Edexcel Economics (A) A-level

Theme 2: The UK Economy - Performance and Policies

2.5 Economic Growth

Detailed Notes

2.5.1 Causes of Growth

Causes of economic growth:

For economic growth to occur, there needs to be an **increase in quality or quantity of one of the four factors of productio**n: land, labour, capital or enterprise, or these being used more **efficiently.** All economists agree that an increase in LRAS will increase the potential level of output in an economy. Any factor which increases the LRAS, will also increase economic growth.

- **Land:** The discovery of new resources e.g. oil will increase economic growth. Economists argue that developing countries tend to grow the most from exploiting new resources, whilst they do not have a significant effect in developed countries. Saudi Arabia has experienced large growth rates almost purely because of their discovery of oil and without this it is likely they would still be developing.

- **Labour:** An increase in the quality or quantity of labour will improve economic growth.
  - **Size of the workforce:** Changes in the size of the workforce can come from immigration, demography (age profile) of the country or participation rates. A change in the age profile of the population i.e. the amount of people of working age will affect economic growth: the more people of working age there are, the more growth there will be. Raising the retirement age will increase the population of working age. The government can take action such as providing free childcare to encourage mothers to go back to work, which will increase participation rates. Immigration can be vital in enabling economic growth if it provides potential workers with the skills, knowledge and desire to work within the country. On the whole, the larger the workforce the more goods and services that can be produced.
  - **Quality of the workforce:** In the long run, improving the quality of labour is perhaps more important; this can be done through education. Improved education will improve labour quality as it will mean that workers have all the skills they need and are more efficient, so output per worker increases. More skilled workers will also be less likely to suffer from structural unemployment as they will have greater occupational mobility and so this will increase the output of the economy as there are less unused resources. Additionally, more skilled workers will be able to contribute to change i.e. new technology, business ideas, innovation etc. and this will help to improve economic growth.

- **Capital:** If a country receives sustained investment, they will be able to access or develop new technology which will enable the country to improve productivity. It will also mean more machines can be bought and used, even if these are not a technological advancement, so more goods can be produced. Not all investment will lead to increased GDP because some investment is unsuccessful whilst it is argued that other investment doesn't increased GDP because of its nature e.g. building houses.

- **Enterprise:** If the government offers tax benefits and grants, they will encourage the development of business, creating jobs and meaning more goods and services are produced, which will increase economic growth. If there is too much wealth distribution (i.e. too high taxes and benefits), there will be little incentive to work hard as the rich know a lot of their money will be taken away and the poor know that there is no need to work as benefits will give them just as much money as a job on minimum wage. This lack of incentive will mean that businesses won't invest and so there will be little to no economic growth.

- **Technological progress:** Improved technologies mean that the average cost of production is lower, whether this is because it is quicker to produce or less labour or equipment is needed. Also, it creates new products for the market and this helps to increase consumption and keeps MPC high as there are new things to buy. Without increased spending, there would be little economic growth.

- **Efficiency:** Efficiency is important in bringing about economic growth as it means less resources are needed to produce each good, so more goods can be produced.
    - One way the government can ensure efficiency is to keep up competition as it will means producers are forced to lower prices or increase quality so will have to improve efficiency to keep profits high.
    - In order for there to be efficiency, the market mechanism must be working properly. In some countries, particularly low and middle-income countries, the mechanism doesn't work properly due to a lack of protection of property rights. If the government doesn't intervene to protect property rights, then people will be unwilling to save and invest which will prevent economic growth.
    - Similarly, there may not be an efficient capital market (i.e. banks) so farmers will not have access to loans to expand their businesses.
    - Countries may experience civil wars or natural disasters which will lead to negative growth as human and physical assets are destroyed.
    - In a communist society, there is lack of efficiency as the government is the only supplier and they are not motivated to cut costs to keep profit high. When governments intervene too much, they can cause inefficiency through government failure rather than market failure.

Synoptic point:

Decisions by individuals can affect economic growth, for example a firms' decision to increase investment can lead to growth. For this to happen, the decision must be undertaken by a number of individuals. One firms' decision to invest is unlikely to have a significant impact, unless they are a very large firm undertaking vast investment.

Actual and potential growth:

- The **actual growth** is the percentage change in GDP. It is when the economy is actually produced more goods and services. **Potential growth** is the change in productive potential of the economy over time, so the LRAS or PPF curve shifts.
- The productive potential is determined by the factors of production and so potential growth means there have been resources discovered or more technology developed that will allow the economy to grow more. They have not yet produced the extra goods and services so GDP hasn't grown. The difficulties in measuring productive potential means changes in GDP are used as a measure of growth.

- The **PPF shows the potential output of the economy**. An outward shift of the PPF is economic growth. If the economy moves from inside the PPF to on the PPF, this would be classed as economic recovery rather than economic growth. However, again, it is difficult to know where the PPF of an economy is and so economists tend to treat all increases in real GDP as economic growth.

International trade:

- Many economists argue that AD can affect economic growth, through **export-led growth**: a rise in AD through increased exports.

- This has been effective in countries such as Germany, Japan and China and prevents the poor balance of payments that tends to occur as a result of economic growth.

- Although increased exports initially increases AD rather than LRAS, sustained high export levels will encourage, or force, **firms to invest and increase demand for labour**, which will lead to economic growth.

- Moreover, in order to be competitive in the international market, British firms will have to become **more efficien**t as they are competing with more firms than in just the UK market.

2.5.2 Output Gaps

Actual growth rates and long-term trends:

- The **long run trend rate of growth** is the average sustainable rate of economic growth over a period of time. It is what tends to happen over a long period of time; the average. **Actual growth** is the actual change (i.e. the change in real GDP) over time and its changes are what make up the business cycle. The difference between the two is an output gap.

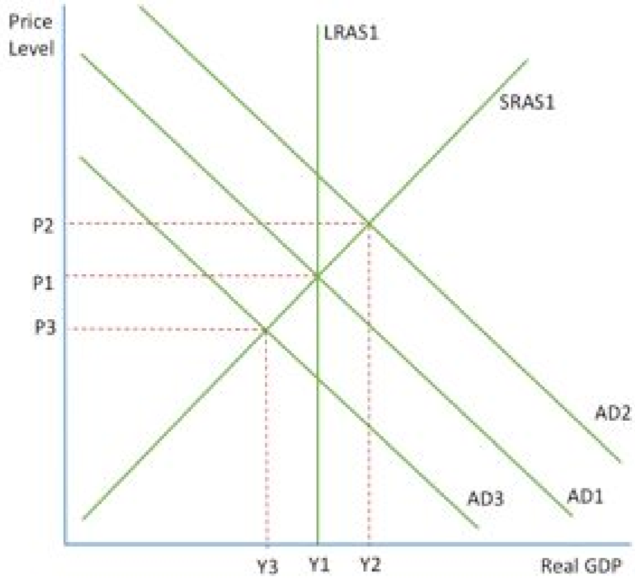
Output gaps:

- An output gap is the **difference between the actual level of GDP and the estimated long-term value for GDP-** this is shown on the trade cycle diagram which demonstrates how the actual GDP is not always on the trend.

- A **positive output gap** is when GDP is higher than estimated whilst a **negative output gap** is when GDP is lower than estimated. With a negative output gap, there is spare capacity in the economy with factories, offices and workers not being utilised to produce goods and services.

- The output gap is **very difficult to measure**, firstly because the exact position of the LRAS is unknown and also because initial estimates of the real GDP are often inaccurate. Some economists believe they are so difficult to measure that they are **not a valid concept to use from the purpose of economic policy.** It is not possible to measure the productive potential of an economy as there is no single monetary value for the level of variables such as machinery, workers and technology.

Aggregate demand and supply:



- Output gaps can also be illustrated using AS and AD diagrams. LRAS shows the **full capacity output** i.e. where all resources are being fully utilised, and this can be linked to output gaps between the GDP trend line and the actual GDP.

- An equilibrium to the right of the LRAS shows the economy working over capacity in the short term but to the left it shows the economy working under capacity.

In the diagram, there is an equilibrium where AD=SRAS=LRAS. However, at AD_1, there is a negative output gap because the SRAS equilibrium is less than the LRAS equilibrium, so the full capacity of the economy is not being met. At AD_2, there is a positive output gap as SRAS is higher than LRAS.

- Classical economists would argue that this positive output gap would be filled by long-run economic growth moving the LRAS curve, a recession which would decrease AD or a rise in the costs of production which would decrease SRAS. They would also argue that the negative output gap would be brought back to equilibrium by rising AD or a fall in SRAS due to lower costs of production.

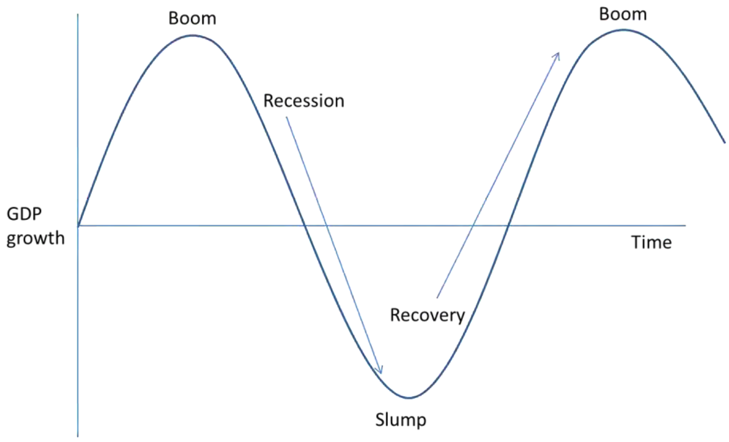
2.5.3 Trade (Business) Cycle

The trade cycle:

- This is the **periodic but irregular up and down movements in economic activit**y, measured by fluctuations in real GDP and other macroeconomic variables. Each business cycle is different, but they tend to have four main phases: **boom, downturn, recession (slump) and recovery**. There is no set definition of each phase and sometimes people simply refer to the cycle as a boom and recession, or contraction and expansion.

- There are two main types of trade cycle: a mild trade cycle where GDP does not fall during recessions but instead doesn't grow by as much as the trend, and a more extreme one like that in the diagram.

The cycle exists because of **demand and supply side shocks**. Demand side shocks include the collapse of a housing bubble, political issues, changes in exchange rates or a recession in the world economy. Supply side shocks could include trade union action, a change in oil prices or a change in the exchange rate. Shocks can either be negative or positive so could cause a boom or recession.



Characteristics of boom:

- When economy is at its peak (the boom), **national income is high** and the economy is likely to be working above PPF where there is a **positive output gap**. Consumption and investment tend to be high as are tax revenues, and wages will be increasing. Usually, the country will increase imports to meet the demand of high-income consumers that cannot be met by the goods produced within the country. There will also be **inflationary pressure**.

During a **downtown**, the economy begins to move from a boom to a recession, output and income fall which leads to a fall in consumption and investment as well as tax revenues. Payments for benefits rise as unemployment rises. People begin to accept jobs for lower wages due to higher levels of unemployment. This causes inflationary pressure to ease and a fall in the number of imports.

Characteristics of a recession:

- When the economy is at the bottom of the cycle, it is in a slump, trough, depression or recession. There tends to be **high unemployment** causing low consumption, investment and imports. **Inflationary pressure will be low** and there may even be deflation. In the UK, the government defines recession as where **real GDP falls in at least two successive quarters.**

As the economy moves out of a recession, it moves into a **recovery/expansion** phase as national income and output begin to increase with unemployment falling and consumption, investment and imports increasing. Inflationary pressure begins to grow as workers start to demand higher wages.

Hysteresis:

The fact that the economy tends to return to the trend line, and go above it, even after a serious recession may suggest that there is little problem with large fluctuations in output. Overall, the economy should be in no better or worse position in the long term as output lost in a recession is regained in a boom. However, there are other problems with recessions and booms. During a recession, many become unemployed and this has many negative effects; these people have a lower standard of living even if it is only for a short period of time. On the other hand, those on fixed incomes suffer during a boom as their real income decreases as prices rise due to inflation. Some economists argue that economies do not bounce back to their previous trend level of growth, this is hysteresis. The economy may never recover fully from the deep recession due to a permanent loss of labour, for example some people may take early retirement if they are made redundant, some lose their skills after being out of work for so long and others may become discouraged workers. Moreover, it may lead to a loss of physical capital if firms do not make up the investment which they cut back on during the recession. Both of these will cause a fall in potential output.

Synoptic point:

The trade cycle has large impacts on individuals within the economy. During recessions, consumers will see lower incomes and living standards and firms will see lower revenues and profits.

2.5.4 The impact of economic growth

Economic growth is a policy which **governments aim to achieve**, and so therefore it must have benefits to consumers, firms, the government and current and future living standards. However, there are also costs.

Consumers:

- There will be an increase in demand for housing as people have more money and so are able to afford to buy properties, which will increase house prices. Shares are likely to increase in value as businesses are making more money and future prospects are good. The rising prices of shares and housing will increase wealth and lead to **positive wealth effect**.
- Improved productive efficiency due to better technology could lead to **lower prices or higher quality goods**.
- Some argue that increased economic growth will lead to **increased happiness**, but this is not necessarily the case.
- On the other hand, economic growth could lead to **increased inequalities** and so may not have any effect on the average consumer and may lead to **inflation**, which has negative effects for consumers.

Firms:

- **Investment** will increase since businesses are more successful. They will have more money to invest and more incentive to invest as they will know they can make money from their investments.
- **Business confidence** will improve as there are potential demand increases for businesses' products and this confidence will also lead to increased investment.
- As a result of increased investment from both businesses and governments, technology will improve. There will be more research and development done to invent more technology and more firms will be able to have the best technology, which is likely to increase productive efficiency and lead to **lower costs.**
- The combination of higher demand and lower costs is likely to lead to **higher profits.**
- Economic growth also provides the **opportunity for new firms to establish themselves** and allows existing ones to make more profit.

- On the other hand, firms who sell inferior goods (with negative income elasticities) **may lose out.** Changing technologies and globalisation also mean that some firms find their **markets disappearing** e.g. DVD rental stores.

The government:

- **Tax revenues** will rise as more goods and services are being bought, more income is being earnt and more profits being made. This means the government has **more money** to put into the NHS, education, benefits etc.; the quality of these systems will be improved, and this will help to improve **living standards**.
- It can help to reduce the **budget deficit,** perhaps even bringing about a budget surplus which would allow money to be saved for future recessions.
- However, economic growth tends to mean people **expect more from the government** i.e. better education, better roads etc.

Current and future living standards:

- Economic growth will result in **lower poverty levels**. An increase in the production of goods and services will increase jobs so there will be less unemployment and less people on benefits. Wages are also likely to increase.
- There will be **more goods and services for people to enjoy**, so the poor will be able to get the goods and services they need instead of only the rich getting what they want.
- **Housing standards and the quality of food** increases due to economic growth. **Health** also tends to increase: not only does life expectancy rise but people have a higher quality of life in their old age.
- Increased **government spending** will lead to improved living standards both now and in the future, as better educated people usually have higher living standards.
- Economic growth is likely to have the **highest benefits in developing countries.**
- However, there could be decreased future living standards due to **exploitation of the environment.** A rise in income means more people have access to electricity etc. and use it more freely. This causes depletion of non-renewable resources, concern about sustainability of growth for future generations and increased levels of pollution/waste/congestion.
- On the other hand, it could be argued that people with higher incomes are able to buy **cleaner fuels** and richer countries can **devote resources for research and development** of cleaner resources and 'greener', more efficient technology. Also, higher income households tend to have less children which lowers natural rate of population growth, meaning less resources are needed for the future.
- Another cost may be that economic growth may result in **increased inequalities** between rich and poor. The rich may be the only ones that have gained from the economic growth and they may even lower the living standards of the poor by exploiting the poor.

Growth pessimists are those who question the long-term sustainability of growth. Renewable resources will be depleted due to the concept of the Tragedy of the Commons: if something is public, no one looks after it and so the quality decreases e.g. the destruction of rainforests. The growth contributes to growing environmental threats due to increased waste from production and consumption; over-population putting increased pressure on scarce land; there is increased pollution; and species extinction.

Synoptic point:

Economic growth has microeconomic consequences through the impact on consumers, workers and firms. It can also lead to increases in efficiency.