CIE Economics A-level

Topic 4: The Macroeconomy

a) Economic growth, economic development and sustainability

Notes

Economic growth, development and sustainability

Economic growth is the increase in a country's real national output. This is caused by increases in the quality or quantity of factors of production, which cause an outward shift in the PPF.

Economic development refers to living standards, freedom (from oppression) and life expectancy. Essentially, it covers a more moral side to economic growth and it is normative. Development is also concerned with how sustainable the economy is and whether the needs of future generations can be met.

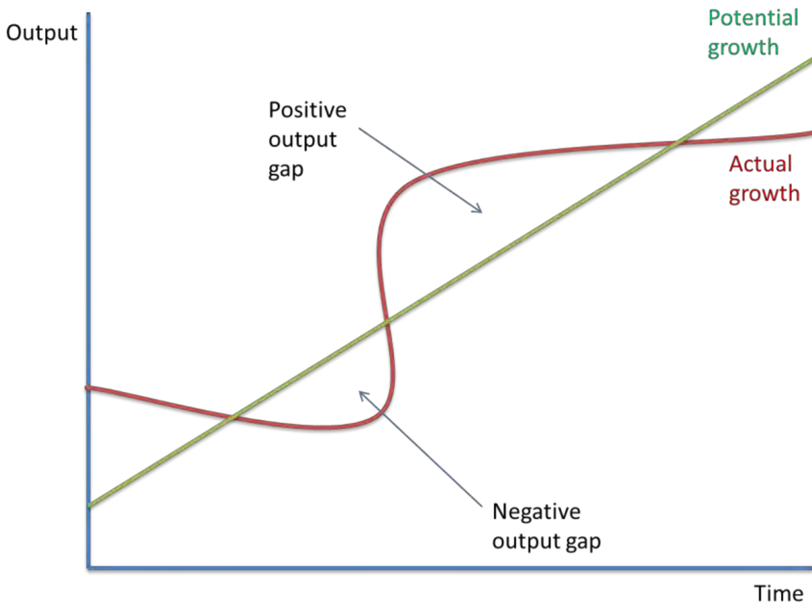
Sustainability is a concept that suggests resources, such as the environment, have to be used effectively and efficiently, so they can be maintained for future generations.

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.

Actual versus potential growth in national output; output gap; business (trade) cycle

- **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:**

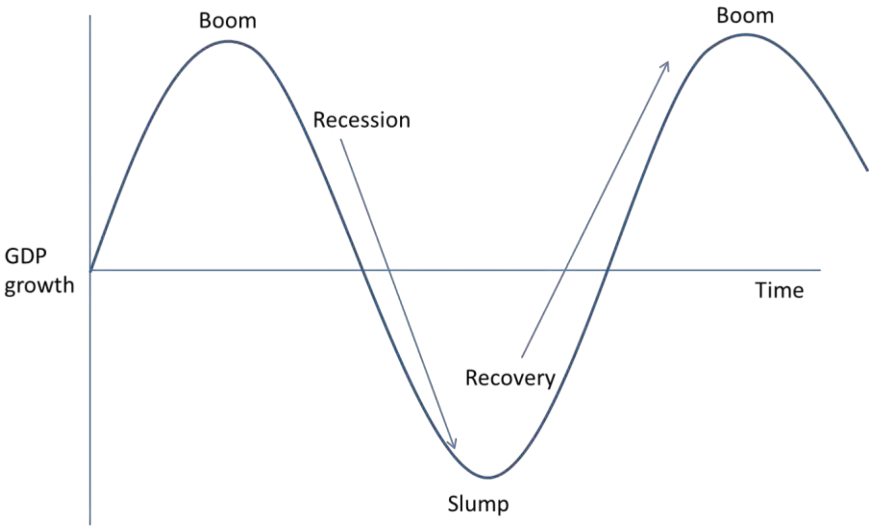


- An output gap occurs when there is a difference between the actual level of output and the potential level of output. It is measured as a percentage of national output.

- 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.

- **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

Factors contributing to economic growth

- **Trade liberalisation**

  Free trade is the act of trading between nations without protectionist barriers, such as tariffs, quotas or regulations. World GDP can be increased using free trade, since output increases when countries specialise. Therefore, living standards might increase and there could be more economic growth.

- **Promotion of FDI**

  FDI is the flow of capital from one country to another, in order to gain a lasting interest in an enterprise in the foreign country.

  FDI can help create employment, encourage the innovation of technology and help promote long term sustainable growth. It provides LEDCs with funds to invest and develop.

- **Microfinance schemes**

  Microfinance involves borrowing small amounts of money from lenders to finance enterprises. It increases the incomes of those who borrow, and can reduce their dependency on primary products. There could be a multiplier effect from the investment of the loan.

  They are small loans for usually unbankable people. It allows them to break away from aid and gives borrowers financial independence. In Bangladesh, 95% of microfinance cohorts are women.

Microfinance loans detach the poor from high interest, exploitative loan sharks. They could help businesses to be set up, although the money could also be spent on immediate consumption, rather than investment. Since the money goes directly to SMEs, it can stimulate employment.

However, the data collected on microfinance loans might not be reliable if there is dishonesty regarding where the money was spent.

In Tamil Nadu, India, less than 2% of microenterprises were still operating after their establishment.

Microfinance loans have high repayment rates.

- **Privatisation**

  This means that assets are transferred from the public sector to the private sector. In other words, the government sells a firm so that it is no longer in their control. The firm is left to the free market and private individuals.

  Free market economists will argue that the private sector gives firms incentives to operate efficiently, which increases economic welfare. This is because firms operating on the free market have a profit incentive, which firms which are nationalised do not.

  Since they are operating on the free market, firms also have to produces the goods and services consumers want. This increases allocative efficiency and might mean goods and services are of a higher quality.

  By selling the asset, revenue is raised for the government. However, this is only a one-off payment.

- **Development of human capital**
  By developing human capital, the skills base in the economy would improve. This would improve productivity and allow more advanced technology to be used, since workers will have the necessary skills.

  Businesses struggle to expand where there are skills shortages. It also limits innovation.

  Primary school enrolment has increased from about 80% to around 90% of children. However, secondary and tertiary education enrolment is still low.

By developing human capital, the country can move their production up the supply chain from primary products, to manufactured goods and to services, which can earn them more.

- **Infrastructure development**

Examples of physical infrastructure include transport, energy, water and telecommunications.

Higher supply costs delay businesses and it reduces the mobility of labour.

For example, India's poor irrigation system makes it difficult to sustain food grain production if there is low rainfall. It hurts the poorest communities and it leads to rising food prices. There are also regular power cuts. The lack of a continuous supply of electricity affects transport, communication and healthcare. It is estimated that $400 billion needs to be invested in power to meet the development goals.

The Asian Infrastructure Investment Bank (AIIB) is led by China and it funds Asian energy, transport and infrastructure. The UK is one of the founding members, along with Germany, Australia and South Korea. The UK's involvement should give British firms an opportunity to invest in fast growing economies.

Infrastructure development is a top priority for the Chinese government. From the late 1990s to 2005, 100 million Chinese people benefited from improved power and telecommunications. Employment can be boosted with improved roads, railways and airport constructions. However, some remote areas still have non-mechanised means of transport.

Some economists argue that the development gap between China and other emerging economies is due to its focus on infrastructure projects. China invested 9% of their GDP in infrastructure in the 1990s and 2000s, whilst most emerging economies only invested around 2%-5% of GDP.

China has the first and only high speed Maglev train system in the world between the city centre in Shanghai and its international airport. Some economists might argue that is it unnecessary to build more airports, since there are already almost 200 airports in China and about 80% of people live within 100km of an airport in China. There is an opportunity cost of not investing funds elsewhere.

More information on the AIIB can be found here:

http://www.bbc.co.uk/news/business-31867934
http://www.bbc.co.uk/news/business-31921011

- **Development of tourism**

  Tourism can create thousands of jobs and help shift a developing country away from dependency on primary products. Developing countries tend to have a marginal propensity to consume, which could create a multiplier effect.

  It helps to diversify the economy and it could make the country more attractive to FDI, as well as developing their infrastructure.

  Tourism accounts for 6% of world trade and 9% of global GDP. For LDCs, about 8% of exports are from tourism. It is one of the largest and fastest growing sectors in the world. Since it is an outward-looking policy, it is considered a more modern way to grow an economy, and the benefits are similar to those of free trade.

  Tourism can also be a way of earning foreign currency for developing countries. The low technology and labour intensive work in tourism is suited to LDCs.

  However, little revenue is retained in the country, since travel agents and hotel owners are likely to repatriate their profits. Moreover, there is the issue of overcrowding and the loss of habitats.

  Income from tourism is likely to be unstable, since it relies heavily on the business cycle in developed countries.

  Investing in tourism can be risky and expensive, however. States have to focus where tourism is attracted, such as transport, land availability and improving infrastructure.

  Locals could feel stigmatised by tourism, especially if they cannot afford the luxuries that the tourists have. There could also be some environmental damage, such as pollution.

  Sri Lanka is trying to develop its tourism industry by building more hotels. It is expected that $1 billion of revenue could be made. It requires very good infrastructure, such as roads and electricity.

- **Development of primary industries**

  Some developing countries have an abundance of raw materials, so some governments might choose to exploit this advantage and develop the industry so the country can have a comparative advantage in its production.

  Moreover, primary industries, especially those allied to farming, form the livelihoods of the bulk of the population. It is sometimes the only source of income for most families. Therefore, it is important that the industry is supported.

- **Fairtrade schemes**

  Fairtrade schemes ensure that farmers can receive a fair price for their goods. Supermarkets buy a guaranteed quantity at a price above the market equilibrium. This helps farmers since they have a guaranteed income and certainty about their sales, so they can plan for the future.

  Fairtrade can help support community development and social projects, as well as ensuring working conditions meet a minimum standard.

  It encourages sustainable production, promotes environmental protection, and stops the use of child labour.

  Critics say the impact of Fairtrade schemes is insignificant. They argue that Fairtrade is simply a psychological influence on consumers in developed countries, who believe they are helping by buying Fairtrade goods. Fairtrade could distract from other policies and development, and it could make producers not part of Fairtrade worse off. This is since it divides the market into Fairtrade and non-Fairtrade markets. It could be argued that by distorting price signals, Fairtrade is less efficient.

  Fairtrade increases the price of goods such as Cocoa and bananas. This encourages farmers to produce more, which increases their supply. The Fairtrade farmers still get their minimum price, but those not on Fairtrade have to deal with a lower market equilibrium price, due to the increase in supply.

  Fairtrade could make farmers reliant on the sale of their produce, but it promotes self-sufficiency and encourages them to be independent. It has its limitations, but it provides a sense of community, working with farmers, rather than for them.

- **Aid**

  Africa has been a top recipient of Chinese aid. By the end of 2009, it received 45.7% of China's cumulative foreign aid. It is important as a policy instrument for China with engagement with Africa.

  Consumers in LEDCs have a higher propensity to consume than save, due to their limited incomes. Capital inflows, including those in the form of aid, can help fill this savings gap.

Aid provides temporary assistance to a country, such as humanitarian aid offered to countries after conflicts or natural disasters. Aid could also be a grant for a project that a country might not have the funds for.

Aid could be used to reduce human capital inadequacies or to pay off debt. It can improve infrastructure, which can help make the country more productive.

However, the benefits of aid are limited by corrupt leaders, the size of the aid payment and the potential for the recipient country to become dependent on aid.

Dambisa Moyo and Jeffrey Sachs are two prominent economists who have looked at the effects of foreign aid. Dambisa Moyo is generally against aid, whilst Jeffrey Sachs is generally pro-aid. It is worthwhile to have a look at some of their research and ideas. To briefly summarise, two of Moyo's arguments are that corruption means aid does not go where it is intended and that dumping goods, such as mosquito nets, into a country means private firms cannot compete and are forced out of business. Sachs suggests that it is possible for rich countries to meet the UN MDG of investing 0.7% of GDP into developing countries, which can help them improve infrastructure, yet this target is not being met.

- **Debt relief**

Debt relief is the partial or total forgiveness of debt.

In developing countries, debt is considered to be a principal cause of poverty, since it causes human suffering and misery, and it hampers development.

With high levels of debt, financial resources are diverted from infrastructure, education and healthcare. The country's ability to pay the debt, not the size, is most important. If a country defaults on its debt, it can make it hard to borrow more money in the future.

Debt forgiveness can allow a country to import more and increase the population's standard of living. It improves government finances, so public services could be funded instead.

However, if debt is forgiven, it could encourage more borrowing in the future. Moreover, there could be corruption.

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 from consuming a good diminishes as more of the good is consumed.	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.
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.