2. **Rate of Interest**. Money can be used to buy financial assets such as bonds. Higher the rate of interest, the higher the opportunity cost of holding money.

Interest Rates can be defined as the reward for saving and the cost of borrowing. The money saved by banks is used to lend out.
Real Interest Rates is the rate when adjusted for inflation.

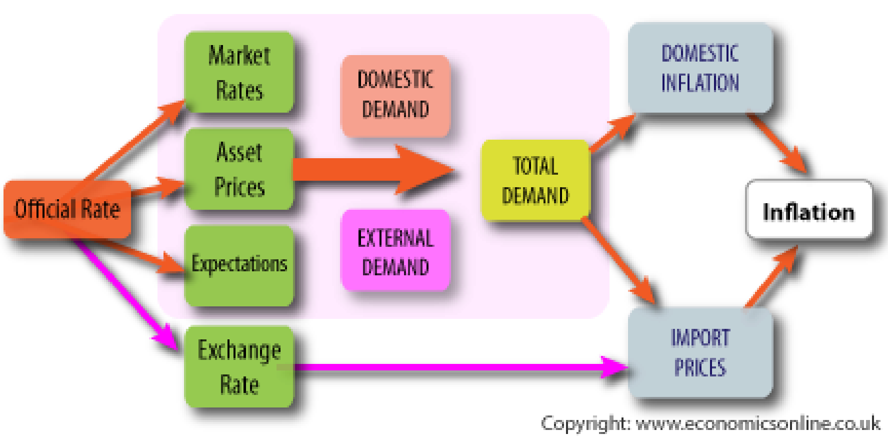
Interest rates are set by the Bank of England on behalf of the government, the Monetary Policy Committee (MPC) are responsible for them. They are based around the inflation target of 2% CPI.

- **Demand-Side:** Interest Rates go up, and AD goes down, inverse relationship.
- **Supply-Side:** Interest Rates go up, LRAS goes down, inverse relationship.

Interest Rates: Demand-

Interest Rates: Supply-

Transmission Mechanism:



Benefits of Interest Rates	Costs of Interest Rates
❖ Have a direct and powerful effect on	❖ Time lag (estimated to be 1 year for

❖ **Lower Rates of Income Tax** - Creates incentives to work. ❖ **Education & Training** - Boost the productivity of labour, which increases the supply capacity of the nation. ❖ **Trade Union Reforms** - Reducing the power of trade unions means reduced unit labour costs and increased efficiency and flexibility.	❖ **Privatisation** - leads to greater productive efficiency and a reduced drain on the public purse. ❖ **Deregulation** - removal of barriers to entry in an industry leads to the creation of much more competitive markets.

Benefits of Supply-Side Policies	Costs of Supply-Side Policies
❖ Sustainable growth together with stable inflation. ❖ Lower unemployment. ❖ Improves quality & quantity of labour force.	❖ Time-lag. ❖ Might increase unemployment gap? ❖ Can be costly.

Supply-side policies may not work, depending on the current output gap of the economy. As shown by the diagram, if the economy is operating in a negative output gap (AD_1), there is no change in output from the rightward shift of LRAS.

Supplv-Side Policv

❖ Employment & better quality of life. ❖ Reduced poverty. ❖ No guarantees that the wealth from inward investment will benefit the local community. ❖ Drive local firms out of business (lowering standard of living for some?)	❖ Lower costs of production, reduced inflationary pressures as a result. ❖ Increased inward investment, encourages firms to invest in other countries. Creates employment, growth and foreign exchange. ❖ Structural unemployment. ❖ Industry may thrive in LEDCs at expense of jobs in manufacturing in UK / other MEDCs (deindustrialisation).

Multinational Companies (MNCs) are companies that are registered in more than one country or that have operations in more than one country.

Role of MNCs in the Development of Globalisation:

- **Crucial to development of globalisation as they provide most FDI into developing countries whether the locate there or generate raw materials.**
- **Willingness to accommodate to needs of local economy -** in terms of employment, training, environmental protection and health and safety considerations.
- **May expect incentives, -** e.g. abolition of trade restrictions, special tax rates, subsidies. Such tax incentives apparent reduce the level of fiscal revenues and frequently create opportunities for illicit behaviour by tax administrators.
- **Mobile -** can exit a country with a disregard for employment. MNCs profit maximise so they may move before of cheaper production opportunities elsewhere and decide to stop producing in a country.

- Increased specialisation may lead to diseconomies of scale.
- Transport costs may outweigh any comparative advantage.
- Government's may restrict trade.

Effects of Trade...	
... on Developing countries	**... on Developed countries**
❖ More integration into the world's economy… …leading to a foreign trade multiplier… …reducing poverty and unemployment… …leading to higher living standards. ❖ Tariffs by developed countries, reducing potential to exploit comparative advantage.	❖ Use cheap production elsewhere… ❖ …leading to reduced inflationary pressures… ❖ …and higher real incomes meaning a higher standard of living. ❖ Firms may relocate to developing countries, causing a loss of employment for the developed country.

Foreign Trade Multiplier: The amount by which the national income of a country will be raised by a unit increase in domestic investment on exports.

Benefits received by all from trade:

- **Specialisation** leading to greater **efficiency** (productive, allocative and dynamic)…
- …efficiency causes firms to reach their **minimum efficient scale**.
- More demand and more supply means more **employment**.

Marshall-Lerner Condition: Depreciation of the currency leads to an overall improvement in the current account.

Protectionism...	
... Arguments for:	**... Arguments against:**
❖ **Infant industries** - own countries, help grow to reach international market. ❖ **Domestic employment** - protect own labour market. ❖ **Prevent 'unfair competition'.**	❖ **Welfare losses** - massive inefficiencies when countries aren't specialising. ❖ **Risk of retaliation** - tariffs etc. ❖ **Reduced choice** - less imports.

- ➢ *Monetary Policy:* Increasing interest rates to depress consumer spending.
- ➢ Recognises that UK citizens generally have a high marginal propensity to import, so if people have less money to spend, they cut back reducing imports.
- ➢ Not long-term solution due to negative impact on growth & unemployment.

❖ **Expenditure-switching policies:**

- ➢ Policies attempting to encourage consumers to switch their spending away from imports towards the output of domestic firms.
- ➢ Direct controls: Import controls consisting of tariffs and quotas.
- ➢ Devaluation: Reducing the value of a currency in a fixed exchange rate system.
- ➢ Devaluation may occur problems in the short-term, known as the J-Curve effect.

Marginal Propensity to Import: The proportion of an increase in income that is spent on imports.

J-Curve effect: In the short-term, a devaluation or depreciation will lead to a deterioration of the current account before it starts to improve.

J-Curve

Balance of Payments Current Account Surplus: Exports > Imports

Balance of Payments

A balance of payments on current account surplus may be undesirable because:

❖ **It is not possible for all countries to run surpluses together**: Countries with persistently large surpluses must act to reduce these in order for countries with balance of payments deficits to improve their positions. May lead to countries experiencing deficits imposing import controls, which penalise all countries.