OCR Economics A-level

Macroeconomics

Topic 2: Economic Policy Objectives

2.2 Development

Notes

- The **primary** sector of an economy covers the extraction of raw materials, such as precious metals, wheat and coal. A large primary sector indicates reliance on the agricultural market.
- The **secondary** sector is largely manufacturing, where raw materials are made into goods. For example, cotton is made into clothes in the secondary sector. A large secondary sector indicates the economy is reliant on manufacturing. Emerging markets, such as China and India have large secondary sectors.
  - The **tertiary** sector is the supply of services, such as finance and restaurants. Developed countries have large tertiary sectors.

- Economic development refers to living standards, freedom (from oppression) and life expectancy. Essentially, it covers a more moral side to economic growth and it is normative. Development is also concerned with how sustainable the economy is and whether the needs of future generations can be met.

- Sustainability is a concept that suggests resources, such as the environment, have to be used effectively and efficiently, so they can be maintained for future generations.

- Growth is sustainable when the rate of economic growth can be maintained in the long run, so future generations can enjoy the same rate of growth. Fast economic growth today could mean that natural resources, such as oil, might deplete, which would create environmental problems for future generations, and mean the future rate of growth might be weak. Unsustainable growth occurs around the boom and bust sections of the business cycle. These are essentially deviations from the trend rate of growth. If growth is excessive, there could be inflation in the average price level, wages and assets. There could be excessive credit, which is unsustainable in the long run, and the savings rate might be low and falling.

The relationship between economic growth, changes in the structure of an economy and sustainable development

- The Lewis model is an explanation of how a developing country which focuses on agriculture could move towards manufacturing.

- It is based on the assumption that in agriculture, there is a surplus of unproductive labour in developing economies. The model assumes that in the manufacturing sector, wages are fixed. Workers from agriculture are attracted to the higher wages in the manufacturing sector.

- In the manufacturing sector, entrepreneurs charge prices above the wage rate, which allows them to make profits. It is assumed these profits are invested into more fixed capital for the business.

- The demand for labour increases since the productive capacity of firms has increased. Since there is surplus labour in the agricultural sector, this labour is employed in the manufacturing sector.

- This grows the manufacturing sector to the extent that the economy moves from agriculture to manufacturing. This is from a traditional state to an industrialised state.

- However, in reality, profits might not be reinvested into the firm. Moreover, the capital investment might replace labour, so the demand for labour could fall instead. Also, it is not always easy for labour in the agricultural sector to move to the manufacturing sector.

Macroeconomic measures and development indicators

- **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.

- **HDI:**
  - The three dimensions of the Human Development Index (HDI) The components of HDI are education, life expectancy and standard of living, measured by real GNI at purchasing power parity (PPP) per capita.
  - It measures economic and social welfare of countries over time.
  - The education component combines the statistics of the mean number of years of schooling and the expected years of schooling. The standard of living component measures GNI adjusted to PPP per capita. GDP was used instead of GNI, but to account for remittances and foreign aid, GNI is now used, since it

reflects average income per person. The average world HDI rose from 0.48 in 1970 to 0.68 in 2010. This was mainly due to the growth of East Asia, the Pacific and South Asia. A value close to 1 is indicative of a high level of economic development. A value close to 0 suggests a low level of development.

Assessing the usefulness of HDI:

- HDI does not consider how free people are politically, their human rights, gender equality or people's cultural identity.
- HDI does not take the environment into account. It could be argued that this should be included to focus on human development more.
- HDI does not consider the distribution of income. A country could have a high HDI but be very unequal. This can mean many people might still be in poverty.
- HDI does allow for comparisons between countries to be made, based upon which countries are generally more developed than other countries.
  - It provides a much broader comparison between countries than GDP does.
- Education and health are important development factors to consider, and it can provide information about the country's infrastructure and opportunities. It also shows how successful government policies have been.

Measure of Economic Welfare (MEW): This is an alternative to GDP. It takes national output, and then adjusts it to include a value for leisure time and unpaid work. This increases the welfare value of GDP. The value of environmental damage caused by industrial production and consumption is also considered.

Human Poverty Index (HPI): measures life expectancy, education and the ability of citizens to meet basic needs. There are two types: HPI-1 and HPI-2. The former measures poverty in developing countries and the latter measures poverty in developed countries.

In HPI-1, the longevity part of the index measures the probability of living to the age of 40. The education component considers the adult literacy rate. The ability of citizens to meet basic needs is measured by the percentage of underweight children and the percentage of people not using improved water sources.

For HPI-2, the probability of not surviving to at least the age of 60 is used. The percentage of adults which do not have literacy skills is calculated, and poverty is calculated by those living below the poverty line. This is below 50% of median income.

- **Multidimensional Poverty Index (MPI):** measures poverty in over 100 developing countries. It works with income based measures, and it considers the lack of education, poor health and low living standards that people face. This means that poverty can be assessed on an individual level, and the intensity of poverty can be measured by considering what is deprived.

- **Gender-related Development Index (GDI):** measures the relative inequality between men and women. It combines HDI with a consideration of gender. For example, it will consider differences in life expectancies, income and education between genders.

Factors contributing to economic growth and development

- **Trade liberalisation**
  Free trade is the act of trading between nations without protectionist barriers, such as tariffs, quotas or regulations. World GDP can be increased using free trade, since output increases when countries specialise. Therefore, living standards might increase and there could be more economic growth.
- **Promotion of FDI**
  FDI is the flow of capital from one country to another, in order to gain a lasting interest in an enterprise in the foreign country.
  FDI can help create employment, encourage the innovation of technology and help promote long term sustainable growth. It provides LEDCs with funds to invest and develop.
- **Microfinance schemes**
  Microfinance involves borrowing small amounts of money from lenders to finance enterprises. It increases the incomes of those who borrow, and can reduce their dependency on primary products. There could be a multiplier effect from the investment of the loan.

- **Privatisation**
  This means that assets are transferred from the public sector to the private sector. In other words, the government sells a firm so that it is no longer in their control. The firm is left to the free market and private individuals.
  Free market economists will argue that the private sector gives firms incentives to operate efficiently, which increases economic welfare. This is because firms operating on the free market have a profit incentive, which firms which are nationalised do not.

- **Development of human capital**
  By developing human capital, the skills base in the economy would improve. This would improve productivity and allow more advanced technology to be used, since workers will have the necessary skills.
  Businesses struggle to expand where there are skills shortages. It also limits innovation.
  By developing human capital, the country can move their production up the supply chain from primary products, to manufactured goods and to services, which can earn them more.

- **Infrastructure development**
  Examples of physical infrastructure include transport, energy, water and telecommunications.

- **Development of tourism**
  Tourism can create thousands of jobs and help shift a developing country away from dependency on primary products. Developing countries tend to have a marginal propensity to consume, which could create a multiplier effect. It helps to diversify the economy and it could make the country more attractive to FDI, as well as developing their infrastructure.

- **Development of primary industries**
  Some developing countries have an abundance of raw materials, so some governments might choose to exploit this advantage and develop the industry so the country can have a comparative advantage in its production.

- **Fairtrade schemes**
  Fairtrade schemes ensure that farmers can receive a fair price for their goods. Supermarkets buy a guaranteed quantity at a price above the market equilibrium. This helps farmers since they have a guaranteed income and certainty about their sales, so they can plan for the future.

- **Aid**
  Overseas Development Assistance (ODA) is foreign aid that is used to help countries develop. Aid provides temporary assistance to a country,

such as humanitarian aid offered to countries after conflicts or natural disasters. Aid could also be a grant for a project that a country might not have the funds for. Aid could be used to reduce human capital inadequacies or to pay off debt. It can improve infrastructure, which can help make the country more productive. However, the benefits of aid are limited by corrupt leaders, the size of the aid payment and the potential for the recipient country to become dependent on aid.

- **Debt relief**
  Debt relief is the partial or total forgiveness of debt.
  With high levels of debt, financial resources are diverted from infrastructure, education and healthcare. The country's ability to pay the debt, not the size, is most important. If a country defaults on its debt, it can make it hard to borrow more money in the future. Debt forgiveness can allow a country to import more and increase the population's standard of living.