

Edexcel Economics (A) A-level

Theme 2: The UK Economy - Performance and Policies

2.1 Measures of Economic Performance

Detailed Notes



2.1.1 Economic growth

Rates of GDP as a measure of economic growth:

- Economic growth is the **rate of change of output**. It is an **increase in the long term productive potential of the country** which means there is an increase in the amount of goods and services that a country produces.
- This is typically measured by the **percentage change in real GDP per annum**. It can also be shown through the **shift of PPF**.

Gross Domestic Product: The standard measure of output, which allows us to compare countries. It is the total value of goods and services produced in a country within a year.

- GDP is an indicator of the standard of living in a country.
- **Total GDP** represents the overall GDP for the country whilst **GDP per capita** is the total GDP divided by the number of people in a country.
- GDP per capita grows if national output grows faster than population over a given time period, so there are more goods and services to enjoy per person.
- **Real GDP** strips out the effects of inflation whilst **nominal GDP** does not.
- Real values can be described as the **volume** of national income i.e. the size of the basket of goods, whilst nominal values represent the **value** of the national income i.e. the monetary cost of this basket of goods. The value is equal to the volume times the current price level. The value of national income is its monetary value at the prices of the day; the volume is national income adjusted for inflation and is expressed either as index number or in money terms.

e.g. Using 2014 as a base year for prices, work out nominal and real GDP:

	2014		2015		Nominal GDP		Real GDP	
	P (£)	Q	P (£)	Q	2014	2015	2014	2015
Fish	4	100	5	120	400	600	400	480
Chips	1	400	1.2	400	400	480	400	600
Total					800	1080	800	880

1. To work out nominal GDP: times the price by the quantity for each year e.g. fish in 2014 is 4×100
2. To work out the total: add the fish and the chips
3. To work out the real GDP: multiply the quantity by the price in 2014- this will strip out the effects of a rising price e.g. real fish in 2015 is 4×120



Other national income measures:

- **Gross National Income (GNI):** The value of goods and services produced by a country over a period of time plus net overseas interest payments and dividends. This means that it adds what a country earns from overseas investments and subtracts what foreigners earn in a country and send back home from the GDP. It is affected by profits from businesses owned overseas and remittances sent home by migrant workers. This is increasingly used rather than GDP because of the growing size of remittances and aid.
- **Gross National Product (GNP):** The value of goods and services over a period of time through labour or property supplied by citizens of a country both domestically (GDP) and overseas. This means it is the value of all the goods produced by citizens of a country, whether they live in the country or not, whilst GDP is the value of all goods produced inside the country, whether they were produced by citizens of the country or not.

Making comparisons about growth:

- **Over time:** Changing national income levels will show us whether the country has grown or shrunk over a period of time.
 - The data is compared to other countries to put figures in a context. Growth figures over a set period of time can be compared against similar countries to see whether the country has done well or not.
 - The figures can also make judgements about economic welfare as growth in national income means a rise in living standards as the economy is producing more goods and services so people have access to more things.
 - It is important to use real, per capita figures. If a country's population grows over time, then this may cause a rise in GDP without a rise in living standards and so provide inaccurate comparisons. We use real GDP in order to strip out the effect of inflation. Inflation is rising prices and therefore can give the impression of GDP growing without any more services and goods being produced.
- **Between countries:** When countries have a difference in population, a difference in total GDP doesn't necessarily mean a difference in living standards so to make comparisons, we work out GDP per capita. It is possible for GDP to increase simply because of an increase in prices in the country and inflation is different in every country, so real GDP figures need to be calculated.

Purchasing Power Parities:

- An exchange rate of one currency for another which compares how much a **typical basket of goods** in the country costs compared to one in another country.



- They provide an alternative to using exchange rates for comparisons of GDP.
- These are useful when comparing countries as it takes into account the **cost of living** (how much has to be spent to maintain living standards), and so will help us better compare living standards.
- The difference between the highest and lowest GDPs will be smaller when PPP is used as poorer countries have a much lower cost of living than richer ones. For example, in Kenya £2 a day in their own currency is enough to survive on, whilst it isn't in the UK.
- One example of this is the Big Mac Index, comparing the cost of the Big Mac throughout the world.

Problems of using GDP to compare standard of living:

National income statistics can be used to compare between countries and overtime to give some indication of the relative living standards: the quality of life enjoyed by people in a country. However, there can be problems with this.

- **Inaccuracy of data:**
 - Some countries are **inefficient at collecting or calculating data** and therefore comparisons can become less effective.
 - There is a **'hidden' or 'black' market** in which people work without declaring their income to avoid tax or to continue claiming benefits, and so GDP is underestimated because these incomes aren't taken into account. This varies hugely between countries and may change overtime.
 - GDP does not take into account **home-produced services**, for example in many poorer countries people work as subsistence farmers where they grow and consume their own crops without trading, and so the GDP is underestimated. This can also be true in the UK where DIY or the service of house-wives/husbands are not recorded.
 - Errors in calculating the **inflation rate** means real GDP will be slightly inaccurate.
 - Over time, **methods used to calculate GDP** will change and so therefore it can be difficult to compare countries overtime. Similarly, different countries may use different methods to calculate their GDP.
 - Also, it is important to take away **transfer payments**, when money is paid to a person without any corresponding increase in output in the economy. For example, the government taxes people who are employed and then gives it straight to the people who are unemployed. Other examples include pocket money and the selling of second hand goods.



- **Inequalities:** An increase in GDP may be due to a growth in income of just one group of people and so therefore a growth in the national income may not increase living standards everywhere. Income distribution changes overtime and varies between countries so makes comparisons difficult.
- **Quality of goods and services:** The quality of goods and services is much higher than those fifty years ago, but this is not necessarily reflected in the real price of these goods and services. Therefore, living standards may have increased more than GDP would suggest since the quality of goods and services has improved greatly. Improved technology may allow prices to fall, suggesting falling living standards, when this is not the case.
- **Comparing different currencies:** There are issues over which unit should be used to compare figures: they are usually converted into US dollars because of the size of the American economy. Some people argue that Purchasing Power Parity should be used to take into account the impact of differences in the cost of living in different countries.
- **Spending:** Some types of expenditure, such as defence, does not increase standard of living but will increase GDP. For example, the GDP of the UK was higher during the Second World War than in the 1930s because a lot of money was spent on defence which increased GDP but it is difficult to argue that standard of living was higher in the Second World War. This therefore makes comparisons difficult as spending varies overtime and between countries.
- There are also many **other factors** which are involved in living standards, such as education.

National happiness:

GDP only measures income but there are other factors affecting welfare. The UN happiness report found **six key factors**: real GDP per capita, health, life expectancy, having someone to count on, perceived freedom to make life choices, freedom from corruption, and generosity.

UK national wellbeing:

- In 2010, the UK Prime Minister launched the **Measuring National Wellbeing** report to measure how lives are improving. They found that self-reported health, relationship status and employment status most affect personal well-being.
- They ask **4 key questions about life satisfaction, anxiety, happiness and worthwhileness**, where people answer on a scale of 0 “not at all” to 10 “completely”. The report is now updated on a quarterly basis, rather than annually.



- In 2012-2016, life satisfaction, happiness and worthwhile have continued to rise whilst anxiety levels fell but have begun to rise slightly. This could be as unemployment is falling/GDP is rising but concerns over global security could be causing anxiety.

Real incomes and subjective happiness:

- One key finding of psychological research is that **happiness and income are positively related at low incomes** i.e. if you are poor and your income increases, you will be happier, but **higher levels of income aren't associated with increases in happiness** i.e. rich people aren't necessarily happy and increases in their income won't necessarily make them happier. This is called the **Easterlin Paradox**. An increase in consumption of material goods will increase happiness if basic needs aren't met (shelter and food), but once these needs are met, an increase in consumption won't increase long term happiness. For example, in the UK as we already enjoy a high standard of living, even if GDP doubles, happiness will not increase.
- Another finding is that income and happiness **depends on the people around us**. For example, if you are the richest out of everyone you associate yourself with, then you will be happier than someone who has the exact same income but is the poorest out of everyone they associate with. Income is linked to **social status** and higher social status tends to make us happier.

2.1.2 Inflation

Inflation is the general increase of prices in the economy which erodes the purchasing power of money. Low inflation is generally considered to be better than high inflation

Deflation is the fall of prices and indicates a slowdown in the rate of growth of output in the economy.

Disinflation is a reduction in the rate of inflation i.e. prices are still rising but they are not rising by as much.

Calculations:

Maths questions based on inflation are similar to GCSE-level percentage questions:

e.g. If the level of inflation is 10%, what will £500 worth of goods in year 1 cost in year 2?

$$110\% \times 500 = \text{£}550$$

e.g. If the level of inflation is 50%, what will £1000 worth of goods in year 2 in year 1?



1000=150%

$(1000/150) = 1\%$

$(1000/150) \times 100 = 100\% = \text{£}666.67$

percentages)

(This requires reverse

Indices: Nominal figures must be changed into real figures to make comparisons. This is done by choosing one year for the base year and adjusting all other figures into equivalent figures. In Britain, the most well-known indices are the retail price index (RPI) and the consumer price index (CPI). The base figure is given an index figure of 100 and all the figures before or after that time are then compared to that figure.

(new figure/base figure) x100

e.g. If the base year is 2005, work out the index of consumer spending for the following data:

Year	Consumer spending	Index
2000	625.1	$(625.1/712.5) \times 100 = 87.73$
2005	712.5	100
2010	630.9	$(630.9/712.5) \times 100 = 88.55$
2015	715.5	$(715.5/712.5) \times 100 = 100.4$

Consumers Price Index (CPI):

- The Office for National Statistics (ONS) collects prices on 710 goods and services from 20,000 shops in 141 locations and online sites and the prices are updated every month, with collectors visiting the same retailers to monitor identical goods. New items are added to the list every year, such as microwaveable rice and nail varnish, whilst others are taken away, including organic carrots.
- All these prices are combined using information on the average household spending pattern to produce an overall price index. The average household spending is worked out through the **Living Costs and Food Survey**, where around 5,500 families keep diaries of what they spend over a fortnight.
- It takes into account how much is spent on each item so they are **weighted** i.e. we spend more on petrol than on postage stamps so an increase in petrol will have a bigger impact on the overall rate of inflation.



Limitations of CPI:

- It is impossible for the figure to take into account every single good that is sold in the country and so therefore the CPI is **not totally representative**. Similarly, different households spend different amounts on each good and so therefore the CPI only measures an average rate of inflation, and is not totally representative.
- Moreover, it does not include the **price of housing** and so, since this has tended to rise more than the price of other goods, the data may be lower than it should be.
- Since the figure is more recent than RPI, it is **difficult to make comparisons** with historical data. It was only used since 1996 with estimates going back to 1988 which means that levels of inflation using CPI can only be accurately compared back to then.

Some people argue that **all inflation indices overestimate inflation** because they don't take into account the fact that goods and services have improved in quality, and so will obviously be more expensive. For example, a car in the 1950s would be far less comfortable and reliable than today's. It has no way of indicating the change of goods that is bought.

Retail Price Index (RPI):

The RPI is very similar to the CPI. However, there are some differences between the data included and the way it is calculated.

- RPI includes **housing costs** such as mortgage and interest payments and council tax, whereas CPI does not.
- CPI takes into account the fact that when prices rise people will **switch** to product that has gone up by less. Therefore, the CPI is generally lower than the RPI.
- RPI excludes the top 4% of income earners and low income pensioners as they are not **'average' households** whilst CPI covers all households and all incomes.

RPI is no longer considered as the best method and has had its national statistic status removed, although the Office for National Statistics still calculates it every month.

Causes of inflation:

Demand pull:

- Prices in a market are determined by demand and supply and a shift in either will cause price to change. Inflation can therefore be caused by an increase in aggregate demand (AD), total demand for goods and services in the economy.
- If any factor which increases AD was to increase (2.2), then inflation would increase



Cost push:

- Whilst an increase in aggregate demand can push prices up, a decrease in aggregate supply may also push prices up.
- When businesses find their costs have risen, they will put up prices to maintain their profit margins. This can be caused by any factor which decreases AS (2.3)

Growth of money supply:

- Another potential cause of inflation is there being too much money in the economy. If people have access to money they will want to spend it but if there is no increase in the amount of goods and services supplied, then prices will have to rise.

This idea grew out of the **fisher equation**: $MV=PT$ where M is money supply, V is speed of money circulating in the economy, P is the price level and T is the number of transactions. An increase in money supply will lead to an increase in price level, ceteris paribus.

- The government can also increase the amount of money that they print and decisions to increase government borrowing can also increase the money supply.

The money supply can be increased by banks creating credit., known as the **bank multiplier**. Banks make their money by taking in our deposits and then lending money out at interest rates. They lend money and keep a certain percentage, and the people who borrow money do so in order to spend it. The person who receives the money the borrower has spent is likely to input it back into the banking system where the bank sees it as a new deposit and a percentage of this deposit is then lent out. For example, if they were to keep 10% of the money deposited with them in cash and lend the rest out: The initial bank deposit is £100m and they keep £10m then lend out £90m so the deposit is then £90m, £9m is kept and £81m is lent out so the deposit is £81m, they keep £8.1m and £72.9m is lent so on. In this way, the banks increase the money supply.

Effects of inflation:

Consumers:

- If people's incomes do not rise with inflation then they will have **less to spend**, which could cause a fall in living standards.
- Those who **are in debt** will be able to pay it off at a price which is of cheaper value, but those who are owed money lose because the money they get back is of cheaper value. Consumers who have **saved** will lose out as their money is worth less.
- Inflation has **psychological effects** on consumers: because prices are rising, they may feel less well-off, even if their income is rising in line with inflation, and so this may cause them to decrease their spending.



Firms:

- If inflation in Britain is higher than other countries, British goods will be more expensive. They will become **less competitive** and make them more difficult to export. This will also affect the balance of payments.
- Deflation isn't good as it encourages people to **postpone their purchases** as they wait for the price to fall further. People will be more likely to save as the value of their money will rise in the future and they will be prevented from borrowing as deflation means the real value of their debt increases. This can lead to a fall in demand for goods, leading to a fall in firms' profit, and in business confidence which can lead to a long term reluctance to invest.
- In general, inflation/deflation/disinflation is **difficult to predict** and so this means that firms cannot plan for the future.
- Another effect of changing prices is that firms will have to calculate new prices then **change their menus, labelling** etc. and this can be expensive.

Governments:

- If the government fails to change excise taxes (taxes at a set amount e.g. £1) in line with inflation then real government revenue will fall. However, if they fail to change personal income tax allowances (the amount a worker can earn tax free) then real government income will increase and taxpayers will have less money.

Workers:

- If workers do not receive **yearly pay rises** of the rate of inflation, they will be worse off and their living standard will decrease. Those in weaker unions tend to be most affected as they are unable to win wage rises in line with inflation.
- Deflation could cause some staff to **lose their jobs** as there is a lack of demand meaning firms see a fall in profit and have to decrease staff to cut costs.

Some of these costs can be reduced if inflation is anticipated, which will allow groups to plan for the future. This can be done through **indexation**, so wages or taxes are increased in line with inflation. An example of this is workers negotiating with employers for wage rises in line with the predicted CPI or RPI. However, indexation may in itself further inflation because wage increases will reflect past increases. Therefore, if inflation has been at 10% previously but the government wants to reduce it to 2%, this will be difficult if workers are still getting a 10% pay rise due to indexation agreements.



Synoptic point:

The effect on individuals, such as firms, consumers or workers, are microeconomic impacts whilst the inflation figure itself is a macroeconomic concept. This shows how the macro-economy has microeconomic effects.

2.1.3 Employment and unemployment

Unemployment represents a waste of resources and so the level of unemployment is a good indicator of a country's economy. Employment tends to be linked to economic growth as fast economic growth will lead to more jobs being created. The level of unemployment can be stated as a number or as a percentage of the population of working age.

Measures of unemployment:

Claimant count:

- The Claimant Count is the **number of people receiving benefits for being unemployed**. It provides the number of claimants on particular day each month and the numbers joining and leaving the count each month.

International Labour Organisation and UK Labour Force Survey:

- The Office of National Statistics (ONS) uses the International Labour Organisation (ILO) definition of unemployment and employed.
- Through the ILO, anyone over 16 can be classed as employed, unemployed or economically inactive.
 - **Employed:** Those who do more than 1 hour of paid work a week or are temporarily away from work (e.g. on holiday), are on a government supported training scheme or do minimum 15 hours of unpaid work for their family business.
 - **Unemployed:** Those of working age who are without work, able to work and seeking work and have actively sought work in the last 4 weeks and are available to start work in the next 2 weeks.
 - **Inactive:** Those who are neither employed nor unemployed; they are people of working age not seeking employment as well as those seeking employment but not able to start work e.g. those in study, looking after family, health related issues, discouraged workers (those who are fed up of applying), retirement and those who do not want or need a job.



- The Labour Force Survey (LFS) is a **sample of people living in households** and is a legal requirement for every country in the EU. It asks questions about personal circumstances and activity in the labour market to class people as employed, unemployed or inactive by the ILO definitions. The figures are only an **estimate** of the true level of unemployment as it is measured by a sample.

Comparisons between the Claimant Count and LFS:

- Some people may not be included in the LFS unemployment measure but would be in the Claimant Count. These may include people working in the **hidden economy** or those who **fraudulently claim benefits**.
- However, **some people aren't eligible for benefits** but are classed as unemployed so would appear in the LFS but not the Claimant count. This can be if their partner is working, if they are looking for work along full-time study or if they are around State Pension Age. The **LFS tends to be higher than the Claimant Count** because of these reasons.
- Sometimes, the claimant count and LFS rates can be going in **different directions**. This could be due to the fact that the LFS is only a sample and different types of people have been asked which can lead to short term changes in the rate. Also, there may be things happening in the labour market not covered by the Claimant Count, for example more students could look for work along their studies or more people above State Pension Age may look for work.

It is argued that **both underestimate the figure** as they do not include those:

- working part time but would like to work full time
- on government training schemes who would prefer employment
- classed as sick or disabled
- who aren't actively looking for jobs but would take a job if offered or are in education because they can't get a job

These are the **hidden unemployed**.

Rates:

- The **economically active** are the employed and unemployed. They are engaged in labour market and are people employers can look to recruit. The **workless** are the unemployed and inactive.
- The **employment rate** is the percentage of the population of working age who are employed, and the **unemployment rate** is the percentage of the economically active who are unemployed.
- The **activity/participation rate** is the percentage of the population of working age who are economically active whilst the **inactivity rate** is percentage of the population of working age who are inactive.



Under-employment

- The underemployed are those who are in **part time or zero hour contracts** when they would prefer to be full time and people who are **self-employed** but would rather be employees.
- It also includes those who are in jobs which **do not reflect their skill level**, for example a university graduate that can't find a graduate job so is working as a bartender.
- The underemployed aren't included in any unemployment statistics.
- Underemployment tends to **increase during recessions** because firms will just reduce staff hours instead of making them redundant and having to pay expensive redundancies packages. It doesn't have as many negative effects as official unemployment, but it does mean the underemployed have lower incomes and so will spend less, reducing aggregate demand and growth of the economy.

Significance of changes in activity:

- Increases in inactivity will decrease the size of the labour force, therefore causing a fall in **productive potential of the country**. There will be a lower GDP and lower tax revenues as less people are working.
- However, decreases in inactivity could just result in more people being unemployed if there are **no jobs available** to them.

Types of unemployment

Frictional unemployment:

- Frictional unemployment is due to **people moving between jobs**. This could be due to new workers entering the labour market or people who have chosen to leave their previous job. These people may take a while to locate and gain a job that they are willing to accept.
- This isn't a serious problem as it is only **short term**.

Structural unemployment:

- This is a much more **serious form of unemployment** as it is a **long term decline in demand in an industry leading to reduction in employment** perhaps because of increasing international competition or technology. It is where the demand for labour is lower than the supply in an individual labour market e.g. ship building.



- The lack of **geographical and occupational mobility** means that people will remain unemployed, so need to be retrained in order to gain a job.
- There are different types of structural unemployment.
 - **Regional unemployment** is where certain areas of a country suffer from very low levels of employment due to industry closures; this is made even worse by the fact that the loss of jobs can mean a fall in demand for other businesses in the area, forcing more closures and job losses.
 - **Sectoral unemployment** is where one sector (primary, secondary and tertiary) suffers a dramatic fall in employment.
 - **Technological unemployment** is where an improvement in technology means that jobs are replaced.

Seasonal unemployment:

- Some employment is **strongly seasonal in demand**. Industries such as tourism are only prominent during certain times of the year so only demand large numbers of workers at a specific time. Once that time of the year has passed then the labour force is drastically reduced.
- There is little that can be done to prevent this from occurring in a free market economy.

Cyclical unemployment:

- This is unemployment due to a **general lack of demand of goods and services within the country**. This is also known as a **Keynesian 'demand deficient'** unemployment.
- When there is a recession or severe slowdown in economic growth, we see a rising unemployment because of plant closures, business failures and an increase in worker layoffs and redundancies. This is due to a decrease in demand causing businesses to cut employment in order to control costs and restore some of their profitability.

Real wage inflexibility:

- This is unemployment considered to be the result of **real wages being above their market clearing level** leading to an excess supply of labour. Some workers might be prepared to work for less than the minimum wage and companies may be prepared to take on more workers if they could pay them less than the minimum wage, but this is illegal and so unemployed workers cannot get a job.
- Some economists believe that the minimum wage risks creating unemployment in industries where **international competition** from low-labour cost producers is severe. As yet, there is **relatively little evidence** that the minimum wage has created rising unemployment on the scale that was feared.



- It can also be caused by unemployed workers refusing to take low paid jobs because they can receive more in welfare benefits.

Migration and skills:

Migration:

- An increase in net inward migration tends to lead to **increased jobs**. Since the 1990s, the UK has seen a large increase in immigration from mainly Eastern European countries. Most of these people come to the UK to work, are of working age and often take lower skilled jobs; they are less likely to claim benefits than the existing population. Due to the **circular flow of income**, immigrants' spending creates jobs and total employment increases without an increase in unemployment. This depends how much money immigrant workers send back home.
- However, it also leads to **lower wages**, particularly for lower-paid, low skilled jobs. UK firms are able to recruit foreign workers meaning that **supply of labour** is increased and so the price equilibrium of labour is reduced. There is more competition for jobs and UK workers who have low motivation to work and are **low skilled are most affected** as they are competing in the job market with hard working, more skilled workers prepared to take the same jobs as them. The impact of this is only small and middle and higher income wages are rarely affected.

Skills:

- Economies progress over time, and as a result, **higher skills are needed** to work in them. In the UK 50 years ago, many jobs were available for those who couldn't read or write but now there are few.
- For the UK to maintain its employment levels, it needs to increase the skills of its workforce over time. Structural unemployment is caused by a **lack of, or the wrong, skills**. For example, engineering companies struggles to recruit skilled workers even though there are unemployed workers in the local area.
- If firms will not train staff, the government has to step in to correct the market failure but this is costly. As a result, people become **long-term unemployed** as their skills don't fit the jobs on offer.
- **Migrant workers may fill these shortages** if their skills fit.



Impacts of unemployment:

Workers:

- Those who are made unemployed normally have a **loss of income** which usually results in a decline in their living standards.
- They often suffer from the **stigma** of being unemployed and feel degraded by the process of signing on to receive benefits to support their family. This can lead to stress, marital breakdown, suicide, physical illness etc.
- The long-term unemployed (those unemployed for more than 12 months) often find it more difficult to get another job as they **lose skills**.
- Those who are in jobs will suffer from **lower job security** and will fear being made redundant. They could also see a fall in wages because the firm can easily find someone to replace them if they complain about pay.

Firms:

- There will tend to be a decrease in demand for their goods (but this depends on the YED) and so this could lead to a **fall in profit**.
- Long term unemployment can lead to loss of skills and reduce employability of workers, so firms have a **smaller pool of skilled people** to employ.
- They can offer **low wages** as people will take the job anyway because they know there is a lack of jobs so have few options.

Consumers:

- Consumers in areas of high unemployment lose out because local shopping centres tend to be run down and don't offer the range of shops available to those in areas of low unemployment. They suffer from **less choice**. The quality of goods may also decrease.
- The unemployed consumers lose out as they have less available to spend.
- However, firms may lower prices and put on **sales** in order to increase demand for their product.

Government:

- The reduced income results in a **fall in tax revenues** and **higher spending** on welfare payments for families with people out of work, incurring an opportunity cost as the money could be better spent elsewhere.
- This will result in an increase in the **budget deficit**. It will be likely that the government will have to raise taxation or scale back plans for public spending on public and merit goods, such as the NHS or education. They may need to increase borrowing.



Society as a whole:

- Rising unemployment is linked to **social deprivation**. There is a relationship with crime and social dislocation (increased divorce rates, worsening health and lower life expectancy).
- Areas of high unemployment often see a fall in demand for local goods and services, leading to a fall in income for those working in the services and sometimes further loss of jobs.
- It results in a **loss of potential national output** and represents an inefficient use of scarce resources. If people chose to leave the labour market permanently, then this will have a negative effect on LRAS and therefore damage the economy's growth potential so the country is unable to achieve their desired PPF.
- Taxpayers paying money to the unemployed is not a loss for the economy as it is a transfer payment but the economy is affected because there is a fall in national output and the social costs of the unemployed e.g. violence and crime.

Synoptic point:

Unemployment has microeconomic impacts in terms of its impacts on individual groups such as consumers. This unit links in well with Labour markets in Theme 3. Job losses are a microeconomic concept whilst unemployment is a macroeconomic concept.

2.1.4 Balance of payments

The balance of payments is a **record of all financial dealings over a period of time between economic agents of one country and all other countries**. Imports are when goods/services come in, so money goes out. Exports are when money comes in, so the good/service goes out.

Components of the balance of payment:

- The balance of payments is made up of the **current account** which records payments for the purchase and sale of goods and services; and the **capital and financial account** which records flows of money associated with saving, investment, speculation and currency stabilisation. Theme 2 focuses only on the current account.
- Flows of money into the country are given a positive sign and flows of money out are given a negative sign. It is important to remember that the balance of payments looks at where the **money** flows.

Current account:

The current account itself is split into different parts:



- **Trade in goods:** These are known as visibles because you can physically see them. They are goods that are traded, whether raw materials or finished goods. The difference between visible exports and visible imports is known as the balance of trade.
- **Trade in services:** These are services traded in or out of the country, known as invisibles. A holiday to Spain by a British family is an invisible import as money leaves the UK and goes to Spain, whilst a Japanese firm buying insurance from a city of London firm is an invisible export as money enters the UK.

The **balance of trade in goods and services** is the balance of trade + balance of invisibles.

- **Income and current transfers:** Wages, interest, profit or dividends can be repatriated into the country. For example, a Polish person could send the money they make in the UK back home to Poland or a British person could take the profits from their overseas country back to the UK. Current transfers are usually done by governments and are when they transfer money into or out of overseas organisations such as the EU. Income and current transfers can be split into primary and secondary incomes: primary income is the result of loans of the factors of production abroad e.g. interest, profits and dividends (including wages sent to other countries) whilst secondary income is a range of mainly government transfers to overseas organisations, such as the EU.

Current account deficits and surpluses:

The **current balance** = Balance of trade + Balance of invisibles + Net income and current transfers.

A **current account surplus** is where exports are greater than imports, so the current balance is positive. A **current account deficit** is where imports are greater than exports, so the current balance is negative.

Macroeconomic objectives:

- Governments tend to have four main objectives: low unemployment, low and stable inflation, economic growth at a similar rate to other economies and a balance of payment equilibrium, including current account balance. However, achieving a balance of payment equilibrium can be affected by achieving other aims.
- **High economic growth** tends to mean that the current account becomes a deficit as there is increased imports due to increased demand, and it is during times of high unemployment etc. that the current account deficit tends to improve.
- Governments tend to want **export led growth**, which would cause economic growth, high employment and improve the current account balance; although it could lead to



inflation. There have been frequent export initiatives but successive UK governments have been unable to achieve this.

Interconnectedness of economies:

Over time, the world economy has become increasingly interconnected, this is due to four key ways which have led to globalisation:

- The proportion of output of an individual economy which is **traded** internationally is growing.
- Many more people (or companies) **own assets in other countries** such as shares, loans or businesses.
- There is increasing **migration** between countries
- More **technology** being shared on a faster basis.

International trade has meant countries have become more **interdependent** so a change in the economic condition of one country will affect another, since the quantity they import or export changes. In theory, all current balances should add up to zero as what one country exports another imports.

