AQA Economics A-level
Macroeconomics

Topic 3: Economic Performance

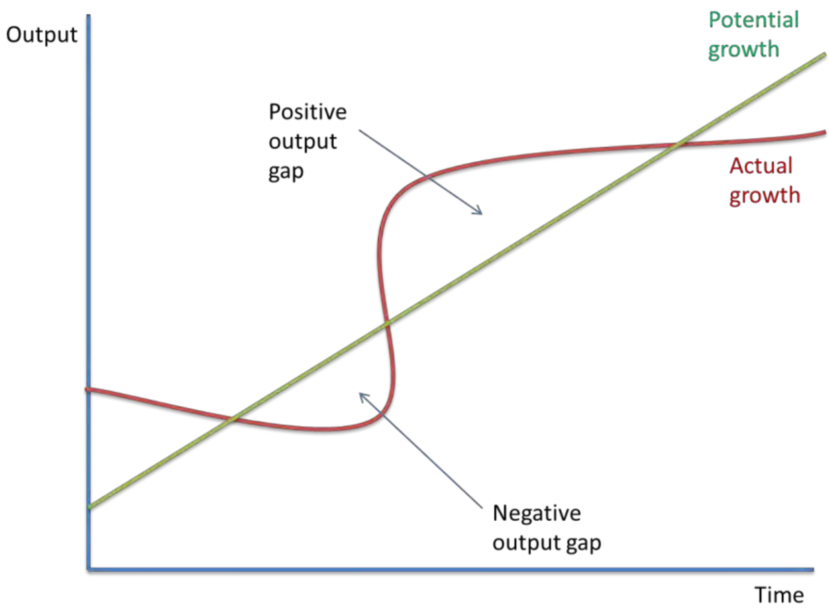
3.1 Economic growth and economic cycle

Notes

The difference between short run and long run growth

- **Short run growth** is the percentage increase in a country's real GDP and it is usually measured annually. It is caused by increases in AD.
- **Long run economic growth** occurs when the productive capacity of the economy is increasing and it refers to the trend rate of growth of real national output in an economy over time. It is caused by increases in AS.
- The potential output of an economy is what the economy could produce if resources were fully employed.

Positive and negative output gaps:



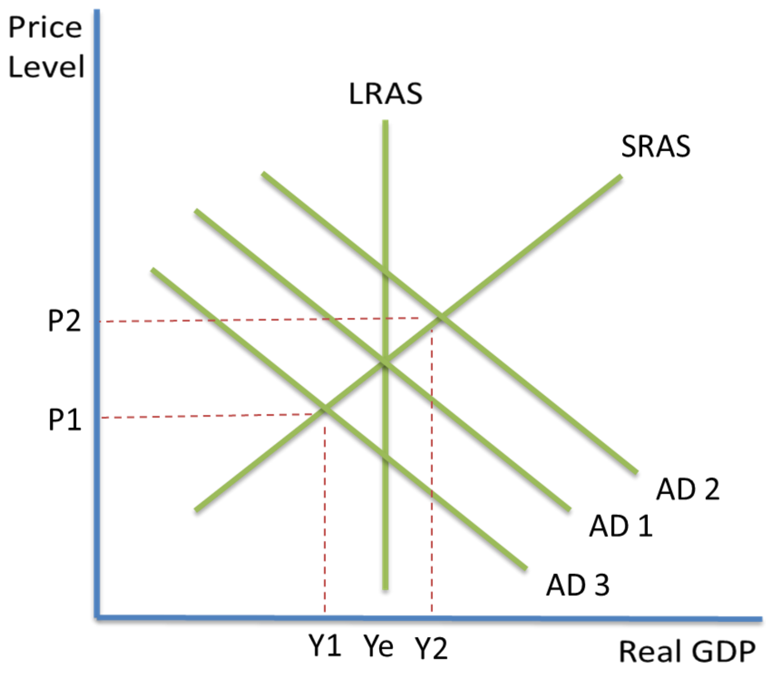
- An output gap occurs when there is a difference between the actual level of output and the potential level of output. It is measured as a percentage of national output.

- A **negative output gap** occurs when the actual level of output is less than the potential level of output.
  This puts downward pressure on inflation. It usually means there is the unemployment of resources in an economy, so labour and capital are not used to their full productive potential. This means there is a lot of spare capacity in the economy.

- A **positive output gap** occurs when the actual level of output is greater than the potential level of output.

It could be due to resources being used beyond the normal capacity, such as if labour works overtime. If productivity is growing, the output gap becomes positive. It puts upwards pressure on inflation.
Countries, such as China and India, which have high rates of inflation due to fast and increasing demand, are associated with positive output gaps.

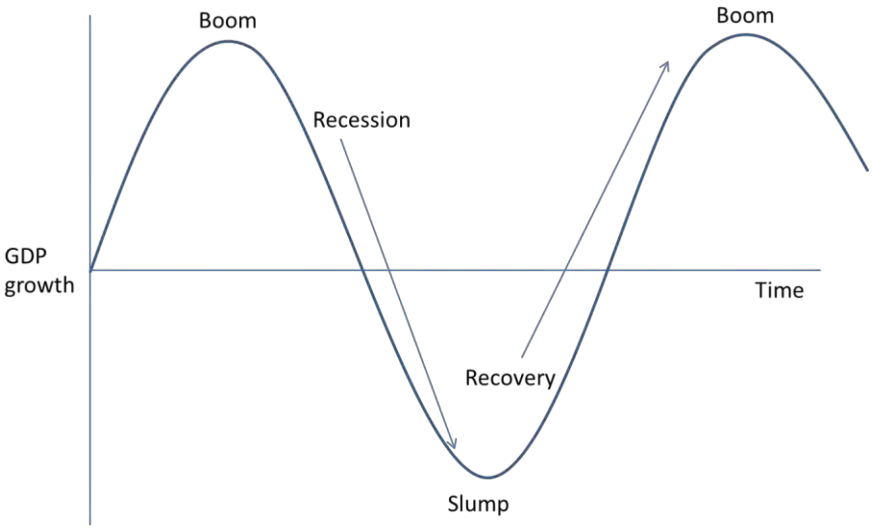
Illustrating an output gap:



Classical economists believe markets clear in the long run, so there is full employment. They believe there are output gaps in the short run. A negative output gap is between Ye and Y1, and a positive output gap is between Ye and Y2.

The business cycle:

- This refers to the stage of economic growth that the economy is in.
- The economy goes through periods of booms and busts.



- Real output increases when there are periods of economic growth. This is the recovery stage.
- The boom is when economic growth is fast, and it could be inflationary or unsustainable.
- During recessions, the real output in the economy falls, and there is negative economic growth.
- During recessions, governments might increase spending to try and stimulate the economy. This could involve spending on welfare payments to help people who have lost their jobs, or cutting taxes.
- During periods of economic growth, governments may receive more tax revenue since consumers will be spending more and earning more. They may decide to spend less, since the economy does not need stimulating, and fewer people will be claiming benefits.

Characteristics of a boom:

- High rates of economic growth
- Near full capacity or positive output gaps
- (Near) full employment
- Demand-pull inflation
- Consumers and firms have a lot of confidence, which leads to high rates of investment
- Government budgets improve, due to higher tax revenues and less spending on welfare payments

Characteristics of a recession:

- In the UK, a recession is defined as negative economic growth over two consecutive quarters. The characteristics are:

- Negative economic growth
- Lots of spare capacity and negative output gaps
- Demand-deficient unemployment
- Low inflation rates
- Government budgets worsen due to more spending on welfare payments and lower tax revenues
- Less confidence amongst consumers and firms, which leads to less spending and investment

The costs and benefits of economic growth:

	Costs	**Benefits**
Consumers	Economic growth does not benefit everyone equally. Those on low and fixed incomes might feel worse off if there is high inflation and inequality could increase. There is likely to be higher demand-pull inflation, due to higher levels of consumer spending. Consumers could face more **shoe leather costs,** which means they have to spend more time and effort finding the best deal while prices are rising. The benefits of more consumption might not last after the first few units, due to the **law of diminishing returns,** which states that the utility consumers derive	The average consumer income increases as more people are in employment and wages increase. Consumers feel more confident in the economy, which increases consumption and leads to higher living standards.

	from consuming a good diminishes as more of the good is consumed.	
Firms	Firms could face more **menu costs** as a result of higher inflation. This means they have to keep changing their prices to meet inflation.	Firms might make more profits, which might in turn increase investment. This is also driven by higher levels of business confidence. Higher levels of investment could develop new technologies to improve productivity and lower average costs in the long run. As firms grow, they can take advantages of the benefits of economies of scale. If there is more economic growth in export markets, firms might face more competition, which will make them more productive and efficient, but it will also give them more sales opportunities.
The government	Governments might increase their spending on healthcare if the consumption of demerit goods increases.	The government budget might improve, since fewer people require welfare payments and more people will be paying tax.

Current and future living standards	High levels of growth could lead to damage to the environment in the long run, due to increase negative externalities from the consumption and production of some goods and services.	As consumer incomes increase, some people might show more concern about the environment. Also, economic growth could lead to the development of technology to produce goods and services more greenly. Higher average wages mean consumers can enjoy more goods and services of a higher quality. Public services improve, since governments have higher tax revenues, so they can afford to spend on improving services. This could increase life expectancy and education levels.

The causes of cyclical instability

The sustainability of economic growth

Growth is sustainable when the rate of economic growth can be maintained in the long run, so future generations can enjoy the same rate of growth.

Fast economic growth today could mean that natural resources, such as oil, might deplete, which would create environmental problems for future generations, and mean the future rate of growth might be weak.

Unsustainable growth occurs around the boom and bust sections of the business cycle. These are essentially deviations from the trend rate of growth.

If growth is excessive, there could be inflation in the average price level, wages and assets. There could be excessive credit, which is unsustainable in the long run, and the savings rate might be low and falling.

Excessive growth in credit and levels of debt

Growth that is financed by public debt might not be sustainable. It might be difficult to pay it back in the future, and it does not contribute to improvements in productivity. By being more productive, growth is likely to be more sustainable. This is since it increases the economy's productive capacity, so there is more room to grow.

Asset price bubbles

A market bubble occurs when the price of an asset is predicted to rise significantly. This causes it to be traded more, and demand exceeds supply so the price rises beyond the intrinsic value. The bubble then 'bursts' when the price steeply and suddenly falls to its ordinary level. This causes panic and investors try and sell their assets.

It results in a loss of confidence and it can lead to economic decline or a depression.

Destabilising speculation and animal spirits

Destabilising speculation leads to changes in the price level in a market, as a result of speculation. Speculators purchase assets when they believe the price is likely to appreciate. Conversely, assets are sold when the price is believed to depreciate. This can affect the actual price of assets in an economy.

Keynes coined the term **animal spirits** when describing instincts and emotions of human behaviour, which drives the level of confidence in an economy.

If firms expect a high rate of return, they will invest more. Firms need to be certain about the future, otherwise they will postpone their investments.

Expectations about society and politics could affect investment. For example, if a change in government might happen, or if commodity prices are due to rise, businesses may postpone their investment decisions.

Herding

Herding is the act of reacting to the behaviour of other economic agents rather than the market. This might be because some investors think other economic agents are better informed about the market, so they follow their actions. This can cause instability in the market.