2 The UK economy: performance and policies

2.1 MEASURES OF ECONOMIC PERFORMANCE

2.1.1 Economic growth

2.1.1.1 GDP as a measure of economic growth

→ Gross domestic product (GDP) is the measure of output of goods and services in a country in a year
→ It is given as a level of output, in the local currency
→ On its own it is almost meaningless; we need to know how many people there are, what the currency is worth in terms of its spending power in the local economy and what the changes have been since the previous measure
→ There are two meanings of the term *economic growth*:
  - *Actual economic growth* refers to an increase in real incomes or GDP
  - *Potential economic growth* is an increase in the productive capacity of an economy

→ Potential economic growth may be caused by an increase in the labour supply, or increased investment or productivity – the difference between actual and potential economic growth is known as an *output gap*
→ Although it is a useful measure, potential economic growth is hard to record and calculate
→ GDP is the sum of all goods and services produced in a country in a year
→ It is also the sum of all incomes earned in a country in a year, and the sum of all expenditure in a year
→ GDP does not include earnings by its residents while they are abroad i.e. the earnings of a British engineer who is working and being paid in Russia do not count toward British GDP
→ A country's GDP can be considered as a circular flow of income where for everything that is earned, something must be produced and something must be spent
→ The government measures all three flows: goods, income and expenditure – in theory these should be equal, all at around £1.4 trillion in the UK, but due to errors this may not always be the case
→ Increases in GDP are therefore a sign that a country is experiencing increasing incomes, output and spending – this has a number of effects:
  - On the face of it, this seems positive – people can have more goods and services and so their standard of living should improve
  - However, if somebody earns more it may be that they are working longer hours or feel at more pressure at work, all of which may negatively affect their non-material standard of living
  - Equally, they may only be working so hard because the cost of living is so high (i.e. increased mortgage payments) and so they need to increase incomes to continue a basic standard of living
  - Pollution is also likely to increase as workers travel greater distances to get to work, and so a wide range of external costs may be incurred

→ Furthermore, for GDP to have any significance in comparing standard of living either across borders or through time, it must be given per head (or *per capita*)

2.1.1.2 Distinction between various terms

→ If economic growth is measured using national income, the value is meaningless unless the figures and given in real values rather than nominal values, i.e. adjusted for inflation

2.1.2 Inflation

2.1.2.1 Inflation, deflation and disinflation

→ Inflation is a sustained rise in the general price level

→ The general price level is measured using the *consumer prices index* (CPI) – the reason for using an index is that percentage changes can be shown easily

→ Deflation is a fall in the general price level

→ It is problematic in a number of ways:

- It is a problem for people with debts, because the real value of money becomes higher, and so the real size of any debt they face becomes larger – it is harder for them to pay back their debts
- It also stops firms from wanting to invest in that country because the value of goods produced by any investment is likely to reduce relative to the cost of the initial costs
- Deflation is also likely to reduce consumption, creating a shock to aggregate demand – why buy an expensive consumer item when you know the prices are going to come down?

→ Disinflation occurs when prices rise more slowly than they have done in the past

→ For example, inflation might fall from 3% to 2%, meaning that prices are rising (there is inflation) but it as at a slower rate than previously

→ Disinflation can be a sign that inflation is coming under control, but on the worrying side it can mean that investment and confidence are low in the economy, and deflation might occur in the near term

2.1.2.2 Calculating the rate of inflation using the CPI

→ Two surveys need to be undertaken to calculate inflation/deflation

→ The first survey collects data on what people buy, currently known as the Living Costs and Food Survey (LCF) run by the Office of National Statistics (ONS):

- This survey collects information from around 7,000 households across the UK
- They submit self-reported diaries of all purchases, including meals eaten out
- The proportion of income spent on each item is used to determine weightings – if twice as much income is spent on food as on leisure then food will carry twice the weighting of leisure
- This survey takes place annually to determine the contents of a virtual 'basket' of goods and services that householders spent their money on, adjusted for weightings

→ The second survey is of prices, and is carried out by civil servants:

- This survey happens every month and observes changes in the prices of the most commonly bought goods and services in a variety of retail outlets
- Because similar products can be bought in high and low shops (a loaf of white sliced bread may cost twice as much in Marks & Spencer's as it does in Aldi), a selection of prices is gathered for each item
- In total, 120,000 prices are tracked, across 650 goods and services

→ The price changes from the second survey are multiplied by the weightings from the first ONS LCF survey to determine a price index

→ Inflation can be measured using this price index by calculating the percentage change in this index across consecutive years

2.1.2.3 The government's target for CPI inflation

→ The UK government has a symmetrical target for CPI inflation of 2% - the shorthand for this is CPI inflation of $2\%\ (\pm 1\%)$

→ As a result, small price rises are acceptable to the UK government, but if prices rise by more than 3% then they start to become a concern

the gap is currently closing between the UK and France, so although the UK has lower nominal productivity than France, this gap is falling
  - Changes in education and skills – increased spending on education and training should mean that a country's workforce can produce more output per worker; education increases the value of their potential output
  - Demographic changes and migration – a decreasing birth rate and increasing life expectancy in the UK we can expect a decline in the size of the economically active work force
  - Increases in health spending – these mean that people are able to work for longer, and can return to work sooner after a health crisis

2.2.2.3.2.2 Product market

→ In the product market, a rightward shift in the AS curve could occur in the following ways:
  - Technological advances – innovation and investment in new ideas tend to reduce costs for all firms, e.g. widespread access to the internet reduces communications costs for firms
  - Changes in government regulations – there are many regulations in the UK economy that have been imposed to try and maintain a disciplined economy; when these are removed firms no longer have to fork out to meet regulations
  - Competition policy and reduction in barriers to international trade – as a country opens up to more trade, competition drives down prices and inefficient domestic firms give way to overseas firms with a comparative advantage; as globalisation develops, AS increases

2.3 NATIONAL INCOME

2.3.1 The circular flow of income

→ The economy can be imagined as a simple model where there are just households and firms

→ The households own all the factors of production – land, labour, capital and enterprise – and the firms are all the producing units

→ Money moves from households to firms when they buy goods and services; money moves back from firms to households as payment for the factors of production they use in the form of rent, wages, interest and profit

→ This simple model is known as the *circular flow of income*, where the income and output of an economy should always be the same, as they are both measured by GDP

2.3.1.1 The distinction between income and wealth

→ *Wealth* is the sum of all the assets in an economy

→ In the UK, most wealth is held in the form of housing (around 60%); the other major forms of wealth are stocks & shares and capital assets

→ Wealth is a stock concept, whereas *income* is a flow concept – wealth does not have a direct impact on the circular flow of income, but changes in wealth have an effect on incomes and spending, through the wealth effect

→ If you live in a property that rises in value, you will feel more secure and will therefore be willing to spend more, and you may be able to secure an equity release on the higher house price increasing the ability to spend

2.3.2 Injections and withdrawals

→ There are three injections into the circular flow of income: investment (I), government spending (G) and exports (X)

→ There are three withdrawals – also called leakages – from the circular flow of income: savings (S), tax (T) and imports (M)

→ If the sum of injections is equal to the sum of withdrawals, then the economy will be in equilibrium

- → One way in which Keynesians illustrate the output gap is by demonstrating the distance along the x-axis between actual output (Y) and output with full and efficient allocation of all factors of production (YFE)
- → Keynesians believe that negative output gaps can exist in the long-run, while Classical economists deny this, drawing long-run aggregate supply vertically at the level of YFE

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2.4.4 Trade (business) cycle

- → The *trade cycle*, also caused the economic or business cycle, demonstrates recurring trends in economic growth rates
- → *Booms* tend to be followed by economic slumps or slowdowns, which tend to be followed by *recession*, before the economy moves into the recovery phase, and then back into a boom
- → This trend is explained in part by animal spirit – Keynes' term for the speculative action that results from any rise or fall in output or asset prices
- → However, other reasons can explain the trend such as the effects of changes in capital which exacerbates changes in output and the role of expectations in the decision-making of businesses

2.4.5 The impact of economic growth

2.4.5.1 *Benefits*

- → Growth benefits consumers in the following ways:
  - Incomes and wealth rise when there is economic growth
  - It also means that people can afford to save money for future consumption
  - People feel more confident about their job when growth is high, so they are more willing to spend on consumer durables such as cars or gadgets
  - There are likely to be more employment opportunities so that people can progress in their careers
  - Wages may rise as firms compete to retain their workers in a labour market that is more orientated towards benefitting workers
- → Growth benefits firms in the following ways:
  - Firms tend to make more profit when there is economic growth
  - In times of growth, consumer spending usually rises, which means that firms sell more
  - As revenues and profits rise, firms can take on more workers and are more likely to invest, increasing future growth prospects
- → Growth benefits governments in the following ways:
  - When income and assets rise in price, people pay more income tax, VAT and capital gains tax, and firms pay more corporation tax
  - Governments also pay fewer unemployment benefits and income support
  - In times of economic growth the government is likely to enjoy a better fiscal position
- → Growth benefits current and future living standards in the following ways:

- More equal distribution of equal

→ The order of priority varies according to the politics of the government in office at the time and institutional arrangements such as the Monetary Policy Committee

→ Some governments see the control of inflation as the most important macroeconomic goal

→ Others, such as governments with a socialist leaning, focus on the redistribution of income and the reduction of unemployment

2.5.2 Demand-side policies

2.5.2.1 Distinction between monetary and fiscal policies

→ A demand-side policy is a deliberate manipulation by the government of AD in order to achieve macroeconomic objectives

→ There are two demand-side policies:

- *Monetary policy* – decision-making using monetary instruments such as the interest rate and quantitative easing
- *Fiscal policy* – the government's management of its spending and taxation with the aim of changing the total level of spending in the economy

2.5.2.2 Monetary policy instruments

→ The manipulation of monetary values such as the interest rates has implications across the whole economy

→ In the UK the interest rate is set by a team of nine economists forming the Bank of England's MPC, whose sole purpose is to control the rate of inflation

→ They meet at least once a month for a day and a half to examine evidence from across the country relating to inflationary pressures

→ They have a target of 2% CPI inflation which is set for them by the Chancellor of the Exchequer – it is a symmetrical target, so if inflation falls below 1% or above 3% then the Governor of the Bank of England must write an open letter to the Chancellor to explain why this has occurred

→ In its first 10 years of operation the Governor had to write only one such letter, in March 2007 when inflation hit 3.1%, but between 2008 and 20111 he had to write 10 of these letters; since then inflation has been less problematic

→ There are two major tools that can be used by the MPC:

- Interest rates
- Quantitative easing (only used since 2009)

2.5.2.2.1 Interest rates

→ The MPC sets the Bank Rate each month, and the objective of their decision-making is to maintain the government's 2% inflation target

→ Changing the rate of interest sets of a number of processes, referred to as *monetary transmissions mechanisms*, which affect aggregate demand (AD)

→ One such transmission mechanism is through consumption, where the interest rate affects mortgage rates, which alter the amount of money available for spending once mortgages have been paid for

→ Furthermore, the cost of credit affects how easily consumers can borrow in order to buy big-ticket items, and the interest rate affects how lucrative saving is compared to spending

→ Investment is sensitive to interest rates, since most investments involve borrowing to pay for productive capital, and higher interest rates mean that fewer projects are deemed worthwhile

→ Net exports are also affected by the interest rate, because with a floating currency higher interest rates attract hot money flows, increasing demand for the currency, so the exchange rate becomes