Edexcel Economics (A) A-level

Theme 2: The UK Economy - Performance and Policies

2.5 Economic Growth

Summary Notes

2.5.1 Causes of growth

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. It is measured by the annual change in real GDP.

Factors which cause economic growth

Economic growth occurs due to an improvement in the quantity or quality of one of the factors of production, or an increase in the efficiency of the way they are used. For example:

- Improving the labour force, with a better quality due to higher education.
- A larger labour force. This may be due to migration, birth rates or improved participation rates.
- Improved technology, which is more productive. This means resources are used more efficiently.
- More investment, to fuel economic growth. More machinery can be bought, which will increase production.
- Discovering new resources, such as oil.
- Incentives for enterprise, such as tax breaks or subsidies.

Synoptic point:

Decisions by individuals can affect economic growth, for example a firm's decisions to increase investment can lead to growth. For this to happen, the decision must be undertaken by a number of individuals. One firms' decision to invest is unlikely to have a significant impact, unless they are a very large firm undertaking vast investment.

- **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.

- **Potential growth** 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.

The importance of international trade for export led economic growth

Export led growth occurs when countries open up their economies to the international market. One of the most famous examples of this is China, which has had export led growth for many years.

International trade is important for this. Countries can specialise where they have a **comparative advantage,** which increases world output and lowers average costs.

A country has comparative advantage when it can produce goods and services at a lower opportunity cost than another.

It will initially increase AD, so will only bring about short term growth. However, it will encourage firms to **invest** and therefore bring about long term growth by improving the supply-side of the economy.

It allows the government to bring about economic growth and high employment without seeing a current account deficit.

Export led growth means the economy is **unbalanced,** since there is a surplus on the current account on the balance of payments. Whilst this means there are net injections into the economy, it is not necessarily sustainable. However, the growth in the economy may lead to an increase in imports which will balance the current account.

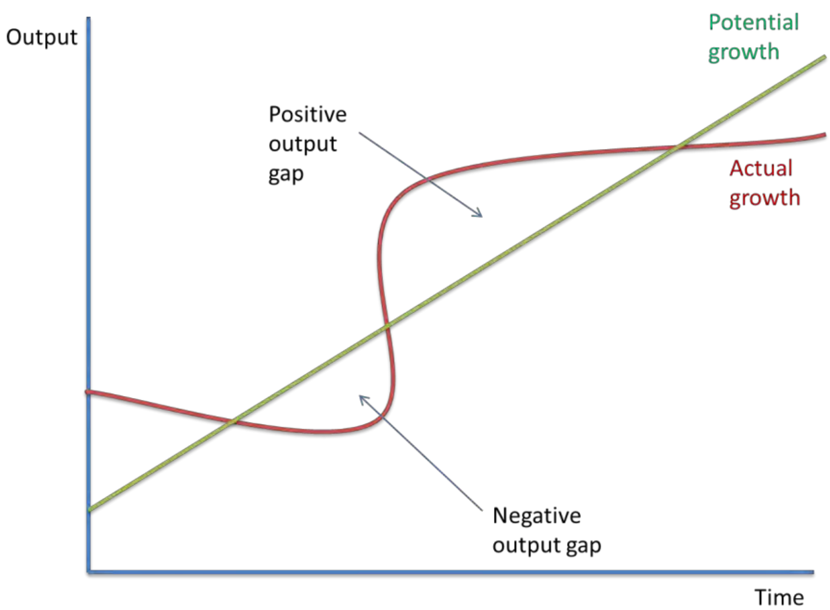
Moreover, it means the country relies on the economic state of other countries, since these are the consumers of their goods and services. If there is a recession in a major export market, exports will fall and so will economic growth.

2.5.2 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 and the difficulty of measurement:



- 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.

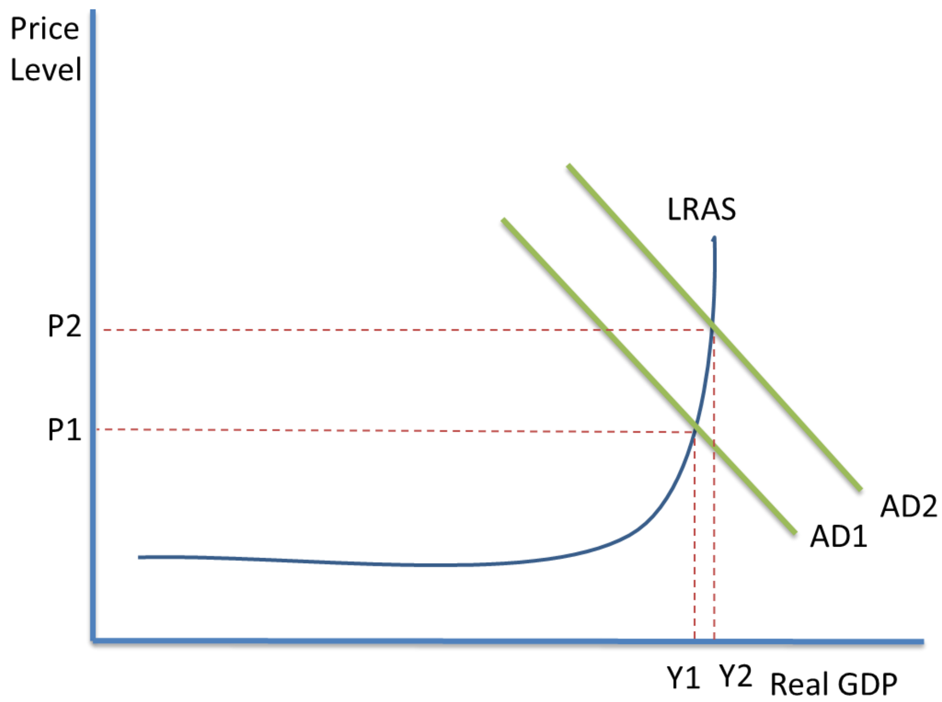
- The structure of the economy often changes, which means estimates may not always be accurate. For example, immediately after a recession, the level of spare capacity might fall below the level anticipated, since some workers might become economically inactive, firms might close and some banks might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

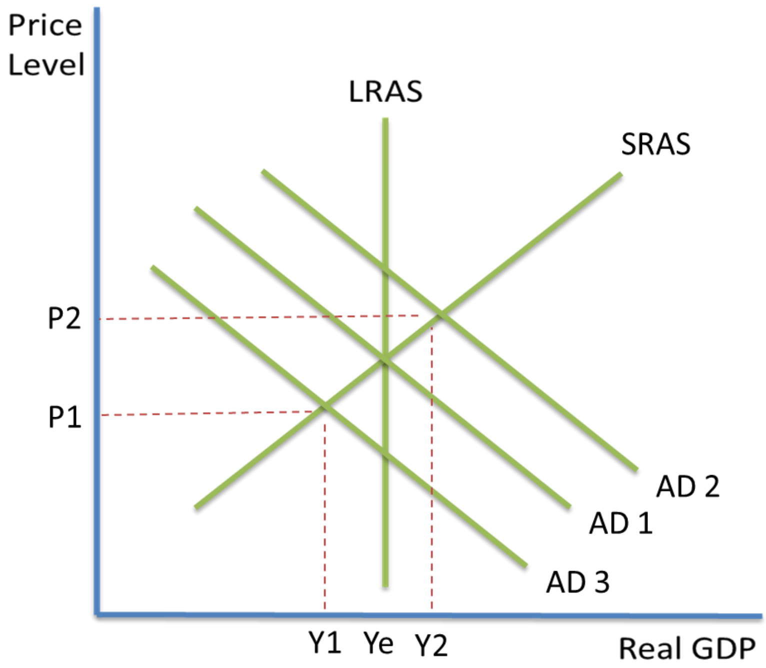
Illustrating an output gap:

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

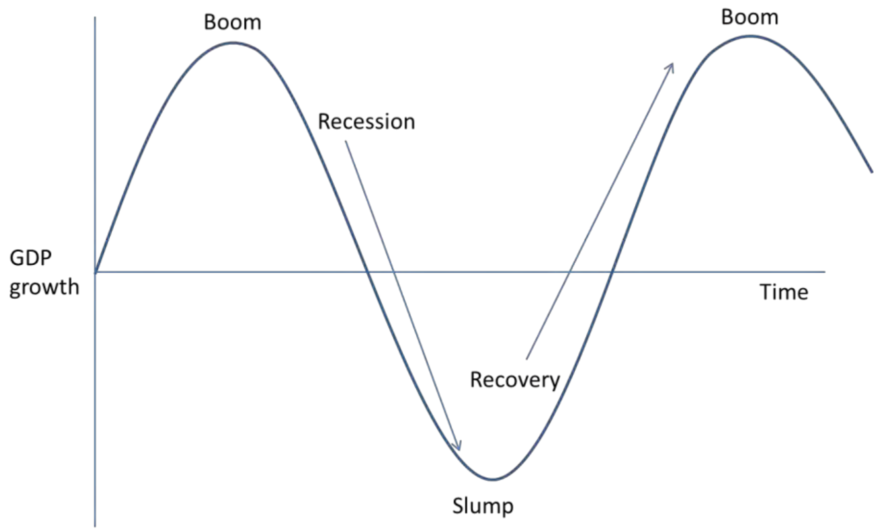


Classical economists believe markets clear in the long run, so there is full employment. They believe there are output gaps in the short run. A negative output gap is between Ye and Y1, and a positive output gap is between Ye and Y2.

2.5.3 Trade (business) cycle

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
- 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

Synoptic point:

The trade cycle has large impacts on individuals within the economy. During recessions, consumers will see lower incomes and living standards and firms will see lower revenues and profits.

2.5.4 The impact of economic growth

The benefits and costs of economic growth and the impact on:

	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.

Synoptic point:

Economic growth has microeconomic consequences through the impacts on consumers, workers and firms.