Edexcel Economics AS-level

Unit 2: Macroeconomic Performance and Policy

Topic 6: Economic Growth

6.1 Economic growth

Notes

Causes of growth

Factors which cause economic growth

- Increase in AD, either from domestic demand or from trade.
- Improving the labour force, with a better quality and quantity to increase productivity. The larger the size of the labour force, the greater the productive potential of the economy.
- Improved technology, which is more productive
- More investment, to fuel economic growth
- **Capital deepening** which is an increase in the size of physical capital stock.

Actual growth

This is short run growth and it is the percentage increase in a country's real GDP. It is usually measured annually and is caused by increases in AD.

Potential growth

This is the long run expansion of the productive potential of an economy. It is caused by increases in AS. The potential output of an economy is what the economy could produce if resources were fully employed.

Constraints on growth

Access to credit and banking

Without a safe, secure and stable banking system, there is unlikely to be a lot of saving in a country. Hence, the rate of growth is limited.

Infrastructure

Poor infrastructure discourages MNCs from setting up premises in the country. This is since production costs increase where basic infrastructure, such as a continuous supply of electricity, is not available.

Education/skills

This is important for developing human capital. Adequate human capital ensures the economy can be productive and produce goods and services of a high quality. It helps generate employment and raise standards of living.

- **Absence of property rights**

Weak or absent property rights mean entrepreneurs cannot protect their ideas, so do not have an incentive to innovate.

- **Corruption**

In sub-Saharan Africa, the money lost from corruption could pay for the education of 10 million children per year in developing countries.

- **Poor governance/civil war**

This could hold back infrastructure development and is a constraint on future economic development. It could destroy current infrastructure and force people into poverty.

- **Vulnerability to external shocks**

For example, an earthquake prone country is likely to find it hard to develop their infrastructure, and people might be pushed into poverty. Nepal was already one of the poorest countries in the world, but the Nepal earthquake in 2015 pushed more people into poverty.

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,	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.

	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.	
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. There is an increase in tax revenue.
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.

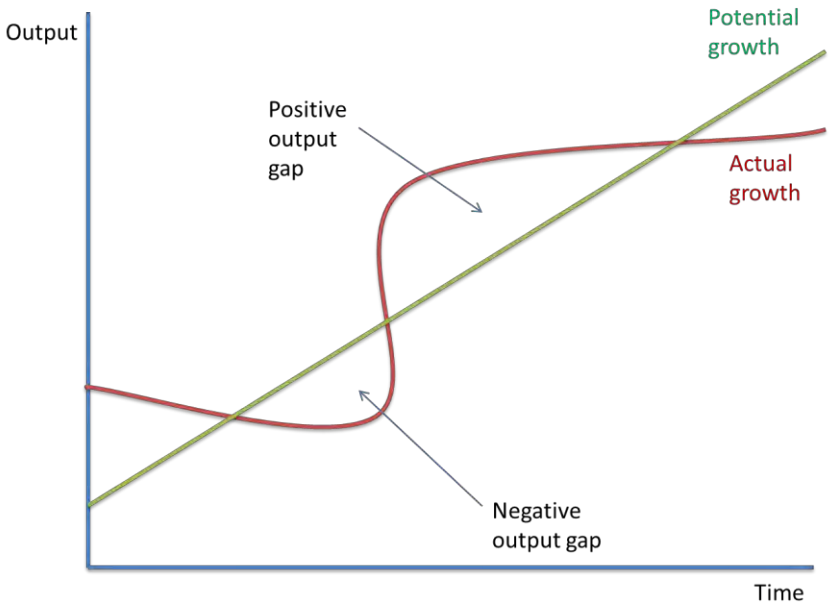
		Higher average wages mean consumers can enjoy more goods and services of a higher quality. Public services improve, since governments have higher tax revenues, so they can afford to spend on improving services. This could increase life expectancy and education levels.

Output gaps

- **The difference between actual growth rates and long-term trends in growth rates:**

- **Actual growth** is the percentage increase in a country's real GDP and it is usually measured annually. It is caused by increases in AD.
- **The long-term trend in growth rates** is the long run expansion of the productive potential of an economy. 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.

- **Difficulties with measuring the output gap**

- It is difficult to estimate the trend in a series of data.

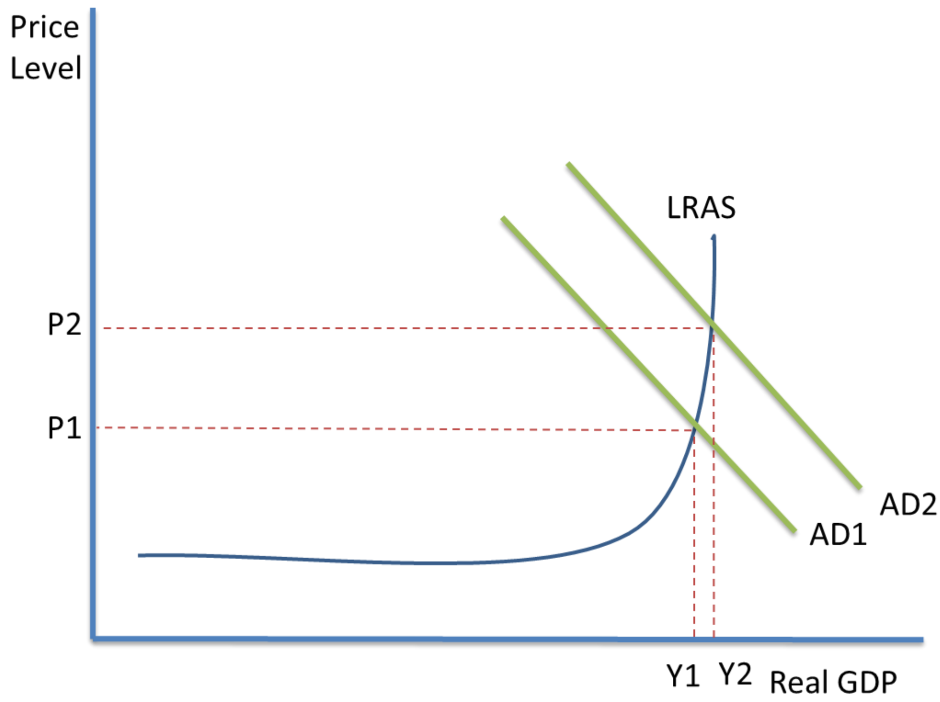
- The structure of the economy often changes, which means estimates may not always be accurate. For example, immediately after a recession, the level of spare capacity might fall below the level anticipated, since some workers might become economically inactive, firms might close and some banks might be unwilling to lend.

- Changes in the exchange rate might offset some inflationary effects of a positive output gap.

- Data is not always reliable, especially from emerging markets, and extrapolating data from past trends might lead to uncertainties.

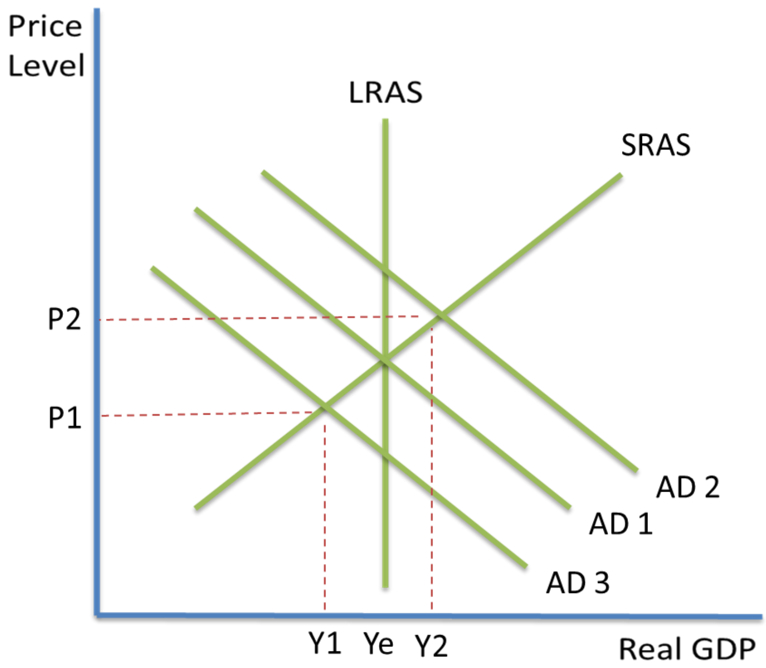
- **Illustrating an output gap:**

Keynesian economists



There is a negative output gap between Y1 and Y2. Keynesians believe that output gaps exist in both the short and long run.

Classical economists



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.

- **Definition and characteristics of recession**
- In the UK, a **recession** is defined as two consecutive quarters of negative economic growth.
- Recessions are characterised by:

- 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