Global Economy

Revision Notes
• Economic Growth / Economic Cycle
• Inflation
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UK Economic Performance

Inflation and Economic Growth
**Different stages of Trade Cycle**

From the above graph we can see different stages in the economic cycle.

- Recovery – pick up in growth e.g. early 1990s
- Economic Booms in late 1980s – high inflation high growth, followed by recession.
- Slow down. When economy slows down. We get a lower rate of economic growth. This means output increases at a slower rate.

- **Period 1994-2007** – Often known as period of great moderation – stable growth, low inflation. However, there was bubble in housing market and bank loans, which precipitated crash of 2009.

**Macro Economic Objectives of the Government:**

1. Sustainable Economic Growth (close to long run trend rate)
2. Low unemployment
3. Control of inflation (inflation target is CPI = 2% +/- 1)
4. Satisfactory Balance of Payments
5. Supporting a stable exchange rate
6. Low government borrowing
7. Maintaining equality within society
8. Protecting the environment

- Note, the first four objectives are considered the most significant. The next four are generally less important.
- For many questions, a good exam tip is to consider how all macro objectives are affected by the factor in question.

- Real GDP per capita measures the average income of a citizen in an economy (taking into account inflation. It is a rough guide to living standards, but has limitations.
Conflicts of Policy Objectives

In practice, it is difficult to achieve all policy objectives at once. For example, increasing the rate of economic growth could lead to inflation and a bigger deficit on the current account.

Increase in AD

• In this diagram there is an increase in AD. This leads to an increase in economic growth. However, as the economy gets closer to full capacity, there is an increase in the rate of inflation.
• Also as consumer spending increases, the level of imports will rise. This tends to cause a deterioration in the current account.

However, higher economic growth will help

1. Reduce the level of unemployment. Higher output leads to higher employment levels
2. Improved government finances. Tax receipts increase with higher growth.

Evaluation
• Higher economic growth doesn't have to cause inflation and a deterioration in current account. If AS increases at same rate as AD, growth can be sustainable and non-inflationary. If growth is export led, (like China), the economy can have a current account surplus.

Graph Showing LRAS shifting to the right.
Causes of Growth

- In short term, an increase in AD. \[(AD = C+I+G+X-M)\]
- In long term, it requires an increase in LRAS
- (See also: Unit 2 notes macro AS for more details.)

Recessions

A recession is defined as a period of time when the economy contracts (negative economic growth) for two consecutive quarters. A recession is characterised by:

1. Lower Output
2. Higher Unemployment
3. Lower Inflation
4. Decline in consumer confidence
5. Fall in value of assets such as houses and shares

Causes of a Recession

Recessions are generally caused by a fall in Aggregate Demand. This could be due to a variety or combination of factors. For example:

- **Fall in House Prices.** Falling wealth leads to lower confidence, negative equity and lower consumer spending.
- **Rise in interest rates.** Higher interest rates reduce consumer spending and investment.
- **Tight Fiscal Policy.** Government decision to raise taxes and cut spending can lead to a fall in AD.
- **Loss of Confidence.** If people believe there is going to be a recession, then they will spend less. They will not borrow money or spend on credit cards. This is because they fear they could be made unemployed.
- **Global Recession.** A recession in our main trading partners will lead to less trade and demand for UK exports.
- **Credit Crunch.** If banks find it difficult to raise money on financial markets, they will cut back lending to firms and consumers leading to lower AD.
Supply Side Shock Recession

- **Rise in Oil Prices.** A rise in oil prices (or other commodity) could spark a recession. Higher oil prices would cause the SRAS to shift to the left, causing both inflation and lower GDP.

![](https://www.economicshelp.org)

Inflation

- **Inflation** means a sustained increase in the general price level. Inflation means the value of money will decrease.
- **CPI** – Official measure of inflation. Also known as ‘core inflation’. Excludes mortgage interest payments.
- **RPI** (Retail Price Index) – includes mortgage interest payments. Used to be the official measure.
- **Deflation** occurs when there is a fall in prices. It means a negative inflation rate. (e.g. CPI = -0.5%)

Costs of Inflation

- **Cost of reducing inflation:**
  High inflation is deemed unacceptable therefore governments feel it is best to reduce it. This will involve higher interest rates; the reduction in AD will lead to a decline in economic growth and unemployment.
- **International competitiveness:**
  Higher UK inflation will make British goods less competitive, leading to a fall in exports. However, this may be offset by a decline in the exchange rate.
- **Confusion and Uncertainty:**
When inflation is high people are uncertain what to spend their money on. Also, firms may be less willing to invest because they are uncertain about future profits and costs. This can lead to lower growth in the long term.

- **Menu Costs.**
  This is the cost of changing price lists frequently.

- **Income redistribution.**
  Borrowers will become better off; lenders will become worse off. However it depends on the real rate of interest.

- **Boom and Bust economic Cycles.**
  High inflationary growth is unsustainable and is usually followed by a recession.

## Causes of Inflation

### Demand Pull inflation

- If the economy is at or close to full employment then an increase in AD leads to an increase in the price level.
- An increase in AD will not always cause inflation if there is spare capacity in the economy.

Demand Pull inflation can be caused by many factors such as:

1. **Loose Monetary policy.** If interest rates are too low then AD will increase faster than AS and the rate of economic growth will be unsustainable.
2. **High consumer confidence and spending.** If wages are increasing and consumers are optimistic about the future they will increase their spending causing $AD$ to increase.

**Cost Push Inflation**

If there is an increase in the costs of firms then firms will pass this on to consumers. There will be a shift to the left in the $SRAS$.

Cost-push inflation can be caused by factors such as:

1. **Wage Push Inflation** Trades unions can bargain for higher wages, this will lead to an increase in costs for firms. It may also cause demand-pull inflation as consumers spend more.

2. **Import prices** One third of all goods are imported in the UK. If there is a devaluation then import prices will become more expensive leading to an increase in inflation.

3. **Raw Material Prices** If the oil price increases by 20% then this will have a significant impact on firms costs and therefore inflation.

4. **Higher Taxes.** E.g. rise in VAT (though will be a one off)
Deflation

**Definition of Deflation** – A Fall in Prices – a negative inflation rate.

**Deflation caused by increased productivity**

- If there is a significant increase in productivity, e.g. better technology, then LRAS will shift to the right.
- This can cause a fall in the price level, but there will also be an increase in Real GDP. This is beneficial for the economy.

**Deflation caused by Falling AD**

- Lower AD has caused a fall in the price level, but has also caused a fall in Real GDP.
- This kind of deflation can be very damaging to the economy.

**Problems of Deflation**

1. **Lower Spending** If prices are falling consumers will be more reluctant to spend because they feel that prices will be lower in the future. This delay in spending will reduce AD and cause lower economic growth.
2. **Liquidity Trap**. Monetary policy becomes ineffective because interest rates cannot fall below zero, meaning real interest rates will be too high and even zero interest rates ineffective in boosting demand.
3. **Real Wage Unemployment**. Workers are reluctant to accept a cut in nominal wages, therefore firms may have to increase real wages by more than they would like. This could increase real wage unemployment.
4. **Real value of debt will increase**. This can reduce AD further as firms and consumers struggle to pay the increasing debt burden.
Fiscal Policy

- **Fiscal Policy** involves the Government changing the levels of Taxation and Govt Spending in order to influence AD. \( AD = C+I+G+X-M \).
- Fiscal Policy will have an impact on the governments budget deficit / surplus.
- **Expansionary (or loose) Fiscal Policy.** This involves increasing AD. Therefore the govt will increase spending (G) and cut taxes (T)
- **Deflationary (or tight) Fiscal Policy.** This involves decreasing AD. Therefore the govt will cut govt spending (G) and increase taxes (T)

**Fine Tuning.** This involves maintaining a steady rate of economic growth through using fiscal policy. However this has proved quite difficult to achieve precisely.

**Automatic Stabilisers.** If the economy is growing, people will automatically pay more taxes (VAT and Income tax) and the Government will spend less on unemployment benefits. The increased T and lower G will act as a check on AD.

**Discretionary Stabilisers.** This is a deliberate attempt by the govt to affect AD and stabilise the economy, e.g. in a boom the govt could increase taxes to reduce inflation.

**Injections (J):** This is an increase of expenditure into the circular flow, it includes: Govt spending (G), Exports (X) and Investment (I)

**Withdrawals (W):** This is leakages from the circular flow It includes: Net savings (S) + Net Taxes (T) + Net Imports (M)

The Multiplier effect

This occurs when an initial injection into the economy causes a bigger final increase in national income.

\[
\text{Multiplier (k)} = \frac{\text{Change in Real GDP (Y)}}{\text{Change in Injections (J)}}
\]

The value of the Multiplier depends upon:

- If people spend a high % of any extra income, then there will be a big multiplier effect.
- However if any extra money is withdrawn from the circular flow the multiplier effect will be very small.

\[
\text{Multiplier (k)} = \frac{1}{1-\text{mpc}} = \frac{1}{\text{mpw}}
\]

1. Marginal Propensity to Consume (mpc). This is the % of any extra income that a person spends
2. Marginal Propensity to Withdraw (mpw). This is when money is withdrawn from the circular flow it includes mpt (tax) + mpm (import) + mps (save)
**Accelerator Effect**

This states the level of investment is determined by change in economic growth rate. An increase in economic growth can cause a more than proportional increase in investment. This can make growth more volatile and contribute to the economic cycle.

**Evaluation of Fiscal Policy**

1. **Disincentives to work** Increasing taxes to reduce \( AD \) may cause disincentives to work; if this occurs there will be a fall in productivity and AS could fall.

2. **Reduced public services** Reduced govt spending to reduce \( AD \) could affect public services.

3. **Poor information** To predict future inflation and growth is not easy, therefore it may be difficult to know how much to increase or decrease \( AD \).

4. **Time Lags.** If the govt plans to increase spending this can take a long time to filter into the economy and it may be too late to have the desired effect.

5. **Increase in budget deficit** Expansionary fiscal policy (cutting taxes and increasing \( G \)) will cause an increase in the budget deficit which has adverse effects. – There is a limit to how much the government can borrow.

6. **Depends upon other components of \( AD \)** For example, if consumer confidence is very low, reducing taxes may not lead to an increase in consumer spending.

**Budget Deficits**

A budget deficit occurs when government spending is greater than tax revenues: (don’t get confused with current account deficit on balance of payments)

- **PSNCR** - Public Sector Net Cash Requirement: This is the official title for the *annual* amount of government borrowing (This used to be called the PSBR)

- **The National Debt:** This is the *total* (cumulative) amount of debt that the government owes the private sector at the moment this is over £850bn (60% of GDP 2010). The official statistic is the public sector net borrowing.
Cyclical Deficit:

During a recession it is likely that there will be an increase in govt borrowing.

1. Tax revenues will be lower. E.g. less income tax and VAT
2. Government spending will increase. E.g. more unemployment benefits

Furthermore, in a recession, a government may pursue discretionary fiscal policy (e.g. change tax rates to try and boost growth.

Economic Effects of a Budget Deficit

1. **Higher debt interest payments.** To finance the budget deficit the govt will have to sell bonds, which will increase the national debt. This increases the annual debt interest payments; therefore future generations may have to pay higher taxes or have lower spending on public services.

2. **Increased AD.** A budget deficit implies lower taxes and increased G, this will increase AD and this may cause higher Real GDP and inflation.

3. **Higher Taxes and lower spending.** In the future the govt may have to increase taxes or cut spending in order to reduce the deficit. Higher taxes may cause reduced incentives to work.

4. **Increased Interest rates.** If the govt sells more bonds this is likely to cause interest rates to increase. This is because they will need to increase interest rates in order to attract investors to buy the extra debt. If government interest rates increase this will push up other interest rates as well. (N.B. This may not always occur e.g. liquidity trap)
5. **Crowding out.** Increased Govt spending to increase AD may cause a corresponding decrease in the size of the private sector. This is because for the govt to finance the deficit they to sell govt bonds, this will reduce the amount that the private sector can spend. Also the govt sector may be more inefficient in spending money. Therefore Monetarists are very critical of govt borrowing

6. **Inflation:** In extreme circumstances the govt may increase the money supply to pay the debt this can cause high inflation, though is unlikely to occur in the UK.

**Advantages of Govt Borrowing**

Govt Borrowing can be beneficial under certain conditions

1. **Recession.** If there is a downturn in the economy there will automatically be a fall in taxation and higher govt spending on benefits, this will cause a budget deficit.
   - However if the govt attempted to solve the budget deficit by increasing the rate of taxes this would further deflate the economy leading to lower growth and more unemployment. If there is a negative multiplier effect this may actually cause the deficit to increase even more.
   - Therefore in a recession a government deficit is necessary to offset the rise in private sector saving and try and increase AD and hence economic growth.

2. **Investment.** If the govt increases spending on public services this may cause a deficit, however if they increase productivity then in the future there will be a higher rate of economic growth and more tax revenues.
   - However, govt spending may not necessarily increase productivity. Some argue, government spending is generally less efficient than leaving it to free market.

3. **Bailout Key Industries.** In the case of the banking sector, the government thought it necessary to bailout banks to prevent them going bankrupt and making people lose confidence in saving their money in banks.
Monetary Policy

This involves the manipulation of the Money Supply and the rate of interest by the monetary authorities (MPC, Bank of England in UK). The purpose of monetary policy is:

1. Control the rate of inflation.
2. Influence the level of economic activity to achieve economic stability.

Tight Monetary Policy:

This involves increasing interest rates to reduce AD:

1. This makes borrowing more expensive, therefore consumers spend less on credit and firms will be less willing to invest by borrowing money.
2. The cost of mortgages increases, therefore people have less disposable income causing a fall in consumption.
3. Saving money in a bank is more attractive therefore there is less spending
4. Exchange rate increases, due to hot money flows
5. Therefore higher interest rates reduce AD and therefore decrease inflation.

- However it is likely to conflict with other objectives such as:
  i) Lower economic growth
  ii) Higher unemployment
  iii) Increased government borrowing.
Evaluation of Monetary Policy in Reducing Inflation

1. If AD falls the effect on inflation depends upon the position of the economy and the slope of the AS curve, e.g. at full capacity higher interest rates will have a significant effect on reducing inflation.

2. It depends upon other variables affecting AD; e.g. if confidence is high, increased interest rates may not reduce inflation.

3. Higher interest rates will cause an appreciation in the exchange rate. This will reduce AD and reduce the price of imports, helping to reduce inflation.

Loose Monetary Policy:

This involves reducing interest rates.

- This will increase spending, investment and increase AD and therefore higher Real GDP (if there is spare capacity in the economy)
- However it may conflict with other macro economic objectives such as:
  i) Inflation will increase.
  ii) Depreciation in the exchange rate.

The Role and Function of the Central Bank

1. Maintain Price stability. Their inflation target is **CPI 2% +/- 1**
2. The issuing of notes and coins.
3. The banker of the commercial banks.
4. Acting as a lender of last resort. If commercial banks need to give money to their customers they can always borrow from the B of E.
5. Setting Interest Rates. Every month the MPC meet to decide on base interest rates which will influence economic activity.

Inflation Targeting

This involves seeking to maintain the governments inflation target of CPI= 2% (+/-1). But, as well as targeting inflation, the Bank must consider wider economic implications such as growth and unemployment.

Benefits of the MPC setting Monetary Policy

1. The MPC have been relatively successful in keeping inflation close to its target.
2. Low inflation is important for ensuring stable and continuous growth.
3. The MPC is independent of political pressures. Therefore, in theory this provides extra credibility to maintaining low inflation expectations. Low expectations make it easier to achieve.

4. The govt could always change the target if there was a shock to the economy.

**Criticisms of The MPC approach**

1. An inflation target is not enough. If the MPC just targets inflation this may lead to lower growth or higher unemployment.

2. If there are shocks to the economy such as higher oil prices this may increase inflation, making it difficult to keep it within the govt's target without conflicting with other objectives.

3. Fine control of Monetary Policy is not possible because it is difficult to get accurate information about the economy.

4. Low inflation since 1997 could be due to other factors such as increased productivity, better technology and low prices of raw materials.

5. The MPC were unable to prevent asset bubble and resulting credit crunch in 2007-2009. This shows limitation of relying on interest rates alone.

6. Oil price shocks make monetary policy difficult. Higher oil prices cause temporary inflation and lower growth. Interest rates can’t deal with both inflation and lower growth at same time.

**Phillips Curve**

This is used to show an inverse relationship between inflation and unemployment.

- Keynesians argue that if there is spare capacity, an increase in AD causes Real GDP to rise therefore unemployment falls, but there is a trade off of higher inflation.

- Keynesians argue that the evidence of the 1950s and 1960s suggest that there was a trade off between unemployment and inflation.
Balance Of Payments

Since the mid 1980s, the UK has experienced a deficit on trade in goods and services (biggest component of current account)

Current account measures:
- Trade in goods
- Trade in services
- Investment incomes
- Transfer flow

A deficit means the value of imports of good and services is greater than exports

If a country has a deficit on the current account it must have a surplus on the Financial / Capital account. A current account deficit therefore has to be financed by either:

1. Attracting direct foreign investment into the economy. (Long term capital flows)
2. Attracting short-term flows of money into the banking sector, e.g. hot money flows.

**Why a Current account is considered harmful to the economy**

1. If a current account deficit is financed through borrowing this can be unsustainable in the long term and countries will be burdened with a high interest payments.
2. If the deficit is financed by attracting long-term investment, foreigners will have an increasing claim on UK assets, which they could desire to return at any time.
3. A large Balance of Payments deficit may cause a loss of confidence
4. It could be argued the persistent deficit in the current account suggests fundamental weaknesses in the UK economy such as:
   i) Declining competitiveness
ii) Lack of productive capacity in the UK  
iii) Declining comparative advantage in many manufactured goods  
These factors could adversely effect job creation in the UK and lead to lower growth.

**However a Current account deficit is not necessarily harmful**

1. Current Account deficit can be used to finance investment. E.g. the US ran a Current account deficit for a long time as it borrowed to invest in its economy. This enabled higher growth and so it was able to pay its debts back.  
2. Inward investment can be beneficial for the economy. It creates jobs and more output; in the UK Japanese firms have also helped increase productivity  
3. With a floating exchange rate a large current account deficit should cause a devaluation which will help reduce the level of the deficit.  
4. It depend on the size of the deficit as a % of GDP, for example the US trade deficit reached 6% of GDP (2007); at this level it is a problem.

**International Trade**

**Absolute Advantage:**
This occurs when one country can produce a good with fewer resources than another.

**Comparative Advantage:**
A country has a comparative advantage if it can produce a good at a lower opportunity cost: i.e. it has to forego less of other goods in order to produce it.

**The Law of Comparative advantage**
This states that trade can benefit all countries if they specialise in the goods in which they have a comparative advantage.

**Terms Of Trade:**

This measures the \( \frac{\text{price index of exports}}{\text{price index of imports}} \).  
- It is expressed as a percentage so in the base year it will be 100.  
- For trade to be beneficial the terms of trade have to lie in between the different opportunity cost ratios.

**Improvement in Terms of Trade**

- An improvement in the terms of trade (an increase in ratio) means that the price of exports increases relative to imports. It means people can buy relatively more imports. However, it may lead to a decline in demand for exports and cause unemployment.  
- If there is an improvement in terms of trade because of better quality goods, firms will be able to maintain their sales.
Benefits of Free Trade.

1. **Economies of Scale:**
   If countries can specialise in certain goods they can benefit from economies of scale and lower average costs. This is especially true in industries with high fixed costs or that require high levels of investment.

2. **Reducing Tariff barriers leads to trade creation**
   Trade creation occurs when consumption switches from high cost producers to low cost producers
   - The removal of tariffs leads to lower prices for consumers (\(P_1 - P_2\)) and an increase in consumer surplus (1+2+3+4)
   - The govt will lose tax revenue of area 3
   - Domestic firms will sell less and lose producer surplus of area 1
   - However overall there will be an increase in economic welfare of 2+4

3. **Increased Exports.**
   If UK firms have a comparative advantage then with lower tariffs they will be able to export more and create more jobs.

4. **Increased Competition.**
   With more trade, domestic firms will face more competition from abroad, therefore there will be more incentives to cut costs and increase efficiency. It may prevent domestic monopolies from charging too high prices.

5. **Trade is an engine of growth.**
   World trade has increased by an average of 7% since the 1945, causing this to be one of the big contributors to global economic growth.

6. **Make use of surplus raw materials**
   Middle Eastern counties such as Qatar are very rich in reserves of oil but without trade there would be not much benefit in having so much oil.
Arguments for Restricting Trade

1. **Infant Industry Argument.**
   If developing countries have industries that are relatively new, then at the moment these industries would struggle against international competition. Therefore they need protection while they develop their industries.

2. **The Senile industry argument.**
   If industries are declining and inefficient they may require large investment to make them efficient again. Protection for these industries could enable firms to invest and reinvent themselves.

3. **Need to diversify the economy**
   Many developing countries rely on producing primary products in which they currently have a comparative advantage. However, relying on agricultural products has several disadvantages:
   i) Prices can fluctuate due to environmental factors.
   ii) Goods have a low income elasticity of demand. Therefore even with economic growth demand will only increase a little.

4. **Protection against dumping**
   The EU sold a lot of its food surplus from the CAP at very low prices on the world market. This caused problems for world farmers because they saw a big fall in their market prices.

5. **Environmental**
   It is argued that free trade can harm the environment because countries with strict pollution controls may find consumers import the goods from other countries where legislation is lax and pollution allowed.

Globalisation

**Definition of Globalisation.** Globalisation refers to the process of how national economies are becoming increasingly interdependent and integrated. In practise, it means there is a greater flow of labour, capital and trade between different countries.

**What Causes Globalisation**

- **Growth of Free Trade.** Trade is increasingly important. Economies rely on importing raw materials and exporting goods to foreign market. Therefore, the state of other economies increasingly impacts upon a domestic economy.
- **Multinational Companies.** There has been a growth in the number and influence of multinational companies who have a cross border presence.
- **Technology.** The development of technology such as the internet has helped improve communication and made it easier to connect to all corners of the world.
- **Transport.** Improved transport has helped to make trade cheaper and made it easier for labour to move.
• **WTO / Trading Blocks like EU.** Institutions like the WTO have helped reduce barriers to trade. Trading areas like the EU have considerably reduced barriers to trade within Europe and also raised the profile of international cooperation.

**Impact of Globalisation**

• **Global Trade Cycles.** Because economies are more closely linked, a recession in a major economy like the US or Eurozone is likely to push many economies into recession. On the other hand, exports will rise as growth in other countries improves.

• **Competition.** Arguably, markets are becoming more competitive as domestic monopolies face greater competition from multinationals. This benefits consumers in the form of lower prices.

• **Economies of Scale.** Global scale production has enabled greater economies of scale, and lower costs. This is significant for industries with high fixed costs like cars, aeroplanes.

**Costs of Globalisation**

• **Domestic Firms Uncompetitive.** Some local firms may be pushed out of business by large multinationals who can use economies of scale and monopsony buying power.

• **Winners and Losers.** Globalisation has definitely created winners and losers. Arguably, some developing countries have benefitted less from globalisation; e.g. their comparative advantage has been in producing raw materials, but this makes an unbalanced economy.

• **Environmental costs.** Globalisation has meant goods are increasingly imported from across the planet, rather than local produce. This increases the carbon and pollution impact of food and trade. Also globalisation enables firms to switch production to countries with weakest environmental law.

**Global Imbalances**

• Before the financial / economic crisis of 2007, the world economy was unbalanced. In the West (US, UK) there was high levels of consumption, low levels of saving. This led to a current account deficit.

• China and other eastern economies had a corresponding current account surplus as they export to the west.

• China sought to maintain a weak currency. They buy US assets to keep Chinese currency weak. This helps reduce US treasury bond rates, but the imbalances can contribute to bubble and busts in asset markets.

• China argue it needs to maintain competitive exchange rate to maintain strong export sector.

• The US often complain China's artificial manipulation of exchange rate creates an unfair advantage leading to lower demand for US exports.

• There is need for encouraging consumption in China and more saving and investment in West.
Multinationals (MNCs)

Globalisation has seen a growth in the prominence of large, globally based multinational companies. (also known as transnational companies)

Benefits of Multinationals

• Economies of Scale. Many industries have substantial scope of economies of scale. Global production enables greater efficiency and lower prices for consumers.
• Foreign Direct Investment. Multinationals have invested in developing countries creating jobs and providing foreign capital
• Consumers have preference for global brands that maintain minimum standards of service / quality.

Costs of Multinationals

• Their financial power has squeezed out many local firms.
• Though they invest in developing countries they repatriate profit and have been accused of exploiting low wages.
• Take benefit of weaker environmental laws in developing countries.

International Financial Flows

• Official financial flows could take form of aid or payments to bodies like EU.
• Short term Capital flows. Refer to movements of financial savings from one country to another. For example, if interest rates relatively higher in one country may lead to ‘hot money flows’ – people taking advantage of higher interest rates in that country.

WTO

• The World Trade Organisation is responsible for trying to promote and regulate free trade and trade agreements between countries.
• It is argued that promoting free trade can lead to economic advantages of lower prices, greater choice and greater competition.
• However, the WTO has been criticised. This is because some argue free trade benefits developed countries more than developing countries. For example, arguably, some developing countries need tariff protection to develop their infant industries.
**IMF**

- The International Monetary Fund plays a role in offering credit to countries that run into difficulties making debt payments. The IMF can arrange a loan.
- However, the IMF usually insists on certain criteria to accompany the loan. This may involve devaluation, control of inflation, tightening of fiscal policy and structural reforms such as privatisation.
- Some criticise the IMF for placing too much pressure on economies to reduce inflation and introduce free market policies which increase inequality.

**Trading Blocks**

There are different types of trading blocks:

- **Free Trade Areas** – Essentially just concentrate on free trade and removing tariff barriers.
- **NAFTA** – US, Canada and Mexico
- **ASEAN** A free trade area based in South East Asia. Aims to improve free trade amongst member countries and close neighbours.
- **Customs Union** – Areas of free trade with common external tariff. The EEC in the beginning.
- **Single Market**. A trading block with free trade and free movement of labour and capital
- **Economic Union** – Single market plus common external tariff and harmonisation of laws and regulations
- **Monetary Union** – Economic Union plus common currency and common monetary policy. (e.g. Euro)

**Impact of Economic Integration**

- Gains from comparative advantage
- Greater competition
- Firms who specialise can benefit from more economies of scale.
- Increased direct investment which helps promote better efficiency.
- Greater clout for international trade negotiations.
- Countries may benefit from more flexible labour markets as workers can migrate to fill labour shortages (e.g. Eastern European nurses and builders in UK)

**Potential Costs of Economic Integration**

- Regional inequality due to geographical immobilities. E.g. difficult to move from Spain to Germany.
- Structural unemployment resulting from increased specialisation.
- May get caught up in other countries trade disputes.
- UK experienced trade diversion when joining EU because agricultural tariffs to Commonwealth countries increased.
• Free movement of labour may cause friction over housing and overpopulation.

Purchasing Power Parity

• Purchasing power parity is a theory which suggests that exchange rates are in equilibrium when they have the same purchasing power in different countries.
• Suppose a Big Mac costs £2 in the UK and $4 in the US. The correct exchange rate according to purchasing power parity would be £1 in $2.
• However, in practise exchange rates don't reflect local purchasing power. In many developing economies, goods are effectively cheaper and the exchange rate undervalued. This could be due to the uncertainty of investing in particular countries.

Exchange Rates
(see also AS notes)

Exchange Rate Systems

• Floating exchange Rates – when governments don’t intervene in exchange rates and allow them to be determined by free market forces.
• Fixed Exchange Rates – When government seek to maintain a certain target exchange rate.
• Semi Fixed Exchange Rates – when government allow a small window of exchange rate fluctuation.

Advantages of Fixed Exchange Rates

• Provide greater stability for firms involved in trade. E.g. exporters don’t have to fear a rapid appreciation which would reduce their profitability.
• Can help reduce inflation as countries have an added discipline to keep inflation low otherwise the currency would be weaker.
• May reduce speculation if markets believe country will stick to exchange rate

Disadvantages of Fixed Exchange Rates

• May lead to exchange rate being overvalued, this can harm exports and economic growth
• To maintain fixed exchange rate may require high interest rates (this may conflict with other objectives such as causing lower growth and higher unemployment)
• UK forced out of ERM in 1992, because markets felt they had joined at wrong rate.
Euro / Monetary union

Joining the Euro involves:

- Replacing domestic currency with Euros.
- No possibility of fluctuating exchange rates within the Euro area.
- A Common Monetary Policy. Interest rates are set by the ECB for the whole Eurozone area.

Advantages of Joining the Euro / Monetary Union

1. **Lower Transaction costs.** If the UK joins the Euro, firms and tourists will not have to pay the cost of converting currencies; this will make trade more profitable. Lower costs have been estimated to be worth around 1% of GDP.

2. **Eliminate exchange rate fluctuations.** If UK exporters experienced a rising Pound Sterling, it makes their exports less competitive. If exchange rates are fixed then firms can invest in export capacity with more confidence about future export prices.

3. **Increased inward investment.** With stable exchange rates and the abolition of transaction costs it will be more desirable to invest in the UK. If we stay out of the Euro we could lose out on this.

4. **Greater Price Transparency.** With a common currency it is easier to compare prices in different EU countries. This should hopefully lead to greater price competition. Also it should be easier for firms to identify the cheapest suppliers.

5. **The UK financial sector would benefit** In the Euro it may be easier to buy shares in German or French companies, British Banks would find it easier to set up in the Eurozone. But, this has proved of limited importance. The City of London has not really lost out by keeping the Pound.

6. **Lower Inflation.** The ECB has a strong tradition of keeping inflation low. Joining the Euro will help reduce inflation expectations. In theory joining the Euro should give countries an incentive to remain competitive and increase productivity because they cannot rely on devaluation to improve competitiveness.
Disadvantages of Joining the EURO

1. **The UK Will Lose Ability to Set Interest Rates.** The ECB set interest rates for the whole Eurozone. However, this may not be suitable for the UK economy.
   - For example, if the UK were in a deep recession and Europe growing, the ECB would set a high interest rate. This high interest rate would make it difficult for UK to recover and grow.
   - For example, the 2008/09 recessions hit the UK very hard. The MPC cut interest rates quicker than the ECB. If the ECB had set UK interest rates, the recession might have been deeper.
   - If ECB rates were too low, the UK may experience inflation.

2. **Could join at the wrong rate** If the UK joins the Euro at an exchange rate that is too high, this will adversely affect the UK economy. This is because UK exports will remain uncompetitive and it is not possible to devalue the exchange rate.
   - E.g. during recession of 2009, the UK benefitted from a weaker pound which helped exports and economic recovery.

3. **Low inflation may conflict with other objectives.** It is argued that the ECB is too concerned with low inflation and ignores other macroeconomic objectives such as growth and unemployment.

4. **Exchange Rate volatility remains.** The exchange rate risk with Euro members will disappear however there is the possibility of increased volatility between the Euro and other currencies e.g. the Dollar. (However 60% of our trade is with the Euro zone)

5. **Conversion Costs.** There will be a cost of replacing the currency and adjusting machines. However this will be a one off cost and shouldn’t be too high.

6. **Loss of Independence over Fiscal Policy** In theory, the Growth and Stability Pact limited government borrowing to no more than 3% of GDP. In practise countries ignored this and ran up large deficits. When faced with the need to cut government deficits, economies suffered. This is because in the Euro, it is harder to offset spending cuts by looser monetary policy and devaluation in the exchange rate.

7. **Lack of convergence in the UK** There are number of reasons why the UK economy may never converge with Euro zone:
   - Firstly the UK housing market is more volatile, low interest rates may cause a soaring housing market, which would create other economic problems
   - Secondly there have often been times when the UK business cycles has been out of step with the EU e.g. in 1992 when the UK suffered a severe recession. The UK economy is more dependent on financial service so suffered proportionately more in the credit crunch of 2008.
Development and Sustainability

- Economic growth measures the increase in GDP. GDP measures national output / national income/ national expenditure.
- GDP is useful for measuring level of economic activity. However, it is limited for measuring level of economic development.
- Economic development is concerned with a much wider range of indicators, such as:
  - GDP per capita
  - Health care / life expectancy
  - Education / literacy
  - Gender equality
  - Pollution and environmental standards
  - Access to basic amenities such as water, good quality shelter.
  - Extent of welfare state.

Limitations of GDP as a measure of Living standards:

1. It is difficult to calculate the total output of an economy because GDP statistics will ignore the underground economy because transactions are not recorded.
2. GDP includes negative externalities, such as, pollution; therefore it will overestimate living standards on this count.
3. GDP does not take into account how hard people work; for example, if you increase your income by working longer hours does this improve living standards?
4. GDP per capita ignores distribution of income; some people may be very poor despite the country being rich.
5. It depends what the economy produces, for example, it is preferable to spend money on health care rather than military spending.
6. When comparing countries GDP, in a common currency like the dollar, we cannot get a true comparison because there will be a different purchasing power of the local currency, e.g. in India a $ would buy more than in Japan.

Human Development Index (HDI)

- The HDI is an alternative measure of economic welfare. It takes into account real GDP per Capita. But, also includes measures such as Health and Education standards in a country.
- The Human Poverty Index (HPI) also takes into account the distribution of welfare within a country to try and measure relative poverty levels.

ISEW Sustainability

- The Index of Sustainable Economic Welfare intends to provide a more comprehensive guide to economic development and economic welfare.
• It includes capital formation, non-defensive expenditure, services of domestic labour and subtracts environmental degradation, defensive spending and depreciation of natural capital.

• The advantage is that it tries to include only expenditure which adds to welfare. It is also more concerned with sustainability e.g. growth based on short term consumption of raw materials will reduce environmental capital.

_**Limitations of ISEW in policy making**_

• By nature it is more subjective. What counts as defensive spending? It uses non-statistical judgements which reflect bias of creators.

• Difficult to calculate environmental degradation.

• Misses out many other variables such as education, literacy levels.

**Different Stage of Economic Development**

• Primary product dependency (Traditional stage)

• Transitional Stage (development of transport infrastructure)

• Industrialisation (switch from agricultural based economy to industry)

• Post industrialisation – greater technological diversification and greater choice of manufactured goods.

• Society geared towards mass consumption and service sector based economy.

_Diverse Nature of Economic Development_

• Not all countries follow same pattern. Some rich countries retain strong primary sector due to natural resource wealth (e.g. Canada, Australia)

• Some countries with little natural resources (e.g. Japan, Taiwan) have developed due to strong manufacturing process and high levels of value added by labour.

• Middle East countries rich in oil have often been characterised by inequality as the benefits of development have not been shared equally.

• Some developing countries much more successful in developing. E.g. Sub-saharan Africa left behind by development in South East Asia and Latin America. Often factors like civil war key features in limiting development.

**Limitations to Economic Growth and Development**

• **Poor infrastructure** - Lack of transport increases cost and makes trade more difficult. Land locked countries are at a disadvantage because cost of trade is much higher.

• **Human capital inadequacies.** Low levels of education and training limit the range of goods and services can be produced. Countries with low levels of education may be constrained to unskilled industries such as extraction of primary products.
• **Primary product dependency.** Primary products (oil, minerals, agriculture) can limit economic development. Volatile prices can lead to fluctuating export earnings. Primary products have a low income elasticity of demand so countries don’t benefit from growth. They are also limited and will some time run out.

• **Savings gap.** A lack of savings limits the amount of funds available for investment and capital accumulation. This is a key factor in growth theories such as Harrod-Domar.

• **Capital / Human flight.** Countries with a poor reputation may struggle to attract and retain capital. Also, the best skilled workers may leave for higher wages elsewhere.

• **Corruption.** High levels of corruption reduce tax revenues.

• **Debt.** High debt interest payments can limit available funds for investment.

• **Political uncertainty.** Civil wars and uncertainty make country unattractive for foreign investment.

**Ways of Promoting Economic Growth / Development**

• **Free Trade.** Arguably exploiting gains from comparative advantage offer countries best hope of increasing economic welfare. Free trade enables countries to specialise in goods where they have lower opportunity cost leading to lower prices and increased economic welfare (see fair trade).
  
  o However, free trade may mean developing economies focus only on primary products; this may limit development in long term. To develop new industry they may need tariff protection at least in short term.

• **Aid.** Aid can be used to finance investment in infrastructure and human capital. This can increase capital stock / Aggregate Supply and enable higher growth rates.
  
  o However, it depends on the quality of the aid. Often aid is tied to purchasing donors exports and is limited in value. There is also a danger aid could be siphoned off due to corruption.

• **Debt relief.** Debt relief aims to end crippling debt interest payments, this enables countries to devote more funds on investment rather than paying interest.
  
  o However, there is a danger debt relief could create moral hazard. If debt is relieved, there may be less incentive to borrow responsibly. Debt relief may make private firms reluctant to lend in the future.

• **Development of human capital.** Supply side policies to improve education and training can lead to better human capital and higher labour productivity.
  
  o However, it takes time to educate workers. Government spending is not guaranteed to improve labour productivity, as people may be reluctant to learn.

• **Free Market Supply Side Polices.** IMF and World Bank place stress on increasing role of market forces. These include privatisation, deregulation, reducing power of trades unions and unnecessary
regulation. The aim is to increase competitive pressures and allow private enterprise to increase efficiency in economy.
  o These policies may increase inequality and the creation of private monopolies.
• **Microfinance.** Helping people on very low incomes access to credit to start small-scale projects, and avoid excessive interest rates of moneylenders.
  o Depends on how managed and directed. Finance could be misused, though default rates are generally low.
• **Tourism.** A way to make use of natural resources. Helps flow of foreign currency and improves
  o However, can lead to exploitation of natural parks
• **Industrialisation.** Countries who rely on primary products face volatile income and limited prospects for growth. Industrialisation enables economic development and higher growth.
  o However, industrialisation can be an expensive failure if there isn’t sufficient skilled labour and infrastructure to deal with process. Governments often choose wrong time to force industrialisation.
• Regional Trading Blocks. Regional trading blocks can help countries benefit from greater free trade and co-operation. For example, the EU has been relatively successful in promoting greater trade and economic welfare within Europe. However, trading blocks in the developing world have found it more difficult to promote economic integration due to lower resources and political concerns. For example, ASEAN in South East Asia has taken some steps to promote free trade, but there are still constraints on economic integration.

**Measures to Increase Competitiveness**

• Education and Training. This increases labour productivity and makes labour markets more flexible. Education can take several years to have effect, but is important for increasing long term productivity
• Investment in infrastructure. E.g. better transport links. This helps reduce costs for firms and improve productivity in the economy. It costs money and takes time, also it is important the government choose beneficial projects. It may benefit from public private partnerships.
• Privatisation and Deregulation. Aim to increase efficiency from incentives of competition and private sector efficiency.
• Devaluation in exchange rate. This gives a temporary boost to competitiveness as exports are cheaper. However, it doesn’t deal with underlying issues of competitiveness such as productivity and wage costs. Devaluation can also lead to inflation, which undermines competitiveness in long run.
• Limiting Wage Growth. Lower wage costs are key to improving competitiveness in many industries. However, it can be difficult for government to limit wages and will keep many workers on low incomes.
Also, it may be better to try to increase labour productivity rather than rely on low wages to increase competitiveness.

**Taxation**

- **Progressive Taxation** – takes higher % of income from high-income earners, e.g. top rate of income tax.
- **Regressive taxation** – takes higher % of income from low-income earners e.g. excise duty on alcohol.
- **Proportional taxation** – takes same % of income whatever income band.
- **Direct Taxation** – taken from people’s earnings directly. E.g. income tax, NI.
- **Indirect Taxation** – Paid by firm selling goods. E.g. VAT is included in final price consumers pay.

**Impact of Increasing Rate of Income Tax**

- Higher income tax should increase tax revenues. The government can spend more on public services and benefits to reduce inequality.
- May encourage tax evasion. E.g. higher rates of income tax could encourage people to work in another country. E.g. many tax exiles from UK. Therefore increase in tax revenues may be less than expected.
- May reduce incentive to work and do overtime (substitution effect). However, the income effect of higher tax may make people work more to maintain target income.
- Higher rates of income tax can help redistribute income.
- Depends what the government spend the tax revenue on. E.g. investment in infrastructure may help productivity of economy. Spending on welfare benefits may create disincentives to work and crowd out private sector.