Economics AS-level

Macroeconomics

Contextual Analysis

Contents

1. How the Macroeconomy Works

Determinants of Aggregate Demand (AD)

Consumer spending (C):

- Increase - when the Trump Administration announced **tax cuts** in 2018 for American households and firms, this increased **disposable income** for consumers across the US. This therefore increased their **marginal propensity to consume**, so shifted the AD curve to the right, and contributed to the economic expansion America was experiencing during this period.

- Decrease - due to the coronavirus pandemic, countries all over the world have experienced the highest **unemployment rates** seen in decades, as a result of national lockdowns which have forced non-essential shops to close and have disproportionately affected the hospitality sector. With fears of redundancy in the US, for example, the **marginal propensity to save** has increased, which has therefore shifted the AD curve leftwards. As shown diagramatically, this has contributed to the **recession** the US is currently experiencing in 2020, due to the reduction of GDP from Y2 to Y1.

Investment (I):

- Increase - despite the coronavirus pandemic that has crippled economies across the planet, China has proved itself resilient as the only country in the **G20** projected to see positive economic output at the end of 2020. China also plan to expand their **Belt and Road Initiative (BRI)** and implement their new **Dual Circulation Strategy**. It is clear covid-19 has accelerated the shift in power from the West to the East, which has simply attracted more and more people to invest their money in Chinese firms.

- Decrease - **Brexit** has deterred investors from the UK ever since the EU referendum in 2016. The multiple deadline extensions, fears of a no-deal Brexit and Boris Johnson's tactic to override parts of the international treaty in September 2020 has created more **uncertainty** surrounding the future of an independent UK. In the event of a no-deal Brexit, the UK would be forced to trade on the terms of the World Trade Organisation (WTO). This

would result in much larger tariffs on UK exports, significantly damaging GDP and thus discourage risk-averse investors from channelling their funds into the UK.

Government spending (G):

- Increase - the UK government has planned to spend millions to introduce the new **T-level** courses starting in September 2020. These are 'technical based qualifications', available to 16-18 year olds that last 2 years long and are equivalent to 3 A-level grades. By spending more on vocational training, the government is helping students find jobs easier by equipping them with the relevant industrial skills. Not only will this increase **AD**, but will also shift out the **LRAS** curve, as T-levels are a form of Training and Education (**T&E**).

- Decrease - in 2010, Greece's **public debt-to-GDP ratio** reached 146%, and was eventually bailed out by the eurozone, who forced the government to adopt **austerity** measures. This meant cutting back spending on services such as healthcare and **education**, which contributed to the fall in **AD** that Greece experienced at the time.

Net exports (X-M):

- Increase - in November 2020, the largest ever **Free Trade Agreement** (FTA) was signed. The Regional Comprehensive Economic Partnership (RCEP) covers a market of nearly 2.2 billion people, with the notable member countries being Australia, China, Japan and South Korea. With the **bloc** covering 28% of **global exports**, members will experience a smoother flow of **trade** and investment, and therefore benefit from a boost in net exports.

- Decrease - as mentioned above, with China projected to come out of 2020 the strongest, demand for the **Yuan** (¥) has grown with more overseas **investors** praising the country's response to covid-19. A strong **exchange rate** would, however, make exports dearer but imports cheaper and so, in theory, reduce the net exports of the economy.

Determinants of Short-run Aggregate Supply (SRAS)

Cost of employment:

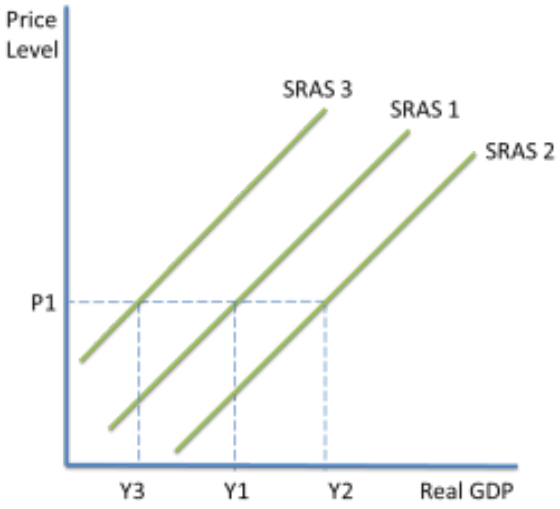
- Increase - during peak seasons at airports (i.e. Christmas), airport baggage handlers are most likely to go on strike with demands for higher wages, as this is the period when airports cannot afford any delays in flights. A rise in **wages** increases the **cost of production** for firms, and therefore shifts the SRAS curve left, from SRAS 1 to SRAS 3.

- Decrease - due to national lockdowns to prevent the spread of coronavirus, the UK government has implemented a **furlough scheme**, which **subsidises** wage bills as 80% of

monthly salaries are covered by the government, with the remaining 20% covered by employers. This should lower the **cost of production** for firms, shifting the curve from SRAS 1 to SRAS 2.

Cost of raw materials:

- Increase - in 1973, the Organisation of Petroleum Exporting Countries (**OPEC**) imposed an oil embargo against the United States due to geopolitical factors in the Middle East. As the country was very reliant on **oil** at that time, and that OPEC controlled roughly 75% of the global supply, an embargo forced the price of oil upwards, which increased the **cost of production** for many firms.



- Decrease - as the issue of **climate change** is becoming increasingly clear, people have started the transition to becoming 'greener', and leaving less harmful impacts on the planet, e.g. through the use of **renewable energy** sources such as wind and solar, as opposed to coal and natural gas. As mentioned above, by shifting away from non-renewable energy sources, countries are less reliant on **OPEC** for oil, as multiple alternatives are available. This in turn reduces the overall cost of production for firms, shifting the curve from SRAS 1 to SRAS 2.

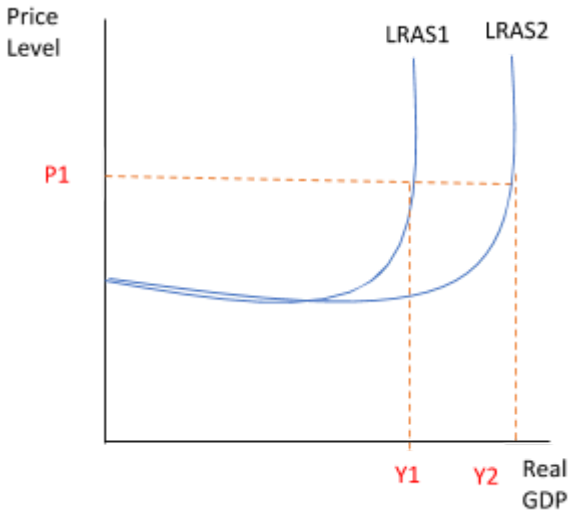
Government regulation:

- The European Union has pledged to become **climate-neutral** by 2050, and in order to achieve this goal, they plan to implement a Border Carbon Adjustment (**BCA**) mechanism by 2022. This is effectively a tax levied on imports that are not produced by environmentally-friendly methods. Firms will therefore either have to pay the tax, or invest in 'green' technology to exempt themselves from it. Either way, firms will see an increase in **cost of production**. As more countries pledge to cut harmful emissions, similar policies will be introduced, to which firms will have to adapt to.

Determinants of Long-run Aggregate Supply (LRAS)

Technological advances:

- In 2015, China made a ten-year plan, "Made in China 2025", to expand their high-tech sectors in order to become a "manufacturing superpower". This involves Research & Development (**R&D**) **subsidies** in the aviation industry, railway equipment, Information Technology, etc. As shown in the diagram, this will shift the LRAS curve to the right, expanding output to Y2 whilst still maintaining the price level at P1.



Changes in relative productivity:

- **Government intervention** (as a result of covid-19), has triggered low **interest rates** and easier access to **credit**, i.e. loans. From this, we have seen a rise in '**zombie firms**', broadly defined as unproductive businesses. If not also for the **furlough scheme** that has subsidised wage bills, the pandemic would have forced these firms into insolvency, but being able to obtain loans easily has kept these uncompetitive firms going. This damages the overall **productivity** of the UK economy, as 'zombie firms' have little incentive to invest in **R&D**. With the pandemic projected to become a long-term issue, more government intervention could further prevent these 'zombie firms' from entering insolvency.

Changes in education and skills:

- As previously mentioned, the new **T-levels** introduced to 16-18 year olds will increase the quality of **human quality**, as the younger generation will be equipped with the skills that potential employers are looking for. This will shift the LRAS curve to the right, boosting the **productive capacity** of an economy.

Competition policy:

- The "Airline Deregulation Act" was passed by Congress in 1978 to effectively remove '**red tape**' in the aviation industry by no longer allowing the U.S. government to control air routes or fares. This allowed more firms to enter the market, which increased **competition** due to the presence of a **profit-motive**.

2. Economic Performance

The causes of unemployment

- Structural unemployment - Due to **technological advances** across a wide range of industries, a high proportion of jobs are at risk of automation. For example, in the automotive industry an increasing number of workers are at risk of **redundancy** from the introduction of robots and machines to perform the same jobs at a fraction of the **cost**. This is classed as structural unemployment because the redundant workers will most likely have no qualifications or **training** in other industries.

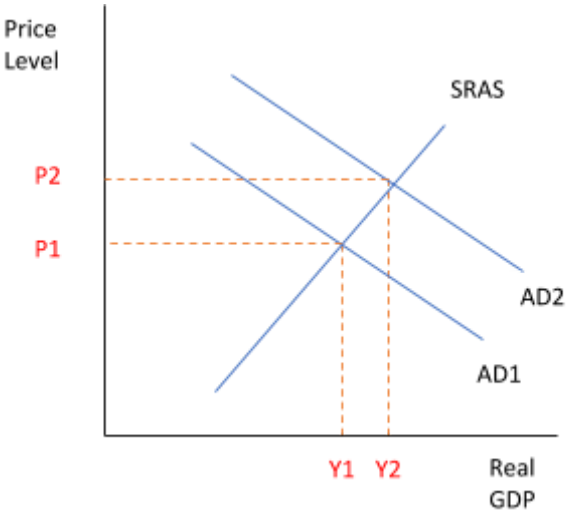
- Structural unemployment - The coronavirus pandemic has forced the UK government to impose multiple national lockdowns over the course of 2020, which has forced people to work from home, if possible. As many jobs in London are **service based** (investment banking, trading, etc.), adapting to this hasn't been an issue as Londoners can work from their home computers. However in the North, a large proportion of jobs are based in the **manufacturing industry**, where it isn't possible to work from home. This links in with **geographical immobility** of labour, as Northerners are unable to travel to work, so are at risk of unemployment. This has also widened the **North-South divide**, with the UK now having the most regionally unbalanced economy in Europe (see notes).

- Seasonal unemployment - **Christmas** is classed as a 'peak season' for firms across many industries. For example, during this 'peak season', Amazon employs temporary workers to cope with the large rise in demand for goods. But these workers would then be laid-off in January.

- Cyclical unemployment - Covid-19 has accelerated the increase in **cyclical unemployment** for those working in the hospitality sector, as these services are classed as non-essential. Government-imposed lockdowns have therefore forced these firms into insolvency, such as pubs and leisure centres, due to a lack of demand from **consumers**.

The causes of inflation

- Demand-pull - Around the christmas period, countries experience **seasonal inflation**, as a result of high demand for goods. As the AD curve shifts to the right, the price level increases from P1 to P2, and economists refer to this period as "**Santa's rally**".



- Cost-push - Talks of a '**great decoupling**' between China and America have grown, as tensions between the world's two largest economies become more apparent. By no longer integrating itself with East, American firms have lost the benefit of low prices for raw materials, as they must now look for alternatives. This cumulatively raises the cost of production for firms, which will be passed on to consumers in the form of **higher prices**.

- During the 1973 oil crisis - whereby **OPEC** imposed an oil embargo on the U.S. - the American economy experienced an increase in **inflation**. This is because oil was a major raw material for most firms, and so a sudden reduction in the supply of it sent the **costs of production** soaring, which firms dealt with by charging consumers higher prices, hence a higher rate of inflation.

The balance of payments on current account

- In November 2020, the World Trade Organisation (**WTO**) allowed the EU to impose **tariffs** on nearly $4 billion of US goods, as a result of the unlawful **subsidies** the U.S. granted to Boeing. Airbus and Boeing (the aviation **duopoly**) are based in Europe and America, respectively. These new tariffs will widen the U.S. **current account deficit**, as the economy will experience more **outflows** of money in order for firms to pay the EU tariffs.

- Being a global leader in innovation, Germany has a considerable current account surplus. One of the driving forces behind this is its low prices (as a result of **R&D** subsidies), which has triggered a boost in **exports**, and Germany is home to many natural resources, so there is little need for **imports**.

- Covid-19 has disrupted global **supply chains** due to national lockdowns and countries closing their borders to outsiders. This has triggered the shift towards more '**domesticated**'

supply chains, which would make countries less prone to **economic shocks** from overseas. One potential implication of this is that current accounts will now be less dependant on the economic conditions of other countries.

Possible conflicts between macroeconomic policy objectives

Economic growth vs the environment:

- As climate change is becoming more of a priority for global leaders, more measures will be implemented to prevent the effects on the environment. But the **trade-off** between the two is becoming increasingly clear. For example, the 2006 Stern Report suggests that climate change is costing the world 20% of **GDP** every year. Governments around the world are being forced to sacrifice economic growth to save the environment. For example, the EU Emissions Trading Scheme (**ETS**) adopts a "cap and trade" approach, whereby firms are capped on how much harmful gases they can emit. Unless firms adapt to these policies, they are at risk of insolvency, which will harm **GDP growth**.

Unemployment vs inflation:

- In 1958, William Phillips plotted a graph of inflation against unemployment for the years that led up to that date, and noticed an inverse correlation between the two indicators. This was named the **Phillips curve** (see notes), and has been used by economists ever since. As unemployment goes down (i.e. more people are in work), the demand for goods and services rises so that prices eventually follow - hence higher inflation. Conversely, as unemployment increases, more people save and inflation falls. However, occasionally there have been periods of high unemployment complemented with high inflation, like seen during the 1970's. This is referred to as **stagflation**, and is frowned upon by many economists as it triggers deep recessions.