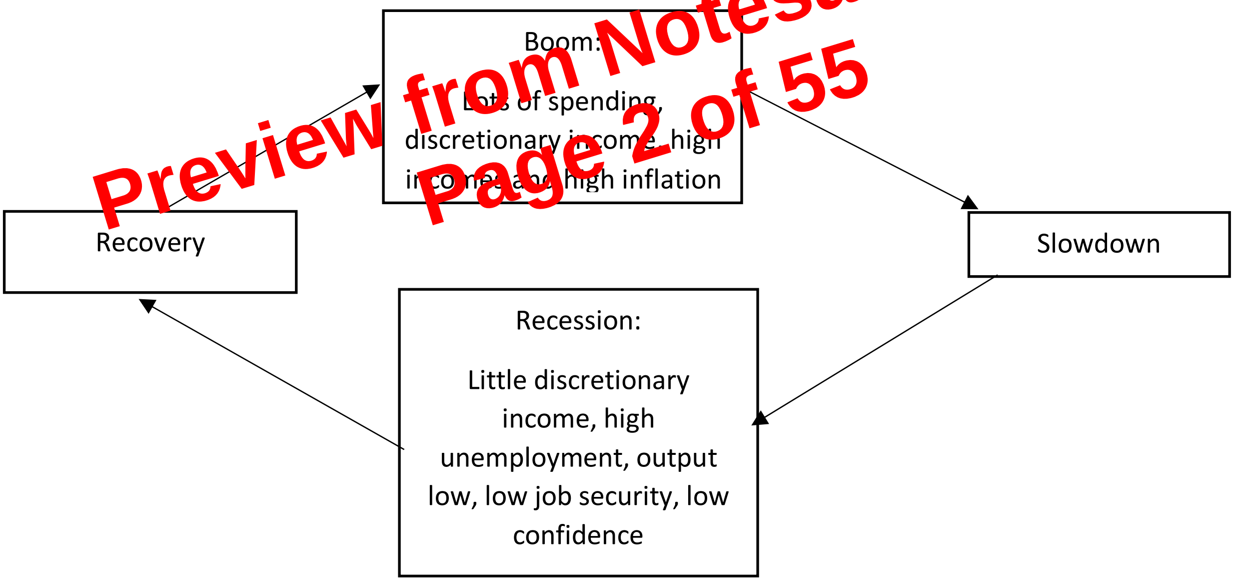
- Nominal mislead – use real
- Double count resources- use value added
- Not all output recorded- Hidden economy so compare expenditure with income
- Different types of spending distort- e.g. spending on clearing up natural disaster

Real GDP per capita: $\frac{Real\ GDP}{Population}$ Believed people better off if this rises- does not show distribution of income though

The PPC: shows the maximum combination of goods and services which an economy can produce with existing resources and technology.

The Trade Cycle:



- **Borrower benefit > lender**
- **Hyperinflation risk**
- **Administration costs for firms** e.g. adjusting accounts
- **Inflationary noise-** lack of price transparency
- **Fiscal Drag:** makes it feel as though being taxed more as pushed into next bracket

Inflation ever good?

Yes, if low, stable and demand pull: implies low unemployment, economic growth, owners of assets benefit, debtors benefit

Inflation Stability: Stable v Unstable

Stable: easier to judge prices, government offset stable inflation (adjust tax rates and benefits), household offset (regularly check savings ensuring reasonable return in real terms), firms and workers offset (adjust wages)

Unstable: costs greater, arbitrary redistribution of income from savers to borrowers, fiscal drag, fluctuating real wages and benefits.

Inflation Conclusions:

- Stability
- Type
- Rate
- Comparison to foreign economies

Deflation Dangers:

- Decline in output; investors less willing
- Decline in firms ability to invest
- Deflationary expectations; consumers may delay purchases

3. To Reduce Unemployment

Unemployment: Number of people in working population that are out of work. Level= number, rate= expressed as % of working pop.

Working Population: aged 16-65, willing and able to work in next two weeks, actively seeking work.

Economically Active: People of working age in work or looking for work.

Economically inactive: People of working age out of work and not seeking it.

Full Employment: A situation where everyone of working age who wants a job at the current wage rate can get one. I.e. No one unemployed.

Measuring Unemployment:

Methods:

- **Claimant Count:** Number of people claiming unemployment related benefits, e.g. JSA
  Pros: quick and easy.

4. <u>Balance of Payments</u>

The balance of payments: a record of a country's economic transactions with other (foreign) countries.

Transactions crossing borders: sending wages, loans, exports and imports, government transfers, FDI, obtaining foreign assets etc

Categories of the Balance of Payments:

1. **Current Account:** records transactions on goods and services and other short-term flows (such as income from investments abroad and interest on government borrowing). Has been in deficit every year since 1984
2. **Financial account:** Records transactions on financial assets (investment flows by firms and government transactions into currency reserves). e.g. government borrowing. Surplus partly forced by deficit in current account. **Balance of payments sums to zero.**
3. **Capital account:** Records capital transfers in assets and liabilities. E.g. immigrant's property become UK owned. Includes Foreign Direct Investment (FDI)

Current Account Deficit: Imports > exports. There is an overall net flow of money out of the economy. To balance this, the government must borrow from abroad, moving the financial account into a surplus.

Causes of a Current Account Deficit:

- **Good and Service Factors:** UK prices and UK domestic supply (can't satisfy demand?)
- **Cyclical Factors:** Boom and bust disposable income levels determines ability to import
- **Structural Factors:** Manufacturing industry may be uncompetitive
- **Exchange Rate:** Strong pound = expensive exports

Deficit: Pros and Cons:

- Living standards may be high
- Lower UK inflation pressure
- Rise in UK unemployment
- Lower UK short-run growth
- Increased Financial account surplus- opportunity cost on government debt interest

Factors Affecting B of P:

- State of economy: current surplus emerging from recession
- Exchange rate
- Interest rates and effect on exchange rate
- External shocks
- Trade barriers

Conclusions for a current account deficit:

- Size of deficit and ease of correction
- Cause of Deficit (structural v cyclical)
- Duration of Deficit

Overall: Current account deficit bad as indicated lack of UK competitiveness.

- **Dutch Disease:** sharp influx of foreign currency

Impacts of Fluctuations:

- Exports and Imports
- AD and economic growth

Unstable Exchange Rate:

- Planning problems
- Fall in international trade
- Fall in production

Why unstable:

- Fluctuations in D & S
- Hot money flows

FDI: An investment made by a company or individual in one country in business interests in another country in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign country.

Aggregate Demand

AD: the total spending in an economy: C + I + G + (X-M)

- AD same as demand curve
- Same movements

1. Consumer Spending

Affected by:

- Real Disposable Income
- Age structure of population (different MPCs and APCs)
- Interest Rates
- Confidence and expectations (animal spirits)
- Distribution of income
- Inflation

Injections < Leakages – Decrease output

The multiplier effect: Any change in a component of AD results in a greater final change in Real GDP.

- Likely to occur in recovery or times when demand rising rapidly
- Consumer spending increase
- One person's spending = another's income
- Investment may increase, shifting AD

N.B: Each shift of AD smaller than the next unless leakages are zero.

The Value of the Multiplier, K = $\frac{1}{\text{Marginal Propensity to Withdraw}}$

MPW= MPS + MPT + MPI (i.e. Marginal Propensity to 'Leak')

Government Policies

Government policy is used to achieve the macroeconomic objectives.

Fiscal Policy: the manipulation of government spending, taxation and borrowing to influence AD in the economy.

Monetary Policy: the manipulation of interest rates, the money supply and exchange rates to influence AD in the economy.

Demand Side Policy: Government policy that aims to increase aggregate demand in an economy. E.g. increase consumer spending.

Supply Side Policy: Government policy that seeks to shift LRAS to the right by improving the quality and quantity of the four factors of production- increasing the productive potential of the economy.

Economic Stability: the absence of volatility in unemployment, inflation, the current account and economic growth in order to reduce uncertainty in the markets and promote consumer and business confidence.

Effectiveness of policy influenced by:

- Quality of information
- Time lags
- Unexpected responses

- Poverty- unable to save, formally spend, or be taxed

Poverty

Poverty is:

- Lack of necessities
- Lack of healthcare
- Lack of education or illiteracy
- Unemployment
- Powerlessness

Types of Poverty:

- **Absolute:** less than $1.35 per day
- **Relative:** income less than 50% of median income

Tackling Poverty: catch 22 situation

Growth for poverty or reduce poverty for growth

Measuring Development Success:

1. **GNI per Capita**

GNI= GDP + net income from abroad

World bank categories:

Low Income	$905 or less
Lower middle	$906-$3595
Upper middle	$3596-$11115
High	More than $11115

The dollar is used for intl comparisons and is adjusted for PPP

However: does not account for

- Distribution of income
- Pollution and resource depletion
- Shadow/hidden economy
- No value on leisure/human freedom

2. **Human Development Index (HDI)**

Developed by the United Nations Development Programme

Early attempt to produce a measure that combined some of the outcomes that might be values when measuring development

Works by:

The Uruguay Round 1995: forced further agreements between govs (tariff cuts, more binding tariffs, remove non-tariff barriers)

The Doha Round 2001: created more contentions agreements (focus on developing countries- provide with increasing share of trade, attempt to phase out export subsidies, introduce free access for goods for 97% of all products exported from developing)

Criticisms:

- Absence of proper enviro regulation
- Labour unions condemned labour rights in developing WTO members
- "green room" discussions unrepresentative and exclusive- diverse members complicated discussions
  Third World Network: "vast majority of developing have very little say in WTO system"

4. World Economic Forum

Founded in 1971

Non-profit organisation

Members: 1000 of world's top organisations

Mission:

- Improve state of world trade through pub and priv sector cooperation
- Encourage sustainability

WEF's Index of Competitiveness (attempts to measure quality of life, 144 countries measured against 12 pillars):

1. Quality of institutions
2. Quality of infrastructure
3. Stable macro environment
4. Health and primary education
5. Higher education and training
6. Goods market efficiency
7. Labour market efficiency
8. Financial market development
9. Technological readiness
10. Market size
11. Business sophistication
12. Innovation

Prices can only increase if the money stock increases

This may occur because of:

- falling interest rates
- more purchasing power
- AD increases
- P increases (as always on full capacity in LR)

<u>The Financial Crises:</u>

Great Depression:

- 1930s monetarist view dominant
- Argued that gov should wait for labour market to adjust
- But deflation occurred
- Keynes' general theory argued that depression would have ended sooner with adequate gov spending

The Financial Crisis:

- Deregulation- banking sector able to engage in hedge fund trading with derivatives increasing demand for mortgages.
- Banks created interest-only loans available to sub-prime borrowers
- Borrowers defaulted, banks sell houses
- House supply increase, price falls
- Mortgages become too expensive relative to house- more people default (as houses worth less)
- Minimum equity of banks meant they ran out of cash and collapsed with huge losses

The Keynesian Revolution

- 1944 Bretton Woods increased Keynes' influence
- $ standard created at Bretton Woods
- Monetary policy no longer used domestically
- Stop-go phenomenon occurred in UK as £ overvalued
- Vietnam war- US pays by printing money
- 1970: $ standard breaks down

The Monetarist Counter Revolution

- 1970 monetarist comeback
- "inflation is a monetary phenomenon"- Milton Friedman
- Keynes couldn't explain stagflation in 1970s
- 1976 UK B of P crisis- IMF lends to UK with condition that UK must control MS
- Fiscal policy discredited
- Gov must intervene through supply-side policy only

Lender of Last Resort: Pros v Cons (Should a central bank bail out a commercial bank)

Pros (yes)	Cons (no)
• Prevents run on the banks: seeing one bank fail may encourage this. If this happens, not every depositor can be paid • Banks borrow and lend to each other- of bank fails, may weaken position of other banks • Run on banks could lead to loss of savings and fall in AD • Collapse in banking system reduce employment and reduce export revenue as selling financial assets decreases • If a number collapse, firms find difficult to obtain finance for investment. Lasting banks may become overcautious. • If bank fails, other banks may respond by building up reserves and reducing lending- MS decreases could lead to inflation	• May reduce risk of moral hazard- banks encouraged to take more risks • Letting bank fails encourages more prudent policies- reduce risk of financial crash • May create more stability in housing market as reduce risk of sub-prime mortgages • Moral- should tax payer money be used to bail out banks aiming to profit themselves through risks

Conclusion:

- Size of bank
- Situation in economy as a whole
- Performance of banking sector
- Role of banking sector in economy/role of bank
- Domestic bank or global bank

Central bank and regulation

Financial regulation is a form of regulation or supervision which subjects financial institutions to certain requirements, restrictions and guidelines, aiming to maintain integrity of financial system. May be handled by gov or NGO

Micro prudential regulation: a firm level oversight or financial regulation by regulators of financial institutions, "ensuring the balance sheets of individual institutions are robust to shocks"

Macroprudential regulation: approach to financial regulation that aims to mitigate risk to financial system as a whole (or systemic risk).

The Bank of England:

- Founded July 1694
- 4 roles: regulate other banks, print money, set monetary policy, maintain stability

Financial Committees and Authorities:

1. **Financial Policy Committee (FPC)**

Identifies, maintains and takes action to reduce systemic risks with view of protecting and enhancing resilience of Uk financial system.