

INTERNATIONAL ADVANCED LEVEL

Economics

Getting Started

Pearson Edexcel International Advanced Subsidiary in Economics (XEC01)

Pearson Edexcel International Advanced Level in Economics (YEC01)

For first teaching in September 2013

First examination January 2014

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A	Getting started for teachers	2
	Introduction	2
	The Specification	3
	Unit 1: Markets in Action	4
	Unit 2: Macroeconomic Performance and Policy	30
	Unit 3: Business Behaviour	47
	Unit 4: Developments in the Global Economy	70
B	Getting started for students	96
	Student Guide	96

Introduction

This *Getting Started* book will give you an overview of the course and what it means for you and your students. The guidance in this book is intended to help you plan the course in outline and give you further insight into the principles behind it to assist you and your students in succeeding in the qualification.

The Specification

About this specification

Pearson Edexcel International Advanced Level in Economics is designed for use in schools and colleges outside the United Kingdom. It is part of a suite of International Advanced Level qualifications offered by Pearson.

Key features of the specification

The International Advanced Level qualification in Economics is designed to enable students to:

- develop an interest in and enthusiasm for the study of economics
- appreciate the contribution of economics to the understanding of the wider economic and social environment
- develop an understanding of a range of concepts and an ability to use these concepts in a variety of national and international contexts
- use an enquiring, critical and thoughtful approach to the study of economics and to think as economists
- develop the skills, qualities and attitudes that will prepare them for the challenges, opportunities and responsibilities of adult and working life.

The Pearson Edexcel International Advanced Level in Economics comprises the following four units:

- Unit 1: Markets in Action
- Unit 2: Macroeconomic Performance and Policy
- Unit 3: Business Behaviour
- Unit 4: Developments in the Global Economy

Assessment

Each unit is equally weighted at 25%. A combination of assessment techniques including supported multiple choice (students have to write a justification of the answer chosen), data response (students apply shorter response answers to a context) and essay questions (students develop their arguments, apply economic models or make links between different parts of the specification and draw their own conclusions), will be used.

Examination of unit 1 and unit 2 will last 1 hour 30 minutes each while examination of unit 3 and unit 4 will last 2 hours each.

Each unit examination paper has an allocation of 80 raw marks.

Unit 1: Markets in Action

BASIC READING

Course books:

- Alain Anderton: *Edexcel A Level Student Book*, Pearson, ISBN 978-1-40589-228-5 [referenced below]
- Alain Anderton: *AS Economics Student Book*, Pearson, ISBN 978-1-40589-234-6
- Alain Anderton: *Edexcel A Level Teaching and Assessment Pack*, Pearson, ISBN 978-1-40589-229-2
- Peter Smith: *Edexcel A2 Economics*, Philip Allan, ISBN 978-0-34094-926-9

Unit book:

- Mark Gavin: *Edexcel AS Economics: Unit 1: Competitive Markets, How They Work and Why They Fail*, Philip Allan, ISBN 978-0-34094-745-6

Magazines:

- *Economics Review*, Philip Allan Updates
- *Economics Today*, Anforme

Useful websites:

- *tutor2u*: www.tutor2u.net/blog/index.php/economics/
- *Sloman Economics*: www.pearsonblog.campaignserver.co.uk/

1.3.1 The nature of economics

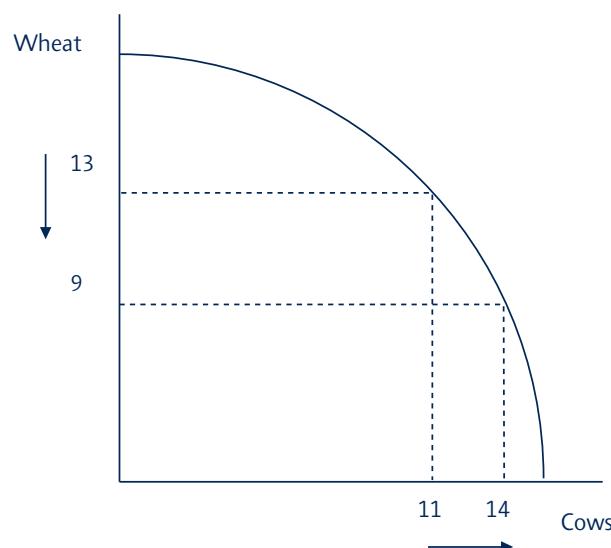
Content	Reading
1. Scarcity <ul style="list-style-type: none"> ■ The problem of unlimited wants and finite resources. ■ The distinction between renewable and non-renewable resources. 	Tutor2u: First lesson idea www.tutor2u.net/blog/index.php/economics/comments/an-activity-for-the-first-economics-lesson-of-the-year/ Anderton Unit 1

Students are likely to be unsure as to what economics entails as a subject — this may be worth a lesson of discussion in itself.

Economics is a social science, which investigates what, how, why, and for whom goods and services are produced. The basic **economic problem** is that there are infinite wants but finite (non-renewable) resources with which to satisfy them. Economics is meant to help us to choose between the competing demands placed on the non-renewable resources that we have.

Content	Reading
2. Production possibility frontiers <ul style="list-style-type: none"> ■ The use of production possibility frontiers to depict opportunity cost, economic growth and the efficient allocation of resources. ■ The use of marginal analysis in depicting opportunity cost. ■ The distinction between movements along and shifts in production possibility frontiers, and their possible causes. 	Anderton Unit 1

Production possibility frontiers, or PPFs, help us to analyse the trade-offs that we must make as a result of the basic economic problem. They show the maximum possible combination of goods/services that can be produced using the resources that we have available.



PPFs demonstrate the concept of **opportunity cost** — the cost of the next best alternative foregone. In the diagram on the previous page, the production of three more cows incurs an opportunity cost of four tonnes of wheat, i.e. we have had to *give up* wheat production in order to produce more cows because of our limited resources.

PPFs can also be used to demonstrate the concept of **efficiency**. Any point on the PPF is a productively efficient point — we are using the **factors of production** (resources, including land, labour, capital and enterprise) we have to their maximum potential. Any point inside the PPF is inefficient — some of the factors of production are unemployed or underemployed.

Economic growth (an increase in the productive potential of the country) can be shown by an outward shift in the PPF. Such a shift can be caused by an increase in the quantity or quality of the factors of production (e.g., better educated labour, hi-tech capital, a new oil field discovery, etc.). Very occasionally, the PPF shifts inwards.

Firms and households choose to keep hold of some of their money in order to make transactions more quickly. However, if they keep hold of cash, they are unable to use that money to purchase financial assets which would provide them with interest. So, the **opportunity cost**, or the price of money, is the interest rate.

Content	Reading
3. Specialisation, the division of labour and the role of money	<ul style="list-style-type: none">The advantages and disadvantages of specialisation and the division of labour in organising production.The functions of money, e.g. medium of exchange, measure and store of value, method of deferred payment. <p>Anderton Unit 2 Sloman: Back to Barter <www.pearsonblog.campaignserver.co.uk/?p=245></p>

Another way in which economic growth can occur is via **specialisation**, or **division of labour**. Adam Smith wrote about the division of labour in *Wealth of Nations* back in the 18th century. He said that by splitting the production of a good into a number of different tasks, and allocating each task to a different worker, then more could be produced as workers developed greater skill in performing their particular task with the use of specialist tools designed for just that task, thus leading to less wastage of materials and less time spent on their task. However, when this method was put into practice in the early 20th century, for example, with Henry Ford's Model T production line, workers became so bored that they had to be paid high wages as compensation for the monotony of their work.

Brighter students could be encouraged to investigate Adam Smith's understanding of division of labour in *Wealth of Nations* with his Glaswegian pin factory example. There are a number of classroom games that illustrate the principles of specialisation, requiring students to make a number of items individually, before then specialising as a group.

Content		Reading
4. Free market and mixed economies	<ul style="list-style-type: none"> ■ The advantages and disadvantages of a free market economy and why there are mixed economies. ■ The role of the state in a mixed economy. 	Anderton Unit 5

Economic systems

There are a number of approaches to organising an economy.

Free market economy: an economic system where all resources are allocated through the market forces of demand and supply, with no intervention by the government

Command, or centrally planned economy: an economic system where all resources are allocated by the government, with no markets (e.g. ex-Soviet bloc, North Korea)

Mixed economy: an economic system where resources are partly allocated by the market and partly by the government (e.g. most economies today)

From the point of view of efficiency, most economists would argue that free markets are the most efficient, in terms of using their resources in the best possible way to meet the needs and wants of consumers. However, when equity is considered, most economists would also argue that free markets lead to an unequal distribution of income and wealth, since owners of capital and entrepreneurs tend to accumulate the most income/wealth, and many people, such as the sick or elderly, are unable to work. As a result, most economies today are mixed economies, where markets allocate many resources, but governments intervene to different extents in order to ensure a minimum standard of living. They do this by raising revenue through taxes, and redistributing in the form of benefits and direct provision of services such as healthcare.

Students should focus on lack of equity being a key reason for mixed economies. A classroom discussion could begin centred on the world described by Charles Dickens in, for example, *A Christmas Carol* or *Oliver Twist*, which many students will know — ask them to discuss whether this society was ‘fair’.

Content	Reading	
5. Positive and normative economics	<ul style="list-style-type: none"> ■ The distinction between objective statements and value judgements on economic issues. ■ The role of value judgements in influencing economic decision making and policy. 	Anderton Unit 4

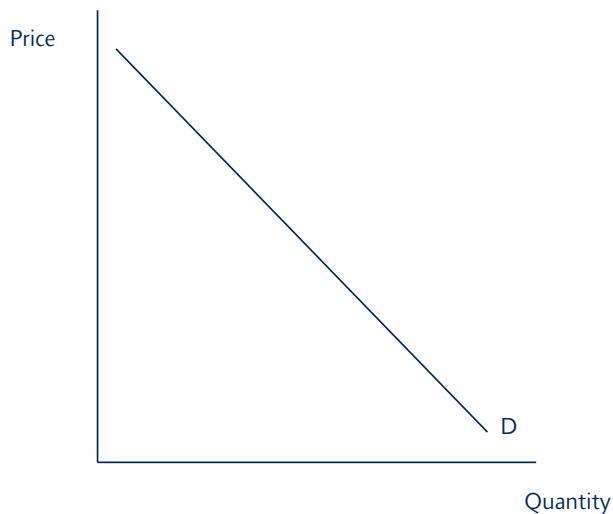
Students should be provided with a list of economic statements and asked to explain why they are either positive or normative.

The extent to which governments are involved in the economy is a **normative** issue, that is, a matter of opinion, requiring a value judgement. Economic analysis tends to be more concerned with positive issues, i.e. statements of fact that can be tested against real-world evidence. For example, the USA has a predominantly private healthcare system, where people have to pay directly for their treatment, whereas the UK has a predominantly publicly provided healthcare system (the NHS). To say that the UK's approach is 'fairer' is essentially a matter of opinion, i.e. a normative issue. To say that the amount spent per head on healthcare in the UK is less than that in the USA is a positive issue.

1.3.2 Demand and consumer behaviour

Many students find these concepts quite abstract — use examples that are able to relate to, such as asking how many times they would visit their local coffee shop per week at different prices of their favourite drink, or how likely they would be to deliver newspapers at different wage rates. A significant number of students find it difficult to remember that a change in price leads to a movement along the curve not a shift — this point needs emphasising.

Demand refers to the amount that consumers are willing and able to buy at any given price. A demand curve shows this relationship between price and quantity demanded. It slopes downwards from left to right, because as price falls, people are more willing to buy a good.



Factors causing demand curve to shift right:

- an increase in income (for normal goods)
- a fall in income (for inferior goods)
- successful advertising
- fall in price of complementary goods
- rise in price of substitute goods
- good becomes more fashionable.

Factors causing demand curve to shift to the left:

- a fall in income (for normal goods)
- a rise in income (for inferior goods)
- rise in price of complementary goods
- fall in price of substitutes
- good becomes less fashionable.

A very important point: a change in the price of a good does not lead to a movement of the demand curve — it simply leads to a shift **along** the demand curve, since the demand curve shows the relationship between price and quantity demanded.

Key terms:

Normal good — one for which demand increases as income rises

Inferior good — one for which demand falls as income rises

Complementary good — a good that is bought with another good, i.e. the two go together well

Substitute good — a good that is bought instead of another good, i.e. consumers choose between one or the other.

Content	Reading
2. Price, income and cross elasticities of demand	<ul style="list-style-type: none">■ Definition of elasticities of demand.■ Calculation and interpretation of numerical values of demand elasticities.■ The factors influencing elasticities of demand and their significance to firms and government.■ The relationship between price elasticity of demand and total revenue.

Students tend to find the concept of elasticity fairly straightforward, but struggle with the interpretation of the numbers generated from calculation — a number line that they keep in the front of their notes will help with this, as will significant calculation practice (this is a good homework to set). A good way to teach the link between PED and total revenue is to get students to work it out themselves with a guided investigative worksheet — give them some questions containing information about the elasticities of various products, and get them to calculate new and old revenue following an increase/decrease in price.

Elasticities

Price Elasticity of Demand (PED) measures the responsiveness of demand to a change in price. A steep demand curve shows a good that has price inelastic demand, that is, demand for it is not responsive to a change in price. A shallow demand curve shows a good that has price elastic demand, that is, demand is responsive to a change in price. Goods with price inelastic demand tend to have few substitutes, are necessities, and/or can be addictive, for example, petrol, alcohol, cigarettes. PED is always a negative number. A number between 0 and -1 means demand is price inelastic. A number between -1 and $-\infty$ means demand is price elastic.

It can be calculated using the formula:

$$\frac{\% \text{ change in quantity demand}}{\% \text{ change in price}}$$

Income Elasticity of Demand (YED) measures responsiveness of demand to a change in income. A positive number means the good is normal; a negative number means the good is inferior. It can be calculated using the formula:

$$\frac{\% \text{ change in quantity demand}}{\% \text{ change in income}}$$

Cross (price) Elasticity of Demand (XED) measures responsiveness of demand for one good to a change in the price of another good. A positive number means the goods are substitutes; a negative number means the goods are complements. It is measured using the formula:

$$\frac{\% \text{ change in quantity demand for good x}}{\% \text{ change in price of good y}}$$

The importance of elasticities

PED is important to businesses because it tells them what their pricing strategy should be in order to increase total revenue: if PED is inelastic, then a rise in price increases total revenue and a fall in price reduces total revenue; if PED is elastic, then a rise in price reduces total revenue and a fall in price increases total revenue. **PED** is also important to governments in terms of understanding the **burden (or incidence) of taxation** on producers and consumers. The more price inelastic the good, a greater proportion of the sales tax is paid by the consumer than the producer. Similarly, for **subsidies** (a government grant given to producers in order to encourage production), the more price inelastic the good, the greater the price fall for consumers. Businesses should also be aware of cross price elasticities, because these will tell them how demand for their own product will change following a price change by their competitors or partners.

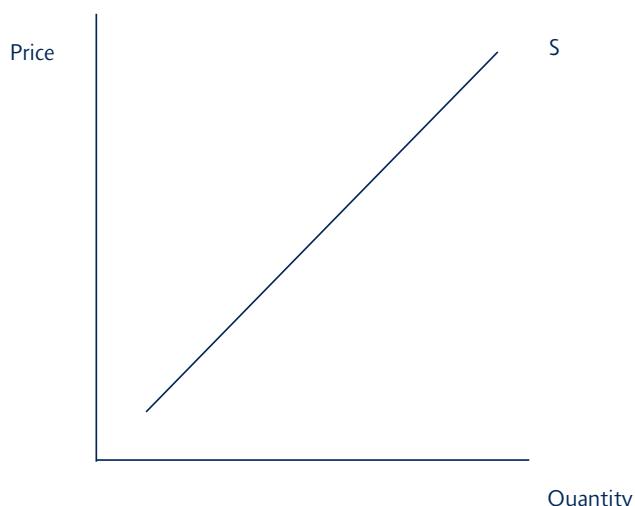
Content	Reading
3. Consumer behaviour	<ul style="list-style-type: none"> ■ The assumption of rationality: consumers aim to maximise utility by making rational choices. ■ Qualifications to assumption of rationality, including other people's behaviour matters, importance of habitual behaviour, inertia, consumers are poor at computation, consumers need to feel valued.

Traditional explanations of consumer behaviour have tended to emphasise the idea of rational choices and the maximisation of utility. More recently, some economists have used psychology and their interpretation of the results of experiments to suggest that we do not always make rational choices and that economic theory should not assume rationality. These **behavioural economists** have tried to demonstrate, for example, that our decisions are often influenced by the opinions of others and that this might not lead to utility maximisation. The field of behavioural economics is still very new and offers a psychological perspective on how people make decisions.

1.3.3 Supply

Content	Reading
1. The supply curve	<ul style="list-style-type: none"> ■ The distinction between movements along a supply curve and shifts of a supply curve. ■ The factors that may cause a shift in the supply curve, e.g. changes in the costs of production, the introduction of new technology, indirect taxes (specific and ad valorem), government subsidies.

Supply refers to the amount that producers are willing and able to sell at any given price. The supply curve shows this relationship between price and quantity supplied. It slopes upwards from left to right, because, as price rises, producers will supply more because of the potential for higher profit (think about delivering newspapers — if you were paid £1 an hour, you wouldn't do the work, but you might if you were paid £10 an hour).



Factors causing supply to shift right: **Factors causing supply to shift left:**

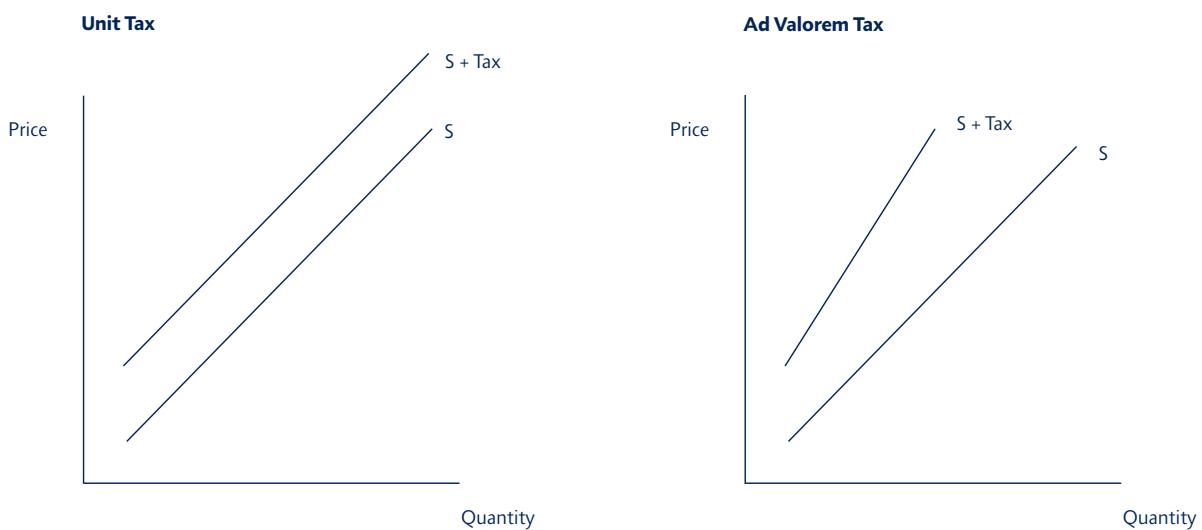
- an increase in productivity
- improvement in technology for production
- increased availability of materials
- a fall in price of raw materials
- a fall in labour/capital costs
- introduction of a subsidy
- a rise in the number of firms in the industry.

- a fall in productivity
- reduced availability of raw materials
- a rise in price of raw materials
- a rise in labour/capital costs
- imposition of a tax
- a fall in the number of firms in the industry.

A very important point: a change in the price of the good leads to a movement along the supply curve, not a shift in the supply curve.

Taxation

Governments impose taxes on goods for a number of reasons, such as trying to reduce production of a good as it may cause pollution or threaten the health of consumers (e.g. cigarettes), and the need to raise tax revenue in order to fund public services such as schools and the NHS.



S+tax is parallel to original supply curve with a unit tax, i.e. 50p tax added to every litre of petrol sold, no matter what the price of petrol

S+tax is steeper than the original supply curve with an ad valorem tax, i.e. tax is added at 17.5% of the price at each and every price

Content	Reading
2. Price elasticity of supply <ul style="list-style-type: none"> ■ Definition of price elasticity of supply. ■ Calculation and interpretation of numerical values of price elasticity of supply. ■ Factors that influence price elasticity of supply. ■ The distinction between the short run and long run in economics and its significance to price elasticity of supply. 	Anderton Unit 11 (price elasticity of supply)

Price elasticity of supply (PES) — the responsiveness of supply to a change in price. Like PED, the steeper the supply curve, the more price inelastic (unresponsive) the supply. It is always a positive number. A number between 0 and 1 means the good has price inelastic supply; between 1 and ∞ , the good has price elastic supply. A good has price inelastic supply if it is complex to make, raw materials are scarce, the production process is lengthy and we are considering the short run (the period of time over which the quantity of some factors of production is fixed). Supply is price elastic when the good is quick and easy to make, and we are considering the long run (the period of time over which all factors of production are variable). The formula for PES is:

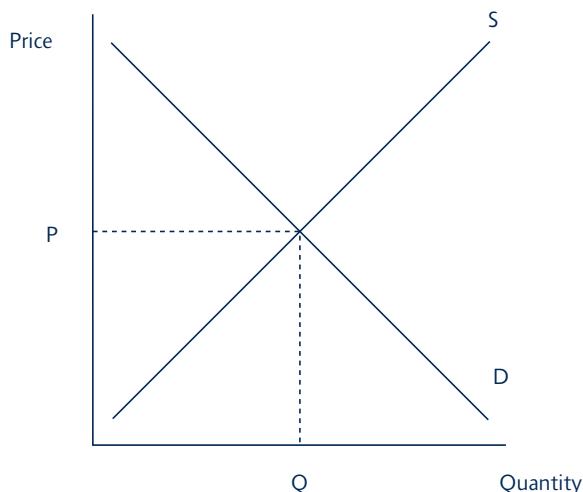
$$\frac{\% \text{ change in quantity supplied}}{\% \text{ change in price}}$$

1.3.4 Price determination

Content	Reading
1. Determination of market equilibrium	<ul style="list-style-type: none"> ■ Equilibrium price and quantity and how they are determined. ■ The use of a supply and demand diagram to show how shifts in demand and supply curves cause the equilibrium price and quantity to change. ■ The operation of market forces to eliminate excess demand and excess supply.

Students can get confused between excess demand and excess supply — it is worth emphasising the need to label market diagrams fully and accurately to avoid this. For explaining the solution to excess supply, use examples of local markets that have stock left at the end of the day — ask students what market traders could do to eliminate their stock. For explaining the solution to excess demand, ask students to think of ways of preventing queues at popular attractions.

In a free market, we combine the forces of demand and supply in order to determine the market price of a good or service.



P is known as the **market clearing price** — the price at which supply exactly meets demand. If the price is too high, then supply > demand, and we have **excess supply**, or **a surplus or glut**. To get rid of the excess supply, producers will have to lower the price, and so the market clearing price will eventually be reached. If the price is too low, then demand > supply, and we have **excess demand** or **a shortage**. To get rid of the excess demand, the price will rise towards the market clearing price, causing consumers to leave the market as the good becomes more expensive than the price they are willing to pay.

How might the change in the price of a good be explained?

It is easy to see that a shift in demand or supply causes a change in the price of a good. **Prices will increase if demand increases** (moves to the right) or supply decreases (moves to the left). **Prices will decrease if demand decreases** (moves to the left) or supply increases (moves to the right).

Demand for **oil** is highly price inelastic, as is supply. Any change in supply of oil will therefore have a very large effect on the price of oil. **Supply shocks** such as the war in Iraq, or the breaking of a pipeline, will cause a dramatic increase in price as supply decreases. Recently, demand for oil from Newly Industrialised Countries,

such as China, has increased, causing the demand curve to shift right, and oil prices to rise. Changes in oil prices have a large impact on the global economy because oil is used as a raw material in the production of many products and the transport industry. So, if the price of raw materials increases, then supply of most goods falls, which pushes up prices of most goods.

Demand for **agricultural goods** is also price inelastic, as they are necessities for the majority of people. Supply is also fairly price inelastic, as supply cannot easily be altered once crops are sown, etc. Farmers always know the maximum that they can sell, as this equals the amount they have planted. However, in periods of bad weather, supply can be radically reduced, forcing prices up. Demand for agricultural products has increased recently with the rise in importance of **biofuels**, where products such as sugar cane are being used to produce ethanol rather than food. Again, this pushes up the price.

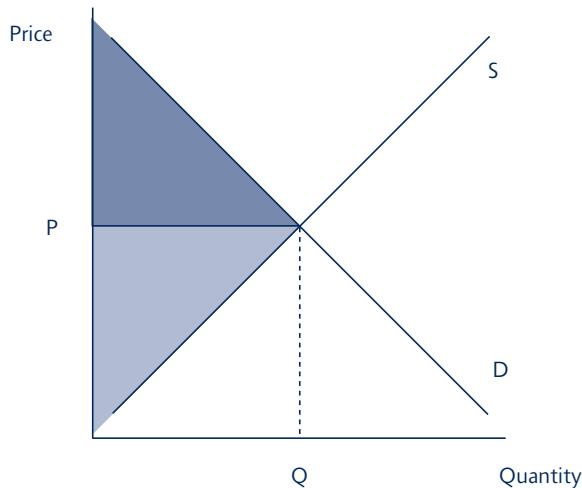
The price of stocks and shares on the **stock market** is determined through market forces. **Confidence** is a key determinant of share prices. Demand for shares tends to increase if people are feeling confident about the state of the economy and the future. Demand falls when events occur that shake people's confidence, for example, terrorist attacks, revelations of scandals at banks, etc.

Speculation is also an important factor. If people believe that share prices will rise, they will want to buy them at a lower price now and sell them at a higher price in the future. So, if people expect share prices to rise then demand will increase — which causes the price to rise, resulting in a self-fulfilling prophecy!

Content		Reading
2. Consumer and producer surplus	<ul style="list-style-type: none"> ■ The distinction between consumer and producer surplus. ■ The use of a supply and demand diagram to illustrate consumer and producer surplus. ■ How changes in demand or supply might affect consumer and producer surplus. 	Anderton Units 6 (consumer surplus), 7 (producer surplus), 8

Consumer surplus: the difference between the amount that a consumer is willing to pay and the price that they actually pay; shown by the difference between the demand curve (the amount they are willing to pay) and the market equilibrium price (the amount they actually pay) — the darker shaded area on the diagram.

Producer surplus: the difference between the amount a producer is willing to sell a good for, and the price they actually receive; shown by the difference between the supply curve and the market equilibrium price — the lighter shaded area on the diagram.



Obviously, the level of consumer and producer surplus will change if there is a shift in the demand or supply curve.

Students need to be able to indicate the correct area on a market diagram, and to identify changes in consumer surplus or producer surplus on a diagram.

Content	Reading
3. Functions of the price mechanism	<ul style="list-style-type: none"> ■ The rationing, incentive and signalling functions of the price mechanism for allocating scarce resources. ■ The price mechanism in the context of different types of markets, including local, national and global market.

The Functions of Prices

Rationing: because resources are scarce and finite, not everyone is able to buy everything they want; when demand is greater than supply, then prices are bid up so that the good/service is rationed out to those who can afford to pay.

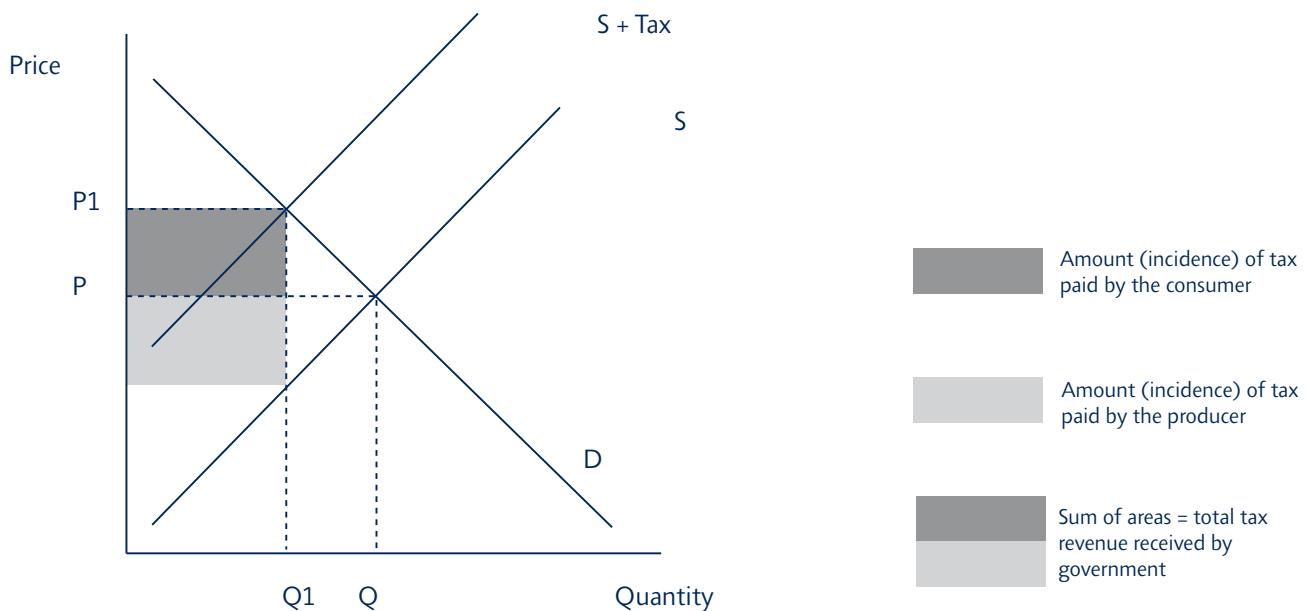
Incentive: when prices are high, then this attracts producers to the market because it can enable higher profits to be earned.

Signalling: prices help to determine where and how resources should be allocated; if prices increase, this signals to producers that demand is probably high and that they should increase production.

Content	Reading
4. Indirect taxes and subsidies	<ul style="list-style-type: none"> ■ The use of supply and demand analysis, including elasticities to demonstrate the impact and incidence of taxes and subsidies on consumers, producers and the government.

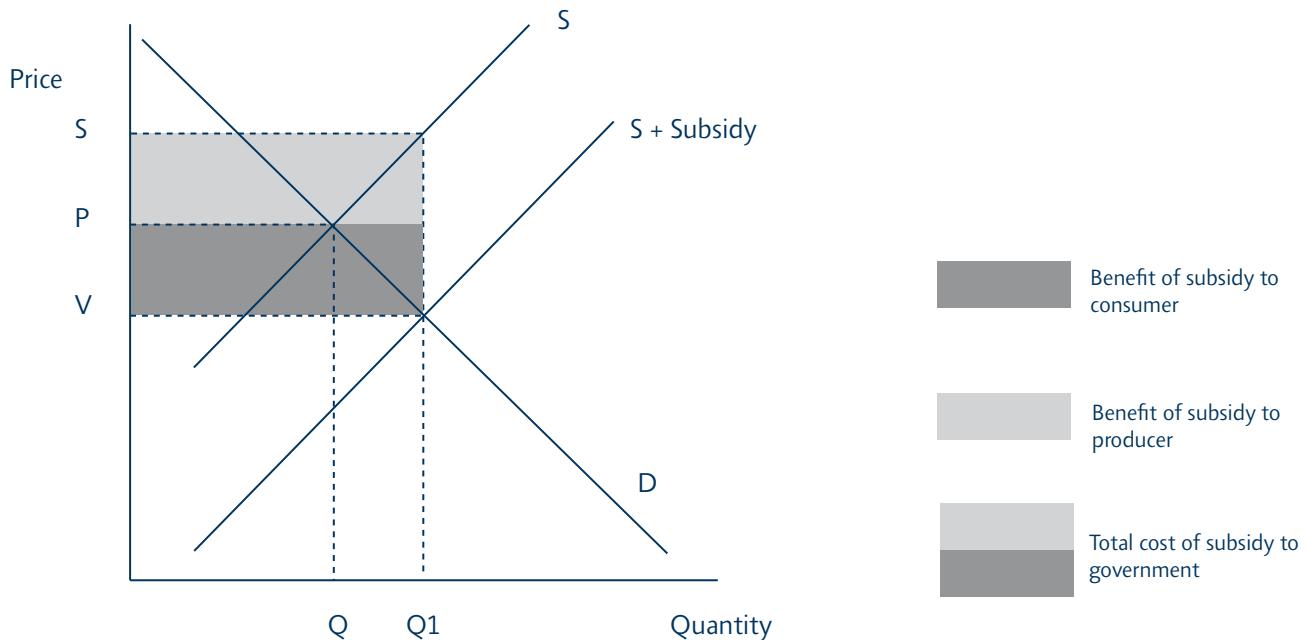
This should be linked to externalities, with negative externalities attracting tax and positive attracting subsidy. Also applicable to imperfect information.

The Incidence of Taxation



NB: the steeper (more inelastic) the demand curve, the greater the darker area (paid by the consumer) and the smaller the lighter area (paid by the producer)

Incidence of a Subsidy



1.3.5 Wage determination in labour markets

Content	Reading
1. The demand for labour <ul style="list-style-type: none"> ■ The factors that influence the demand for labour. ■ How the demand for labour in the private sector is derived from the demand for the final product. ■ The elasticity of demand for labour. 	Anderton Unit 14

In the labour market, people from households supply labour and businesses **demand** labour.

The **demand for labour** is known as **derived demand** — this means that demand for labour is determined by demand for the goods and services that they produce. Businesses will demand more labour if there is a high demand for the goods and services they produce, for example at times of economic boom. Demand for labour also increases if workers are more productive, or if capital becomes more expensive (labour and capital are **substitutes**).

Content	Reading
2. The supply of labour <ul style="list-style-type: none"> ■ The factors that influence the supply of labour, e.g. population migration, income tax and benefits, government regulations, trades unions. ■ The geographical and occupational mobility of labour. ■ The elasticity of supply of labour. 	Anderton Unit 14

Supply of labour is determined by a number of factors:

- **changes in migration patterns:** when many of the newer member states of the EU joined the EU, countries such as the UK saw an increase in immigrants, and therefore an increase in the labour supply
- **income tax:** when income tax is high, workers may feel that it is not worth working because they take home too little of their pay, and so labour supply may fall, that is, the value of their leisure time is more valuable than an hour of work, and so they substitute leisure for work. On the other hand, workers may feel that they have to work longer hours to compensate for the reduction in pay, and so labour supply may increase
- **benefits:** if state benefits (e.g. for sickness, disability, unemployment, etc.) are generous, then people are more likely to stay at home rather than work, thus reducing the labour supply
- **trades unions:** because trades unions act to increase wage rates through a process of collective bargaining, this may increase the labour supply as more people are encouraged to join the workforce. However, higher wage rates mean reduced demand for labour and encourage the substitution of capital for labour, so unemployment might result
- **social trends:** increased female participation in the workforce increases labour supply.

Content	Reading
3. Determination of wage rates <ul style="list-style-type: none">■ Use of supply and demand diagram to illustrate labour market equilibrium.■ Government intervention in the labour market, e.g. maximum and minimum wages.	Anderton Unit 14

The price of labour is known as the **wage rate**. If **wages are too high**, then there is more labour supplied than demanded — we have **unemployment**. If this occurs in a free labour market, then workers will have to accept lower wages or go without a job; thus the wage rate will tend to fall to the market clearing rate. If **wages are too low**, then demand for labour will be high but supply will be low so there will be a **labour shortage**, that is, workers will not work if they are paid too little (an hour of their leisure time is more valuable than a hour of work). Firms will have to pay workers more as an incentive to work, and so the wage rate will be bid up to the market clearing wage.

Students should also consider the importance of the participation rate in the labour force, and recognise the concepts of unemployment and underemployment.

1.3.6 Market failure

Content	Reading	
1. Types of market failure	<ul style="list-style-type: none"> ■ Definition of market failure, e.g. too much or too little of a good is produced and/or consumed compared with the socially optimal level of output. ■ Types of market failure, including externalities, public goods, imperfect market information, labour immobility. 	Anderton Unit 16
2. Externalities	<ul style="list-style-type: none"> ■ Distinction between private costs, external costs and social costs. ■ Distinction between private benefits, external benefits and social benefits. ■ Use of diagrams to illustrate the external costs from production, and external benefits from consumption using marginal analysis. The distinction between the market and social optimum positions, and identification of the welfare loss or gain areas. ■ The impact of externalities and government intervention in various markets, e.g. transport, health, education, environment. 	Anderton Unit 17

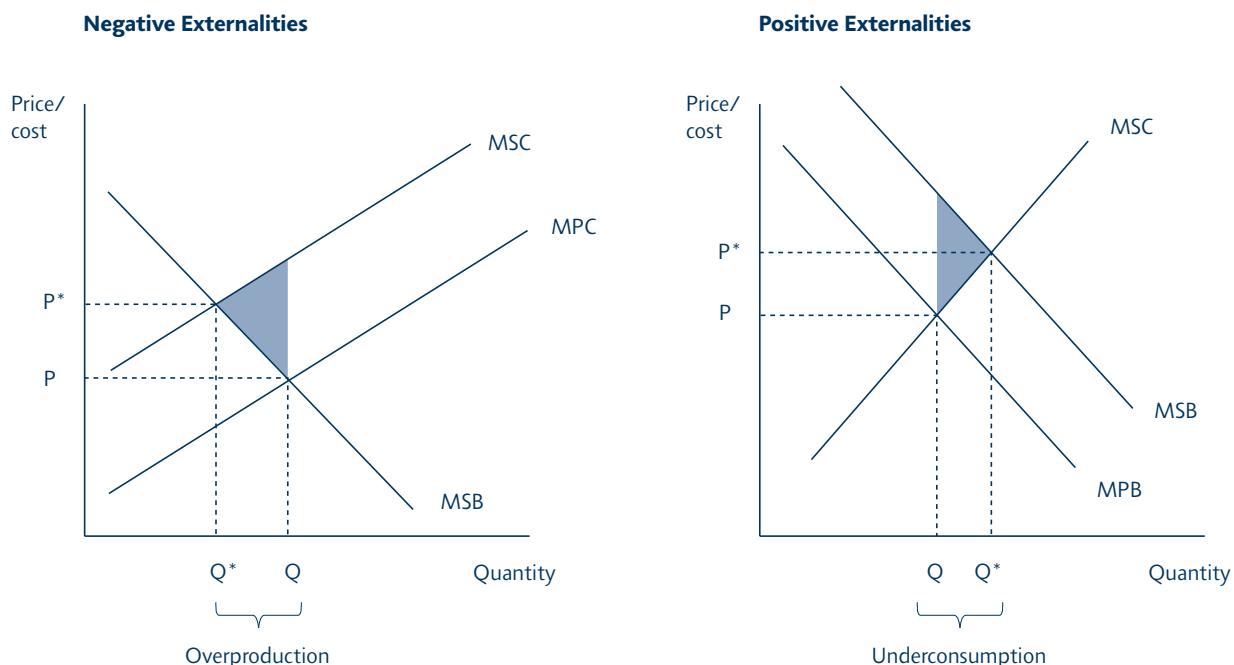
Negative externalities (or external costs) exist when the social costs of an economic action are greater than the private costs. For example, a toy manufacturer located on the banks of a river will incur a number of private costs of production (e.g. raw materials, labour, running machinery, etc.) but may also impose costs on third parties, such as noise from delivery lorries and an ugly factory affecting the quality of life of local residents or pollution being pumped into the river.

$$\text{Social costs} = \text{private costs} + \text{external costs}.$$

Positive externalities (or external benefits) exist when the social benefits of an economic action are greater than the private benefits. For example, the education received by a child means that he or she can get a job that pays a reasonable income (i.e. there is a private benefit to education); however, that child's education may also benefit wider society if he or she becomes a doctor and is able to treat people so that they can return to work (i.e. there is also a social benefit).

$$\text{Social benefits} = \text{private benefits} + \text{external benefits}.$$

Many students find this topic abstract and therefore difficult. Use as many practical examples as possible and get students to identify private and external costs/benefits, for example, traffic congestion, building of new airports, improved access to education, etc.



MSB = marginal social benefit
MSC = marginal social cost
MPC = marginal private cost
MPB = marginal private benefit
 P^*Q^* = ideal, efficient equilibrium, where $MSC = MSB$
 PQ = actual, inefficient equilibrium = market failure
Shaded area = welfare loss/gain

Cost benefit analysis (CBA) is an investment appraisal tool that applies the externalities idea. Major projects, such as the building of a new airport, are often controversial. To decide whether a project should go ahead or not, planners work out the private and external costs (to give social costs), and the private and external benefits (to give social benefits). If social costs exceed social benefits, then the project shouldn't go ahead. If social benefits exceed social costs, then the project might go ahead. In practice, however, it is very difficult to value external costs and benefits because different people have different opinions as to their value (i.e. it can be normative). It is also very costly to undertake a CBA. Finally, politicians may adopt rent-seeking behaviour, where they decide to press ahead with a project where social costs are high because it might win their party votes.

Content	Reading
3. Public goods	<ul style="list-style-type: none"> ■ Distinction between public and private goods using the concepts of non-rivalry and non-excludability. ■ Why public goods may not be provided by the private sector making reference to the free-rider problem.

Use examples. Students can get confused between non-rival and non-excludable — it is worth emphasising this.

Public goods

Non-rival means that consumption of a product does not prevent another person from also consuming that product, e.g. a radio programme demonstrates non-rivalry, because if one person listens to the programme it does not prevent another person from also listening to it. However, the radio itself is a rival good.

Non-excludable means that once a good is provided, it is impossible to stop people from using it, e.g. once a lighthouse is provided, then ships at sea cannot be prevented from benefiting from it. However, if a car manufacturer provides a new model of car, people can be excluded from purchasing one if they do not have enough disposable income with which to buy the car.

Goods that are both non-rival and non-excludable are called **public goods**. Goods that are rival and excludable are **private goods**. Goods that are either non-rival or non-excludable, but not both, are **quasi-public goods**.

Public goods have to be provided by the government, because since people cannot be prevented from using them, no one has any incentive to pay to provide them as they cannot make a profit. Thus there is market failure. People who use public goods without paying for them are known as **free-riders**.

Content	Reading
4. Imperfect market information	<ul style="list-style-type: none"> ■ The distinction between symmetric and asymmetric information. ■ How imperfect market information may lead to a misallocation of resources, drawing examples from areas such as healthcare, education, pensions and insurance.

Emphasise the importance of perfect information to enable markets to work properly. Discuss the effects of imperfect information in terms of over-consumption (tobacco) and under-consumption (healthcare/education).

Imperfect information

For markets to work, there needs to be perfect and **symmetric** information, i.e. consumers and producers have the same level of knowledge about the products, and they know everything there is to know about them. In many cases, however, information may be **asymmetric** (producers know more than consumers) or **incomplete/imperfect**. In these situations, we have market failure.

In the **private healthcare market**, doctors know more than patients about healthcare and treatments (asymmetric information). There is an incentive, therefore, for doctors to prescribe more expensive treatment than is necessary in order to increase their profits. This is an inefficient use of resources. Many consumers in the healthcare market take out **insurance** to help pay for treatment; this, however, leads to a problem of **moral hazard**, where they take more risks and therefore require more treatment because they are insured. Again, this is a consequence of asymmetric information in the market where consumers know more than insurers about their intended future actions.

In many markets, such as the **tobacco, alcohol or pensions markets**, providers of these goods and services often **withhold** information deliberately from consumers. For example, many tobacco companies knew of the link between tobacco and lung cancer before consumers were aware of it, and continued to advertise tobacco as being 'healthy' and 'sociable', leading to over-consumption of tobacco, and therefore market failure. In the pensions market, many consumers do not understand the workings of the pensions market, and that the type of fund into which they pay money may result in a loss of money rather than a gain, should stock markets fall. Thus, consumers' information is incomplete, and an inefficient market outcome results.

Content		Reading
5. Labour immobility	<ul style="list-style-type: none">Causes of geographical and occupational immobility of labour.Measures to reduce immobility, including training programmes, relocation subsidies.	Anderton Unit 19

Labour immobility

The labour market is not very efficient, and market failure results from the inability of workers to easily move between jobs. There are a number of reasons for this. Geographical immobility refers to the inability of workers to move around the country in search of work. This may be due to social reasons, such as not wanting to move away from family or not wanting to uproot children from good schools.

Occupational immobility refers to the inability of workers to move between jobs owing to lack of appropriate skills or training. As economies shift from having a manufacturing base to a service-sector base, many low-skilled manual workers find themselves without jobs.

1.3.7 Government interventions

Content	Reading
1. Methods of government intervention <ul style="list-style-type: none"> ■ Government intervention in various contexts, e.g. labour market, health, housing, education, transport, waste management, environment, energy, agriculture and commodities. ■ Purpose of intervention, including reference to market failure. ■ Methods, including indirect taxation, subsidies, maximum and minimum prices, buffer stocks, tradable pollution permits, extension of property rights, state provision, regulation. ■ Use of diagrams where appropriate. 	Anderton Units 13 (transport), 18, 21

A number of students become confused over minimum prices being a price above the market equilibrium, not below — this needs emphasising. There are a number of approaches to buffer stock diagrams, but all should involve a floor and ceiling price, and a notion of buying and storing excess supply for times when supply is low or demand high.

Commodity markets

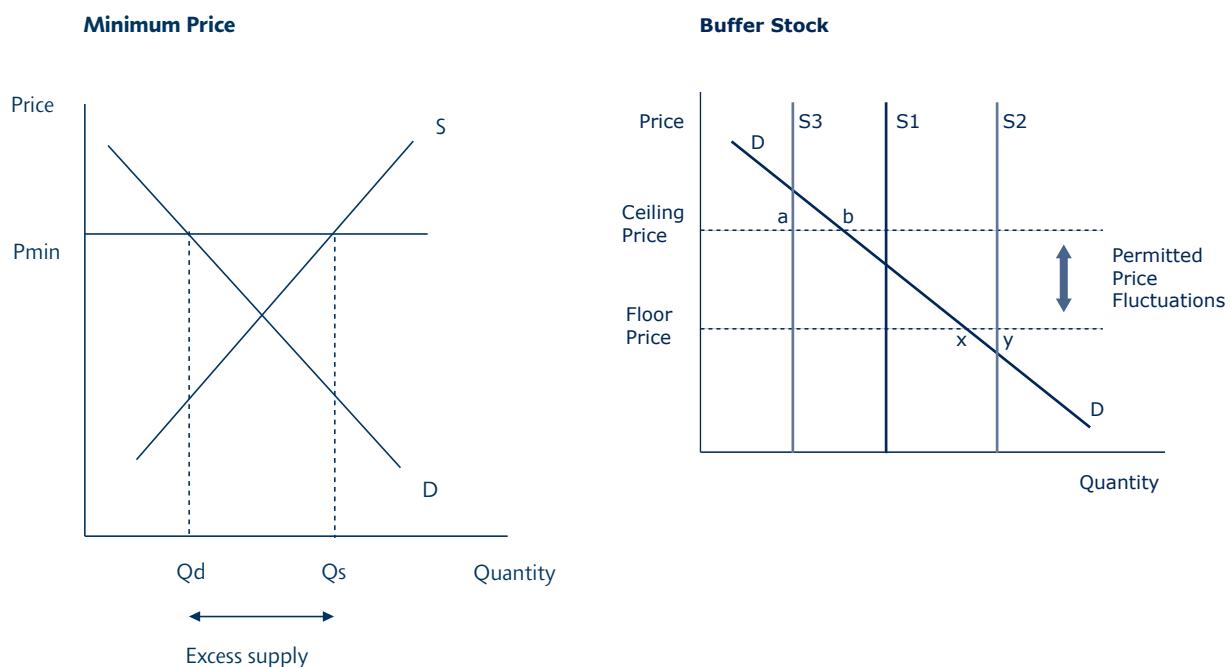
These are the markets concerned with raw materials, such as precious metals and minerals, and agricultural products. Agricultural markets in particular are prone to strong fluctuations in prices, as **supply can be unpredictable** (owing to the weather and crop diseases). There is also a **time-lag** problem, owing to the fact that crops can take up to a year to grow, and animals several years to raise, meaning that farmers have to base their decisions on how much to plant or raise, and therefore sell in the future, based on current prices. So, if the price of wheat is very high this year, farmers will plant large wheat crops for reaping next year, but this increased supply will force down the market price, which in turn encourages them to plant less, thus reducing supply and forcing prices back up. These fluctuating prices are bad for producers, because it leads to unstable income, and also bad for consumers, for whom many of these goods are necessities.

Governments can tackle these problems in a number of ways. Firstly, they could introduce a **minimum price**, where goods cannot be sold at a price below this. Minimum prices are set above the market price. This means that supply will exceed demand, and so there will be a glut or surplus.

Secondly, they could use a **buffer stock**, which entails a price ceiling and a price floor. If the price of the commodity drops too low (probably through high supply), then the government or buffer stock authority purchases large quantities of the good and stores it, in order to reduce the supply available to the market and raise the market price. If the price becomes too high, the government or buffer stock authority release the good onto the market from storage, thus increasing supply and

lowering price. However, there are a number of problems with buffer stock schemes:

- storage is expensive
- transport to and from storage is expensive
- it works only if goods are non-perishable
- it is nearly impossible to ensure that the amount kept in storage will equal the amount required for release in the future to lower prices (many buffer stock schemes end up storing too much, creating butter mountains, grain mountains and wine lakes).



Much of the evaluation of these alternative methods of correcting market failure looks at the cost of these approaches (including opportunity cost). The idea of problems caused by monopoly could be introduced with respect to state provision of goods with positive externalities or that are public goods. More able students could be introduced to the work of Ronald Coase on property rights. Evaluation of regulation should take into account the cost of a monitoring agency and the application of fines.

Type of intervention	How it works	Strengths	Weaknesses
Taxation	Reduces supply and therefore increases price, to discourage production/consumption of a good that has negative externalities.	Works through the price mechanism. Easy to understand.	Can be expensive to collect. Difficult to know the correct level of tax to set, as it should equal the external costs (= difficult to measure). Ineffective if PED is inelastic, as tax will have to be very high to reduce equilibrium quantity. Can be regressive.
Subsidy	Increases supply and therefore reduces price, to encourage production/consumption of a good with positive externalities.	Works through the price mechanism. Easy to understand.	Expensive for government — incurs an opportunity cost. Difficult to know correct subsidy to provide as it should equal external benefits. Producers may pocket the money and not increase supply.
State provision	Government directly provides a good or service, funded through tax revenue, in order to provide goods which have positive externalities or are public goods.	Increases fairness of access to services such as healthcare and education, which have many positive externalities attached. Without government provision, public goods wouldn't be provided. Trustworthy, provided with common standards.	Expensive for Government — incurs opportunity cost. State monopoly can result in inefficiency (e.g. through bureaucracy etc). Difficult to maintain consistent standards.
Buffer stocks	Government purchases commodities if a floor price is reached, and sells commodities if a ceiling price is reached.	Ensures fair income for producers and fair prices for consumers.	See section below
Regulation	Government imposes rules regarding the production, sale or use of a good/service, and backs this up legally by fines/prison sentences, etc. Aims to tackle negative externalities.	Easy to understand and often easy to monitor/police.	Expensive to monitor/police. Firms may ignore fines if they are not large enough. Can be anti-competitive. Often difficult to 'pin the blame' on the appropriate person, therefore unfair.

Type of intervention	How it works	Strengths	Weaknesses
Pollution permits	An efficient amount of pollution is agreed, and a corresponding number of permits released — these can be traded among firms so that low polluters can sell to high polluters and make a profit. Aims to tackle negative externalities.	Uses the market mechanism, therefore efficient. Requires little government intervention, therefore cheap to run.	Difficult to set correct amount of pollution and therefore right number of permits.
Extended property rights	Aims to identify who is responsible for paying for external costs, therefore reducing negative externalities. The economist Ronald Coase argued that it didn't matter whether the producer or the consumer took responsibility — either would be an efficient outcome.	Once property rights are allocated, no more government intervention needed in theory, therefore cheap.	Difficult to allocate property rights when they have never existed before. Some property rights cannot be allocated, e.g. carbon emissions cause global warming, but no one 'owns' the world and it would be politically undesirable for this to happen.

Content	Reading
2. Government failure <ul style="list-style-type: none"> ■ Definition of government failure as intervention that results in a net welfare loss. ■ Government failure, e.g. from agricultural stabilisation policies, environmental policies, transport and housing policies, maximum and minimum wages. ■ Causes of government failure, e.g. distortion of price signals, unintended consequences, excessive administrative costs. 	Anderton Units 17, 19 (housing), 21 (agriculture), 22 (environment), 23 (minimum wage)

Government failure exists when the government intervenes to correct a market failure, but this can result in a more inefficient allocation of resources. Examples to be covered include failure in the agricultural sector, transport sector, labour market, and housing. There are many practical examples of these failures.

Example 1: Mexico City and emissions from cars — tackling transport market failure

A good example of government failure is Mexico's approach to reducing CO₂ emissions in Mexico City. Their policy was very simple — cars with even/odd number plates were allowed into the city on alternate days, which in theory should have reduced the number of cars entering the city by a half. However, the reality was very different. Car owners sold their nice cars, and bought two, older

and more polluting cars — one with an even number plate and one with an odd plate. Result: an increase in CO₂ emissions and government failure.

Example 2: The Common Agricultural Policy (CAP) — tackling agricultural market failure

The aim of CAP is to stabilise agricultural prices and provide a satisfactory level of income for farmers in the European Union (EU). However, the outcome is inefficient. Farmers produce too much, and excess supply is bought by the EU and stored (causing 'wine lakes' and 'butter mountains'). So, the EU has to pay subsidies to farmers AND pay for warehouses and storage. Result: an inefficient use of government money, and government failure.

Example 3: The National Minimum Wage — tackling labour market failure

Often introduced to protect workers who receive low pay, by making it illegal for employers to pay a wage below the minimum. Those workers who manage to retain their job end up with higher pay, but some workers may lose their jobs and therefore be worse off, although this may depend on the level at which the minimum wage is set and how substitutable the labour is by machinery. Result: a more inefficient market outcome and government failure.

Example 4: Rent controls — tackling housing market failure

When governments consider the level of rent to be unacceptably high, they could impose a maximum rent. Maximum prices are set below the market equilibrium price, so that in this case demand for houses exceeds supply of houses, causing a housing shortage — some people will be worse off. Result: government failure.

Unit 2: Macroeconomic Performance and Policy

BASIC READING

Course books:

- Alain Anderton: *Edexcel A Level Student Book*, Pearson, ISBN 978-1-40589-228-5 [referenced below]
- Alain Anderton: *AS Economics Student Book*, Pearson, ISBN 978-1-40589-234-6
- Alain Anderton: *Edexcel A Level Teaching and Assessment Pack*, Pearson, ISBN 978-1-40589-229-2
- Peter Smith: *Edexcel A2 Economics*, Philip Allan, ISBN 978-0-34094-926-9

Unit book:

- Rachel Cole: *Edexcel AS Economics Student Unit Guide, Unit 2: Managing the Economy*, Philip Allan, ISBN 978-1-44414-785-8

Magazines:

- *Economics Review*, Philip Allan Updates
- *Economics Today*, Anforme

Useful websites:

- *tutor2u*: www.tutor2u.net/blog/index.php/economics/
- *Sloman Economics*: www.pearsonblog.campaignserver.co.uk/

2.3.1 Measures of economic performance

Content	Reading
1. Economic growth	<ul style="list-style-type: none"> ■ Rate of change of real Gross Domestic Product (GDP) as a measure of economic growth. ■ Distinction between real and nominal GDP and total and per capita GDP. ■ Awareness of other national income measures including Gross National Product (GNP), Gross National Income (GNI). ■ Comparison of GDP rates of growth between countries and over time. ■ The limitations of using GDP to compare living standards between countries and over time

Economic growth

Economic growth is measured in two main ways — as an *increase in real GDP* or as an *increase in potential GDP*. The first is easy to measure, and is the most readily available data on websites such as www.imf.org/external/country. By contrast, the increase in potential GDP is a very useful measure of how the economy is performing relative to its capacity constraints and its use of resources, and ignores the possibility that some of the resources might be unused at the time of measurement. Figures relating to spare capacity are usually available on the Bank of England website www.bankofengland.co.uk — go to the link providing the latest inflation report.

It is of major importance to measure growth accurately, one reason being that growth is an indicator of the success of current economic policies and a guide to future ones. Growth figures also influence consumer borrowing or saving and business investment, so inaccurate figures might mean that inappropriate levels are chosen. Growth figures also influence the confidence in the domestic economy held by the global economy, and therefore affects flows of investment funds (known as foreign direct investment) and 'hot money' (short-term speculative flows of cash chasing high interest rates and potential currency changes).

However, there are many problems with the growth measures that we use. An economy might be growing quickly but this may mean that the **income gap** is widening and causing problems of relative poverty. There may be increases in other problems alongside economic growth. There may be more pollution, congestion, number of hours worked, stress levels — all these can contribute to worsening living standards even for those whose incomes are rising.

Another problem is the difficulty of comparing growth in different countries and over different time periods. Some economies consume much of what they produce, meaning that the true value of the output is not reflected in the GDP figures.

Content	Reading
2. Inflation <ul style="list-style-type: none"> ■ Definitions of inflation, deflation and disinflation. ■ The process of calculating the rate of inflation using a consumer price index; reference should be made to a weighted basket of goods and services. ■ The producer (wholesale) price index as an indicator of future trend in the rate of inflation. ■ Causes of inflation, including demand pull, cost push, excessive growth of money supply. ■ Effects of inflation including the impact on income distribution, on competitiveness, on investment. 	Anderton Unit 30 Sloman: The Chinese Economy < www.pearsonblog.campaignserver.co.uk/?p=1474 >

Inflation

The use of indices is intended to make comparisons easier over time and between countries, and a base year is chosen to make effective comparisons.

The second idea is to understand the weighting of expenditure, changes in the weighting of expenditure over time, and the difference in weighting across households and countries.

Content	Reading
3. Employment and unemployment <ul style="list-style-type: none"> ■ Measure of unemployment using the International Labour Organisation (ILO) definition. ■ The causes of unemployment, e.g. skills mismatch, occupation immobility, geographical immobility, demand deficiency, real wage inflexibility. ■ The effects of unemployment, e.g. waste of resources, poverty, government budget, social effects. ■ Distinction between unemployment and underemployment. ■ The significance of changes in the rates of employment, unemployment and inactivity. ■ The significance of migration for employment and unemployment. 	Anderton Unit 29

Employment and unemployment

While the ILO method of measuring unemployment is fairly inclusive and internationally comparable, there are problems in data collection and in the definition of unemployment (see www.ilo.org).

There are various names for different types of unemployment. **Cyclical** or **demand deficient** — the idea that unemployment levels might be related to the *business cycle*. **Classical** — that unemployment might be positively related to wage pressures, especially when wages are deliberately maintained above

equilibrium level. The relative importance of some types might be considered, for example, that **structural** unemployment might have long-term detrimental effects, whereas **frictional** unemployment might not. Other types should also be considered: for example, **seasonal** — where there are factors over which the government has little control, and **regional** unemployment. Each type of unemployment has different implications for government policy.

Employment and unemployment are not the opposite sides of the same issue — in fact the number of people in work in the UK is often increasing at the same time that unemployment rises. This might be owing to increased immigration, for example, so there are more people in the labour market, some of whom get jobs and some who don't or replace others already working.

Content	Reading
4. Balance of Payments	<ul style="list-style-type: none"> ■ Components of the balance of payments with particular reference to the current account and balance of trade in goods and services. ■ Definition of balance of payments deficits and surpluses on the current account. ■ The causes of an imbalance in the current account, at a basic level.

Balance of payments with emphasis on the current account of the balance of payments

The four elements of the current account (trade in goods, trade in services, investment income and transfers) should be understood, and their relative importance to the UK. Changes in the balance of payments on current account should be understood, from the viewpoint of cause and effect. Time series data should be used to show the context of an imbalance. The issue of '*who pays for the imbalance?*' might be discussed in class and whether the costs of trying to correct an imbalance are worthwhile in terms of damage to other measures.

Content	Reading
5. Measures of development – Human Development Index (HDI)	<ul style="list-style-type: none"> ■ The three components of HDI (education, health, income) and how they are measured and combined. ■ Definition of Purchasing Power Parities (PPPs). ■ Advantages and limitations of HDI in making comparisons of living standards between countries.

Measures of development — Human Development Index (HDI)

There are three equal weights within the HDI: education (years of schooling and literacy), health (mortality) and real GDP per head at PPPs. These are ranked 0 (best) to worst (1) in an **index**. This index does not take account of poverty or other measures of deprivation, and in that respect is regarded by some as being

of limited value. The advantage of HDI is that it does combine the effects of increased growth with other quality of life indicators, and in that respect is an important measure of development. It might be worth comparing the HDI with other measures, some of which contain a GDP element and some that don't.

PPPs are a way of measuring exchange rates using the idea of how much a basket of goods would cost in various countries. Rather than using nominal exchange rates, the PPP shows how much can be bought in another country with a unit of another currency — much like the 'Big Mac Index' (see www.economist.com) which shows relative exchange rates based on the uniform (if distasteful) currency unit of a McDonald's burger. It measures the real exchange rate, in terms of the cost of buying a fairly standard product that can be bought in almost every country of the world, and where the ingredients are approximately the same. It can be used to measure the **cost of living** of a standard basket of goods.

Content	Reading
6. Other measures of development <ul style="list-style-type: none">■ Other measures of development, e.g. the percentage of adult male labour in agriculture, access to clean water, energy consumption per capita, access to mobile phones per thousand of the population.	Anderton Unit 32

Other measures of development

The important issue is that economic growth is not the same as increases in standards of living, but the latter is difficult to achieve without the former. Measures of economic development incorporate the concept of the quality of life, which is of course almost impossible to measure, but there are indications of quality in life expectancy, access to mobile phone technology and so on. Some measures of economic development do not grow in direct proportion to economic growth (e.g. GDP per head if infant mortality is falling dramatically with small increases in income), and some far outpace it (increase in life expectancy with the advent of inoculations).

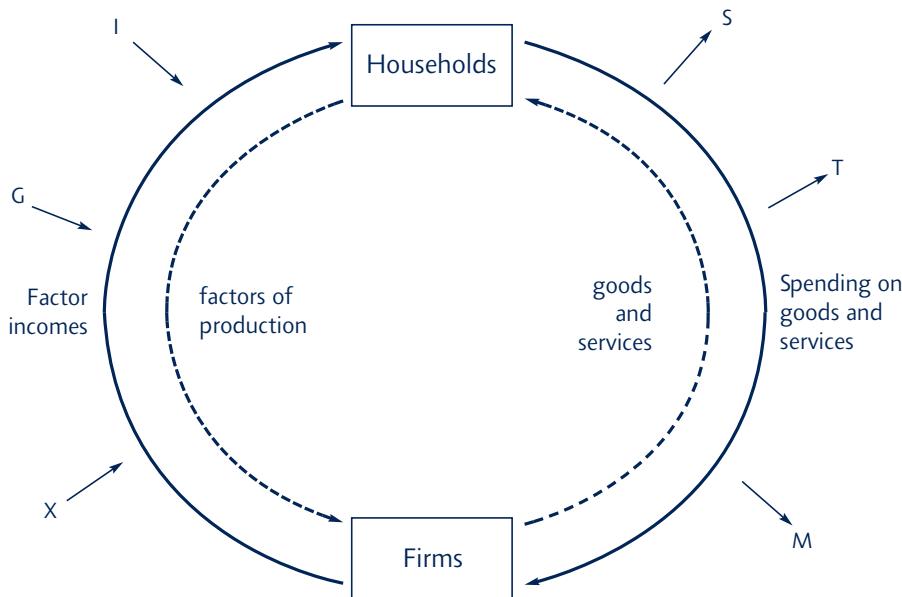
Data for student research projects: IMF Outlook: <<http://www.imf.org/external/pubs/ft/weo/2012/02/weodata/index.aspx>>.

2.3.2 The circular flow of income

Content	Reading
1. National income <ul style="list-style-type: none"> ■ The circular flow of income. ■ The distinction between income and wealth. 	Anderton Unit 25
2. Injections and withdrawals <ul style="list-style-type: none"> ■ The impact of injections into and withdrawals from the circular flow of income. 	Anderton Unit 25

If income increases are going to have a direct impact on **wealth** then a decision must be made to forego current consumption in order to enjoy increased welfare in the future — a '*jam tomorrow not jam today*' principle. Clearly many people with high incomes do not build up their personal wealth, and the same is true for firms and governments. The decision to increase productive resources, that is, build up wealth, is one of the most significant economic decisions made in an economy.

An acceptable simple diagram of the circular flow of income might be sketched as follows:



The purpose of the diagram is to stress the concept of money flows, which are changed, with multiplied effects, when there is a change in injections or leakages.

It is of course possible to add the government and overseas market in this diagram, and to show repeated rounds of spending, if these are helpful in the student's understanding. It is very unlikely that the circular flow of income will be requested as a diagram — rather, the diagram is useful in gaining an understanding of the central concepts of macroeconomics.

2.3.3 Aggregate demand (AD)

Content	Reading
1. The characteristics of AD <ul style="list-style-type: none"> ■ Definition and components of aggregate demand: $C + I + G + (X - M)$. ■ The use of the AD curve diagram. ■ The distinction between a movement along and a shift of the AD curve. 	Anderton Unit 36

The components of aggregate demand: $C + I + G + (X - M)$

Movements along and shifts of the AD curve

Aggregate demand may be drawn as a straight downward sloping line at AS level, although this does rather omit the concept to the real balance effect — that the total amount spent is likely to be fairly constant along the AD, and therefore the area under the AD is likely to remain fairly constant, as in the rectangular hyperbola.

Other reasons for drawing a downward sloping AD are that, at higher average prices, an economy is less likely to export, more likely to import (increasing the M component of AD and therefore decreasing AD overall) — the international competitiveness argument.

Another argument for the downward sloping AD is that, at higher prices, the interest rate is likely to be higher, meaning that investment (a component of AD) is lower. They might also save more.

Whichever argument is used to explain the downward sloping AD, the vital point is that the AD does NOT slope downwards because people spend more at lower prices. There must be something else on which consumers choose to spend their money at higher prices — for example, imports — or the argument does not make sense in a macroeconomics context.

Content	Reading
2. Consumption (C) <ul style="list-style-type: none"> ■ (Disposable) income as a key influence on consumer spending. ■ Definition of the marginal propensity to consume and the marginal propensity to save. ■ Other influences on consumer spending, e.g. interest rates, consumer confidence, social safety net, culture, wealth effects. ■ Relationship between savings and consumption. 	Anderton Unit 33

Consumption (C)

Consumer spending is often the main driver of growth or a recession. The amount that consumers spend is largely influenced by the attitude of the consumer — is

he or she worried about losing a job, confident that shares and house prices are growing, or saving because of worries about a hopeless pension. Actual changes in the economy (such as rises in the FTSE) can cause real spending increases, if people decide to trade in their increased wealth, or may simply increase confidence in spending. By contrast, a worrying stock market in, say, the USA, might cause people in the UK to reign in on their spending plans, whether or not the stock market in the UK reacts immediately or convincingly.

Content	Reading	
3. Investment (I)	<ul style="list-style-type: none"> ■ Definition of investment. ■ The main influences on investment, e.g. interest rates, confidence levels, risk, the influence of government and regulations. 	Anderton Unit 34

Investment (I)

The interest rate, as the cost of borrowing, is likely to have an inverse relationship with the amount of investment — only a few projects will be viable if the cost of credit is high. Increasingly, business confidence is seen as a major influence on the decision to invest, and it may be that this contradicts the impact of interest rates. For example, monetary policy might raise rates because there are signs of consumer spending accelerating, which might encourage firms to invest more.

Content	Reading	
4. Government expenditure (G)	<ul style="list-style-type: none"> ■ The main influences on government spending, e.g. the use of government spending to influence the level of economic activity. 	Anderton Unit 35

Government expenditure (G)

Government spending is by central and local government on goods and services. While to some extent this spending is determined by the fiscal policy of the government, it is also largely dependent upon the business cycle. In a boom, tax receipts increase and the demands on government spending will fall, and vice versa in an economic slowdown.

Changes in G are likely to have a large multiplier effect, in that the spending changes have a direct impact upon the spending in the economy.

Content	Reading
5. Exports - Imports ($X - M$)	<ul style="list-style-type: none"> ■ The impact on the current account of factors, including real income, the exchange rate, the state of the world economy, degree of protectionism, non-price factors. ■ Definition of the marginal propensity to import.

Exports — Imports ($X - M$)

$X - M$ is the current account balance. If a country's main trading partners are suffering a slowdown in growth, then this is likely to worsen their current account balance, as X falls and M increases (their imports become more competitive). As AD falls, we would expect a multiplied fall in that country's national income but less inflationary pressure in the economy. By contrast, if the country's main trading partners are growing quickly, then this might stimulate the country's economy.

If the exchange rate strengthens (i.e. a country's own currency gets stronger), then exports will become relatively expensive and imports relatively cheap. This would worsen the current account position. However, this depends on the elasticity of demand for exports and imports; if the competition is based on quality rather than price, then the changes in demand might not be significant, and the current account might not suffer at all.

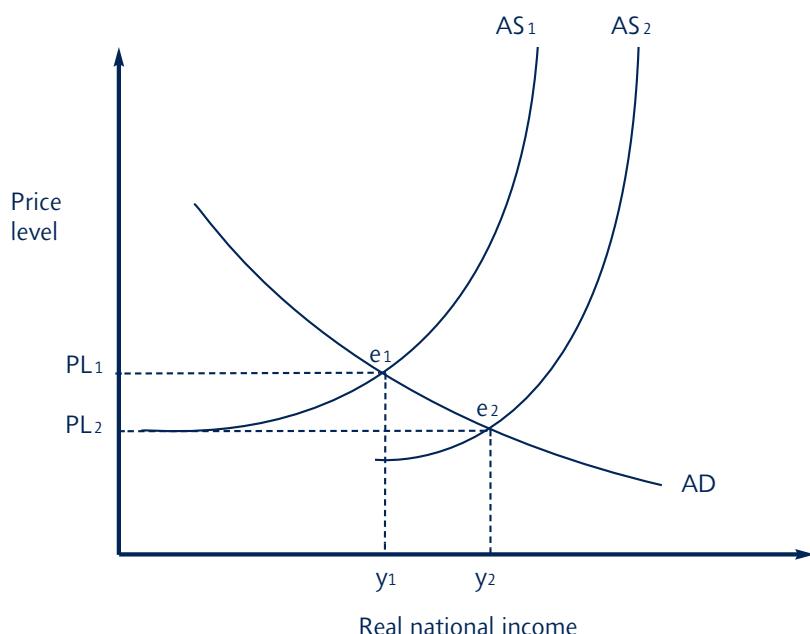
2.3.4 Aggregate supply (AS)

Content	Reading
1. The characteristics of AS <ul style="list-style-type: none"> ■ Definition of aggregate supply. ■ The use of the AS curve diagram. ■ The distinction between a movement along and a shift of the AS curve. ■ Different shapes of AS curve, e.g. Keynesian, classical. 	Anderton Unit 37
2. Short-run and long-run AS <ul style="list-style-type: none"> ■ Causes of shifts in short-run and long-run AS curves. ■ Factors influencing short-run AS, e.g. costs of raw materials and energy, exchange rates, tax rates. ■ Factors influencing long-run AS, e.g. technological advances, relative productivity changes, education and skills changes, regulation and tax changes, demographic changes and migration, competition policy. 	Anderton Unit 37

Aggregate supply

Movements along and shifts of the AS curve

Movements along the AS curve occur when there is a shift in AD, as a new equilibrium point is established. A short-run AS curve might be shown as a static backward-bending L-shape (Keynesian), and a shift in AS might be seen as the long-run AS situation. Other interpretations are acceptable. This diagram shows a possible analysis of a successful supply-side shift.



2.3.5 The interaction of AD and AS to determine equilibrium

Content	Reading
1. Equilibrium level of real output	<ul style="list-style-type: none"> ■ The concept of equilibrium real national output. ■ Causes of changes in equilibrium real national output, as a result of shifts in AD and/or AS curves.

Equilibrium level of output

Equilibrium income or output occurs where planned AD equals planned AS, and many economists argue that this point can occur even if there is unemployment. The implication is that the unemployment does not act as a force to clear the market, that is, wages do not keep falling until everyone is employed.

One real-world example is that people with very low skills can find it hard to get a job when the economy is not growing very fast. There might be seasonal work, for example, in agriculture, but there are lean times of the year when casual workers find it hard to get jobs. It might be that these workers are too expensive to take on — but it might also be that there is no incentive for employers to take on workers whatever the going wage.

Content	Reading
2. The multiplier	<ul style="list-style-type: none"> ■ Definition of the multiplier ratio. ■ The multiplier process. ■ Calculations of the multiplier using the formula $1/(1-MPC)$. ■ The significance of the multiplier to shifts in AD.

The multiplier

An injection such as an increase in exports means that there is an immediate increase in AD. But the extra income raised by selling goods abroad will raise incomes of those making the goods and services, and this income will be spent in the economy. Whatever is not spent on **withdrawals** will cause second round increases in AD, which leads to further rounds of income and spending. These **knock on** effects are the multiplier effects of an increase in injections, and the process work in reverse when injections fall — a reverse multiplier, or multiplied contraction of AD.

2.3.6 Economic growth

Content	Reading
1. Causes of growth <ul style="list-style-type: none"> ■ Actual growth caused by an increase in the components of AD. ■ Potential growth caused by different factors, including investment, innovation, growth in size of labour force, degree of competition. 	Anderton Unit 26 Sloman: Asia's Moderate Boom < www.pearsonblog.campaignserver.co.uk/?p=5787 >

Actual and potential growth

Actual growth is measured as increases in real GDP, and potential growth is an increase in the capacity in the economy.

Causes of growth

Growth can be achieved by increases in the components of aggregate demand, for example, an increase in consumer spending. The size of this increase depends on the size of the multiplier, and therefore any changes in injections and leakages will have an impact on the degree of change in growth.

Growth can be achieved by increases or improvements in any of the factors of production, e.g. productivity growth or immigration. The effect is to shift the aggregate supply curve to the right.

It is important to be able to compare and contrast the causes of growth, and to be able to illustrate them with an AD/AS diagram.

Content	Reading
2. Constraints on growth <ul style="list-style-type: none"> ■ Constraint factors, including availability and quality of factors of production, inadequacy of capital markets, instability of government, inadequate infrastructure, absence of property rights, inappropriate regulation. 	Anderton Unit 26
3. Benefits of growth <ul style="list-style-type: none"> ■ The benefits of growth to citizens of increased standards of living, to firms (increased profits) and to government (e.g. increasing tax revenues). 	Anderton Unit 27

Benefits of growth

Increased wealth and income is no doubt a factor determining living standards, but the impact should not be considered without evaluation of the issues.

Increased income resulting from growth is likely to increase income inequality, and there might be structural unemployment as some industries are replaced by new ones but workers' skills are not transferable.

Understand the benefits of growth to citizens of increased standards of living, to firms (increased profits) and to government (for example, increasing tax revenues).

Students may consider whether an increase in income necessarily increases living standards.

Content	Reading
4. Costs of growth <ul style="list-style-type: none">■ Costs of growth, including adverse consequences of growth for the environment, balance of payment problems, the opportunity cost of growth.	Anderton Unit 27

Costs of growth

Costs of growth are well documented, most particularly by political pressure groups such as Friends of the Earth (www.foe.org.uk). The following should be considered, but there are many other valid factors: the adverse consequences of growth for the environment; the balance of payments problems; income distribution and the opportunity cost of growth.

Content	Reading
5. Output gaps <ul style="list-style-type: none">■ Difference between actual growth rate and long-term trends in growth.■ Distinction between positive and negative output gaps.■ Definition and characteristics of recession.	Anderton Unit 26

Trends in growth rate are shown by changes in real GDP over time; these may be compared with changes in capacity over time, or compared with the trend or sustainable rate of growth — the vertical difference between the trend and actual being shown as the output gap. The gap signifies whether the economy is operating with spare capacity and therefore worries about unemployment or, by contrast, at over capacity, with worries about inflation.

2.3.7 Macroeconomic objectives and policies

Content		Reading
1. Macroeconomic objectives	<ul style="list-style-type: none"> ■ Objectives, including increased economic growth, control of inflation, a reduction in unemployment, equilibrium of the Balance of Payments, balanced budgets, redistribution of income, protection of the environment. 	Anderton Units 24 and 41

Current macroeconomic objectives

Students should have a sense of the trends in macroeconomic measures over the past five to ten years, and the stage at which governments might become concerned about them. The side effects of macroeconomic problems could be considered, and the changing importance of objectives as other factors change might be used as ways of weighing up which objectives are the most important to a government.

Content		Reading
2. Conflicts between objectives	<ul style="list-style-type: none"> ■ Basic conflicts between objectives, including inflation and unemployment (including the short-run Phillips curve), economic growth and environmental sustainability, inflation and equilibrium on the current account of the Balance of Payments, balanced budgets and short-run growth. 	Anderton Units 24 and 41

Conflicts between objectives

The Phillips Curve, an empirical observation in 1958, comments that a shortage of labour might set off an increase in wages. The implication is that there might be a trade off between unemployment and increases in inflation. This is set against the classical view that there is only unemployment if wages are too high — that is, if the supply of labour is greater than the demand for labour — in which case if more people are allowed to become unemployed the pressure on wages will fall.

The student should come to a view as to whether unemployment exists because wages are high or because there are other factors in the economy causing deficiencies in the labour market.

Another trade off which may be considered is that between economic growth and the current account of the balance of payments. If an economy is growing quickly, as in India, it is likely to suck in many imports, and exporters have reduced incentive to export if the output can be sold at home. However, if the growth is export led, as in China, economic growth may *improve* the current account, as the exports are bringing spending power to the economy. (Note that country specific data is not required.)

Growth may damage the environment if it involves increased manufacturing, but if service based, it may not. Indeed, the increased incomes from growth might enable a country to 'clean up': convert to cleaner or renewable fuels or tighten legislation.

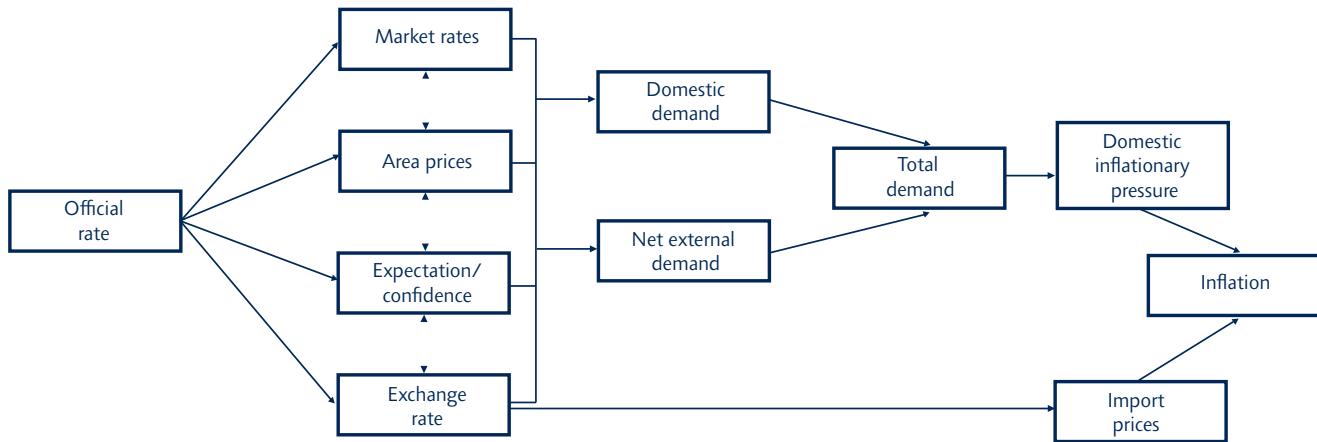
Content	Reading
3. Macroeconomic policy instruments <ul style="list-style-type: none"> ■ Definition of demand-side policies. ■ Distinction between monetary and fiscal policy. ■ Distinction between reflationalary and deflationary policies. ■ Monetary policy instruments, including interest rates, asset purchases to increase money supply, reserve ratios. ■ Fiscal policy instruments: government spending and taxation (direct and indirect). ■ The use of diagrams to illustrate demand-side policies. ■ Use of intermediate targets, e.g. inflation rate, nominal GDP. ■ Definition of supply-side policies to include free market and interventionist methods designed to increase productivity. ■ Free market measures, including deregulation of product and labour markets, privatisation, reduction in taxation, competition policy, changing the levels of benefits, cutting the costs of bureaucracy in firms. ■ Interventionist methods, including subsidies to education, training and investment, infrastructure investment, finance for business start-ups, regional policy. ■ Strengths and weaknesses of demand-side and supply-side policies. 	Anderton Units 39-41 Sloman: Monetary Policy < www.pearsonblog.campaignserver.co.uk/?tag=monetary-policy > Sloman: Fiscal Policy < www.pearsonblog.campaignserver.co.uk/?tag=fiscal-policy > Sloman: Asset Purchase Scheme < www.pearsonblog.campaignserver.co.uk/?tag=asset-purchase-scheme >

Demand-side policies

The diagram on the following page illustrates the transmission mechanisms involved with monetary policy in the UK, and it is fully described on the Bank of England website.

The effects of fiscal policy should be considered in terms of changes in **government spending** and the rate of **taxation**.

The transmission mechanisms of monetary policy



Note: for simplicity this figure does not show all interactions between variables, but these can be important.

Supply-side policies

A supply-side policy is a government scheme to promote market forces, cut costs and raise the full employment level of output.

The main categories for a supply-side policy are:

- improve price flexibility and signalling within a market
- increase competition
- improve incentives.

Arguments for supply-side policies propose that competition between firms can be improved. Students will require descriptions and examples of how this might be achieved, and/or be able to discuss the effects of flexibility and incentives.

Conflicts resulting from the use of policy instruments

An increase in government spending (part of fiscal policy) is likely to have a direct impact on the supply side of the economy — namely in health and education or through the impact of changes in taxes and benefits. The increased spending might cause problems in supply — (**bottlenecks**) — but in the long run it is thought that spending in these areas would help to improve the supply-side conditions in an economy.

The investment by a government on the infrastructure of an economy, the educational establishments or the health infrastructure will also have a direct impact on the costs of production of firms. However, overspending by governments may mean that there is a shortage of credit in the financial markets, and the shortage of liquid assets will push up the cost of credit — that is, the *interest rate*.

An increase in interest rates, while intended to control inflation, might have the effect of attracting **hot money** into the economy. This may make the exchange rate stronger, or simply destabilise it. While a stronger currency might help to control AD (exports become less competitive and imports relatively cheaper), these effects are not guaranteed. Increasing interest rates is often seen as being damaging to the **supply side** of the economy.

Unit 3: Business Behaviour

BASIC READING

Course books:

- Alain Anderton: *Edexcel A Level Student Book*, Pearson, ISBN 978-1-40589-228-5 [referenced below]
- Alain Anderton: *AS Economics Student Book*, Pearson, ISBN 978-1-40589-234-6
- Alain Anderton: *Edexcel A Level Teaching and Assessment Pack*, Pearson, ISBN 978-1-40589-229-2
- Robert Nutter: *Business Economics: Microeconomics for A2*, Anforme, ISBN 978-1-90550-479-4
- Peter Smith: *Edexcel A2 Economics*, Philip Allan, ISBN 978-0-34094-926-9 [referenced below]
- Andrew Threadgould: *Macroeconomics for A2 Level*, Anforme, ISBN 978-1-90550-471-8

Unit book:

- Marwan Mikdadi and Rachel Cole: *Edexcel A2 Economics Student Unit Guide, Unit 3: Business Economics and Economic Efficiency*, Philip Allan, ISBN 978-1-44414-788-9

Magazines:

- *Economics Review*, Philip Allan Updates
- *Economics Today*, Anforme

Useful websites:

- *tutor2u*: www.tutor2u.net/blog/index.php/economics/
- *Sloman Economics*: www.pearsonblog.campaignserver.co.uk/

3.3.1 The firm and its objectives

Content	Reading
1. Objectives	<ul style="list-style-type: none"> ■ The size and types of businesses, including small and large firms, public and private sector organisations, for profit and not for profit organisations, mutuals and co-operatives. ■ Significance of the divorce of ownership from control. ■ Different business objectives that include: <ul style="list-style-type: none"> ◆ profit maximisation ◆ revenue maximisation ◆ sales maximisation. ■ Behavioural theories, e.g. satisficing.

What motivates a firm?

Who are the main participants in a firm's daily decision-making process?

- a) **Directors and Managers:** Shareholders in a PLC will elect directors to look after their interests in the company for them. Directors in turn appoint managers to manage and run the company. The only way owners can influence decisions is through the AGM.
- b) **The workers:** don't have the power to run the company, but collectively may be able to influence decisions. Trades Unions may exert influence over wages (and therefore costs), job losses and health and safety.
- c) **The consumers:** can influence the work of businesses through their demand patterns. If a firm fails to provide goods that consumers demand they will eventually cease trading.

Short-run profit maximisation

Shareholders will be motivated by maximising their profits from the company, in other words — dividends. Thus it is assumed that the firm will want to maximise its profits. However, not all firms are able to operate at a profit. Some will be faced with making a loss.

Long-run profit maximisation

Keynesian economists believe that firms will seek to maximise their long-run rather than their short-run profits. This is based upon the belief that firms will use cost plus pricing. In other words, the price of the product is worked out by calculating the average cost, when the firm is operating at full capacity and adding a mark-up.

Short-run profit maximisation suggests that firms adjust price and output in response to changes in market conditions. However, most economists agree that rapid price changes may affect a firm's position in the market. Consumers dislike rapid price adjustments, and often view price cuts as signs of desperation and distress.

This theory suggests that a firm might continue to operate in the short run even if it were making a loss. The management would hope to be able to turn the business around and make profits in the long run.

Managerial theories

Some managers would seek to maximise sales rather than profits. It is often the case that increased sales go hand in hand with increased salaries for top executives.

Other managers are said to be motivated by factors, such as high salaries, the number of people under their control, the power they can yield over investment decisions and the availability of fringe benefits. This idea originates from the concept that managers in large firms will have enough discretion to pursue policies giving them personally most satisfaction.

However, profit remains a shareholder's best measure of success. Managers and directors are prone to shareholder revolts, and may even get voted out of office. Managers will therefore **profit satisfice**, in other words, satisfy the demands of shareholders. Once those demands have been met, managers would be free to maximise their own rewards from the company.

Content		Reading
2. Size of businesses	<ul style="list-style-type: none"> ■ How businesses grow: <ul style="list-style-type: none"> ◆ organic growth ◆ merger/takeover (forward and backward vertical integration; horizontal integration and conglomerate integration). ■ Constraints on business growth, including size of market, access to finances, owner objectives. ■ Why some firms tend to remain small and others grow. ■ Reasons for demergers. 	Anderton Unit 59 Smith Ch.1 Sloman: Mergers and Acquisitions < www.pearsonblog.campaignserver.co.uk/?tag=asset-purchase-scheme >
3. Transnational companies (TNCs)	<ul style="list-style-type: none"> ■ Reasons why companies become TNCs. ■ Advantages and limitations to a company of becoming a TNC. 	Anderton Unit 77

3.3.2 Revenue, costs and profit

It is important to establish these as preconditions for studying the ‘theory of the firm’.

Content	Reading
1. Revenue <ul style="list-style-type: none"> ■ Relationship between total revenue, average revenue, and marginal revenue. ■ Price elasticity of demand and its relationship to revenue concepts. 	Anderton Unit 44
2. Costs <ul style="list-style-type: none"> ■ Derivation of short-run cost curves from assumption of diminishing marginal productivity. ■ Relationship between: <ul style="list-style-type: none"> ◆ total cost ◆ total fixed cost ◆ total variable cost ◆ average total cost ◆ average fixed cost ◆ average variable cost ◆ marginal cost. ■ Relationship between short-run and long-run costs. 	Anderton Unit 43 Smith Ch.1
3. Economies and diseconomies of scale <ul style="list-style-type: none"> ■ Types of economies of scale, including financial, technical, managerial, marketing, purchasing. ■ Long-run average cost and economies and diseconomies of scale. ■ Distinction between internal and external economies of scale. ■ Causes of diseconomies of scale. 	Anderton Unit 43 Smith Ch.1
4. Profit <ul style="list-style-type: none"> ■ Conditions for profit maximisation (numerical, diagrammatic). ■ Distinction between normal and supernormal profit. 	Anderton Unit 45 Smith Ch.1

3.3.3 Market structures and contestability

Much of the groundwork for this has already been done in 3.3.2. Use comparisons between perfect competition and monopoly to highlight efficiency issues. Use oligopoly to look at firms' motivation.

Market structure

Market structures are based on the characteristics of a market. Economists identify a number of characteristics which determine the market structure a firm is said to operate in:

- the **size** and **number of firms** in the market
- the **ease** or **difficulty** with which these new firms might enter the market (barriers to entry and exit)
- the extent to which goods in the market are similar (**homogeneity**)
- the extent of **knowledge** shared by firms in the market
- the extent to which the actions of one firm will affect another firm (**interdependence**).

The number of firms in an industry

The number of firms in an industry may vary from one to many. For example, in the UK, Thames Water is the sole supplier of water in the London area, that is, a monopoly. In agriculture, on the other hand, there are tens of thousands of farms supplying eggs to the market.

1. **Monopoly** is said to exist where there is only one supplier in the market.
2. **Oligopoly** is said to exist in a market dominated by a few large producers alongside a large number of small and relatively unimportant firms.
3. **Perfect Competition or Monopolistic Competition.** In this market structure there are a large number of small firms, none of which are large enough to influence price.

Barriers to entry

Market structures are also affected by the ease with which new entrants can access the market. Firms in an industry that is unlikely to experience many new entrants may behave differently to those operating in an industry that has low barriers to entry.

Product homogeneity and branding

In some industries, such as gas and oil extraction and agriculture, the product is essentially the same whoever produces it. These identical goods are known as homogenous goods. This means that no producer has a monopoly over production.

Firms find it much easier to maximise profits if they are able to differentiate their product by creating brand loyalty and reducing the elasticity of demand for the good. This also creates barriers to entry, reducing the competitiveness of the market.

Knowledge

Buyers and sellers are said to have perfect knowledge if they are fully informed about price and output. Therefore, if one producer puts its prices up, then that producer will lose all its customers because they will buy the good from elsewhere in the industry.

Perfect knowledge does not mean that all firms or consumers possess all the knowledge, but instead that this information is freely available; it is up to firms and consumers to access this.

Imperfect knowledge exists where there are patents protecting a particular process, such as the recipe for Coca-Cola. Individual firms may not be aware of all the new innovations to be introduced. A lack of information acts as a barrier to entry, preventing or discouraging new firms from entering the market.

Interrelationships within markets

Firms may be independent of each other, in other words the actions of one firm will have no significant impact on any other firm in the industry.

If firms are interdependent, then the actions of one firm will have an impact on others. For example, when one firm advertises, it is hoping to take consumers away from their current purchases. This will necessarily have an impact on other producers' level of demand.

Content		Reading
1. Perfect competition	<ul style="list-style-type: none">Assumptions of perfect competition.Profit maximising equilibrium (diagrammatic and numerical) in the short run and the long run.The short-run shut-down point.Distinction between productive and allocative efficiency.How perfect competition produces both productive and allocative efficiency in the long run.	Anderton Units 45, 48, 56 Smith Ch.2

The model of perfect competition describes a market where there is a high degree of competition.

Assumptions

A perfectly competitive market must possess four characteristics:

1. There must be **many buyers and sellers** in the market, none of whom is large enough to influence price. Buyers and sellers are said to be price-takers.

2. There is **freedom of entry and exit** to the industry. Firms must be able to establish themselves in the industry quickly.
3. Buyers and sellers possess **perfect knowledge** of prices. Thus, if one producer charges higher prices than its competitors for a good, consumers will buy from elsewhere in the market and demand will fall to zero.
4. Firms produce a **homogenous product**. There is no branding of products.

There are only a few industries in the world that approximate to this model. However, the foreign exchange market is a close approximation. There are a large number of foreign exchange dealers supplying the market, none of whom is large enough to influence the exchange rate. It is relatively easy to establish a bureau-de-change and thus enter the industry, and equally easy to leave. A foreign exchange dealer will know the market-determined exchange rate. Currencies are homogenous — US dollars are indistinguishable from other US dollars sold by another bureau-de-change.

Demand and revenue

The model of perfect competition assumes that there are a large number of suppliers in the market. A firm in perfect competition can expand output or reduce output without influencing price. In other words, a bureau de change cannot put up the exchange rate for US dollars and expect to sell anything. It may decide to lower the exchange rate, but there is no gain by doing this, as the foreign exchange dealer may sell all his or her output at the original higher price.

As can be seen in the figure below, the demand curve for the foreign exchange dealer is horizontal, in other words perfectly elastic.

The perfectly competitive firm's demand curve



The horizontal demand curve as depicted in the above figure is also the firm's average and marginal revenue curves. If a firm sells all its output at the market price, then this price must be the average price or revenue. In addition, if a firm sells an extra, i.e. marginal, unit, it will receive the same price for each additional unit as it did for each preceding unit sold, and therefore, marginal revenue will be the same as average revenue.

Total Revenue = Price \times Quantity *therefore*

$$\text{Average Revenue} = \frac{\text{Total Revenue}}{\text{Quantity}} \quad \text{or} \quad \frac{\text{Price} \times \text{Quantity}}{\text{Quantity}}$$

if the quantity cancel each other $\frac{\text{Price} \times \text{Quantity}}{\text{Quantity}}$ $\text{AR} = \text{Price}$

Cost and supply curves

In the perfectly competitive market, the supply curve of the firm is the marginal cost curve above the average variable cost in the short run, and the average total cost in the long run.

The marginal cost of production, i.e. the change in total cost resulting from the sale of one more unit, represents the lowest price a firm would be prepared to supply an extra unit of output for.

If the price of a good was £8, and the marginal cost £5, then the firm would produce the good and gain £3 super normal profit. If the price was £5 and marginal cost £5, then the firm would still produce the product, as the revenue gained will contain an element of normal profit. If the price fell to £4, and marginal cost remained at £5, then the firm would make a loss of £1 per unit. The firm would not supply the good in this case.

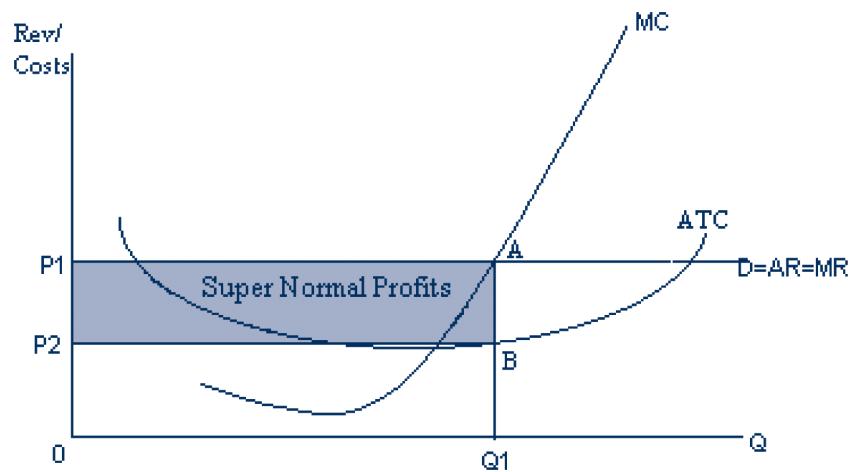
In the short run, a firm will not necessarily shut down if it is making a loss. It will remain open as long as it covers the average variable cost. The firm will only stop supplying if average revenue or price is less than average variable cost.

Short-run equilibrium

In perfect competition, firms are assumed to be profit maximisers. Firms will therefore produce where marginal cost is equal to marginal revenue (MC=MR). The price the firm charges is determined by the market because the individual firm is too small to influence price and is therefore a price-taker.

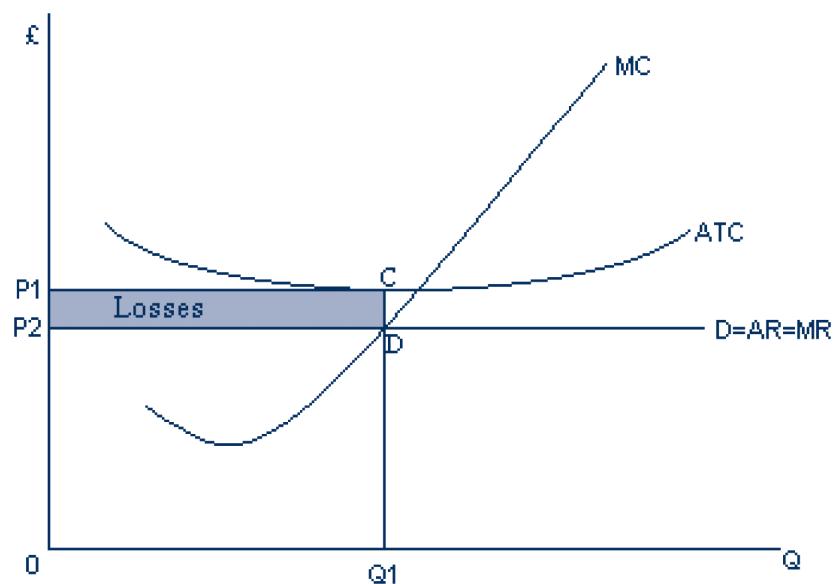
Perfectly competitive firms can make super-normal profits in the short run as shown in the figure on the following page (top). In this diagram the horizontal average revenue curve is shown to be above the average total cost at the point where MC=MR (point A). At Q1 the firm charges P1, but faces only average costs of P2, therefore it makes super normal profits as indicated by the shaded area (P1, P2, A, B).

Short-run profit maximisation



In the next figure, the firm is making a loss at its equilibrium, profit maximising or loss minimising output, where $MC=MR$. The price charged per unit of output P_2 is lower than average total cost, P_1 and hence the firm makes a loss of P_1P_2CD .

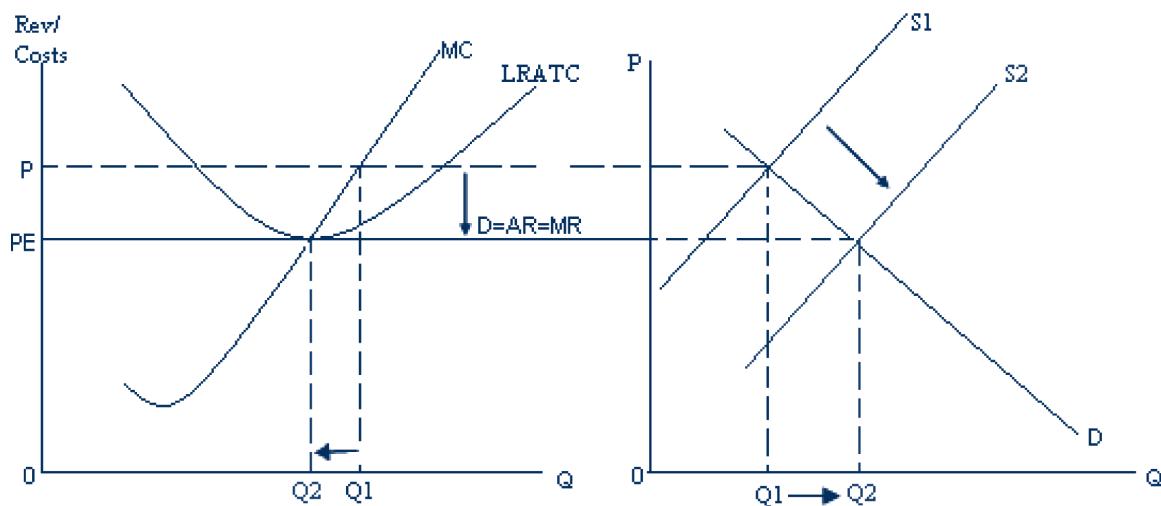
Short-run firm making losses



Long-run equilibrium

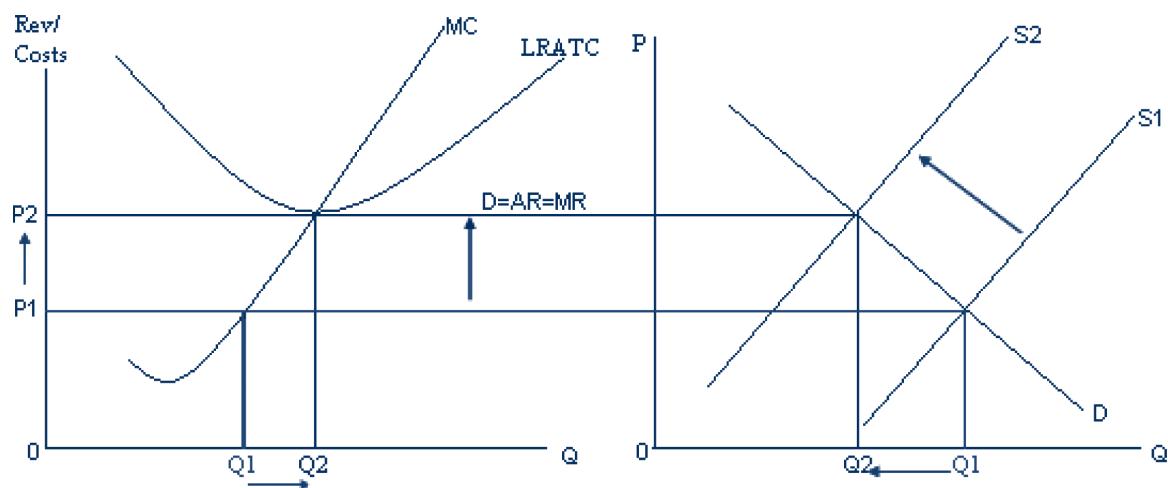
If a firm were making super normal profits in the short run, other firms would enter the industry eager to share these high profits. They would be able to do this as there are no barriers to entry in perfect competition. The entry of new firms stimulates an increase in supply from S_1 to S_2 , establishing a price just low enough for firms to make normal profits.

Long-run equilibrium position of a firm in an industry facing short-term super normal profits



If a firm were making losses in the long run, some firms would leave the industry as there are no barriers to exit. As a result of these departures, total supply would fall from S_1 to S_2 . Firms would continue to leave the industry until the whole industry returned to profitability. This can be seen in the next figure. When the supply curve is at S_1 , the firm is making a loss. At S_2 , the supply curve is high enough to make normal profits.

Long-run equilibrium position of a firm in an industry facing short-term losses



In the long run, competition ensures equilibrium occurs where the firm makes neither super normal profits nor losses. This means, in equilibrium, average cost equals average revenue.

Content	Reading
2. Monopolistic competition <ul style="list-style-type: none"> ■ Characteristics of a monopolistically competitive market. ■ Types of product differentiation. ■ Profit maximising equilibrium (diagrammatic) in the short run and the long run. ■ Efficiency and monopolistic competition. 	Anderton Units 51 and 57 Smith Ch.3

Imperfect competition

Perfect competition assumes that there are many small firms and all goods are homogenous, and in monopoly it is assumed there is only one supplier. However, in reality neither of these conditions is exactly met and therefore often industries fall in between these two extremes.

In most industries some competition exists because there are at least two firms, but competition is imperfect because firms sell products that are not homogenous.

Assumptions

The assumptions made for monopolistic competition are almost the same as perfect competition minus one important assumption. Goods don't have to be homogenous. The assumptions made are:

1. There are a large number of small firms.
2. There are low barriers to entry or exit.
3. Firms produce similar but differentiated products.

What is meant here is that the products are similar but differentiated in terms of packaging, colour, design, specification, marketing or price from rival products.

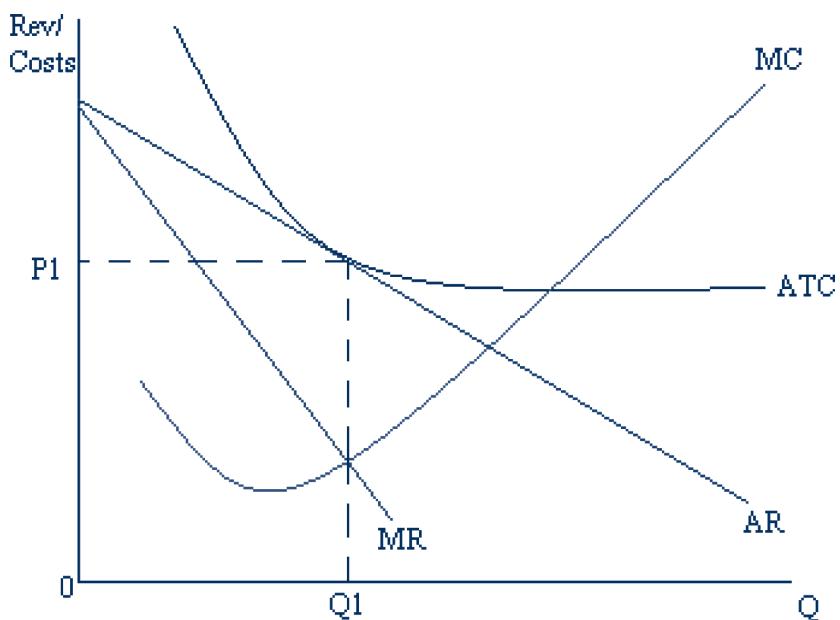
The downward sloping demand curve

Firms producing a product that is slightly different from their rivals will have a certain amount of market power. They will, for instance, be able to raise price without losing all of their customers to those firms who have maintained stable prices. Therefore, the firm's demand curve is downward sloping.

It is not a price-taker like a firm operating in a perfectly competitive environment. Yet because there are a large number of firms producing close substitutes, its market power is likely to be relatively weak.

In the case of Chinese restaurants operating in Chinatown in London, because the consumer has a great deal of choice, the prices which are set by the individual restaurants will be similar. If one restaurant were to drastically raise prices then it is likely they would lose many customers unless they were able to brand their product in such a way as to differentiate it from the rivals.

The monopolistically competitive firm in long-run equilibrium



Long-run equilibrium

The firm will produce where $MC=MR$ so as to profit maximise. In the figure above, this means that it will produce at an output level of Q_1 . It will charge a price based on its demand or average revenue curve, in this case P_1 .

In the long run, the firm will not be able to obtain super normal profits, because new firms will enter the industry if they see profits to be made exploiting the lack of barriers to entry. The entry of new firms will increase supply, shifting the average revenue curve downwards to the point where average revenue is just equal to average cost, as in the figure.

If the firm were making a loss, firms would leave the industry, reducing supply and shifting the AR curve upwards again to a point where average revenue is equal to average cost.

Therefore, in the long run, a monopolistically competitive firm can make neither super normal profits nor losses.

Content	Reading
3. Oligopoly	<ul style="list-style-type: none"> ■ Barriers to entry and exit, e.g. economies of scale, limit pricing, branding, patents, sunk costs. ■ Characteristics of oligopoly, including concentration ratios and the interdependence of firms. ■ Reasons for collusive and non-collusive behaviour, including the distinction between overt and tacit collusion. ■ Reasons for cartels, non-price competition, price wars, predatory pricing and price leadership.

Oligopoly

Firms operating in oligopoly industries tend to keep prices stable. They know that the actions of one firm will impact on the other firms in the industry, in other words, they are interdependent. If one firm were to raise its prices, the others would not follow, and because the goods traded are similar, customers will move to the lower cost option. If a firm were to lower prices, then other firms would follow suit and a price war would result, with no real gain for any of the firms in the industry.

Instead, oligopoly firms will tend to work together through collusive agreements, whether they are tacit or overt or engage in non-price competition. Non-price competition can take the form of advertising, issuing of loyalty cards, branding, packaging and other measures to reduce the closeness of substitutes.

Game theory

Game theory can be used by economists to predict how firms will react in a number of given scenarios. It is used mainly when dealing with oligopoly to explain why firms may collude and furthermore why they may later decide to abandon any agreement to collude. The prisoner's dilemma can explain the way that game theory can be used by firms.

Prisoner's dilemma

Assumptions

- The model assumes a zero sum game — there will be a winner and loser.
- The prisoners have been kept separate and so do not know what each is doing, but they do know the outcome of each action.

		Rixy	
		Not Confess	Confess
Franky	Not Confess	A Each get 1 year	C Franky gets 10 years <i>Rixy gets 3 months</i>
	Confess	B Franky gets 3 months <i>Rixy gets 10 years</i>	D Each gets 3 years

What should they do?

Confess — If one of them were to confess, then they would get a 3-month prison sentence, but as they cannot trust each other, and cannot be sure that the other party has not also confessed (which would result in a 10-year sentence for the prisoner who did not confess), they will act selfishly, therefore both confessing to get the best solution for themselves. Thus they will tend to D, where both confess.

Not Confess — if they could trust each other and be sure of each other's response this would be the best option. By not confessing both prisoners would get one year each — i.e. option A.

Maximax — maximising the maximum benefit for the individual, i.e. B and C which would mean that Rixy should confess and would get 3 months, but only if Franky could be trusted not to confess, otherwise both will get 3 years.

Maximin — minimum benefit, i.e. D, which is where the prisoners will tend to because they cannot trust each other.

Game theory suggests that firms don't trust each other and although they know that it is mutually beneficial for them to collude to set the price at £2, they will tend to an option where they will both set price at £1.80 as neither firm can be trusted to keep to any agreement.

Dominant strategy — in this case the same policy is suggested by different strategies. This is a dominant strategy game because both strategies encourage a cut in price, i.e. Maximax (where each firm in isolation would set the price at £1.80 hoping that the other firm has gone for £2) and Maximin (where both firms will eventually end up at because they have set price at £1.80).

		Firm X	
		£2	£1.80
		A	C
Firm Y		Each get £10m	Firm Y £5m Firm X £12m
		B	D
		Firm Y £12m	Each gets £8m
		Firm X £5m	

- A Collude
- B Firm X
- C Firm Y
- D Nash Equilibrium i.e. Maximin

} Maximax

Both strategies suggest a Nash Equilibrium.

Nash Equilibrium — is the position resulting from everyone making their optimal decision, i.e. setting price at £1.80, by attempting, independently, to choose the best strategy for whatever the other is likely to do, ending up in a worse position than if they had colluded to set price at £2.

Content	Reading
4. Monopoly	<ul style="list-style-type: none"> ■ Characteristics of monopoly, including barriers to entry and exit. ■ Profit maximising equilibrium (diagrammatic). ■ Comparison of efficiency between monopoly and other market structures, including reference to x-inefficiency. ■ Conditions necessary for third degree price discrimination (diagrammatic). ■ Costs and benefits of monopoly to both firms and consumers.

Assumptions

A monopoly is assumed to:

- be the **only** firm in the industry
- have **high barriers to entry** preventing new firms from entering the market
- be a **short-run profit maximiser**.

In the UK, gas, electricity and water supply, telecommunications and the railway track are all monopolies. These industries are often referred to as natural monopolies because economies of scale are so large that any new entrant would find it impossible to match the costs and prices of the established firm. There are many industries in the world economy which possess most if not all of the characteristics identified.

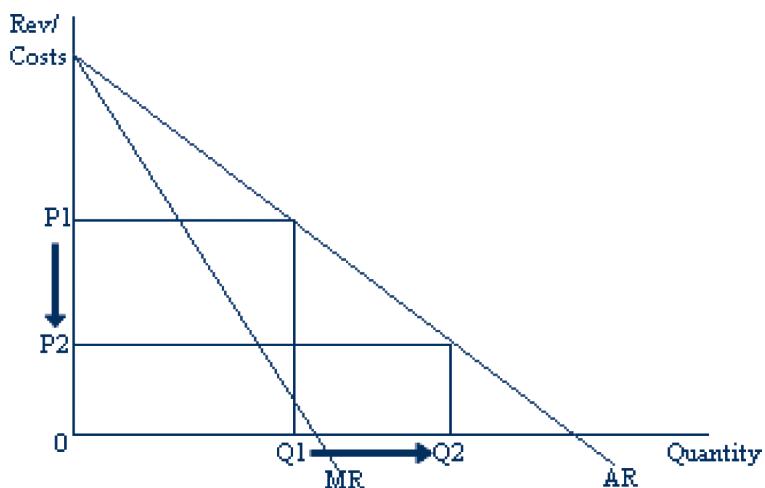
Some monopolies, such as the water companies have considerable monopoly power because there are no good substitutes for their product. BP does not possess a monopoly in oil production or supply but might be said to possess a local monopoly if it had the only petrol station in a village.

A monopoly is able to maintain its position as the sole supplier of a good or service because it is able to establish high barriers to entry. Barriers to entry include legal barriers such as patents, marketing barriers such as advertising, restrictive practices and access to specific technology or raw materials.

Revenue curves

A monopoly firm is the same as the industry as it is the only firm that is operational in the industry. The industry faces a downward sloping demand curve, meaning the monopolist also faces a downward sloping demand curve. The monopolist can therefore only set the level of price or output. If it wishes to sell more units, it must lower price, or if it wishes to increase price, then it must reduce output as shown in the figure below.

The monopolist's average revenue and marginal revenue curves



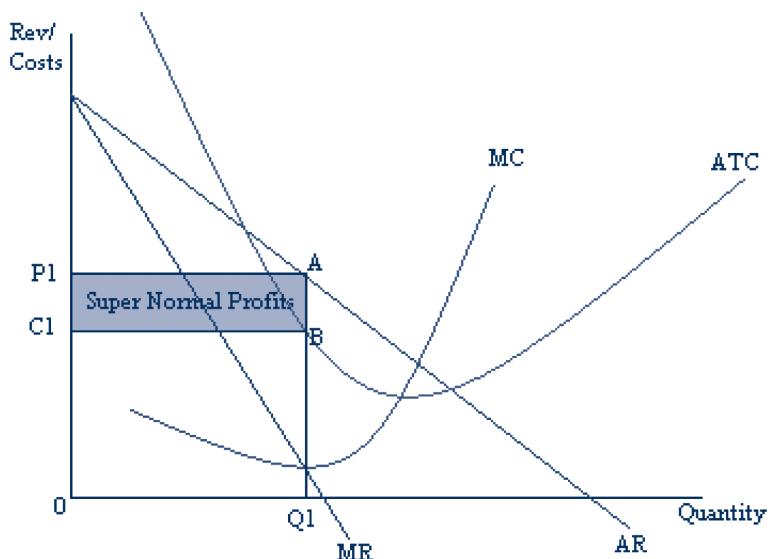
Equilibrium output

A monopolist is assumed to profit maximise, in other words, aims to achieve an output equal to the point where $MC=MR$. The figure below shows:

- the equilibrium profit maximising level of output at Q_1 , where $MC=MR$
- the monopolist is able to supply Q_1 at a price of P_1
- super normal profits of P_1C_1BA will be made. The super-normal profit per unit (AB) is the difference between the average revenue received (P_1) and average cost of C_1 .

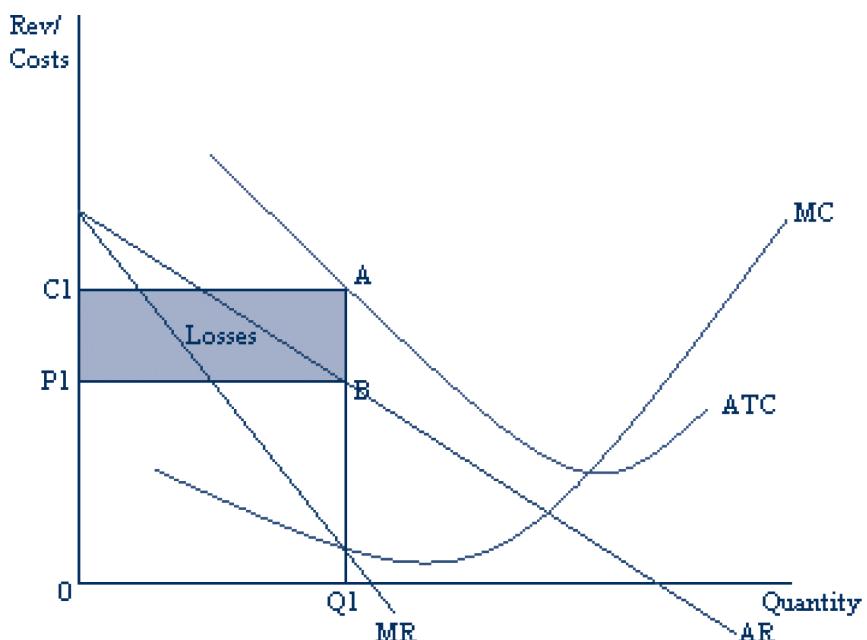
The price is determined by establishing the output level where $MC = MR$ and then identifying the average revenue for this — i.e. the monopolist sets price using the AR or demand curve.

Profit-maximising monopolist

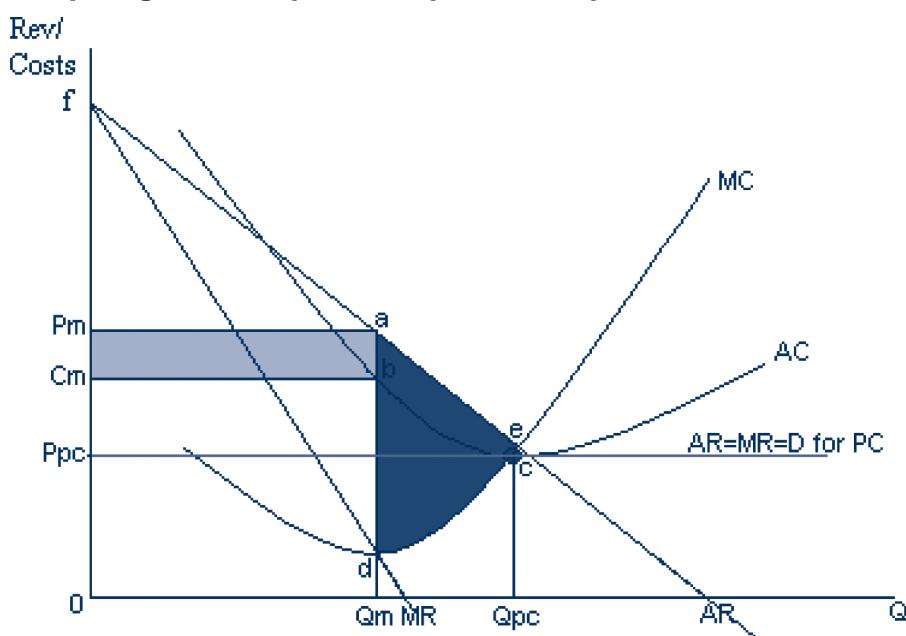


The next figure shows a loss-making monopolist. A monopolist may decide to remain operational while it makes a loss in the short run as long as it is covering its variable costs and therefore making a contribution to its fixed costs. The monopolist may feel that in the long run super normal profits might be achieved.

Loss-making monopolist



Comparing the monopolist and perfect competition



If we assume that the perfectly competitive firm and the monopolist share the same cost curves (average cost and marginal cost), we can compare the output and efficiency levels of the two firms.

- The monopolist makes super normal profits equal to the area $P_m C_m b_a$, by operating at the profit-maximising point.
- The monopolist is not productively efficient as the profit-maximising level of output (Q_m) does not maximise economies of scale, which occur at the minimum point of the AC curve, i.e. the point C.
- The monopolist is not allocatively efficient because P (AR) is not equal to MC (necessary condition for allocative efficiency). Note: AR is greater than MC at an output of Q_m .
- Perfectly competitive firms operate where $AC=AR$ and where $MC=MR$. This occurs on the AR curve marked for the perfectly competitive firm, ($AR=MR=D$ for PC). At the point C the firm is profit maximising.
- A perfectly competitive firm is also allocatively efficient because $P=MC$.
- A perfectly competitive firm is also productively efficient, operating at the lowest point of its average cost curve.
- Consumer surplus is reduced by the monopolist. A perfectly competitive firm will have consumer surplus equal to $P_{pc} c_f$, while the monopolist, by raising price, is able to reduce consumer surplus to $P_m f_a$.
- Under perfect competition output is greater at Q_{pc} and price is lower at P_{pc} than if the firm were to operate as a monopoly (Q_m & P_m), allowing them to make normal profits.
- Deadweight welfare loss from the firm operating as a monopolist is equal to ade .

The advantages and disadvantages of monopoly

Disadvantages of monopoly power	Advantages of monopoly power
Abnormal profit means: <ul style="list-style-type: none">■ less incentive to be efficient and to develop new products.■ efforts are directed to protect market dominance.	Abnormal profit means: <ul style="list-style-type: none">■ finance for investment to maintain competitive edge.■ reserves to overcome short-term difficulties and provide funds for research and development.
Monopoly power means: <ul style="list-style-type: none">■ higher prices and lower output for domestic consumers.	Monopoly power means: <ul style="list-style-type: none">■ powers to match large overseas organisations.
Monopolies may waste resources by undertaking cross-subsidisation, using profits from one sector to finance losses in another sector.	Cross-subsidisation may lead to an increased range of goods or services available to the consumer.
Monopolists may undertake price discrimination to raise producer surplus and reduce consumer surplus.	Price discrimination may raise total revenue to a point that allows survival of a product or service. It is often said that economy-class flights are funded by those flying business and first class.
Monopolists do not produce at the most efficient point of output (i.e. at the lowest point of the average cost curve).	Monopolists can take advantage of economies of scale, which means that average costs may still be lower than the most efficient average of a small competitive firm.
Monopolists can be complacent and develop inefficiencies.	There are few permanent monopolies. Super normal profits act as an incentive to break down the monopoly through a process of creative destruction, i.e. undermining the monopoly through product development and innovation.
Monopolies lead to a misallocation of resources by setting prices above marginal cost, so that price is above the opportunity cost of providing the good.	Monopolists avoid undesirable duplication of services and therefore a misallocation of resources.

Content	Reading
5. Monopsony <ul style="list-style-type: none">■ Characteristics and conditions for a monopsony to operate.■ Costs and benefits of a monopsony to firms, consumers and employees.	Anderton Unit 50 Smith Ch.5
6. Contestability <ul style="list-style-type: none">■ Definition of contestability and its implications for firms' behaviour.■ Relationship between sunk costs and the degree of contestability.	Anderton Unit 55 Smith Ch.4

3.3.4 Government intervention to promote competition

Content	Reading	
1. Government intervention to protect consumers	<ul style="list-style-type: none"> ■ Types of government intervention and their impact, e.g. legislation to control mergers and takeovers, price and profit regulation, quality standards and performance targets. ■ Measures aimed at enhancing competition between firms domestically, e.g. the promotion of small businesses. ■ Competitive tendering for government contracts. ■ The role of pressure groups in influencing government policy to protect consumers. 	Anderton Units 57-60 Smith Ch.5 Sloman: Competition Policy < www.pearsonblog.campaignserver.co.uk/?tag=competition-policy > Sloman: Competition Authorities < www.pearsonblog.campaignserver.co.uk/?tag=competitionAuthorities >

In the EU, the European Competition Commission investigates anti-competitive behaviour issuing fines where appropriate.

Examples of fines issued by the European Competition Commission include:

- April 2007 Dutch brewers: Heineken €219m, Grolsch €31.7m and Bavaria €22.9m for sharing prices
- February 2007 European escalator and lift manufacturers: Kone €142m, Otis €225m, Schindler €144m and Thyssen Krupp €480m for price fixing
- January 2007 manufacturers of gas insulators operating in the EU: Hitachi €52m, Toshiba €91m, Mitsubishi €119m, and Siemens €419m.

In the USA, the Antitrust Commission seeks to promote competition in market places. Individuals who undertake anti-competitive behaviour can be fined up to \$1 million and jailed for a maximum of 10 years. In addition, firms may be fined up to \$100 million for each violation.

In 1999, over \$850 million in fines was imposed on members of the vitamins cartel, including a record \$500 million fine imposed on Hoffmann-La Roche and a \$225-million fine imposed on BASF AG. This was in addition to a number of top executives being sentenced to terms in jail.

The Consumers Association in the UK has a magazine, *Which?*, where consumers can read about the results of tests conducted by the magazine on household products. There are also Consumers' Associations in Ireland, Singapore, Bangladesh, Australia and other countries. Consumer organizations generally try to provide consumers with information to help them make better product choices. These organisations may also campaign around product safety issues and try to influence government policy. An example might be anti-smoking pressure groups.

Content	Reading
2. Government intervention to protect suppliers and employees	<ul style="list-style-type: none"> ■ Types of government intervention and their impact, e.g. local sourcing of raw materials and components, local involvement of businesses in joint ventures, government barrier to entry of foreign firms, restrictions on monopsony power of firms, employment legislation to protect workers from exploitation. ■ The role of pressure groups in influencing government policy to protect suppliers and employees.

When a government intervenes to protect domestic suppliers against foreign rivals it is clearly a form of protectionism. This can take the form of controls on foreign investment – directing it to strategic industries, insisting on technology transfer through joint ventures, local content requirements – all with the aim of helping domestic infant industries. This has been a key contributor to the development of most of the world's rich countries.

Pressure groups protecting suppliers tend to be trade associations or industry groups who lobby governments hoping to ensure that laws unfavourable to their industry do not get passed. The tobacco industry is perhaps a good example. Pressure groups protecting employees will tend to try to influence government social policy in areas such as child labour, working hours and conditions, paid holidays, maternity and paternity rights. This may well bring them into conflict with pressure groups protecting the interests of business owners.

Content	Reading
3. Government intervention to promote international competitiveness	<ul style="list-style-type: none"> ■ Measures of international competitiveness, e.g. relative unit labour costs, relative export prices. ■ Factors influencing a country's competitiveness, e.g. exchange rate, productivity, wage and non-wage costs, regulation. ■ Measures to increase international competitiveness, e.g. policies to improve education and training, incentives for investment, deregulation.

Competitiveness refers to the ability of a country to sell its goods/services abroad. Competitiveness is usually determined by the price and/or quality of the good or service.

Measures of competitiveness

The price of a good abroad depends on both its **cost of manufacture** and the **exchange rate**.

Cost of manufacture:

- unit labour costs compared to competitors
 - ◆ productivity
 - measured by GDP per capita
 - influenced by level of education/training, trade union activity, labour laws, level of investment
 - ◆ wages
 - depends on cost of living, productivity, trade union activity, labour laws, etc.
- costs of capital
 - ◆ depends on cost of finance, e.g. interest rates
- transport costs compared with competitors'
- rate of inflation.

Exchange rate:

- real, rather than nominal, exchange rate is important
 - ◆ the exchange rate adjusted for inflation
- terms of trade: index of export prices/index of import prices.

Improving competitiveness

Competitiveness can be improved by influencing any of the factors outlined above. Supply-side policies are the most likely to be used in most developed countries — these will improve productivity, reduce 'red-tape' surrounding businesses, reduce trade union activity and so on. It is impossible for countries with floating exchange rates to manipulate the exchange rate to improve competitiveness (although countries such as China, with fixed exchange rates, have been accused of deliberately keeping their exchange rates undervalued in order to maintain competitiveness). Governments want to improve competitiveness in order to boost AD (exports are a component of AD), thus reducing unemployment and causing economic growth, and therefore an increase in living standards.

The falling competitiveness of 'developed' economies in comparison to the Newly Industrialised Countries could be considered. Students should be aware that competitiveness does not solely relate to price; quality is also important. This would be a good opportunity to recap supply-side policies from Unit 2.

Content		Reading
4. Government policy towards transnational companies (TNCs)	<ul style="list-style-type: none"> ■ Measures to attract foreign direct investment (FDI). ■ Measures to control TNC operations, which may be in response to pressure group activity, e.g. regulation of transfer pricing. ■ Limits to government ability to control TNCs. 	Smith Chs. 8, 12 Anderton Unit 77

Measures to attract FDI could include creating a favourable regulatory and tax environment and improving the general ease of doing business, e.g. the World Bank publishes an Ease of Doing Business Index (www://data.worldbank.org/indicator/IC.BUS.EASE.XQ). The political environment and respect for property rights and the rule of law will also be factors, as will the country's potential as a market.

Measures to control TNC operations might include a requirement that local factors of production such as labour and local component suppliers are used, a requirement that the TNC exports as much as it imports, or exports a certain proportion of its output, and requirements to set up joint ventures with technology transfer to the domestic firm. Measures to regulate transfer pricing are more difficult for less powerful countries.

One limit to a government's ability to control TNCs is that many are 'footloose'. Other limits might be international agreements a government has signed up to. The WTO has introduced TRIMS (Trade Related Investment Measures), which can limit the ability of governments to control TNCs, for example, banning the use of local content requirements.

Unit 4: Developments in the Global Economy

BASIC READING

Course books:

- Alain Anderton: *Edexcel A Level Student Book*, Pearson, ISBN 978-1-40589-228-5 [referenced below]
- Alain Anderton: *AS Economics Student Book*, Pearson, ISBN 978-1-40589-234-6
- Alain Anderton: *Edexcel A Level Teaching and Assessment Pack*, Pearson, ISBN 978-1-40589-229-2
- Robert Nutter: *Business Economics: Microeconomics for A2*, Anforme, ISBN 978-1-90550-479-4
- Peter Smith: *Edexcel A2 Economics*, Philip Allan, ISBN 978-0-34094-926-9 [referenced below]
- Andrew Threadgould: *Macroeconomics for A2 Level*, Anforme, ISBN 978-1-90550-471-8

Unit book:

- Quentin Brewer: *Edexcel A2 Economics, Unit 4: The Global Economy*, Philip Allan, ISBN 978-0-34095-815-5

Magazines:

- *Economics Review*, Philip Allan Updates
- *Economics Today*, Anforme

Useful websites:

- *tutor2u*: www.tutor2u.net/blog/index.php/economics/
- *Sloman Economics*: www.pearsonblog.campaignserver.co.uk/

4.3.1 Causes and effects of globalisation

Content		Reading
1. Causes of globalisation	<ul style="list-style-type: none"> ■ Meaning of globalisation, e.g. investment flows, world trade as a proportion of GDP, migration. ■ Factors contributing to increased globalisation in the past 40 years, including trade liberalisation, political change (e.g. breakdown of Soviet system and opening up of China), reduced cost of transport and communications, increased significance of transnational companies. 	Anderton Unit 68 Smith Ch. 6

Definition of globalisation (from Peter Jay):

'The ability to produce any goods (or service) anywhere in the world, using raw materials, components, capital and technology from anywhere, sell the resulting output anywhere, and place the profits anywhere.'

Characteristics

Globalisation refers to the **increasing** interdependence of economic actors (producers, consumers, governments, entrepreneurs). Key phrases include global branding and global sourcing, although it is not just about the activity of multinational companies (MNCs). Globalisation is characterised by increasing foreign ownership of companies, increases in trade in both goods and services, de-industrialisation in developed countries, and increasing global media presence.

Causes:

- improvements in transport infrastructure and operations
- improvements in communications technology and IT (especially the Internet, allowing a global media presence)
- reduced protectionism (although this is debatable, with the increase in trading blocs' power). **Trading blocs** are seen as both a contributor to globalisation, with their emphasis on **creating trade** within their boundaries, and also an inhibitor to globalisation, since they **divert trade** away from economies not within their boundaries
- development of international financial markets
- increasing number and influence of multinational companies
- end of the Cold War and subsequent increase in global labour supply as formerly closed economies in communist countries were opened up.

Content	Reading
2. Effects of globalisation	<ul style="list-style-type: none"> ■ Benefits of globalisation, e.g. rising living standards, greater choice, lower prices. ■ Costs of globalisation, e.g. displaced workers, closing of traditional industries. ■ Sustainability and environmental impact of globalisation.

Consequences:

- increased dependency of economies on the output of other economies
- greater consumer choice
- lower prices, through specialisation according to comparative advantage
- increasing environmental destruction and other negative externalities. Students should be aware of environmental problems caused by globalisation, e.g. rising greenhouse gases from cheaper transport.
- ‘Footloose’ companies (which can cause unemployment as they move from Place to place). Global branding and global sourcing should be considered in the light of activity by MNCs/TNCs.
- possible loss of culture/national identities
- **de-industrialisation** in developed countries, combined with a global search for new sources of energy (especially oil/gas reserves) and the growth of economies such as China and India has left many ‘Western’ countries concerned about their future and their future power in the global economy.

Students should also be introduced to the idea that globalisation is not a new phenomenon and that we have been in a continual process of globalisation since the time of the first humans — this is supported by the fact that the rate of increase in exports has not really changed recently.

4.3.2 Trade and the world economy

Content		Reading
1. Specialisation and comparative advantage	<ul style="list-style-type: none"> ■ Benefits and costs of specialisation and trade in the international context. ■ Theory of comparative advantage (numerical and diagrammatic): <ul style="list-style-type: none"> ◆ the distinction between absolute and comparative advantage ◆ assumptions and limitations. 	Anderton Units 2, 69 Smith Ch. 6

International trade can be defined as the buying and selling of goods across international boundaries.

Why do countries trade?

The basic reason is that countries are not able to produce everything that they want in today's society — gone are the days when people lived off local produce and owned very few assets. This is associated with economic development and increases in income. Trade allows countries to specialise in producing the goods/services that can be produced efficiently — receipts from exports can then be used to buy goods that would be inefficient for that country to make. We buy goods from abroad because of their:

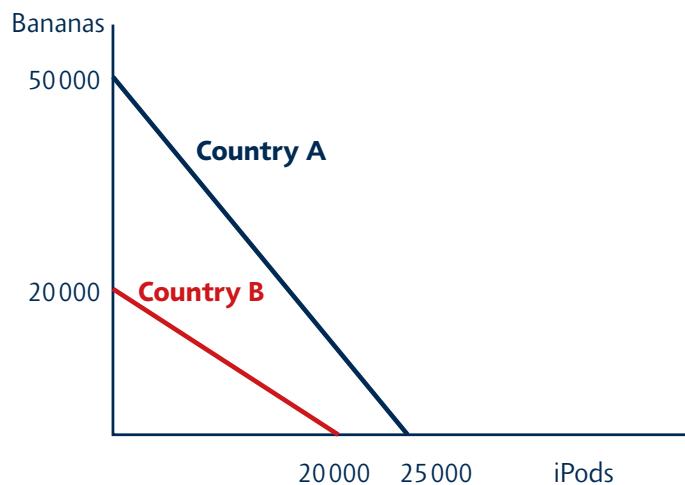
- **availability**, e.g. coconuts cannot be grown in the UK so they have to be imported from the Caribbean
- **price**, e.g. other countries may be able to produce much more cheaply than the UK can, because of lower labour costs or easier access to raw materials
- **product differentiation**, e.g. a car is not just a car — many people in Asia now want to own large American SUVs.

Comparative advantage

This refers to the ability to produce a good or service at a lower opportunity cost than another country, that is, a country has a comparative advantage in production of a good if it has to forego the production of fewer other products in order to make it. This differs from absolute advantage, which is the ability to produce a good or service at a lower cost than another country. **The Theory of Comparative Advantage** states that countries should specialise in the production of a good in which they have a comparative advantage and then trade, causing global output to increase.

Using numerical examples to illustrate comparative advantage

Assume a world with two countries (A and B) and two products (bananas and iPods). To produce one iPod, country A must give up production of 2 bananas, whereas country B must give up production of 1 banana. Because Country B gives up fewer bananas to make more iPods, it has a comparative advantage in iPods (similarly Country A for bananas).



Country A's PPF is shown in blue.

Country B's PPF is shown in red.

The opportunity cost of producing an iPod in country A is 2 bananas.

The opportunity cost of producing an iPod in country B is 1 banana.

Country A should specialise in producing bananas

Country B should specialise in producing iPods

Content		Reading
2. Patterns of trade	<ul style="list-style-type: none"> Factors influencing patterns of trade between countries. Changes in trade flows between countries and the reasons for them, e.g. the potential impact of rapidly growing economies on world trade patterns. 	Anderton Units 69 and 85 Smith Ch. 6

Patterns of trade

The G7 share of world trade in manufacturing has fallen significantly over the past century. In global terms, trade flows with NICs and the **Tiger economies** have radically increased. Trade within trading blocs, such as the EU, has also significantly increased (**trade creation**), but at the expense of trade with more traditional trading partners, such as between the UK and the Commonwealth countries (**trade diversion**). Trade has also been influenced by the increase in outsourcing over the past decade or so.

Students should be encouraged to look at how patterns of trade have changed, particularly with reference to the growing importance of trading blocs.

Content	Reading
3. Terms of trade	<ul style="list-style-type: none"> ■ Definition and calculation of terms of trade. ■ Factors influencing a country's terms of trade. ■ Impact of changes in a country's terms of trade.
4. Trade liberalisation	<ul style="list-style-type: none"> ■ The role of the World Trade Organization (WTO) in trade liberalisation. ■ Types of trading blocs, including free trade areas, customs unions, common markets, monetary unions. ■ Conflicts between trading blocs and the WTO.

Trading blocs

There are several types. Free Trade Areas are blocs in which groups of countries agree to abolish trade restrictions between themselves but maintain their own restrictions with other countries. Customs Unions have free trade internally and a common set of protectionist measures. Examples include the EU, the North American Free Trade Agreement (NAFTA), and the Association of Southeast Asian Nations (ASEAN). They comply with the aims of the WTO in terms of creating trade between members, but they contradict the aims by causing trade diversion, where non-members are excluded from trade in favour of less efficient producers within the bloc.

Students should know the characteristics of the various types of trading bloc (e.g. Free Trade Areas, Customs Unions), and understand the idea of trade creation and trade diversion (which links to the conflict between blocs and the WTO).

Arguments FOR free trade (advocated by the WTO, who act to reduce trade barriers and settle trade disputes):

- increased consumer choice
- lower prices, through existence of economies of scale
- reduced domestic monopoly power
- increasing world output as a result of comparative advantage.

Content	Reading	
5. Restrictions on free trade	<ul style="list-style-type: none"> ■ Reasons for restrictions on free trade, e.g. to protect domestic industries and employment, for strategic reasons, to prevent dumping. ■ Types of restrictions, including tariffs (with diagrammatic exposition), quotas, non-tariff barriers, subsidies to domestic producers. ■ Impacts of protectionist policies. 	Anderton Unit 70 Smith Ch. 6

Problems with comparative advantage and specialisation:

- ignores transport costs (i.e. it may be cheaper to produce sheep in the UK rather than pay for shipping from New Zealand)
- ignores external costs of production (e.g. environmental degradation)
- ignores gains from economies of scale
- assumes that factors of production can easily be switched from producing one good to producing another (which they can't)
- assumes perfect knowledge (which doesn't exist)
- reduces self-sufficiency.

Why protectionism?

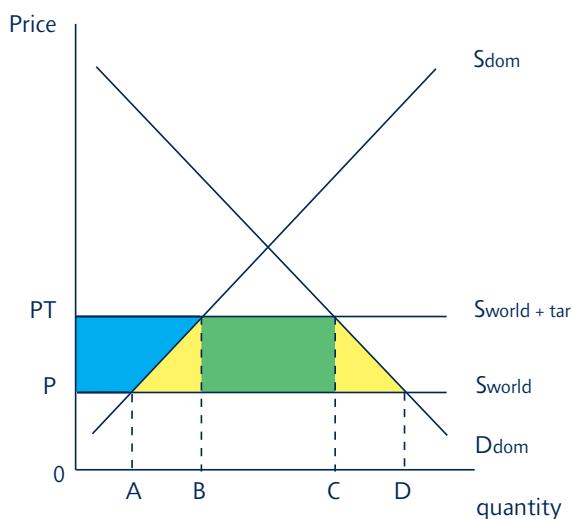
- protect infant industries and sunset industries
- employment protection
- retain self-sufficiency
- tackle balance of payments current account problems
- retaliation
- prevent dumping
- prevent competition from countries with cheap labour and poor labour/environmental laws
- protect strategic industries, e.g. defence, essential foodstuffs, electricity generation.

Arguments for protectionism should include infant industries and employment protection. Students should be aware of current examples of protectionist measures, and consequent retaliation.

Able students could be introduced to the ideas of David Ricardo regarding the benefits of free trade versus protectionism, as well as criticisms of these ideas from economists such as Ha-Joon Chang.

Types of protectionism

Tariffs are taxes on imported goods. They are also known as import or customs duties. They raise prices to consumers and restrict imports. Deadweight welfare loss triangles should be used on tariff/quota diagrams as part of their evaluation.



Before tariff

Domestic suppliers supply 0A, total demand is 0D, so imports are AD.

After tariff

Domestic suppliers supply 0B, total demand is 0C, so imports are BC.

Green area shows tariff revenue raised by government.

Blue area shows additional domestic producer surplus.

Yellow triangles show deadweight welfare loss

Quotas are a physical limit on the quantity of imports. They:

- have a similar effect to tariffs but no tax revenue is raised, therefore there is larger domestic welfare loss
- create shortages.

In the Uruguay Round of WTO negotiations, the abolishment of quotas on textiles/clothing was achieved from 2005.

Domestic subsidies are grants given to domestic producers to enable them to lower production costs, thus lowering prices, which should make the country's products more competitive internationally. They:

- are difficult for WTO to tackle because not overt protectionism
- incur an opportunity cost.

Non-tariff barriers are protectionist measures that do not necessarily result in price increases; these might include restrictions on quality (e.g. Kite Marks) or product specifications, etc.

4.3.3 Balance of payments and exchange rates

Content	Reading
<p>1. Balance of payments</p> <ul style="list-style-type: none"> ■ Components of the balance of payments: <ul style="list-style-type: none"> ◆ the current account ◆ the capital and financial account. ■ Causes of, and factors influencing, the size of deficits and surpluses on the current account. ■ Causes of, and factors influencing, the size of deficits and surpluses on the capital and financial account. ■ Measures to reduce a country's imbalances on the current account and/or capital and financial account. ■ Significance of global imbalances. 	Anderton Units 71-72 Smith Ch. 7

The **balance of payments** is a record of all a country's financial dealings with the rest of the world over the course of a year. It has three parts: the current account, the capital account and the financial account.

The **current account** has three parts.

1. **Balance of Trade** — this looks at the value of imports and the value of exports. **Exports** are goods/services that are made by domestic companies and sold abroad. They appear as a **positive entry** into the balance of payments because they bring money into the country. **Imports** are goods/services made abroad and sold to people in the country. They appear as a **negative entry** into the balance of payments because money **leaves** the country. We can split the balance of trade up even further by looking at trade in goods, or **visible trade**, and trade in services, or **invisible trade**.
2. **Income** — this is made up of income earned by domestic citizens who own assets overseas. It includes profits, dividends on investments abroad (payments made to shareholders by companies who earn a profit) and interest.
3. **International transfers** — these are usually money transfers between central governments (who lend and borrow money from each other) or grants, such as those that the UK receives as part of the CAP from the EU.

If a country has a **current account deficit**, then **value of money leaving the country > value of money entering the country**. We usually abbreviate this to value of imports > value of exports. If a country has a **current account surplus**, then **value of money entering the country > value of money leaving the country**, or value of exports > value of imports.

The **capital account** refers to transactions in fixed assets and is relatively small. The largest aspect of the capital account refers to flows of capital associated with migration.

The financial account refers to transactions in financial assets, or what is more commonly known as Foreign Direct Investment (lots of older textbooks refer to this as the capital account — don't get confused, the name changed a few years ago!).

The Balance of Payments must always balance

If a country has a current account deficit, it must have a surplus on the capital and financial accounts. This is because it has to pay for everything it consumes and funds it in some way — to fund a current account deficit, a country must be selling assets to foreign investors. It is debatable whether this is sustainable in the long run, since if people invest in a country, at some point they will require a return on their investment, and this will cause a deficit on the financial account.

Additionally, because the data is never completely accurate, the accounts also incorporate a 'net errors and omissions' item, which makes sure that everything will balance.

Students should understand the components within the current account, and should be aware of which components record deficits or surpluses. Students should consider the size of deficits or surpluses on the current account in a global context, and examine the implications of large imbalances between countries.

Measures to correct imbalances on the current account include expenditure reducing, expenditure switching and supply-side policies; each of these should be evaluated, and students should be encouraged to reach their own conclusions as to the most appropriate measure. Students should consider the option of doing nothing, in light of theory on floating exchange rates.

Correcting problems on the balance of payments current account

Governments tend not to be as concerned with correcting surpluses or deficits on the current account as they used to be, but there is evidence of global imbalance, with some countries running the largest (persistent) deficits they have ever seen, and others (particularly oil-producing countries and China) running enormous surpluses. Theoretically, under a floating exchange rate regime, current account imbalances will be self-correcting. In practice, this tends not to happen for a multitude of reasons.

There are essentially three ways of correcting a deficit: expenditure-reducing, expenditure-switching and supply-side policies.

- Expenditure-reducing policies require the government to cut the income of its citizens, so that they spend less on imports (e.g. through deflationary fiscal policy); however, a side-effect of this is that spending on domestic goods also decreases, so AD falls. This can reduce economic growth and cause recession. It is an unpopular policy, especially politically, and therefore unlikely to be used.

- Expenditure-switching policies require the government to find ways of reducing its citizens' spending on imports, using protectionist measures such as tariffs or quotas, or even a devaluation of the currency under a fixed exchange rate regime. However, since this often leads to retaliation, exports will also fall, and the current account deficit may not be corrected.
- Supply-side policies, such as spending on education and training in order to improve the quality and therefore competitiveness of exports, aim to boost export demand rather than reduce import demand. While they can incur an opportunity cost, they contribute positively to economic growth and can be anti-inflationary in the long run.

Are persistent imbalances on the current account a cause for concern?

Traditionally, deficits have been seen as 'worse' than surpluses. However, a small imbalance should not be cause for concern; persistent large imbalances are more worrying. Large and persistent deficits can be a problem because there is a need to finance the increasing expenditure on imports, usually through loans from abroad (which show as a surplus on the financial account); having large debts, especially with creditors abroad, can be problematic when those creditors want their money back or decide to discontinue lending. Large and persistent surpluses can be a problem because resources are focused on producing to meet export demand rather than domestic demand, so consumer choice and resulting living standards could actually be low.

Content	Reading
2. Exchange rates	<ul style="list-style-type: none"> ■ Distinction between fixed, managed and floating exchange rates. ■ Government intervention in currency markets, e.g. through foreign currency transactions, the use of interest rates. ■ Factors influencing floating exchange rates, e.g. relative interest rates, relative inflation rates (purchasing power parity theory), speculation. ■ Distinction between revaluation and appreciation of a currency. ■ Distinction between devaluation and depreciation of a currency. ■ Impact of changes in exchange rates, including on the current account of the balance of payments, on other macroeconomic objectives. ■ Competitive devaluation/depreciation and its consequences.

Students should use foreign exchange market diagrams, and should understand causes of movements in the demand and supply curve.

Exchange rates are the price of one currency in terms of another. Exchange rates are determined much like any other price in a free market, via demand and supply.

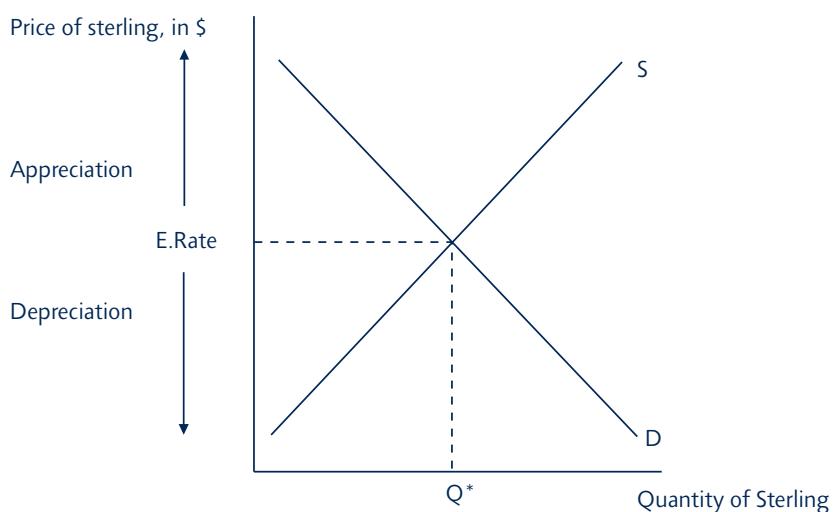
The demand curve for sterling

1. Demand for the pound comes from demand for the UK's exports from abroad. People in the UK want to be paid in pounds, no matter where their customers come from, and so people abroad have to purchase pounds on the foreign exchange market. **If demand for exports increases, then demand for the pound on the foreign exchange market increases.**
2. Demand for the pound also comes from demand for saving in UK bank accounts — if the UK interest rate goes up compared with interest rates abroad, then people abroad will want to save their money in UK bank accounts. Because you can save only pounds (rather than dollars or euros) in UK banks, **demand for the pound on the foreign exchange market will rise if the interest rate rises.** The stocks of funds that move around the world in search of the best return is called hot money.
3. Long-term capital movements are also important. So, **inwards investment into the UK increases demand for the pound.**

The supply curve for sterling

1. Supply of the pound onto the foreign exchange market comes from our demand for imports. People abroad want to be paid in their own currency, so we take our pounds along to the foreign exchange market, releasing them on to the market in return for other currencies. **So, supply of the pound on the foreign exchange market increases if demand for imports increases.**
2. If the interest rate abroad increases relative to the interest rate in the UK, then funds will move from the UK to overseas bank accounts, increasing the supply of the pound on foreign exchange markets.
3. If there is net outwards investment from the UK economy, then the supply of pounds will increase.

The exchange rate is determined at the point where the demand curve and supply curve for sterling on the foreign exchange market meet.



Depreciation means that the value of the pound, in terms of other currencies, goes down. For example, £1 = \$1.60 to £1 = \$1.40 — in the second example, it takes fewer dollars to buy £1. With a depreciation, even though a good may still be priced at £10, it now costs Americans only \$14 instead of \$16 — demand will increase.

Appreciation means that the value of the pound, in terms of other currencies, goes up. For example, £1 = \$1.50 to £1 = \$1.70 — in the second example, it now takes more dollars to buy £1. With an appreciation, even though a good may still be priced at £10, it now costs Americans \$17 instead of \$15, therefore reducing demand for our exports.

The effect of speculation

The minute-to-minute fluctuations in the exchange rate are caused by speculation, that is, people trying to earn profit from buying and selling currencies by predicting which way market forces will move. Speculation actually causes a self-fulfilling prophecy. Think about this scenario — imagine that traders in the City of London expect the value of the pound to rise. In order to make a profit, they should buy pounds while they are cheap and then sell them once they have risen in price. So, they start to buy pounds on the foreign exchange market. This increases demand for the pound, and therefore increases the price — exactly as they anticipated! Until about 30 years ago, many developed economies imposed exchange controls on their currency movements in order to prevent speculation. Under a strict exchange control, currency could only be bought and sold through a country's central bank. China is one country that still has some degree of exchange control.

The Marshall-Lerner condition and J-Curve effect could be applied to analysis of impacts of exchange rate changes.

4.3.4 Poverty and inequality

Content	Reading
1. Absolute and relative poverty	<ul style="list-style-type: none"> ■ Distinction between absolute and relative poverty. ■ Measures of absolute and relative poverty.

Relative poverty exists when a person is poor compared with others in their society. Most poverty in developed countries tends to be relative poverty. Absolute poverty exists when a person's continued daily existence is threatened. Much of the poverty in developing countries tends to be absolute poverty.

Content	Reading
2. Inequality	<ul style="list-style-type: none"> ■ Distinction between wealth and income inequality. ■ Measurements of inequality: <ul style="list-style-type: none"> ◆ the Lorenz curve ◆ the Gini coefficient. ■ Causes of inequality in income and wealth within countries and between countries. ■ Impacts of inequality, e.g. on incentives, on savings, on education, on migration, on life expectancy. ■ Impact of economic change and development on inequality.

The different causes and consequences of poverty in light of developed and developing countries should be considered. Students' understanding often benefits from actually drawing Lorenz curves from a data set.

Inequality can occur in terms of either income or wealth. Income is a flow concept — people earn income, either through paid work or through dividends on financial assets. Wealth is a stock concept — it is a measure of the value of people's assets.

Causes of unequal income distribution include:

- receipt of different wages
 - ◆ different abilities/skills resulting in differing levels of productivity and therefore differing wages
 - ◆ discrimination
 - ◆ compensating differentials, e.g. some jobs are considered intrinsically rewarding and therefore attract lower pay
 - ◆ regional differences in pay
- unemployment

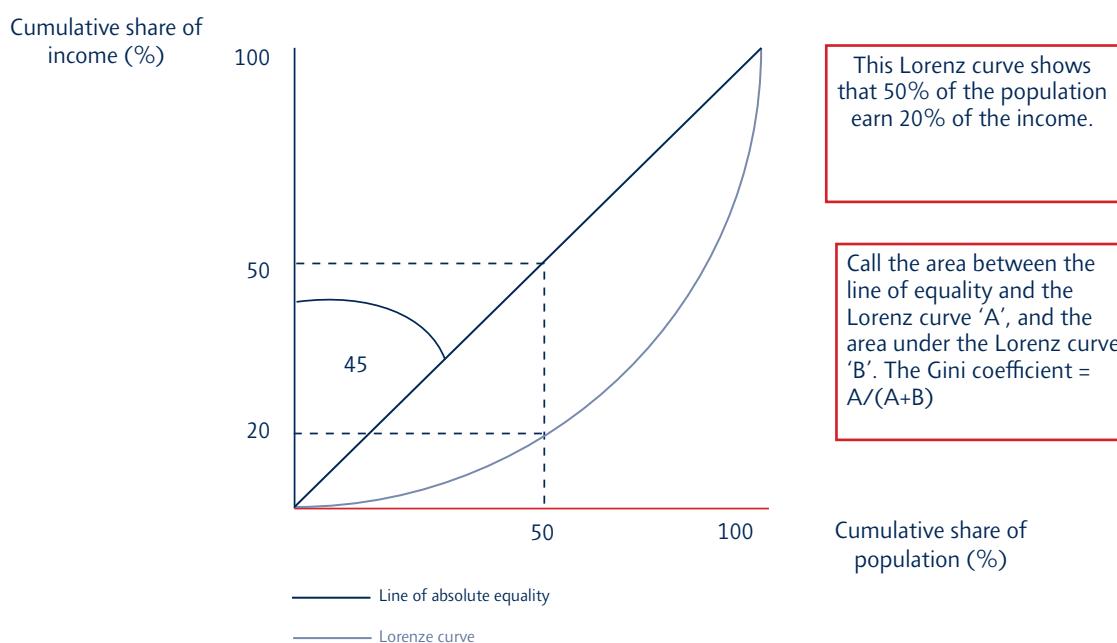
- varying ownership of financial assets, since these generate income
 - ◆ people on higher income are able to afford to purchase assets, which in turn then generate more income, leading to a virtuous cycle.

Inequality in a free market economy is inevitable, since people with higher skills and abilities will attract higher wages, and some people, perhaps with disabilities or poor skill levels, will earn nothing. This is one of the strongest arguments in favour of a mixed economy with government intervention to redistribute income through the tax system.

Causes of unequal wealth distribution include:

- different levels of income
- inheritance.

Measures of inequality include the Lorenz curve and the Gini coefficient. Lorenz Curves plot cumulative share of income (or wealth) against the cumulative share of the population with that income (or wealth). The Gini coefficient is a numerical measure between 0 and 1 of the degree of inequality in a society; it can be measured using areas on a Lorenz curve. 0 denotes absolute equality; 1 is absolute inequality.



4.3.5 The role of the state in the macroeconomy

Content		Reading
1. Public expenditure	<ul style="list-style-type: none"> ■ Reasons for the changing size and pattern of public expenditure in an international context, including changing incomes, changing age distributions, changing expectations. ■ Distinction between capital expenditure, current expenditure and transfer payments. ■ The significance of differing levels of public expenditure as a proportion of GDP, including on productivity, on crowding out theory, on level of taxation. 	Anderton Unit 63 Smith Ch. 11

Reasons for taxation:

- reduce consumption/production of goods with negative externalities
- raise funds to provide public goods, e.g. defence, roads
- fund government
- provide goods with positive externalities, such as education and healthcare
- redistribute income, reducing inequality.

Content		Reading
2. Taxation	<ul style="list-style-type: none"> ■ Distinction between, and examples of, direct and indirect taxes. ■ Distinction between progressive, proportional and regressive taxes. ■ The possible links between changes in tax rates and tax revenues, including the Laffer curve. 	Anderton Unit 62 Smith Ch. 11

Progressive taxation — as income rises, a larger % of income is paid in tax (e.g. UK income tax).

Regressive taxation — as income rises, a smaller % of income is paid in tax (e.g. VAT).

Proportional taxation — the same % of income is paid in tax, no matter what the level of income.

Direct tax — a tax taken directly from a person's or business's income (e.g. income tax and corporation tax).

Indirect tax — a tax paid as a result of the purchase of goods or services (e.g. VAT, excise duties).

Content	Reading	
3. Public sector borrowing and public sector debt	<ul style="list-style-type: none"> ■ Distinction between public sector (fiscal) deficits and public sector debts. ■ Distinction between structural and cyclical fiscal deficits. ■ Factors influencing the size of public sector borrowing and debt. ■ The significance of the size of public sector borrowing and debt, e.g. impact on interest rates, debt servicing, intergenerational equity. 	Anderton Units 62, 64 Smith Ch. 11

Budget deficit:

- government spending exceeds tax revenue
- caused by
 - ◆ economic recession or slump
 - ◆ increase in supply-side policy
 - ◆ economic shock requiring government response
- funded by rise in current borrowing, to be repaid by increasing future taxes, or issue of gilts
- consequences can include:
 - ◆ rise in productive potential of country if spending improves education
 - ◆ increased dependency on benefits
 - ◆ inflation (and resulting loss in international competitiveness and rise in inequality) although this may be wiped out if the supply side improves and the long-run aggregate supply (LRAS) increases
 - ◆ reduced attractiveness for FDI if government seen as incompetent, although could raise FDI if the deficit has led to an improvement in the supply side, etc.

A **budget surplus** is essentially the opposite. Governments are able to pay back loans, raising their creditworthiness. If taxes become too high, governments need to be aware of the **Laffer curve effect**, where tax revenue may begin to fall as people decide that work is not worth the effort to simply pay high taxes.

Students should be encouraged to consider the direct consequences of public sector deficits/surpluses (e.g. deficits can be inflationary), rather than secondary effects (e.g. deficits mean that $G > T$, so taxes need to be increased to tackle the deficit). The switch from a direct tax system to one focused on indirect taxes (which are considered regressive) should be considered in the light of tackling poverty.

Content	Reading
4. Macroeconomic policies	<ul style="list-style-type: none"> ■ Distinction between fiscal deficits and fiscal surpluses. ■ Methods and impact of measures to reduce fiscal deficits and public sector debt. ■ How governments might use public expenditure and taxation to reduce poverty and inequality. ■ Assignment of policies to achieve specific macroeconomic objectives, including macroeconomic stability, including fiscal policy used to achieve budgetary objectives, monetary policy to achieve inflation targets, supply-side policies to achieve economic growth and development. ■ Application of macroeconomic policies in dealing with major external shocks, e.g. a rise in commodity prices. ■ Problems facing policy-makers when applying policies, including inaccurate information, risks and uncertainties, inability to control external shocks.

This builds on the work on macro policies covered in Unit 2 — students should be asked to recap this IAS work in preparation for their IA2 lessons. Students should be aware of global causes of national macroeconomic problems, and therefore be aware of the limitations of national macroeconomic policies in correcting these problems. This would be a good opportunity to discuss the differences between Keynesian and Monetarist approaches, using LR and SR aggregate supply curves.

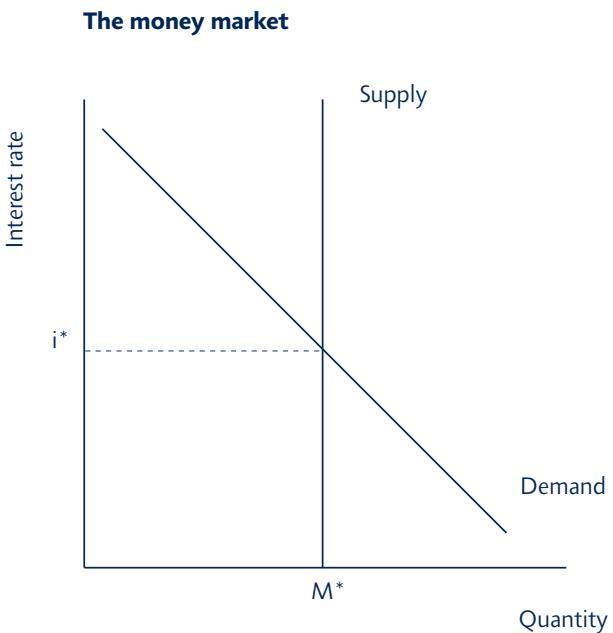
Fiscal policy — any policy concerned with government spending, taxation or government borrowing. If government spending = taxation, there is a balanced budget. An increase in government spending/a fall in tax, causes an increase in AD (expansionary fiscal policy). In the short run, this can be inflationary, reduce unemployment and increase GDP. In the long run, depending on what the government spends its money on, it can be anti-inflationary, raise employment and cause sustained economic growth (if the LRAS increases owing to spending on education, for example). The opposite is true of a restrictionist or deflationary fiscal policy.

Automatic stabilisers/automatic fiscal policy — government spending/taxation vary automatically over the course of the economic cycle (e.g. G rises in a slump owing to increased benefit payments and T falls as fewer people work and spend).

Discretionary fiscal policy — deliberate alteration of G and T.

Monetary policy — any policy concerned with manipulation of interest rates, the money supply or exchange rates. Many countries have independent central banks — this means that they set interest rates in order to control inflation rather than to satisfy political whims. This independence gives their policy more credibility — if people believe that the changes are permanent and correct, then they will adjust their spending more quickly.

Firms and households choose to keep hold of some of their money in order to make transactions more quickly. However, if they keep hold of cash, they are unable to use that money to purchase financial assets which would provide them with interest. So, the opportunity cost, or the price of money, is the interest rate.



The government cannot control both the money supply and the interest rate. If the government wanted the money supply to be M^* , it could either control the money supply and allow the interest rate to adjust automatically to i^* , or it could control the interest rate and allow the money supply to adjust automatically to M^* .

Control of the money supply itself is extremely difficult, as it is nearly impossible to actually measure the amount of money. The UK chooses to control the interest rate in order to control inflation.

However, control of inflation is becoming more difficult as the influence of globalisation increases. Domestic causes of inflation include increased government spending, low domestic interest rates (increasing availability of credit), increased business/consumer confidence (perhaps through increased house prices, trust in the government, etc. There are also a number of international causes of inflation, which domestic central banks can do less to correct, for example, the growth of China has pushed up prices (owing to increased demand) of raw materials such as copper and oil — this causes cost-push inflation in the domestic economy. This makes the decisions of policy-makers all the more difficult, as the level of complexity increases, causing more uncertainty about the future.

Evaluation of monetary policy

Strengths	Weaknesses
Stable inflation increases consumer/business/investor confidence, thus allowing economic growth to be more easily achieved	It can take up to two years for the effects of interest rate changes to fully affect the CPI — this is not helpful if there are significant external shocks to the economy
The implications of changes in the interest rate are clear to understand	Just because the Bank of England changes the base rate, doesn't mean that interest rates change for everyone in the economy
It has effects on both AD and AS, so can have short-term and longer-term effects	Affects the exchange rate, which can alter the competitiveness of the economy (although this could be a strength!)
There is clear framework and remit for the MPC, removing political bias	If inflation is primarily cost-push, rather than demand-pull, then a rise in interest rates will increase the costs of businesses as the interest to be paid on their debt increases, which could make inflation worse
Initial effects on consumer and business spending can be fairly rapid, so long as the MPC's decision is credible	In the UK, many poorer people currently face significant debt problems, and already face high interest rates — monetary policy may therefore worsen the distribution of income
Evidence — since 1997, the rate of inflation has been low and steady	We can't calculate the exact effect of a rise in interest rates — data is uncertain and incomplete
Particularly effective in the UK as there is high household debt (high house prices, high borrowing) so changes in interest rates are felt quickly	We cannot attribute the low inflation rates solely to effective monetary policy from the MPC — much of the recent low inflation reflects recession abroad (reducing demand for exports) and falling worldwide commodity prices (with the exception of oil)
	Many businesses borrow their funds from overseas, where interest rates are lower, so a rise in interest rates in the UK will have relatively little effect
	Goodhart's Law — this states that economic variables often lose their relationship with other variables once we try to control them

Supply-side policies — any policy concerned with increasing the quantity or improving the quality of a country's factors of production, in order to increase the productive potential of the country and increase LRAS. Such policies might include improving education so that it is appropriate to the skills required in the modern economy, reducing 'red-tape' for new business start-ups, improving healthcare so that people take less time off sick, teaching entrepreneurship, reducing access to benefits, encouraging increased labour force participation.

These policies are usually funded through tax revenues — there is therefore a close link between fiscal policy and supply-side policies. Supply-side policies can take several years to have an effect on the economy, and may be inflationary in the short run as government spending increases. Governments also need to ensure that they are not spending their money on training people in skills that will soon be outdated, since this will then contribute to future structural unemployment.

Key evaluative points for supply-side policies

There is an opportunity cost of spending on education and training. Governments might not be in the best position to determine which skills will be needed in the future. By the time education programmes have been developed, they may be out of date and inappropriate.

Labour market flexibility is not necessarily desirable from the point of view of many workers — it makes it easier to lose jobs and increases competition for jobs, which can cause insecurity and reduce worker motivation and labour productivity.

Reducing access to unemployment benefits may encourage people into work, but this might involve sacrificing the safety net upon which many rely.

There will always be political debates about how progressive a tax system should be. This is an area where normative judgements are made. Economists can make a case for progressive, proportional and regressive taxes! Economists can also argue about the relative merits of taxing income, spending, land, property, corporate profits, carbon emissions...!

4.3.6 Measures to promote growth and development

Economic growth: an increase in real GDP/an increase in the productive potential of a country. Measured by assessing growth in GDP, or sometimes GDP per capita.

Economic development: an increase in living standards — this could relate to income per head, levels of education, healthcare, access to housing, etc. Measured in many ways, usually using composite measures such as the Human Development Index (HDI), which provides a score between 0 and 1 based on GDP per capita, literacy rates and life expectancy.

Reasons for different levels of development

Reason	Explanation/examples
Different availability of natural resources	Countries such as Nigeria have significant oil wealth — if used wisely, this could improve growth and development. Other natural resources would include precious metals/minerals. However, control of these are often fought over in civil war . Many Least Developed Countries (LDCs) have subsistence or primary-sector economies, which produce low-value-added goods and therefore low income. Consequently, people cannot save any excess income, and funds for investing in the secondary sector are not available.
Differing geographical terrain	Highly mountainous regions may struggle to develop transport infrastructure and primary/secondary sector economies, e.g. Himalayan communities.
Climate	Many sub-Saharan economies are severely affected by droughts followed by flooding, making it difficult to establish any industry and attract any investment.
Political stability	 Democratically elected , non-military governments may reassure investors that property rights will be respected and that the rule of law will be enforced.
Education	Countries which place an emphasis on education and provide some state funding are more likely to grow and develop, e.g. Tiger economies and China take education seriously. This improves human capital and shifts the PPF outwards.
Investment	Low investment means that economic growth is unlikely. Low investment could be due to lack of confidence by businesses/consumers/MNCs, low savings rates leading to lack of finance (Harrod–Domar model), poor availability and trustworthiness of financial institutions (this may be heightened by poor transport infrastructure, reducing access to banking). Low public-sector investment in education, healthcare, transport or communications could be due to corruption, inability to raise taxes, or conditions imposed by the IMF/World Bank in return for loans.
Population	Many LDCs are characterised by high birth and death rates — families aim to have many children in order to increase family income, but these children are often underemployed in the informal sector in low value-added jobs — result: low development. The education of girls is key to reducing birth rates.
Finance	Many LDCs are laden with international debt , on terms that they cannot afford to repay. Many people blame the IMF for making poor lending decisions, others blame incompetence on the part of the borrowing government. Corruption in some countries diverts funds to the political elite. Another problem is capital flight . The owners of any extra income that could be saved and therefore used for investment often leave the country in search of higher return for their money; this reduces the growth of capital and therefore economic growth.

Content		Reading
1. Market orientated strategies	<ul style="list-style-type: none"> ■ Impacts of policies, including trade liberalisation, promotion of Foreign Direct Investment (FDI), removal of government subsidies, privatisation, freely floating exchange rates, microfinance schemes. 	Anderton Units 84 and 86 Smith Ch. 12
2. Government-led strategies	<ul style="list-style-type: none"> ■ Impacts of policies, including development of human capital, protectionism, managed exchange rates, infrastructure development, promoting joint ventures with transnational companies. 	Anderton Unit 84 Smith Ch. 12
3. Other strategies	<ul style="list-style-type: none"> ■ Impacts of other approaches on growth and development, including industrialisation, development of tourism, development of primary product industries. 	Anderton Units 84–85 Smith Ch. 12

Role of tourism

Many LDCs are increasingly highly dependent on tourism from the developed world as incomes rise. Most LDCs positively encourage tourism because it allows foreign currency to be earned and it is not capital-intensive (therefore not reliant on high investment). However, there may be significant negative externalities resulting from tourism growth, for example, use of clean water for tourists not locals, expansion of airports causing pollution and loss of farmland, etc. The Kingdom of Bhutan, in the Himalayas, aims to tackle this problem by taxing tourists heavily for every night they spend in the country.

Content		Reading
4. Role of foreign governments and international institutions and non-governmental organisations (NGOs)	<ul style="list-style-type: none"> ■ Impact of World Bank, International Monetary Fund (IMF), WTO and NGOs on growth and development. ■ Impacts of policies, including aid, debt relief, fair trade. 	Anderton Units 85–86 Smith Ch. 12

The role of institutions such as the IMF could be considered, and the World Bank's Structural Adjustment Programmes. Students should also understand criticisms of the 'Washington Consensus'.

Foreign aid

This is increasingly multilateral (between many countries), rather than bilateral (between two countries), which reduces the restrictions under which aid is provided. There are different types of aid, ranging from humanitarian aid (such as food and shelter, in times of emergency), to grants (sums of money that do not need to be repaid) and loans (money that should be repaid). While many in the

developed world see aid as a positive thing, critics argue that much of the aid is squandered on projects that will not contribute to development, are duplicated by different aid agencies who do not communicate with each other, or diverted into the private bank accounts of government ministers. Other criticisms suggest that aid is channelled into projects which have captured the global media interest and that, in the long run, the provision of aid can reduce the level of development in an LDC.

Debt relief

Many LDCs hit a 'debt crisis' in the 1980s and 1990s, as they could not afford to pay the interest on their large debts to international financial institutions. This was a combination of interest rates rising and the value of the dollar rising (and most loans were agreed in terms of US dollars). Latin American countries and many African countries were among the worst hit — Mexico defaulted on its loans first, and others followed suit. This meant that these countries were then unable to borrow. The massive debts that they had to repay meant that governments of these countries were unable to invest in human capital or other infrastructure necessary for growth and development. Initially, the IMF set up Structural Adjustment Programmes, where it would lend the debtors money to pay off their original debts, but on strict conditions with respect to fiscal policy and trade policy terms which hindered development. Another potential solution is debt forgiveness, where the loans are essentially cancelled — many lenders do not want to do this. Another alternative is debt rescheduling, where the repayment terms are altered.

Fairer trade

The WTO works towards reducing protectionist policies. Many LDCs argue that they need to protect their economies, however, as they cannot afford to compete with the subsidies provided to the agricultural sectors in developed economies, such as the CAP in the EU. Many LDCs are unable to sell their mainly primary-sector products abroad because of protectionism in the developed world. The Fair Trade movement is one way in which farmers in LDCs are supposed to benefit, thus improving development. This guarantees farmers a certain income, so that they are not subject to monopsony purchasing power from developed countries, particularly with respect to coffee, cocoa and cotton. However, there are often a significant number of 'middle men' involved, reducing the benefits that fair trade farmers receive. Additionally, not every farmer in every LDC benefits — many are unaware of the scheme, and many are not able to afford the membership fees that are required. There is significant debate regarding the impact of Fair Trade schemes, particularly with respect to the coffee market — much of the literature on this is available on the Internet.

Content	Reading
5. Constraints on growth and development	<ul style="list-style-type: none"> ■ Impact of economic factors in different countries, including primary product dependency, savings gap, inadequate capital accumulation, foreign currency gap, capital flight, rapid population growth, ageing populations, debt and inadequate provision of credit and banking. ■ Impact of other factors on the economy in different countries, including corruption, poor governance, absence of property rights, civil wars.

Students should understand the nature and consequences of the causes of low growth rates. Case studies are important — it might be useful to analyse causes of rapid growth in countries such as China and India as a contrast. Students should understand the nature of different measures to promote growth and development, and be able to evaluate them, remembering that different measures will be valid depending on the nature of the country undergoing development (e.g. degree of political stability/corruption, or sophistication of transport and communication links).

Students could be introduced to some of the theories of growth and development, such as Harrod–Domar, Solow, Rostow's stages of growth, and the Lewis 2-sector model.

Models/theories of growth and development

Harrod-Domar	Now considered an 'old' theory that focuses on the role of investment for growth, this theory states that the rate of growth equals the marginal propensity to save (which provides funds for investment) divided by the capital-output ratio. A problem with this theory is that it doesn't help LDCs to establish a financial system in which savings and investment are possible in the first place.
Rostow's 5 stages of growth	The 5 stages of development are: traditional society, precursor to take-off (high savings), take-off, drive to maturity, mass consumption. Again, savings and investment are key. To help LDCs gain enough funds for investment, Rostow suggested that foreign aid could be used.
Lewis 2-sector	This is a structural change model. Lewis said that growth would be achieved by the migration of workers from the rural primary sector to the modern industrial urban sector — this would occur through higher wage incentives. However, despite evidence from current developed economies, this model often seems inappropriate for LDCs, where the population in the urban slums is often unemployed, and would be more productive in the rural sector. This theory also assumes that secondary-sector production would be labour-intensive, whereas it is often capital-intensive.
Dependency theory	Lack of growth and development is not the fault of LDCs, but by the conditions under which they operate as a result of their links to MDCs, i.e. ex-colonial rule forcing specialisation in the primary sector, the constraints placed on LDCs as a result of accumulation of debt from 'Western' institutions. However, India's recent growth rates are contrary to this theory.
Market liberalisation/neo-classical theory	The idea here is that by opening up markets (by reducing protectionism, etc.) and encouraging FDI (MNC activity), LDCs will grow and develop as their goods can be sold on the international market and they benefit from infrastructure development by MNCs. However, many economists argue that this will lead to growth but not necessarily development, as only some people in the LDCs will benefit. The environmental degradation and other negative externalities caused as a result may reduce living standards. The success of this approach also depends on the political climate in the LDC being stable.

Able students could also consider whether growth and development is actually desirable, since it may be accompanied by a number of negative externalities. (The Hans Rosling TED talk on 'The Washing Machine' is relevant here).

Student guide

What do I need to know, or be able to do, before taking this course?

Some students may have studied a GCSE/International GCSE in Economics, GCSE/International GCSE in Business and Economics or GCSE/International GCSE in Business before studying this course, although this is not an essential requirement for studying Economics IAL. What is likely to be much more important is your attitude to Maths, as you will be required to interpret data and make assumptions from it. Some teachers will look for a good grade in Maths GCSE/International GCSE and some universities will look for the combination of Maths IAL and Economics IAL before allowing you to study for an Economics Honours degree.

What will I learn?

Unit 1: Markets in Action gives an introduction to the nature of economics and examines how the price mechanism allocates resources in local, national and global markets. Students will learn to apply supply and demand analysis to real-world situations, and will be able to suggest reasons for consumer behaviour. They will analyse the nature and causes of market failure and also understand the strengths and weaknesses of possible policy remedies.

Unit 2: Macroeconomic Performance and Policy introduces the key measures of economic performance and the main objectives and instruments of economic policy in an international context. Students will learn how to use a basic AD/AS model to analyse changes in real output and the price level. Students will look at when demand and/or supply-side policies may be appropriate ways of improving an economy's performance; consider these policies in an historical context; predict the possible impact of such policies and recognise the assumptions involved. Students should understand different approaches that may be used by policy-makers to address macroeconomic problems and to identify criteria for success.

Unit 3: Business Behaviour develops the content of Unit 1 and examines how pricing and the nature of competition between firms are affected by the number and size of market participants. At the end of this unit, students should be able to analyse and evaluate the pricing and output decisions of firms in different contexts and understand the role of competition in business decision-making. They should also be capable of making an appraisal of government intervention aimed at promoting competitive markets.

Unit 4: Developments in the Global Economy develops the knowledge and skills gained in Unit 2. The application, analysis and evaluation of economic models is required as well as an ability to assess policies that might be used to deal with economic problems. An awareness of trends and developments in the global economy over the past 40 years, including contemporary issues, is required. Wider reading and research will enable students to use up-to-date and relevant examples in their analysis and evaluation of issues and developments in the global economy.

Is this the right subject for me?

This course is suitable if you:

- have an interest in learning how businesses and the government create benefits and economic wealth and conversely, how they may create costs which society has to pay, such as those associated with pollution or new house building projects
- enjoy assessing and presenting the merits of alternative courses of action
- are interested in playing a full part in society: understanding why government pursues certain actions and how it may use the tax system to influence peoples' actions
- want to learn how to analyse data and economic models in order to suggest solutions to real-world problems or forecast future trends.

How will I be assessed?

Unit number and unit title	Level	Assessment information	Number of marks allocated in the Unit
Unit 1: Markets in Action	IAS	Examination length: 1 hour and 30 minutes Examination paper in two sections: Section A Supported multiple-choice questions. Worth 32 marks. Section B One data-response question out of a choice of two questions. Worth 48 marks.	80
Unit 2: Macroeconomic Performance and Policy	IAS	Examination length: 1 hour and 30 minutes Examination paper in two sections: Section A Supported multiple-choice questions. Worth 32 marks. Section B One data-response question out of a choice of two questions. Worth 48 marks.	80
Unit 3: Business Behaviour	IA2	Examination length: 2 hours Examination paper in two sections: Section A Two essay questions from a choice of four questions. Worth 40 marks. Section B One data-response question out of a choice of two questions. Worth 40 marks.	80
Unit 4: Developments in the Global Economy	IA2	Examination length: 2 hours Examination paper in two sections: Section A One essay question with two parts from a choice of three topic areas. Worth 40 marks. Section B One data-response question out of a choice of two questions. Worth 40 marks.	80

What can I do after I've completed the course?

This qualification should enable you to progress on to a straight economics degree with a focus on theory, or a degree in applied economics such as environmental economics, labour economics, public sector economics or monetary economics. Alternatively students may like to study a business economics or mathematical economics degree. Economics can also be combined with another subject as a joint degree or with other subjects, e.g. politics, philosophy or history as a combined degree.

Post university employment rates of economists are among the highest for graduates. An economics degree enables students to gain transferable skills in problem solving, quantitative analysis and communication. They are likely to find employment in finance, banking, insurance, accountancy, management and consultancy. Some become professional economists.

Next steps!

You should:

- Find out what grade you are likely to get in your GCSE/International GCSE Maths.
- Ask your Careers Advisor if an Economics IAL will assist you in progressing on to the degree course or in getting the job you want to do?
- Familiarise yourself with the specification and additional support material, especially the mapping document, for each Economics unit, which can be found under the IAL Economics subject heading at www.edexcel.com/ial.

For more information on Edexcel and BTEC qualifications
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