Economics A-level

Macroeconomics

Contextual Analysis

(Please note: This contextual analysis document is not exam-board specific)

Contents

1. Macroeconomic Policy

Monetary policy

- Low interest rates - following the EU referendum - in which the UK chose to leave the trading **bloc** - the Bank of England reduced interest rates to 0.25%, as low interest rates theoretically stimulate demand. This was done **preemptively** to prevent a reduction in GDP growth, as Brexit created **uncertainty** for the UK economy, which resulted in less **investment** from overseas as well as from domestic firms.

- Low interest rates - governments have responded to the coronavirus pandemic by drastically reducing interest rates, in order to cope with the lack of **demand** and **investment** in the global economy.

- High interest rates - from 2009 to 2020, America experienced their longest ever **economic expansion,** to which the Fed responded by increasing interest rates near the end of this period, to prevent **demand-pull inflation** which would have harmed the economy in the future. However these rates were then dropped amid the U.S.-China **trade war** that was projected to adversely impact both economies. Following the 2008 Global Financial Crisis (**GFC**) and the coronavirus pandemic, high interest rates will be extremely rare in major economies, as low interest rates are "locked in for the long term", as the Chancellor of the Exchequer Rishi Sunak stated in early 2020.

- Now that more governments are responding to the 21st century climate crisis, more is being done to mitigate the drastic effects it will have on society. **Green Quantitative Easing** is gaining popularity by many central banks. As opposed to conventional QE, banks would only buy **bonds** off companies that fund environmentally-friendly projects.

- A perfect example of when we saw central banks act as a **lender of last resor**t was during the 2008 Great Financial Crisis (**GFC**). The Federal Reserve, the central bank in the U.S., lent to several Wall Street banks to prevent insolvency. However, many argued that too much government intervention would promote the idea of "**moral hazard**". This concept refers to when parties purposely act irresponsibly and inefficiently because they know the risk is transferred to a third-party member. So, in the cast of the GFC, banks knew that if governments would bail them out then, they would bail them out in the future and so could continue to participate in risky investments. This idea is often referred to as banks being "too big to fail". The Fed therefore decided not to lend to the Lehman Brothers (a bank), and allowed them to become insolvent to prevent **government failure**.

- Although most **central banks** are now independent of their respective governments (e.g. the BoE gained independence in the 1990's), covid-19 has become a threat to this. The response to the pandemic has resulted in **quantitative easing** programmes on an unprecedented scale. The European Central Bank (**ECB**) announced a €750 billion Public Sector Purchase Programme (PSPP), to which the German High Court opposed, as they felt the ECB exceeded their powers. This has sparked debates as to whether central banks should be under the control of their governments.

- In 2020, the **Federal Reserve** (the central bank in the U.S.) announced their plans to change the way they set inflation rate targets, and named it the **Flexible form of Average Inflation Targeting (FAIT)**. Put simply, in the past the Fed has set a target of 2.0% annual inflation. However, with the new FAIT system, the Fed will now ensure 2.0% inflation in the long-run (i.e. on a more average basis). For example, if in 2025 the inflation rate was 5%, but in 2026 the inflation rate was 0.1%, as long as it is 2.0% on average, the central bank will still be seen as achieving their targets. This means the Fed will have a much more laid-back approach to inflation (often referred to as a dovish approach), which means lower interest rates and more credit expansion is expected to come.

- **Monetary Financing** - a term used when central banks directly buy **bonds** from their governments as a way to finance their spending. Covid-19 has brought this term under the spotlight as the pandemic has forced major **fiscal stimulus** packages across the world, to which central banks felt almost as if they had to pay for. This is yet another threat to the independence of central banks, but by constantly paying for stimulus packages, it encourages reckless spending by the government, which could lead to higher **inflation** rates. The Bank for International Settlements (**BIS**), a group of central banks, stated that the "*fine line between monetary policy and government debt management has become blurred*".

- Covid-19 has triggered a shift from **monetary** to **fiscal** policy, as we begin to see the limits of the former:

➔ The independence of central banks is threatened (explained above).
➔ The vast majority of **interest rates** around the world are very low, and cannot be lowered further to stimulate demand before entering negative territory.
➔ We are starting to see how Quantitative Easing programmes are subject to the law of **diminishing returns** (see notes). As many central banks have bought billions of dollars worth of government and corporate bonds, the effect of this being able to stimulate demand is diminishing - hence the name. Despite having the money from central banks to **invest**, firms in many countries are choosing to delay this due to high levels of uncertainty brought by covid-19, as investment is a **derived demand**.

Fiscal policy

- **Corporation tax** in the UK decreased by 9% from 2010 to 2019, which, in theory, would shift the LRAS curve to the right by stimulating more **investment**, however this was delayed by uncertainty from Brexit and the US-China trade war. Therefore, when we disregard the **ceteris paribus** assumption, economic theories do not always manifest into the real world.

- In 2013, the UK government made further reductions in corporation tax, and this attracted around 40 different overseas firms to set up bases in the country. The surge of investment should have boosted the economy by creating more jobs, however once the UK public voted to leave the **European Union** in 2016, there was a high level of uncertainty amongst firms, and so they decided to delay their investment plans. This cancelled out the increases in investment in 2013, so had no overall effect on the economy.

- Now that **climate change i**s becoming an increasingly worrying issue, more investment plans are being scrutinised by the public, for example Heathrow Airport's plans for a third runway were rejected by the court of appeal after the adverse environmental effects were assessed, even though it would have boosted economic growth by creating more **jobs**.

- In 2019, Boris Johnson promised a "**triple-tax lock**" in his manifesto. His pledge was that, under a conservative government, VAT, income tax and National Insurance Contributions would not rise. However after the recent covid-19 pandemic, whether he will stick to his manifesto is unknown but the effects of this 'tax lock' could prove to significantly improve the state of the economy, as households will now have more disposable income so their **marginal propensity to consume** will rise.

- Although the idea of **budget deficits** for prolonged periods of time is frowned upon, the coronavirus pandemic has meant that for many governments this has become the new norm. For example, during the 2008 Global Financial Crisis, the UK government deployed several large stimulus packages (e.g. cutting VAT), to which Germany regarded as "**crass Keynesianism**", i.e. the UK were spending recklessly. Germany has always been strong advocates of balanced budgets, but covid-19 has brought even this country into the territory of budget deficits.

- Another way governments could deal with their large **national debt** is by becoming supporters of **financial repression**. This concept explains how funds are channelled from savers to the government as a method of eroding the value of their debt. In practice, governments try to boost the **inflation rate** and lower **interest rates**, so the former is higher than the latter. Governments can now simply grow their economies out of debt, however the low interest rates mean **savers** lose out as their rate of return is not as high as it used to be.

- During the 2010-12 **European debt crisis**, Greece was forced to cut spending and raise taxes to deal with their national debt. This increased unemployment and decreased economic growth by 25%. Another victim of Greece's **fiscal austerity** programme was training and education (**T&E**), as spending on this was reduced by 20%. This shifted the SRAS curve to the left due to lower productivity from workers, and further contributed to lower economic growth.

- In most cases, fiscal austerity is politically difficult as it tarnishes the reputation of those in charge. For example, in 2019 the French president, Mr Macron, announced his **pension** reforms that sparked protests across the country, even though they were clearly stated in his manifesto during his election campaign.

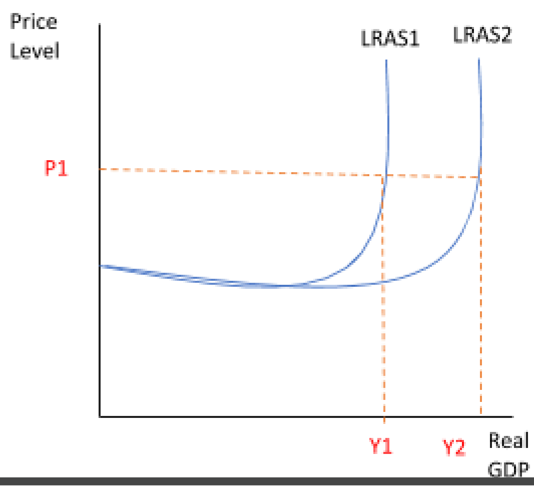
- British Airways was **privatised** in 1987, and has since then witnessed remarkable increases in efficiency. The aviation industry also saw a major decrease in regulation as a result of the **Airline Deregulation Act** in the 1970's, which allowed new firms to enter the market and challenge **incumbents**.

- The UK government announced a new regulatory body within the Competition and Markets Authority, called the **Digital Markets Unit (DMU)**. This unit will regulate firms that have a "strategic market status" and are funded by digital advertising, so namely Facebook and Google. This particular approach is called "**ex ante**" regulation, as opposed to the conventional "**ex post**" regulation. Ex post is when the government intervene in the market following the evidence of market power abuse, e.g. if Google exploits consumer data the government will then set rules banning them from collecting data. Ex ante regulation refers to government intervention prior to any market power abuse, so the government will essentially tell firms how to behave rather than punishing them after they have misbehaved. The DMU will arguably strengthen ties with the EU, who share the same view on tech regulation as the UK. However, the UK must make sure not to impose too much regulation on these firms, else it will deter them from investing in the country.

Supply-side policy

- In 2019, the UK government spent £400 million on improving **schools**, and has pledged to raise teachers' salaries to £30,000 by 2022. A rise in wages means teachers are more motivated to work, resulting in a better quality of education and therefore workers with better skills.

- In 2020, Boris Johnson announced his new **immigration** plans that would allow migrants citizenship if they had sufficient educational qualifications. This would result in a much more **skilled workforce** across the UK, which would improve the productive capacity of the economy as firms would become more efficient. However, current British citizens may have less of an incentive to find jobs if they know they are competing against a more skilled applicant, and so may simply apply for universal credit instead, which would increase the **natural rate of unemployment**.



- 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.

- Reducing **corporation tax**, among other factors, made the UK appealing to Jaguar Land Rover (JLR) as an investment hotspot. They therefore made plans to build a warehouse in the West Midlands, opening up multiple job opportunities for local residents and therefore reduced unemployment. Although it didn't make a huge impact, the state of the UK budget deficit was improved as JLR had to start contributing towards tax revenues.

- Privatisation does not necessarily result in productivity improvements, as perfectly illustrated by the **probation industry**. Firms operating in this industry were handed over to private ownership in 2014, with the hopes of improving efficiency. However since then, these firms have been **bailed out** by the government several times, until the government announced plans to **re-nationalise** these firms by 2021. Therefore, we can argue that firms in certain industries operate more efficiently in the hands of the government.

- The Conservative party have already started plans to build two of the largest **rail infrastructure** projects in Europe, with the total cost estimated at around £80 billion. **HS2** is a high-speed railway that connects through London, Birmingham and Manchester. The government hopes to improve **labour mobility** across the UK, i.e. the ease of workers to move around the country.

- Margaret Thatcher, a former prime minister (regarded as the "iron lady"), disliked the idea of **trade unions** and saw them as an 'obstacle to economic growth', as workers would negotiate higher wages and better work conditions through these unions, which increased the **cost of production** for firms. Therefore, by diminishing the power of these unions, firms would save a lot of revenue and fewer costs are passed down to consumers in the form of higher prices. However if politicians were to deal with unions with an oppressive approach in today's modern society then, like with many policies, there would be **unintended consequences**. For instance, employees would start adopting a "**work-to-rule**" approach to their jobs. This is when workers do no more than the bare minimum that is required by them by their employers, as they no longer want to work extra hours with no extra pay - like they may have once done before had it been for the influence trade unions once had. This can damage the overall productivity of firms, and can therefore have drastic effects for the macroeconomy.

2. The International Economy

Exchange rates

- **FOREX** markets are incredibly volatile and exchange rates are constantly changing in all countries, as investors weigh up the risks and benefits of buying currencies by assessing factors such as geopolitics (i.e. current affairs between countries), the current economic climate, etc.

- In 2015 - prior to the EU referendum - the Pound (£) rose against the Euro (€), but by memorising the **WIDEC** and **SPICED** acronyms we can explain how this wasn't necessarily a 'win' for the UK. As the UK has a stronger currency than those countries within the **eurozone**, exports become more expensive (and EU imports follow suit). This scenario is exemplified by what happened to 'Oxford Instruments' in 2015. This firm produces high technology tools and systems for multiple industries and, following the **appreciation** of the Pound, reported a loss of all exports to Russia as a result of the price change.

- Prior to the Covid-19 pandemic, America was experiencing its longest ever economic expansion since the Global Financial Crisis (**GFC**). It was also seen as winning the **trade war** between itself and China, as its counterpart was facing an economic slowdown at that time. Both these factors contributed to a strong dollar ($), as investors saw America as a haven for high returns with minimal risk. However, as currency appreciations trigger cheaper imports, multiple domestic firms reported a loss in profits, because consumers found cheaper goods in other countries.

- Although floating exchange rates have their many benefits, it isn't uncommon that countries decide to implement **fixed exchange rates against** other currencies, for example the United Arab Emirates (UAE) with America. The UAE stated that this is to promote exchange rate stability, in particular the stability of oil prices following several shocks that have triggered global recessions, i.e. the **1973 oil crisis** (see notes). As the exchange rate is fixed, there are low levels of uncertainty amongst investors, which the UAE are currently trying to attract as their supply of oil is limited and they attempt to find other ways of remaining a powerful nation.

- The Chinese government has admitted to managing their exchange rates on multiple occasions for the benefit of their economy. Before the coronavirus pandemic hit, Chinese policymakers would cut **interest rates** in order to boost exports. By cutting interest rates, there is a net outflow of **hot money** - money that moves around countries in search of the best return - as the rate of return was considerably lower. The Yuan (¥) is then **devalued**, which makes exports cheaper, hence a rise in demand for them. The Chinese hoped that by doing this it would diminish the power America had over the trade war.

Globalisation and trade

- The **Covid-19** pandemic forced countries around the world to close their borders to foreigners in order to reduce the spread of the virus. This also meant a temporary halt to imports and exports between countries. However this has forced firms across the planet to rethink their structuring of **supply chains** - as these chains have clearly proven to be more vulnerable to economic shocks than once thought. The virus has therefore encouraged a shift towards more **'domesticated'** supply chains, i.e. within a country's borders. Although firms think it will benefit them in the long term - by providing more stability - it may in fact do the opposite. If countries become less globalised and consumers turn to buying domestic goods only, there is potential for prices to rise, as the benefits from **economies of scale** (see notes) are eradicated because goods and services are now produced in smaller amounts to suit a smaller market. In addition, domesticating supply chains may in fact make firms *less* resilient, such as in the case of weather strikes, which would disrupt production lines. Firms would be unable to turn to other countries as they once did in a globalised world, and this can actually be seen in North Korea, whereby crop failures result in mass famines as the country refuses to import from overseas.

- As China is on the rise to becoming a global superpower, foreign firms are starting to move supply chains away from the country as they transition away from the 'Low Income Country' status, which means wage rises and higher costs for firms. This movement is referred to as "**China plus one**".

- Although globalisation and Foreign Direct Investment (FDI) usually complement each other, the latter tends to come with its disadvantages. For instance, FDI can "**crowd out**" domestic investment, and governments would prefer domestic investors as the profits are injected back into its own economy. FDI can also threaten **economic welfare**, as foreign investors are less aware of **consumer preferences** than domestic ones. This can be seen in Tesco, a supermarket chain that set up bases in Malaysia, but then had to compete with firms who were more aware of what Malaysian consumers demanded. This eventually led to Tesco selling all their foreign stores in 2020.

- In many cases, **tariffs** and **quotas** arise from geopolitical factors between countries. For example, the World Trade Organisation (**WTO**), an intergovernmental organisation that regulates international trade, settled a decade-long argument between the EU and America regarding subsidies. The US was accused of illegal subsidies to Boeing, an American aerospace corporation. By providing subsidies, the firm's costs of production were reduced, which meant they were able to lower prices to consumers. This had adverse impacts for the competitiveness of Airbus, the European-owned counterpart to the aviation duopoly. The EU therefore took the issue up with the WTO, and was permitted to add tariffs to $4 billion worth of US imports to compensate for the loss of profits to Airbus.

- Globalisation does not always benefit countries, as trade liberalisation has encouraged firms from the West (i.e. the UK, America and Europe) to **outsource** their factories to the

East (i.e. Asia and the Middle East). Low Income Countries in the East offer cheap labour, and therefore attract foreign firms as a way of reducing costs. However, this resulted in mass **structural unemployment** in countries in the West, particularly regarding the textiles and manufacturing industries.

- As the UK has officially left the European Union, politicians are promising a more "global Britain", i.e. a Britain that has more influence in international markets. However so far all Brexit has done is damage confidence in the UK, as one of the conditions of the EU withdrawal agreement was to leave Northern Ireland a part of the **single market** in order to prevent a "hard border" with itself and the republic. This has narrowed the gap towards Northern Ireland and the Republic removing the border between them. On top of this, talks of a Scottish referendum are gaining popularity, which further weakens the reputation of the UK - or what's left of it. Therefore even though lowering interest rates, tariffs and taxes attract foreign investors into the UK as economic theory suggests, in reality it's a completely different story once we disregard the "**ceteris paribus**" assumption.

Economic development

- The rise of China from a third world country to one of the largest economies in the world can be traced back to years of economic reforms in the 20th century. In the 1960's, under the command of Mao, China played by the rules of a '**command economy**', whereby there was an abundance of regulation with no room for market-based policies. This proved unsuccessful in boosting China's economy, and in the 1970's (under a new leader), Deng brought China under a '**market economy**', by incentivising hard work and bringing 700 million people out of extreme poverty. Deng also opened China up to the world, by creating 4 **Special Economic Zones** (SEZ's) that were subject to unique economic regulation and allowed in **FDI** and imports from overseas. This proved successful and opened the pathway for Deng's successors to continue boosting China's economy until it became the global superpower we see today.