theory also assumes that secondary sector production would be labour-intensive, whereas it is often capital-intensive.
Dependency theory	Lack of growth and development is not the fault of LDCs, but by the conditions under which they operate as a result of their links to MDCs ie ex-colonial rule forcing specialisation in the primary sector, the constraints placed on LDCs as a result of accumulation of debt from 'Western' institutions. However, India's recent growth rates are contrary to this theory.
Market liberalisation/neo-classical theory	The idea here is that by opening up markets (by reducing protectionism etc) and encouraging FDI (MNC activity), LDCs will grow and develop as their goods can be sold on the international market and they benefit from infrastructure development by MNCs. However, many economists argue that this will lead to growth but not necessarily development, as only some people in the LDCs will benefit. The environmental degradation and other negative externalities caused as a result may reduce living standards. The success of this approach also depends on the political climate in the LDC being stable.

Q21 – Which country could you use as an example where tourism has influenced development?

Role of tourism

Many LDCs are increasingly highly dependent on tourism from the developed world as incomes rise. Most LDCs positively encourage tourism because it allows foreign currency to be earned and it is not capital-intensive (therefore not reliant on high investment). However, there may be significant negative externalities resulting from tourism growth, eg use of clean water for tourists not locals, expansion of airports causing pollution and loss of farmland etc. The Kingdom of Bhutan, in the Himalayas, aims to tackle this problem by taxing tourists heavily for every night they spend in the country.

Microfinance

The lack of extensive financial infrastructure in many LDCs is an inhibitor to development. Microfinance allows people in LDCs to borrow small amounts of money from local lenders — much of this business is now conducted using mobile telephones, which have leapfrogged landlines in many LDCs. The idea is that local but poor entrepreneurs will be able to set up small businesses, and go on to employ other local people — a sort of 'grassroots' approach to development. Debtors must be sure, however, that their micro-creditor does not charge extortionate interest — given a lack of education in many LDCs, this may prove difficult.

Debt relief

Many LDCs hit a 'debt crisis' in the 1980s and 1990s, as they could not afford to pay the interest on their large debts to international financial institutions. This was a combination of interest rates rising and the value of the dollar rising (and most loans were agreed in terms of US dollars). Latin American countries and many African countries were amongst the worst hit — Mexico defaulted on its loans first, and others followed suit. This meant that these countries were then unable to borrow. The massive debts that they had to repay meant that governments of these countries were unable to invest in human capital or other infrastructure necessary for growth and development. Initially, the IMF set up Structural Adjustment Programmes, where it would lend the debtors money to pay off their original debts, but on strict conditions with respect to fiscal policy and trade policy. These were very unpopular. One solution is debt forgiveness, where the loans are essentially cancelled — many lenders do not want to do this. An alternative is debt rescheduling, where the repayment terms are altered. Jubilee 2000, a pressure group, actively campaigns for debt cancellation.

Foreign aid

This is increasingly multilateral (between many countries), rather than bilateral (between two countries), which reduces the restrictions under which aid is provided. There are different types of aid, ranging from humanitarian aid (such as food and shelter, in times of emergency), to grants (sums of money that do not need to be repaid) and loans (money that should be repaid). Whilst many in the developed world see aid as a positive thing, much of the aid is squandered on projects that will not contribute to development, or are duplicated by different aid agencies who do not communicate with each other, or even spent by corrupt governments on themselves in the LDCS. If humanitarian aid is continued for a long period, then people become overly dependent on it, and forget their own skills — this has happened in Ethiopia. Many of the most needy do not get any aid; much of it is channelled into those projects which have captured the global media interest. As mentioned earlier, dependency theory suggests that provision of aid can reduce the level of development in an LDC.

Fairer trade

The WTO works towards reducing protectionist policies. Many LDCs argue that they need to protect their economies however, as they cannot afford to compete with the subsidies provided to the agricultural sectors in developed economies, such as the CAP in the EU. Many LDCs are unable to sell their mainly primary sector products abroad because of protectionism in the developed world. The Fair Trade movement is one way in which farmers in LDCs are supposed to benefit, thus improving development. This guarantees farmers a certain income, so that they are not subject to monopsony purchasing power from developed countries, particularly with respect to coffee, cocoa and cotton. However, there are often a significant number of 'middle men' involved, reducing the benefits that fair trade farmers receive. Additionally, not every farmer in every LDC benefits — many are unaware of the scheme, and many are not able to afford the membership fees that are required. Some cynical people argue that the Fair Trade movement is just a means of making people in the developed world 'feel better' about their position in relation to those in LDCs.

Q22 – How has the world recession affected – foreign aid
- fairer trade?