# Edexcel Economics (A) A-level

# Theme 2: The UK Economy - Performance and Policies

## 2.1 Measures of Economic Performance

**Summary Notes**

# 2.1.1 Economic Growth

- Economic growth 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.
- **Total GDP** is the combined monetary value of all goods and services produced within a country's borders during a specific time period.
- **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.
- **Volume of GDP** is GDP adjusted for inflation. It is the size of the basket of goods and the real level of GDP.
- **Value of GDP** is the monetary value of GDP at prices of the day. It is the nominal figure and can be calculated by volume times current price level.

- National income can also be measured by:
  - **Gross National Product (GNP)** is the market value of all products produced in an annum by the labour and property supplied by the citizens of one country. It includes GDP plus income earned from overseas assets minus income earned by overseas residents. GDP is within a country's borders, whilst GNP includes products produced by citizens of a country, whether inside the border or not.
  - **Gross National Income (GNI)** is the sum of value added by all producers who reside in a nation, plus net overseas interest payments and dividends. It includes what a country earns from overseas and removes any money that is sent back home by foreigners in that country.

- **Purchasing Power Parity (PPP)**

- This is a theory that estimates how much the exchange rate needs adjusting so that an exchange between countries is equivalent, according to each currency's

purchasing power. For example, if a car cost £15,000 and the exchange rate between the UK and the US is 1.5 £ per $, then in the US, the car should cost
- $10,000. This means both cars cost the same number of US dollars, and the same number of pounds Sterling.
- This helps to minimise misleading comparisons between countries.

## The limitations of using GDP to compare living standards between countries over time

- GDP does not give any indication of the distribution of income. Therefore, two countries with similar GDPs per capita may have different distributions which lead to different living standards in the country.
- 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.
- GDP gives no indication of welfare. Other measures, such as the happiness index, might be used to compare living standards instead or in conjunction with GDP.

### National happiness (statistics from the ONS):

- **UK national well-being**
  The Office for National Statistics is trying to develop more ways of measuring national well-being. It should give a wider picture of society and the standard of living within the UK.
  The UN happiness report found that the six factors which affect national well-being are: real GDP per capita, health, life-expectancy, having someone to count on, perceived freedom to make life choices, freedom from corruption and generosity.
  The UK 'Measuring National Wellbeing' report includes questions about life satisfaction, anxiety, happiness and worthwhileness.
- **The relationship between real incomes and subjective happiness**
  The UK economy grew by 5% in GDP per capita between 2007 and 2014, but showed no change in life satisfaction. However, generally, the higher the GDP per capita, the higher the average life satisfaction score.
  One finding is that happiness and income tend to be positively related at low levels of income but, once basic needs are met, higher income does not lead to increased happiness.

# 2.1.2 Inflation

- **Inflation** is the sustained rise in the general price level over time. This means that the cost of living increases and the purchasing power of money decreases.
- **Deflation** is the opposite, where the average price level in the economy falls. There is a negative inflation rate.
- **Disinflation** is the falling rate of inflation. This is when the average price level is still rising, but to a slower extent. This means goods and services are relatively cheaper now than a year ago, and the purchasing power of money has increased.
- For example, a 4% increase in the price level between 2014 and 2015 would be inflation. A change from 4% to 2% is still inflation, but there has been disinflation where the price rise has slowed. If the change in the price level is now -3%, there is deflation.

## Calculating the inflation rate in the UK

- This is done using the **Consumer Prices Index (CPI).** It measures household purchasing power with the Family Expenditure Survey. The survey finds out what consumers spend their income on. From this, a basket of goods is created. The goods are weighted according to how much income is spent on each item. Petrol has a higher weighting than tea, for example. Each year, the basket is updated to account for changes in spending patterns.

- In the UK, it is a government macroeconomic objective for inflation to be at 2%, or 1% either side of this. They want to maintain price stability.

- The key points when answering an exam question on CPI are:
    - A survey is used
    - Weighted basket of goods
    - Measures average price change of the goods
    - Updated annually

### Limitations of CPI when measuring inflation

- The basket of goods is only representative of the average household, so it is not accurate for households who do not own cars, for example, and therefore do not spend 14% of their income on motoring.

- Different demographics have different spending patterns.

- CPI is slow to respond to new goods and services, even though it is updated regularly.

- Moreover, it is hard to make historical comparisons, since technology twenty years ago was of a vastly different quality, and arguably a different product altogether, than now.

- **Retail Price Index (RPI)**

- This is an alternative measure of inflation.
- Unlike CPI, RPI includes housing costs, such as payments on mortgage interest and council tax. This is why RPI tends to have a higher value than CPI.
- It excludes the top 4% of earners and low income pensioners.
- CPI takes into account the fact that when prices rise people will switch to product that has gone up by less, whilst RPI does not.

## Causes of inflation

- **Demand pull:** This is from the demand side of the economy. When **aggregate demand** is growing unsustainably, there is pressure on resources. Producers increase their prices and earn more profits. It usually occurs when resources are fully employed.
  The main triggers for demand pull inflation are:
  - A depreciation in the exchange rate, which causes imports to become more expensive, whilst exports become cheaper. This causes AD to rise.
  - Fiscal stimulus in the form of lower taxes or more government spending. This means consumers have more disposable income, so consumer spending increases.
  - Lower interest rates makes saving less attractive and borrowing more attractive, so consumer spending increases.
  - High growth in UK export markets means UK exports increase and AD increases.

- **Cost push:** This is from the supply side of the economy, and occurs when firms face rising costs. This occurs when:
  - Raw materials become more expensive, such as when oil prices rise.
  - Labour becomes more expensive. This could be through trade unions, for example.

- Expectations of inflation- if consumers expect prices to rise, they may ask for higher wages to make up for this, and this could trigger more inflation.
- Indirect taxes could increase the cost of goods such as cigarettes or fuel, if producers choose to pass the costs onto the consumer.
- Depreciation in the exchange rate, which causes imports to become more expensive, which pushes up the price of raw materials.
- Monopolies, using their dominant market position to exploit consumers with high prices.

- **Growth of the money supply:** If, for instance, the Bank of England printed more money, there would be more money flowing in the economy. Extreme increases in the money supply usually cause **hyperinflation**, when the rate of inflation is incredibly high and uncontrollable. It is only inflationary if the money supply increases at a faster rate than real output.

## The effects of inflation on:

- **Consumers**
  - Those on low and fixed incomes are hit hardest by inflation, due to its regressive effect, because the cost of necessities such as food and water becomes expensive. The purchasing power of money falls, which affects those with high incomes the least.
  - If consumers have loans, the value of the repayment will be lower, because the amount owed does not increase with inflation, so the real value of debt decreases.

- **Firms**
  - Low interest rates means borrowing and investing is more attractive than saving profits. With high inflation, interest rates are likely to be higher, so the cost of investing will be higher and firms are less likely to invest.
  - Workers might demand higher wages, which could increase the costs of production for firms.
  - Firms may be less price competitive on a global scale if inflation is high. This depends on what happens in other countries, though.
  - Unpredictable inflation will reduce business confidence, since they are not aware of what their costs will be. This could mean there is less investment.
- **The government**
  - The government will have to increase the value of the state pension and welfare payments because the cost of living is increasing.

- **Workers**
  - Real incomes fall with inflation, so workers will have less disposable income.
  - If firms face higher costs, there could be more redundancies when firms try and cut their costs.

**Synoptic point:**

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

# 2.1.3 Employment and Unemployment

## Measures of unemployment

It is usually difficult to accurately measure unemployment. Some of those in employment might claim unemployment related benefits, whilst some of the unemployed might not reveal this in a survey.

The two main measures of unemployment in the UK are:

**The Claimant Count**
This counts the number of people claiming unemployment related benefits, such as Job Seeker's Allowance (JSA). They have to prove they are actively looking for work.

**Evaluating the Claimant Count:**

Not every unemployed person is eligible for, or bothers claiming JSA. Those with partners on high incomes will not be eligible for the benefit, even if they are unemployed. Although there may be instances of people claiming the benefit whilst they are employed, the method generally underestimated the level of unemployment.

**The International Labour Organisation (ILO) and the UK Labour Force Survey (LFS)**
The LFS is taken on by the ILO. It directly asks people if they meet the following criteria:

- Been out of work for 4 weeks
- Able and willing to start working within 2 weeks
- Workers should be available for 1 hour per week. Part time unemployment is included.

Since the part time unemployed are less likely to claim unemployment benefit, this method gives a higher unemployment figure than the Claimant Count.

## The distinction between unemployment and underemployment

The **unemployed** are those able and willing to work, but are not employed. They are actively seeking work and usually looking to start within the next two weeks.

- The **underemployed** are those who have a job, but their labour is not used to its full productive potential. Those who are in part-time work, but are looking for a full-time jobs are underemployed.
- **The significance of changes in the rates of and the effects of**:

  - **Employment and Unemployment:**

    - **Consumers**
      If consumers are unemployed, they have less disposable income and their standard of living may fall as a result.
      There are also psychological consequences of losing a job, which could affect the mental health of workers.
    - **Firms**
      With a higher rate of unemployment, firms have a larger supply of labour to employ from. This causes wages to fall, which would help firms reduce their costs.
      However, with higher rates of unemployment, since consumers have less disposable income, consumer spending falls so firms may lose profits. Producers which sell inferior goods might see a rise in sales. It might cost firms to retrain workers, especially if they have been out of work for a long time.
    - **Workers**
      With unemployment, there is a waste of workers' resources. They could also lose their existing skills if they are not fully utilized. Those in jobs are likely to see a fall in their wages as supply of labour increases.
    - **The government**
      If the unemployment rate increases, the government may have to spend more on JSA, which incurs an opportunity cost because the money could have been invested elsewhere.
      The government would also receive less revenue from income tax, and from indirect taxes on expenditure, since the unemployed have less disposable income to spend.
    - **Society**
      There is an opportunity cost to society, since workers could have produced goods and services if they were employed.
      There could be negative externalities in the form of crime and vandalism, if the unemployment rate increases.
  - **Inactivity**: The economically inactive are those who are not actively looking for jobs. These could include carers for the elderly, disabled or children, or those who have retired. Some workers are discouraged from the labour

market, since they have been out of work for so long that they have stopped looking for work. If the number of the economically inactive increases, the size of the labour force may decrease, which means the productive potential of the economy could fall.

**Synoptic point:**

Whilst unemployment is a macroeconomic concept, it has microeconomic impacts in terms of its impacts on individual groups such as consumers.

## The causes of unemployment:

### Structural unemployment

This occurs with a long term decline in demand for the goods and services in an industry, which costs jobs. In the UK, this has included job losses in industries such as car manufacturing, coal and ship building.

This type of unemployment is worsened by the geographical and occupational immobility of labour. If workers do not have the transferable skills to move to another industry, or if it is not easy to move somewhere jobs are available, then those facing structural unemployment are likely to remain unemployed in the long run.

Globalisation contributes to structural unemployment, since production in the manufacturing sectors, such as in clothing or motor cars, moves abroad to countries with lower labour costs. Technological change also contributes as workers began to be replaced by machinery.

### Frictional unemployment

This is the time between leaving a job and looking for another job. It is common for there to always be some frictional unemployment, and it is not particularly damaging since it is only temporary. For example, it could be the time between graduating from university and finding a job.

This is why it is rare to get 100% employment: there will always be people moving between jobs.

## Seasonal unemployment

This occurs during certain points in the year, usually around summer and winter. During the summer, more people will be employed in the tourist industry, when demand increases.

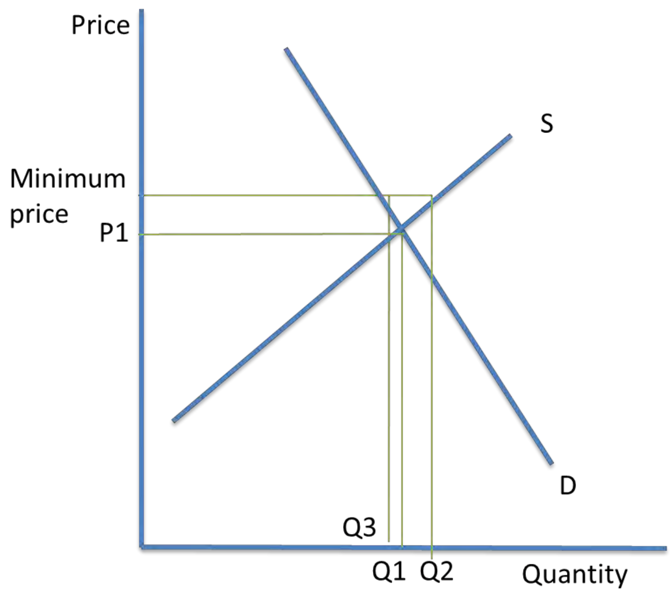
## Demand deficiency (cyclical unemployment)

This is caused by a lack of demand for goods and services, and it usually occurs during periods of economic decline or recessions. Firms are either forced to close or make workers redundant, because their profits are falling due to decreased consumer spending, and they need to reduce their costs. This then causes output to fall in several industries.

This type of unemployment could actually be caused by increases in productivity, which means each worker can produce a higher output, and therefore fewer workers are needed to produce the same quantity of goods and services.

## Real wage inflexibility

Wages above the market equilibrium may cause unemployment. Classical economists argue that by letting wages fall to the equilibrium level, there would be no unemployment.




In the diagram, the point at 'minimum price' reflects the NMW. This causes unemployment of Q1 – Q3.

If demand then shifts to the left, due to a fall in consumer spending for example, there would be more unemployment since wages are not able to adjust

Classical economists would argue that by letting wages be flexible, by removing trade union power and removing the NMW, wages could fall and unemployment would fall to 0.

However, cutting wages during times of weak consumer spending would cause further falls in consumer spending, and there would be even lower economic growth. Moreover, the classical economist argument is made on the assumption of a perfectly competitive market, which is not true in reality.

## The significance of migration and skills for employment and unemployment:

- Migrants are usually of working age and many are looking for a job, so the supply of labour at all wage rates tends to increase with more migration.

- Migrants tend to bring high quality skills to the domestic workforce, which can increase productivity and increase the skillset of the labour market. This could increase global competitiveness.

- Migrant labour affects the wages of the lowest paid in the domestic labour market, by bringing them down. This is because migrants are usually from economies with lower average wages than the UK NMW. However, this impact is only small. For the medium and higher income households, it is hard to find evidence of worker displacement or depressed wages.

- In general, a higher skilled work force is more employable. Economies progress over time and so higher skills are needed to work in them. This means that the skills of the workforce need to continuously improve in order to maintain employment. Structural unemployment occurs if individuals don't have the right skills.

**Synoptic point:**

This unit links in well with the Labour markets unit in Theme 3. Job losses are a microeconomic concept whilst unemployment is a macroeconomic concept.

# 2.1.4 Balance of Payments

## Components of the balance of payments

This is a record of all financial transactions made between consumers, firms and the government from one country with other countries.

It states how much is spent on imports, and what the value of exports is.

**Exports** are goods and services sold to foreign countries, and are positive in the balance of payments. This is because they are an **inflow** of money.

**Imports** are goods and services bought from foreign countries, and they are negative on the balance of payments. They are an **outflow** of money.

The balance of payments is made up of:
- The current account
- The capital account
- The official financing account.

For the AS course, only the current account is focussed on.

- The **current account on the balance of payments** is the balance of trade in goods and services.

## Current account deficits and surpluses

- A current account surplus means there is a net inflow of money into the circular flow of income. The UK has a surplus with services, but a deficit with goods.

- The UK has a current account deficit. This means the UK spends more on imports from foreign countries, than they earn from exports to foreign countries. If the deficit is large and runs for a long time, there could be financial difficulties with financing the deficit.

## The relationship between current account imbalances and other macroeconomic objectives

- The UK government's macroeconomic objectives are to have:

  - Full employment
  - Low, stable inflation
  - A sustainable current account on the balance of payments
  - Sustainable economic growth

- By selling more exports to foreign countries, the UK will have a greater inflow of money into the circular flow of income. This will increase AD and improve the rate of economic growth.
- In the UK, during periods of economic decline or recessions, the current account deficit falls. This is because consumer spending falls.
- During periods of economic growth, when consumers have higher incomes and they can afford to consume more, there is a larger deficit on the current account.
- If imported raw materials are expensive, there could be cost-push inflation in the UK, since firms face higher production costs.

## The interconnectedness of economies through international trade

- In theory, the sum of all countries' trade balances should be zero, since what one country exports will be imported by another country.

- If the UK's main export market, such as the EU, faces an economic downturn then demand for UK goods and services will fall, since consumers in the EU are less able to afford imports.

- International trade has meant countries have become interdependent. Therefore, the economic conditions in one country affect another country, since the quantity they export or import will change.