OCR Economics A-level

Macroeconomics

Topic 2: Economic Policy Objectives

2.1 Economic Growth

Notes

- Economic growth is defined as the expansion of the productive potential of the economy. It can be depicted by an outward shift in the PPF or an outward shift in a country's LRAS curve.

- The government's economic growth macroeconomic objective is to have sustained and sustainable economic growth. This aims to provide macro stability. In the UK, the long run trend of economic growth is about 2.5%.

- Short term growth is calculated annually by the percentage change in real national output. Long term growth is a **trend**, which is a potential.

- It occurs when there is a rise in the value of Gross Domestic Product (GDP). GDP measures the quantity of goods and services produced in an economy. In other words, a rise in economic growth means there has been an increase in national output. Economic growth leads to higher living standards and more employment opportunities.

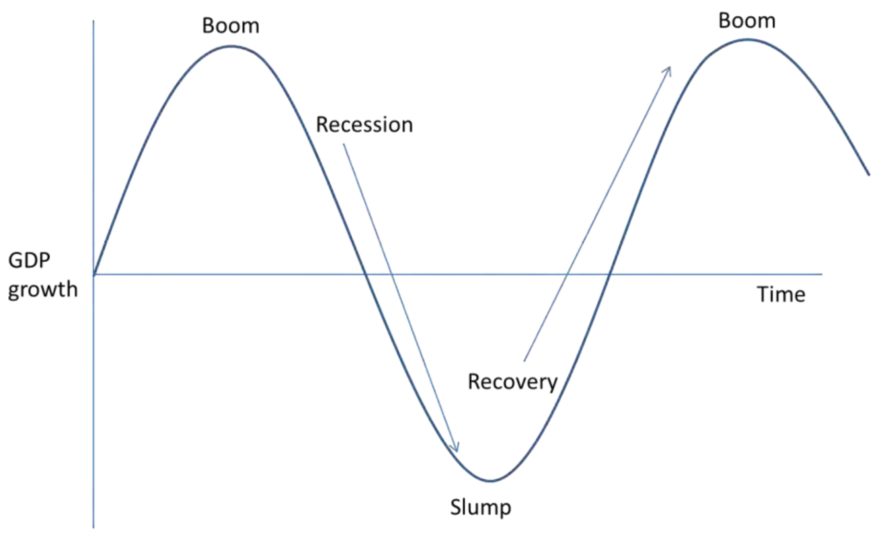
- **Real GDP** is the value of GDP adjusted for inflation. For example, if the economy grew by 4% since last year, but inflation was 2%, real economic growth was 2%.

- **Nominal GDP** is the value of GDP without being adjusted for inflation. In the above example, nominal economic growth is 4%. This is misleading, because it can make GDP appear higher than it really is.

- **GDP per capita** is the value of total GDP divided by the population of the country. Capita is another word for 'head', so it essentially measures the average output per person in an economy. This is useful for comparing the relative performance of countries.

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
- 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
- Demand-deficient unemployment

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

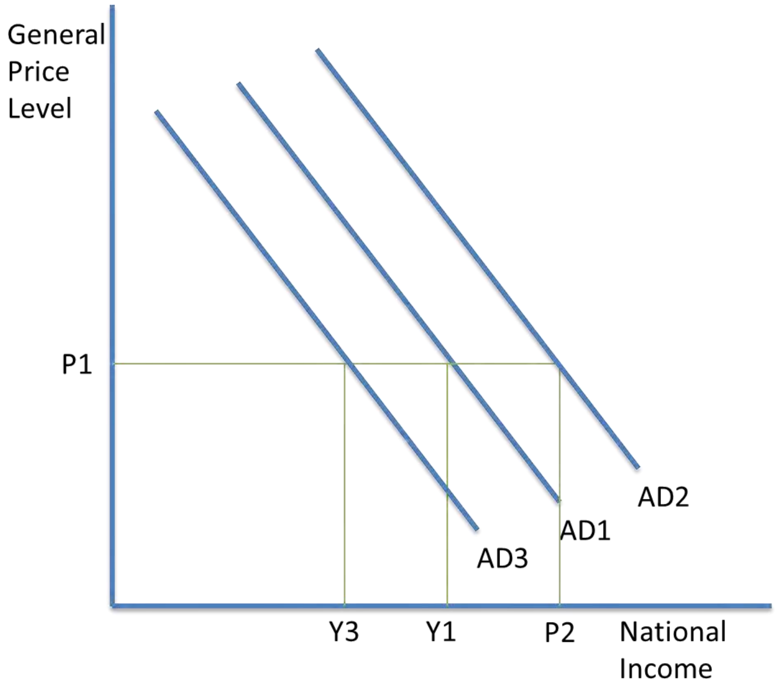
This is short run growth and it is the percentage increase in a country's real GDP. It is usually measured annually and is caused by increases in AD.

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.

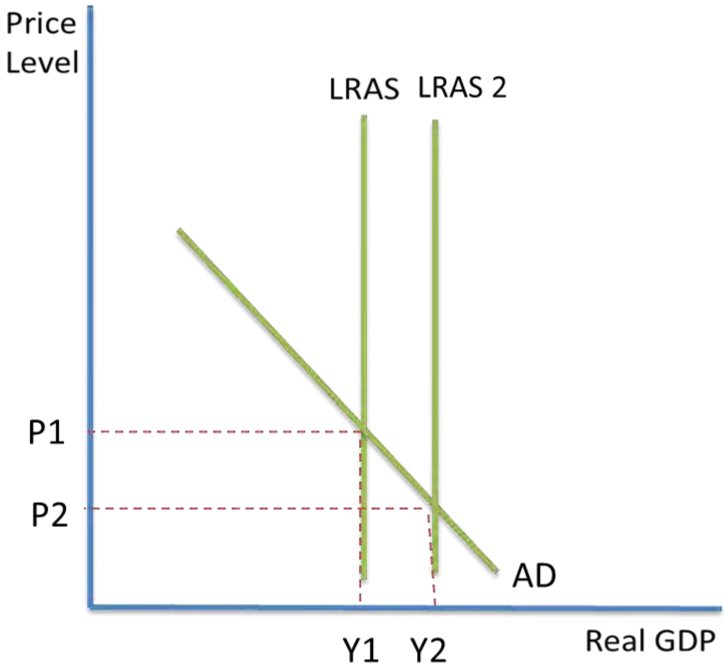
Illustrating short run economic growth

- A right shift in the AD curve shows short run economic growth. This is from AD1 to AD2. Negative economic growth is shown by AD1 to AD3.

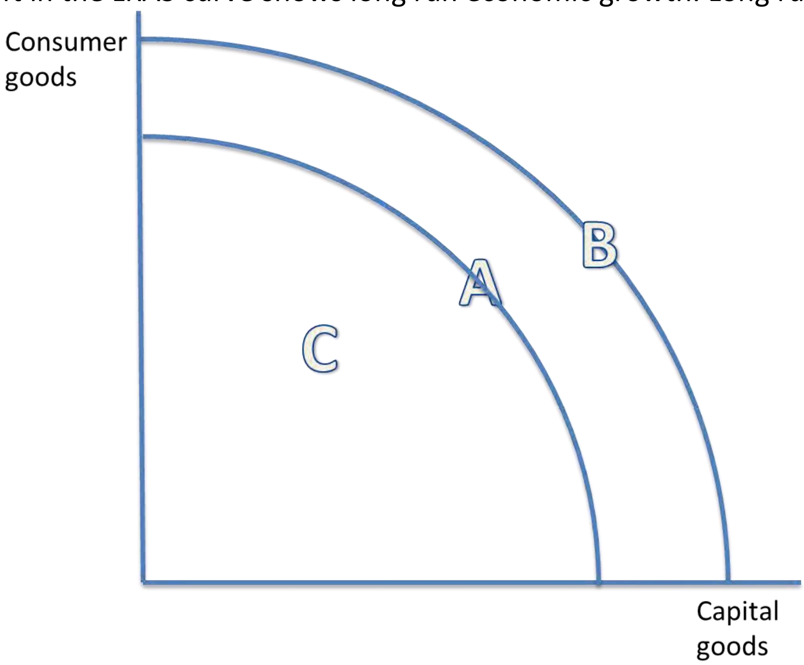


- The rise in economic growth occurs when:
  - Consumers and firms have higher confidence levels, so they invest and spend more, because they feel as though they will get a higher return on them. This is affected by anticipated income and inflation.
  - If the Monetary Policy Committee lowers interest rates, it is cheaper to borrow and reduces the incentive to save, so spending and investment increase. However, there are time lags between the change in interest rates and the rise in AD, so this is not suitable if a rise in AD is needed immediately.
  - Lower taxes mean consumers have more disposable income, so AD rises.
  - An increase in government spending will boost AD.
  - Depreciation in a currency means M is more expensive, and X is cheaper, so AD increases. A decline in economic growth in one of the UK's export markets means there will be a fall in X, so AD falls.
  - In the UK, most people own their houses. This means that a rise in the price of houses makes people feel wealthier, so they are likely to spend more. This is the **wealth effect.**
  - If credit is more available, then spending and investment might increase. Recently, since the financial crisis of 2008, banks have been less willing to lend due to the risks associated with lending.

Illustrating long run economic growth



A right shift in the LRAS curve shows long run economic growth. Long run growth can



also be shown by an outward shift in the PPF. This shows how the productive potential of the economy increases

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.

The role of international organisations, such as the International Monetary Fund (IMF), the World Bank and the World Trade Organisation (WTO) in promoting economic growth and development

The WTO

The WTO promotes world trade through reducing trade barriers and policing existing agreements. It also settles trade disputes, by acting as the judge, and organises trade negotiations.

Every member of the WTO must follow the rules. Those who break the rules face trade sanctions. In addition to trade in goods, the WTO covers the trade in services and intellectual property rights.

As of 2015, there are 161 member states in the WTO.

Possible conflicts between regional trade agreements and the WTO:

Trading blocs might distort world trade or adversely affect those who do not belong to them. There could be an inefficient allocation of resources as a result of policies such as the EU CAP.

Conflicts between blocs could lead to a rise in protectionism. A common external tariff contradicts the WTO's principles, since although there is free trade between members, protectionist barriers are imposed on those who are not members.

Some countries might argue that the WTO is too powerful, or that it ignores the problems of developing countries. This could be since developed countries do not trade completely freely with developing countries, which limits their ability to grow.

Setting up a customs union or a free trade area could be seen to violate the WTO's principle of having all trading partners treated equally. This is especially if a common external tariff is applied. However, they can complement the trading system and the WTO strives to ensure that non-members can trade freely and easily with the members of a trade bloc.

The World Bank and IMF

The World Bank and IMF are sometimes called the Bretton Woods Institutions. They aim to provide structure and stability to the world's economic and financial systems.

Almost every country is a member of both institutions. The governments of each member nations own and direct the institutions.

The World Bank mainly focuses on development. The IMF tries to keep payments and receipts between countries logical and ordered.

World Bank

The World Bank can loan funds to member countries, and its aim is to promote economic and social progress by raising productivity and reducing poverty.

The World Bank is involved in several projects globally, such as providing microcredit, supporting education, and helping the rebuilding of countries after earthquakes.

International Monetary Fund (IMF)

The IMF aims to promote monetary cooperation between nations, and monetary problems can be consulted in the institution.

It also aims to help free trade globally, so jobs are supported. The IMF promotes exchange rate stability, and tries to avoid competitive depreciations in the currency.

Members can also borrow from the IMF, such as if they need to correct an imbalance in the balance of payments.