WJEC (Wales) Economics A-level

Macroeconomics

Topic 2: Macroeconomic 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.

- In the UK, a **recession** is defined as two consecutive quarters of negative economic growth.

The difficulties of measuring economic growth and GDP

- GDP does not give any indication of the distribution of income.

- GDP may need to be recalculated in terms of purchasing power, so that it can account for international price differences. The purchasing power is determined by the cost of living in each country, and the inflation rate.
- There are also large hidden economies, such as the black market, which are not accounted for in GDP. This can make GDP comparisons misleading and difficult to compare.

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

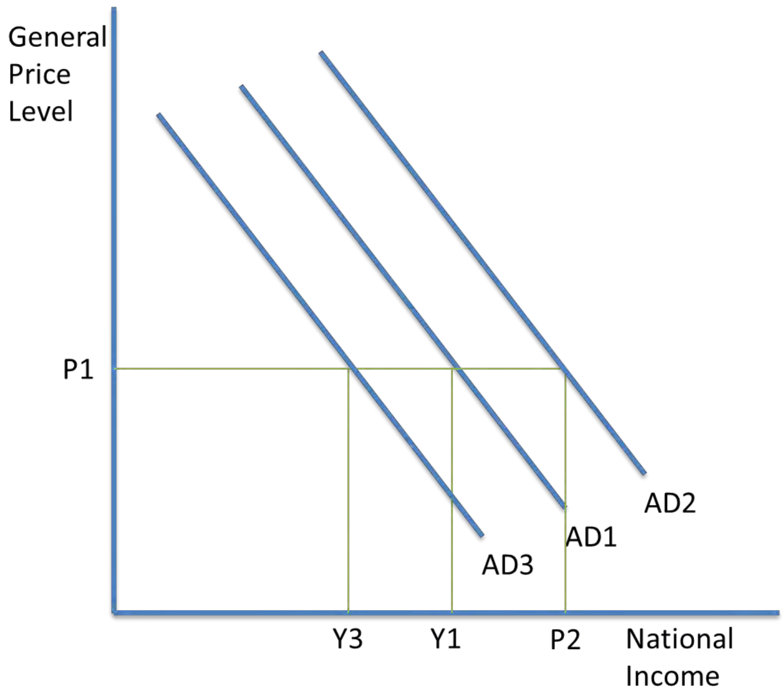
This is short run growth and it is the percentage increase in a country's real GDP. It is usually measured annually and is caused by increases in AD.

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.

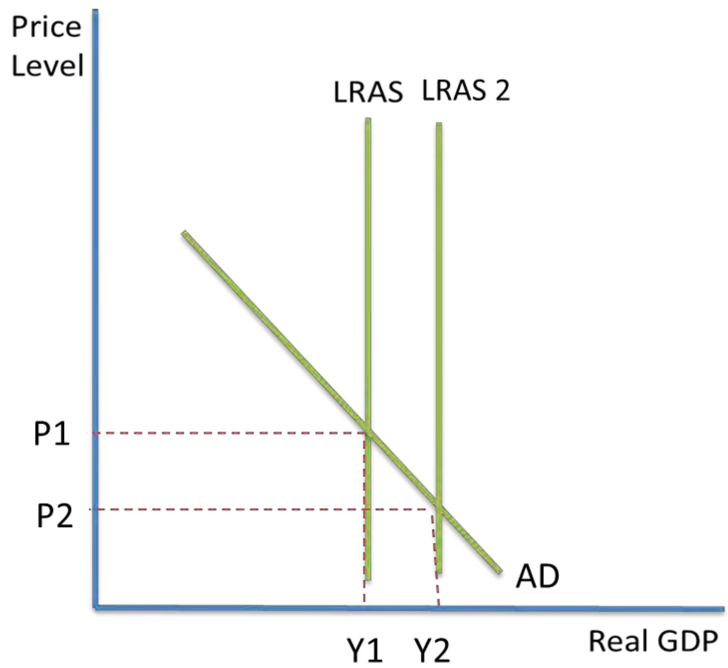
Illustrating short run economic growth

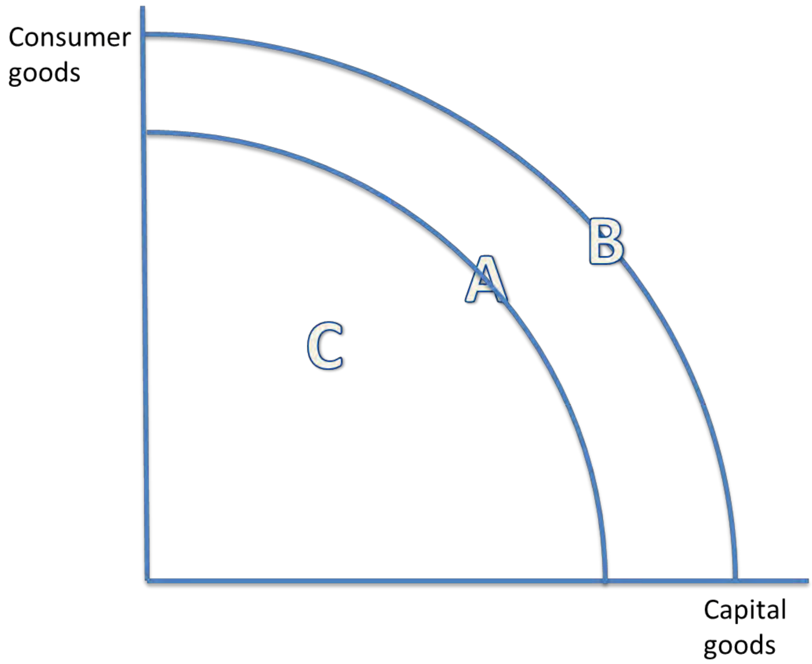
- A right shift in the AD curve shows short run economic growth. This is from AD1 to AD2. Negative economic growth is shown by AD1 to AD3.



- 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	Firms might make more profits, which might in

	higher inflation. This means they have to keep changing their prices to meet inflation.	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 consequences of a recession**

- 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